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# BORROWING BY SMSFs

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# Borrowing by SMSFs

Presentation to Geelong Law Association

by

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# 1. Introduction

According to the ATO's self-managed super fund statistical report from March 2015, there are over 500,000 SMSFs in Australia and more than 1 million members of SMSFs. About 30% of those are in Victoria. SMSFs have over $9,000 million in limited recourse borrowed funds. There has been a lot of conjecture about whether this is the cause of Australia's residential real estate bubble.

In any event, SMSF's represent a significant pool of investment funds, which appears set to keep growing. This paper looks at the following issues:

- The general prohibition on borrowing by superannuation funds and the penalties for non-compliance and how these may affect advisers and lenders as well as superannuation funds and their members.
- The exceptions to the prohibition on borrowing, the main one being limited recourse borrowing arrangements under s67A of the SIS Act.
- The requirements to fall within the limited recourse borrowing arrangement exception: single acquirable asset, limited recourse, asset held on trust, identity of custodian, use of the borrowed funds.
- Tax implications of limited recourse borrowing arrangements: stamp duty, GST, capital gains tax.
- Related party borrowing arrangements - additional considerations arising in this space - Division 7A, contributions to the fund, non-arm's length income.
- Other borrowing structures - use of unit trust as borrower, when will these arrangements breach the in-house asset rule?

# 2. General prohibition on borrowing

## a. SIS Act prohibition on borrowing

The *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) prohibits a superannuation fund from borrowing money or maintaining a borrowing of money, subject to limited exceptions. - see s 67 SIS Act.

The purpose behind this restriction is to limit the risk posed to retirement income by the gearing of investments.

The prohibition on borrowing is complemented by the prohibition against granting a charge against an asset of the SMSF - see Regulations 13.14 and 13.15 of the *SIS Regulations 1994* (Cth).

## b. Penalties for non-compliance

An SMSF risks being ruled non-compliant by the ATO if it engages in a borrowing that does not meet the requirements of the SIS Act. This has serious tax consequences. The fund's total assets (less the sum of the part of the crystallised undeducted contributions that relates to the period after 30 June 1983 and the contributions segment for current members at that time so far as they have not been, and cannot be, deducted) are subject to tax at the highest marginal rate. In addition, any income in a year in which a fund is non-complying is taxed at the highest marginal rate. In order to avoid such consequences or indeed because of such consequences the borrowing arrangement may have to be unwound and assets sold at a less than optimal time.

Further, civil and criminal penalties may arise for contravening the SIS Act or being involved in the contravention. Section 67(1) is a 'civil penalty provision' under s 193 of the SIS Act and s 194 provides that a person 'involved in a contravention' is taken to have contravened that provision. Civil penalties of up to 2000 penalty units (currently $360,000 and up to 5 times that for a body corporate) can be imposed (s 196).

If the breach is done dishonestly with an intention to gain an advantage, or is done with an intention to deceive or defraud someone then the breach is a criminal offence punishable by up to 5 years imprisonment (s 202).

From 1 July 2014 the ATO has also had the option of imposing administrative penalties on SMSF trustees and directors of corporate trustees (ranging from fines of $900 to $10,800) or directing the trustee to rectify the breach and/or undertake education (Part 20).

Therefore, there are potentially serious consequences not only for the SMSF itself and its members, but for the trustees, lenders and advisors if a non-compliant borrowing is undertaken.

## 3. <u>Exceptions to prohibition on borrowing</u>

### a. Exceptions in s 67 of the SIS Act

There are limited exceptions to the prohibition on borrowing contained in section 67 of the SIS Act. These exceptions are only available if, should the borrowing occur, the total amount borrowed by the trustee would not exceed 10% of the value of the assets of the fund. The exceptions include borrowings:

- **i.** to fund a payment to a beneficiary (a borrowing for not more than 90 days to enable a payment to be made to a beneficiary of the superannuation fund which the trustee is required to make by law or by the governing rules and which, apart from the borrowing, the trustee would not be able to make),

- **ii.** to fund a payment of the superannuation surcharge (a borrowing for not more than 90 days to enable the trustee to make a payment of surcharge or advance instalment which the trustee is required to make under the Superannuation Contributions Tax (Assessment and Collection) Act 1997 and which, apart from the borrowing, the trustee would not be able to make);

iii. to cover settlement of certain securities transactions (a borrowing for not more than 7 days to cover settlement of a securities transaction or foreign currency transaction).

## b. Limited Recourse Borrowing Arrangements (LRBAs)

Section 67A of the SIS Act contains the exception which we will discuss in detail in this session - limited recourse borrowing arrangements (**LRBA**).

The section itself is set out in full in the Annexure.

The main requirements of an LRBA under section 67A are that:

i. the trustee of the superannuation fund is the entity which borrows the funds and has the obligation to repay the loan,

ii. the borrowed money is or has been applied for the acquisition of a single acquirable asset,

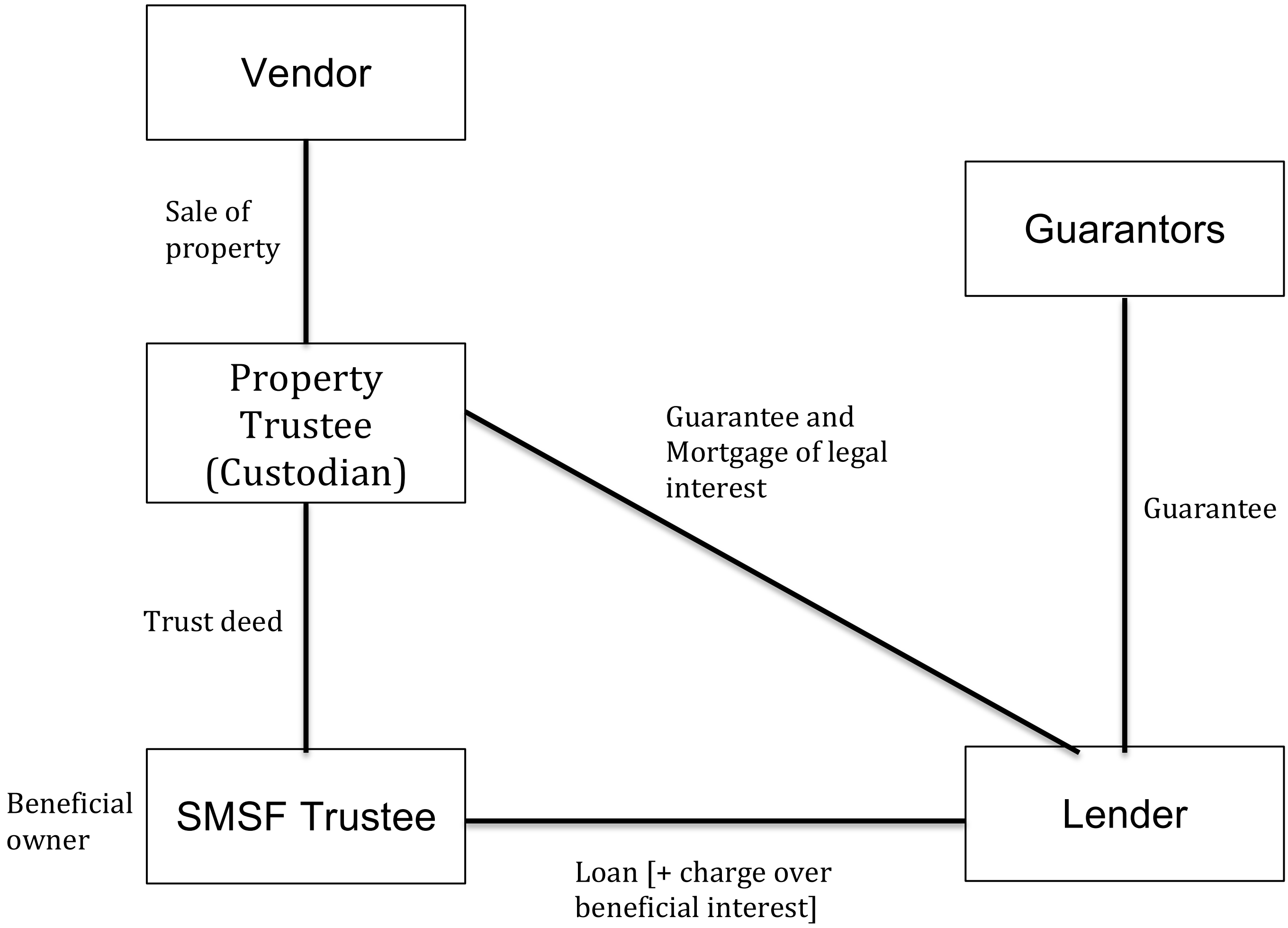
iii. the acquirable asset is held on trust by a "Custodian" so that the trustee of the SMSF acquires a beneficial interest in the acquirable asset,

iv. the trustee of the SMSF has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest,

v. the rights of the lender or any other person against the trustee of the SMSF are limited to rights relating to the acquirable asset.

Section 67B of the SIS Act contains a number of specific circumstances under which an existing borrowing arrangement may be maintained in relation to a replacement asset rather than the asset originally acquired.

## 4. Structure of an LRBA




## 5. Single acquirable asset

### a. Asset

The definition of "asset" contained in section 10 of the SIS Act provides that the term includes any form of property including money.

The ATO has confirmed in its Self-Managed Superannuation Funds Ruling 2012/1 *"Limited recourse borrowing arrangements - application of key concepts"* that the term "property" has a very broad meaning, and can include any type of right, interest or thing of value which is legally capable of ownership.

### b. Acquirable assets

The definition of "acquirable asset" in section 67A of the SIS Act excludes money and also requires the asset that is to be the subject of a limited recourse borrowing arrangement to be one that the trustee of an SMSF is not prohibited from acquiring either by the SIS Act or by any other law (s 67A(2)(b)).

The SIS Act prohibits a trustee or a regulated superannuation fund from intentionally acquiring assets (other than money) from a related party of the SMSF (s 66(1)). Accordingly, such assets can not be the subject of an LRBA under section 67A. Note that there is an exception for an SMSF acquiring "business real property" from a related party.

Similarly, an in-house asset (being an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund (s 71(1)) cannot be the subject of an LRBA if its acquisition will cause the SMSF to breach the cap on in-house assets in section 83 of the SIS Act.

The SIS Act also contains restrictions with regard to personal use assets and collectables that need to be considered if it is proposed to enter an LRBA for the purpose of acquiring such assets.

**c. Why single?**

The former subsection 67(4A), which applies to arrangements entered into before 7 July 2010, did not prohibit one borrowing arrangement extending over multiple assets. The concern was that this allowed an SMSF to pool different assets in one arrangement and hence allowed a lender to choose which assets are sold in the event of a default on the borrowing. By limiting a borrowing arrangement to a single acquirable asset, lenders no longer have this ability.

**d. When is an acquirable asset a single acquirable asset?**

Subsection 67A(3) of the SIS Act provides some guidance as to when an "acquirable asset" is taken to be a "single acquirable asset", noting that a collection of identical assets with the same market value and which are otherwise identical will constitute a single acquirable asset (such as a collection of shares of the same class).

The ATO states in SMSFR 2012/1 that a "single acquirable asset" is acquired where a single object of property is acquired, notwithstanding that such property may comprise separate bundles of proprietary rights (for example, if there are two or more blocks of land). It must be reasonable to conclude that, notwithstanding the separate bundles of proprietary rights, the asset being acquired is distinctly identifiable as a single asset.

Factors evidencing that the asset being acquired is a single acquirable asset, notwithstanding separate bundles of proprietary rights, include:

- **i.** the existence of a unifying physical object, such as a fixture attached to the land which is permanent in nature and not easily removed and that is significant in value relative to the value of the asset, or

- **ii.** whether under a law of the relevant jurisdiction the two assets must be dealt with together.

However, factors that would not, without more, be sufficient to support a conclusion that what is being acquired is identifiable as a single object of property include:

**i.** there is a physical object situated across two or more titles and that object:

  **a.** is not significant in value relative to the value of the land, or

  **b.** is temporary in nature or otherwise able to be relocated or removed relatively easily therefore not preventing the titles being dealt with separately,

**ii.** a business is being conducted on two or more titles, or

**iii.** the assets are being acquired under a single contract because, for example, the vendor wants to deal with the assets as a package for simplicity.

**e. Examples of a single acquirable asset**

Some of the examples in SMSFR 2012/1 to explain this concept are:

**i.** Two vacant adjacent blocks: not a single acquirable asset.

**ii.** A factory complex on more than one title: the factory will be sufficient to unite several titles as one acquirable asset if it is a significant part of the value of the asset.

**iii.** Farmland with multiple titles: generally problematic even if crops, fencing and/or irrigation systems span the titles. Even if one block of land is inaccessible other than via another block, this will not prevent it being a single acquirable asset.

iv. Apartment with separate car park: Only a single acquirable asset if the titles are restricted such that one title can't be dealt with without the other.

v. Purchase of land and construction of house using borrowings: If title to the vacant land transfers to the custodian prior to the house being built, then it is vacant land that is subject to the LRBA. If a house is subsequently built then this fundamentally changes the character of the asset from vacant land to residential premises and the borrowed funds are no longer secured over the acquirable asset.

vi. Acquisition of yet to be constructed house on land using borrowings: A house and land package can be acquired under an LRBA provided what is contracted to be bought is the house and land and settlement occurs once construction of the house is finished.

## 6. Practical aspects

### a. Identity of the Custodian

There are no specifications as to who can act as Custodian and therefore this role can be filled by an individual or a company and can be entirely independent of or a related party of the SMSF. It cannot be the same entity that acts as trustee of the SMSF as there must be a separation between the legal and the beneficial interests. For the same reason it is not generally recommended that a member of the SMSF acts as Custodian.

If borrowing funds from a bank, the bank may require that the Custodian is incorporated.

### b. Who should sign the contract of sale?

The Contract of Sale should generally be signed by the Custodian. In Victoria we have the luxury of being able to nominate substitute purchasers without suffering double stamp duty, and therefore it is wise to sign the Contract of Sale 'and/or nominee' just in case an issue should come to light indicating that the property is not in fact a 'single acquirable asset' or some other requirement of the SIS Act cannot be satisfied. This provides an escape route without the indignity of double duty even if it doesn't ultimately result in the property being held by the SMSF.

However, often the custodian has not been incorporated before the contract of sale is signed. In these circumstances the SMSF, or another party (but not a member of the SMSF) can sign the contract of sale and later nominate the Custodian as purchaser once it has been established. Care must be taken in other States as nominations are not possible in every State without double stamp duty.

The most common error encountered is that a member of the SMSF signs the Contract of Sale in their personal capacity, thinking that they can subsequently nominate the Custodian. This is problematic as the member is a related party of the SMSF, and the contractual rights the member enjoys under the Contract of Sale constitute "property" for the purposes of the SIS Act. Thus nomination, on a strict interpretation, constitutes an acquisition of "property" from a related party by the SMSF trustee and thus likely constitutes a breach of the SIS Act.

### c. Timing of entry into LRBA

It is important to note that this varies from State to State as it is stamp duty dependent. In Victoria, although not fatal, it is better to put the bare trust deed in place after signing the contract of sale and to rely on the 'apparent purchaser' exemption to ensure that nil or nominal duty is payable in respect of the declaration of trust - see below under the heading 'Stamp duty'.

### d. Bare Trust?

The SIS Act does not specify that any particular type of trust must be used for an LRBA. It states only that the SMSF trustee must have a beneficial interest in the asset being held in the trust and the right to acquire legal ownership of that asset after making one or more payments. In addition, for the special in-house asset rule to apply, the asset must be the only property of the trust.

However, for ease of GST, CGT and income tax treatment, it is generally agreed that a bare trust is the preferred vehicle as this allows a 'look-through' approach to be employed, meaning that for taxation purposes the bare trust is ignored and the SMSF trustee is treated as the owner of the asset. Specific legislation is before Parliament to ensure this 'look-through' treatment because under the current legislation there are some technical difficulties with it. However, it is not an issue that the ATO has an interest in pursuing.

If a bank is doing the lending, some of them have established their own "Security Trustees" to act as Custodian under a trust deed prepared by the bank. Otherwise, if you need to prepare the trust deed, a simple bare trust is sufficient. The loan documentation will contain the restriction that an SMSF trustee cannot call for legal title to the asset until the loan has been repaid in full and it is not necessary for this to be included in the bare trust deed as well. From a taxation point of view it is preferable that the trust deed does not contain this restriction but rather allows the trustee of the SMSF to call for a transfer of the legal title at any time.

**e. Restrictions on the use of borrowed funds**

Section 67A(1)(a)(i) of the SIS Act specifically prohibits an SMSF trustee from using funds borrowed under an LRBA to "improve" an asset, but allows the monies to be used for "repairing" or "maintaining" the asset acquired under the LRBA.

The ATO considers that:

- **i.** "maintaining" an asset means: "...work done to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration, provided that the work merely ensures the continued functioning of the asset in its present state",

- **ii.** "repairing" an asset means: "...remedying or making good defects in damage to, or deterioration of an asset and contemplates the continued existence of the asset", and

- **iii.** "improving" an asset means: "...the state or function of the asset is significantly altered for the better, through substantial alterations, or the addition of further substantial features or rights, to the asset".

Thus borrowed funds can be used to repair an asset such as a house, should it be damaged by fire or otherwise, but if the repair essentially upgrades the house, then it may be an improvement, which is not permitted.

It is permissible to use money from other sources to improve an asset as this will not breach the rules regarding borrowed funds only being used for repair or maintenance. However, the improvement must not be so extensive that it results in the asset becoming a different asset because the single acquirable asset identified when the LRBA is put in place must continue to be the asset that is held on trust under that LRBA unless its replacement is covered by section 67B.

If the asset is owned outright by the SMSF then a borrowing to fund repairs or maintenance for that asset will not fall within the LRBA exception because:

- **i.** the money is not applied for the acquisition of a single acquirable asset but is instead applied to repair an asset that the SMSF already owns,

- **ii.** the asset to be repaired is not held on a separate trust for the benefit of the SMSF but is held by the SMSF outright.

## 7. Stamp duty

### a. Dutiable property

If the asset acquired with borrowed funds is "dutiable property" then the transfer of that asset to the Custodian will attract stamp duty at ad valorem rates. Ordinarily, the declaration of a trust over dutiable property would also attract stamp duty. However, as set out below, only one round of duty should apply to LRBAs.

Generally the apparent purchaser provision is relied on (see s 34 *Duties Act 2000*) so that the declaration of the trust by the Custodian attracts nil or nominal duty only. This requires the SMSF to prove that it paid the purchase price for the asset either from its funds or from a loan.

Alternatively, if the transfer of the property to the Custodian and the declaration of the trust occurred 'contemporaneously' then the declaration of trust may be exempt from duty under section 17 of the Duties Act, which prevents double duty applying to one transfer of property.

If the apparent purchaser provision is relied upon for an exemption on the declaration of the trust, then the same exemption is then relied upon again on a transfer of the property from the custodian to the SMSF Trustee at the end of the LRBA. It is to be recommended that the trust deed is submitted for stamping with Nil duty so that, when the LRBA is unwound at the end of the loan (which could be as much as 25 years later), then there is some documentary evidence of the arrangement and the applicability of the exemption from duty.

If instead section 17 of the Duties Act is relied upon to avoid double duty at the start of the LRBA, then when the LRBA comes to an end and the property is transferred from the Custodian to the SMSF Trustee, this should be exempt under s 36 of the Duties Act (property passing to beneficiaries of fixed trusts).

A further possibility is to never unwind the trust structure so that the asset remains in the name of the Custodian and when the time comes to sell, the asset is sold directly from the Custodian to the third party. This avoids any hassle of applying for the exemption from duty on the transfer from the Custodian to the SMSF Trustee.

Section 67A requires the SMSF trustee to have the right to acquire legal ownership of the asset by making one or more payments. There is no legal requirement for the asset to be transferred to the SMSF trustee upon full repayment of the borrowings (and related charges).

Such a strategy used to raise issues under the in-house asset rules. This is because the trust is generally a related trust of the SMSF and accordingly the SMSF's interest in the trust would normally be an in-house asset for the purposes of the SIS Act. However, sections 71(8) and (9) of the SIS Act specifically state that, providing the asset is the only property of the bare trust, the SMSF trustee's investment in the bare trust is only an in-house asset if the underlying asset would be an in-house asset if held directly by the SMSF trustee. The specific wording of section 71(8) is that the bare trust "is one described in paragraph 67A(1)(b) in connection with a borrowing, by the trustee of the fund, that is covered by subsection 67A(1)".

The exception provided by section 71(8) gave rise to a technical issue as the ATO view is that section 71(8) no longer applies once the borrowing is repaid and therefore that the bare trust will become an in-house asset of the SMSF if legal title to the underlying asset is not transferred to the SMSF trustee upon repayment of the borrowed money. Further, the exception may also not apply at the outset if there is a point in time when the asset is held by the Custodian but the borrowing has not yet commenced or the bare trust has not yet been declared.

In order to rectify this position, on 10 April 2014 the *Self Managed Superannuation Funds (Limited Recourse Borrowing Arrangements - In-House Asset Exclusion) Determination 2014* legislative instrument was registered. This legislative instrument provides an exception to the definition of an 'in-house asset' so that an asset held by a Custodian is not an in-house asset even after the borrowing has been repaid, or in circumstances where the borrowing has not yet begun (i.e. on the set up of an LRBA) The legislative instrument was registered on 10 April 2014 but is taken to have commenced on 24 September 2007 which aligns with the date of effect of the introduction of provisions in the SIS Act that allow trustees of regulated superannuation funds to enter into LRBAs.

A transfer of the asset from the Custodian to the SMSF trustee has the potential to attract stamp duty and the ability to obtain the relevant exemption often depends on the set up and timing of the bare trust structure, which may have occurred 20 or 30 years earlier. In the light of the legislative instrument this issue no longer carries the risk of exceeding the cap on in-house assets and as a result, SMSF trustees may wish to consider simply leaving a bare trust arrangement in place even after repayment of the borrowing if stamp duty may be an issue. However, the Commissioner has warned that the exemption provided by the legislative instrument is not intended to provide indefinite relief from the in-house asset rules and therefore SMSF trustees should not unreasonably delay in transferring the asset from the custodian to the SMSF trustee after the borrowing is repaid.

**b. Non-Dutiable property**

However, if the property the subject of the LRBA is not otherwise dutiable property (e.g. LRBA established for a parcel of listed shares) then the bare trust will attract duty under a different provision, being a declaration of trust over property, none of which is dutiable property or property not identified in the instrument (s 37 Duties Act 2000 attracting $200 duty).

A transfer of non-dutiable property from the Custodian to the SMSF trustee at the end of the LRBA will not be a dutiable transaction.

## 8. GST

The ATO has set out its view of the correct GST treatment of a bare trust arrangement in GSTR 2008/3.

Broadly, a look through approach is adopted by the ATO. In the context of an LRBA, the SMSF trustee as beneficiary under the bare trust would be the entity that has the liability to pay GST and that is entitled to input tax credits. It follows that the Custodian would not need to register separately for GST.

Furthermore, if legal title to the property is subsequently transferred from the bare trustee to the SMSF trustee on repayment of the borrowing, there would be no GST payable (see GSTR 2008/3, paragraph 64).

## 9. Capital Gains Tax

Capital gains tax is only likely to arise when an asset is disposed of at a gain. At the end of an LRBA, the Custodian may dispose of the relevant asset directly to a third party. Technically, the proceeds of sale are received by the Custodian as trustee, and it must be determined whether the SMSF, as beneficiary of the trust, then has a present entitlement to those proceeds in order to determine the taxation outcome.

Alternatively, at the end of the LRBA, the Custodian might transfer the asset to the SMSF trustee in order to collapse the bare trust. The transfer of an asset from a trustee to a beneficiary would typically be CGT event A1 or CGT event E5 and could trigger capital gains tax because the Custodian will be deemed to receive market value for the asset.

However, the 'absolute entitlement' provision in section 106-50 of the *Income Tax Assessment Act 1997* (Cth) provides that:

> *"If you are absolutely entitled to a CGT asset as against the Trustee of a trust (disregarding any legal disability), this part and part 3-3 apply to an act done by the Trustee in relation to the asset as if you have done it."*

Accordingly, if the SMSF is absolutely entitled to the acquirable asset as against the Custodian then the CGT provisions will apply as though the asset has always been held by the SMSF trustee and any capital gain will be included directly in the assessable income of the SMSF.

Further, the CGT provisions will apply as though the asset were held by the SMSF trustee, even if the asset is sold while the legal ownership is with the Custodian. Thus, any capital gain that is made on a sale of the asset from the Custodian directly to a third party will be sheeted home to the SMSF, without the need to account for it passing through the bare trust.

However, if absolute entitlement cannot be established, then a capital gains tax liability may arise on a transfer of an asset from the Custodian to the SMSF Trustee and other taxation issues may arise, for example, the Custodian may be required to submit an income tax return.

The concept of 'absolute entitlement' is a vexed issue, perhaps best demonstrated by the fact that the taxation ruling on the meaning of 'absolute entitlement' has been in draft form since 2004. The ATO has indicated that it is seeking Treasury guidance particularly in relation to the troublesome areas of joint and multiple beneficiaries and the indemnity of the bare trustee of a bare trust. In the SMSF space a further item could be added as problematic - the issue of whether it is possible to have a bare trust in favour of an entity that is itself acting as trustee.

Further, the ATO has made comments in NTLG Superannuation Subcommittee Minutes, that a holding trust in an LRBA is not a bare trust because of the charge over the property granted to the lender.

Despite these unresolved issues I am not aware of the ATO taking issue with SMSFs proceeding on the basis that the LRBA involves a bare trust for GST, income tax and capital gains tax purposes.

A legislative fix for these issues has also been proposed in the form of *Tax and Superannuation Laws Amendment (2015 Measures No. 2) Bill* which will insert a new Division 235 in the *Income Tax Assessment Act 1997* and specifically provide that a look-through treatment is to apply to trusts established for limited recourse borrowing arrangements for most income tax purposes (which includes CGT).

## 10. Related party borrowings

There is no restriction in the SIS Act on the identity of the lender under an LRBA. Accordingly, there is no magic to the lender being a bank or other financial institution, it can equally be any other entity, including a related party of an SMSF borrower. However, there are also no concessions for related party lenders and therefore all the requirements that otherwise apply to LRBAs under section 67A of the SIS Act must be met.

### a. Limited recourse

Other than the requirements of an LRBA that have already been canvassed, in a related party situation particular care will need to be taken with the requirement that the rights of the lender are limited to rights relating to the acquirable asset. Where a bank is involved, although the SMSF should satisfy itself that all SIS Act requirements are met, generally a degree of reliance can be placed on the bank to ensure that the limited recourse requirements are met. In a related party lending arrangement there is no such luxury.

Section 67A(d) states that the recourse of the lender **or any other person** against the SMSF trustee on a default must be limited to rights relating to the asset that is being acquired under the arrangement. Accordingly, not only must the rights of the lender be limited, any guarantor must not have general rights of indemnity against the SMSF trustee.

Under typical guarantee documents, a guarantor may have the right to recover amounts it has been called on to pay to a lender from the principal debtor - being the

SMSF trustee. Therefore, these rights must also be limited to rights relating to the asset which is the subject of the arrangement.

### b. Risks involved - Division 7A

There are some additional risks involved in related party lending structures. One of these is the application of Division 7A of the *Income Tax Assessment Act 1936*. That division operates to treat amounts lent by a private company to certain associated entities as dividends in the hands of the borrower.

Therefore, if it is proposed that a private company lend the SMSF funds to acquire an asset then, even if an SMSF is not itself a shareholder of the company, it must be considered if it is an associate of a shareholder for Division 7A purposes. In a related party lending situation this is most likely to be the case.

If Division 7A applies, then deemed dividends are taken to be paid at the end of the income year of the private company in which the loan was granted to the SMSF. This may deem the entire loan to the SMSF to be dividends subject to taxation. Even worse, the dividend may be taxed to the SMSF trustee as non-arm's length income under section 295-550 of the *Income Tax Assessment Act 1997*, meaning that it is taxed at the highest marginal rate.

The question also arises as to whether the deemed dividend would be considered to be a contribution to the fund. However, on the basis of Taxation Ruling TR 2010/1 it would appear that such a deemed dividend does not increase the capital of the fund, and therefore is not a contribution.

Advisers should also turn their minds to the possibility of Division 7A applying in circumstances where a discretionary trust is the related party lender if the discretionary trust has unpaid present entitlements in favour of a private company beneficiary.

A loan meeting specified minimum interest rate and maximum term criteria is excepted from Division 7A. Essentially there are two options open - a maximum term of 7 years for an unsecured loan or a maximum term of 25 years if the loan is fully secured by a registered mortgage over real property and the market value of the property is at least 110% of the loan amount.

However, such Division 7A compliant loans are generally expensive for the borrower and if possible, the lender should be chosen so that Division 7A is not an issue.

### c. Risks involved - Contribution to the fund

Generally SMSF trustees and related party lenders have been advised to apply market rates to their lending arrangements. However, the actual requirements are contained in section 109 of the SIS Act and require either:

- **i.** that the SMSF trustee and the lender are dealing with each other at arm's length in respect to the transaction, or

**ii.** the terms and conditions of the transaction are no more favourable to the lender than those which it is reasonable to expect would apply if the SMSF trustee and the lender were dealing with each other at arm's length.

It is clear from the language of section 109 of the SIS Act that above-market interest rates cannot be charged in a related party lending arrangement. Such an arrangement would be a breach of the prohibition on SMSF trustees giving financial assistance to members or their relatives using the resources of the SMSF and would enable related parties to siphon funds out of an SMSF ahead of time, both of which are contrary to the whole purpose of superannuation. However, there has been some speculation as to whether below-market rates could be charged or whether this may be seen as a contribution to the fund.

In 2010 the ATO issued ATOID 2010/162 which clarifies that related party lenders can provide terms that are more favourable to the SMSF than market terms and this will not be a breach of the SIS Act.

The question arises as to whether there are any limits on this. If a related party provides a zero interest rate loan to an SMSF, does this essentially amount to the related party making a contribution to the SMSF of the difference between what the SMSF would have paid in respect of a loan on commercial terms and what the SMSF is paying under the related-party loan?

The NTLG Super Technical Minutes for June 2012 considered the issue of whether a discounted rate of interest may result in a contribution to the SMSF. The issue was phrased as follows:

> *"As a discounted rate of interest, compared to an interest rate that could have reasonably been expected to have been charged if the parties were dealing at arm's length, has the effect of increasing the capital value of the fund, it has been suggested by some industry practitioners that a contribution has been made to the fund in these circumstances."*

The ATO's response was that the absence of a requirement to pay interest on money loaned to the trustee does not increase the capital of the fund. The ATO stated that "A saving on an expense of an SMSF in the circumstances described is analogous to the circumstances outlined in examples 2 and 5 in Taxation Ruling TR 2010/1 Income tax: superannuation contributions. The purpose of a person in offering a low interest loan to an SMSF does not fall for consideration if there has been no increase in the capital of the fund. The outcome is different if, for example, interest incurred by the fund is paid by a third party, forgiven or reimbursed. In all of those circumstances the capital of the fund is increased as the interest liability has been met by a third party or forgiven or an amount has been reimbursed to the SMSF."

The ATO response is predicated on the fact that the related party transaction does in fact amount to a borrowing. This means that it must be a genuine loan with an intention on the part of the SMSF to repay it. This is best evidenced with a properly documented loan agreement and repayments in accordance with that document.

If the loan is seen to be a contribution to the fund then this could lead to significant tax consequences if it results in a contribution cap being exceeded.

**d. Risks involved - Non-arm's length income**

A further risk associated with related party lending is that income derived by the SMSF from the borrowed funds may be classified as non-arm's length income with the result that it is subject to tax at the highest marginal rate.

A private ruling issued by the ATO in 2013 indicated that a related party lender can provide a zero interest loan to an SMSF trustee and this would not result in the SMSF deriving non-arm's length income under subsection 295-550(1) of the ITAA 1997.

In this private ruling the SMSF had purchased a commercial building and entered an LRBA with a related party lender. The loan was documented with a term of 10 years and interest payable. However, the SMSF came under pressure to fund future minimum pension payment increases and the lender stated that it was willing to reduce the interest rate to nil in order to take the pressure off the SMSF.

The ATO confirmed that reducing the interest due on the loan to 0% would not result in the SMSF deriving non-arm's length income. This was on the basis that subsection 295-550(1) of the ITAA97 focuses on the *income derived* and not on the economic outcome - i.e. the income less expenses. The ATO found that the SMSF would derive a greater level of *taxable income* because the rate of interest payable by the SMSF is reduced to 0%. That is, the level of taxable income derived by the SMSF will be inflated as a result of a lower level of deduction amounts than would normally be incurred if the parties were dealing at arm's length However, the amount of *income* would not be inflated - rather the deductible expenses are reduced. Therefore, subsection 295-550(1) of the ITAA 1997 does not apply and the income is not non-arm's length income.

**e. Non-arm's length income - private ruling 1012582301006 - ATOID 2014/39**

However, the ATO has released a more recent private ruling (and has subsequently also released this private ruling in the form of an ATOID) in which it concludes that the income derived by the SMSF as a result of a zero-interest related party borrowing is non-arm's length income under section 295-550 ITAA 1997 with the result that it is subject to tax at the highest marginal rate.

In this private ruling the zero-interest loan was to acquire listed ASX shares and was of an unspecified maximum duration (presumable to last until a sale of the shares), the amount of the loan was equal to the value of the shares (i.e.the LVR was 100%), no personal guarantees were required to secure the loan and the SMSF was required to repay the loan as a single lump sum at the end of the loan term, or earlier by agreement.

In order to find that the income generated by the SMSF from the shares was non-arm's length income, it was necessary for the ATO to find that the amount of the income (derived by the SMSF as a beneficiary of the bare trust under an LRBA) is more than the amount that the SMSF might have otherwise expected to have received if the parties were dealing with each other at arm's length. The ATO concludes that this final requirement is met on the facts presented in the private ruling because if the parties were dealing with each other at arm's length, the amount of income the SMSF might be expected to derive through the bare trust would have been either:

**i.** Nil - on the basis that no loan on those terms would have been obtained if the parties had been dealing at arm's length and therefore no income would have been derived by the SMSF, or

**ii.** Less than under the proposed arrangement - on the basis that the LVR would have been less than 100% if the parties had been dealing at arm's length and therefore there would have been less borrowed funds available and less income would have been generated.

It was originally thought that there may be some scope for limiting this decision to the aggressive facts in this instance (LVR of 100%, no personal guarantees required and length, unspecified loan term). However, since then, rulings 101259001544, 1012630099511 and 1012634565634 have been released, all indicating that zero interest related party borrowing arrangements result in non-arm's length income for the fund. Thus the ATO appears to be hardening in its view of such arrangements.

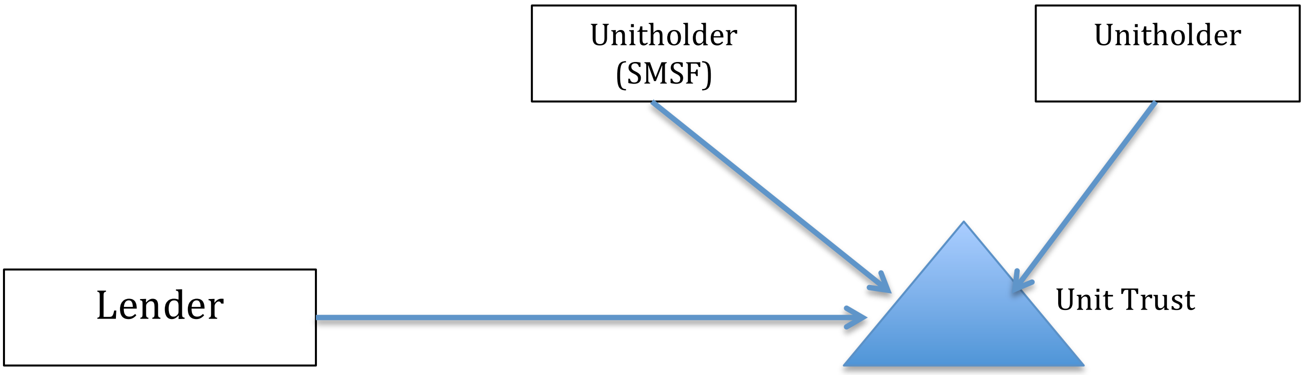
It has also released ATOID 2014/40, which involves a zero interest related party loan in order for an SMSF to acquire a commercial property, and the loan is only 80% of the property value with a loan term of 15 years. A mortgage is registered over the property but no personal guarantees are provided. The ATO also concludes that this arrangement results in non-arm's length income to the fund for the reason that an arm's length arrangement would have given rise to nil income in the fund's hands because an arm's length lender would not have lent any capital on those loan terms.

There may be scope to challenge this reasoning by arguing, as the ATO did in its early private rulings on the issue, that the income derived is not necessarily greater than that which would have been achieved under a commercial lending arrangement, it is just that the costs of borrowing have been reduced, thus reducing any deductions that may have otherwise been claimable.

Nonetheless, the fact that the highest marginal tax rate might apply to such income rather than the concessional rates usually applicable to super funds should cause even the most aggressive tax planners to think twice about zero interest borrowing arrangements.

It is worth recognising that, as yet, no public ruling has been issued and neither the NTLG Minutes nor the private binding rulings, nor the ATOIDS are binding on the ATO, other than in respect of the parties to the private binding rulings.

## 11. Other borrowing structures




If a limited recourse borrowing arrangement is not workable for one reason or another, then it may be possible to utilise other structures so that a standard lending arrangement can be entered into. Typically this is done using a unit trust structure where the unit trust is the borrower and one or more SMSFs are unitholders in the SMSF.

As the SMSF is not the borrower, the general prohibition on borrowing under the SIS Act has no application.

The issue that arises with these lending arrangements is whether the units held by the SMSF in the unit trust are in-house assets and, if so, whether they exceed the 5% cap on such assets (see s 84 SIS Act).

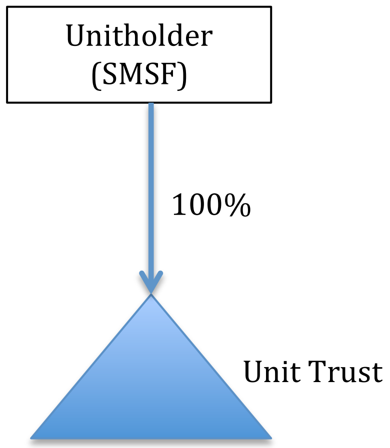
If the units are in-house assets and the 5% cap is breached then the super fund is again at risk of being ruled non-compliant by the ATO, with the attendant tax consequences, and the super fund and the lender may both be at risk of civil penalties for being involved in a contravention of a civil penalty provision. Further, a criminal prosecution may result if the breach is done dishonestly with an intention to gain an advantage, or is done with an intention to deceive or defraud someone.

The units held by an SMSF in a unit trust will be in-house assets if the unit trust is "related" to the SMSF. This really comes down to a question of whether the SMSF <u>controls</u> the unit trust.

Control includes:

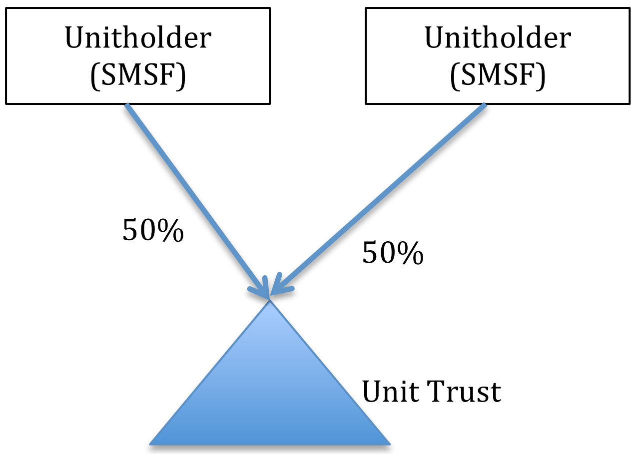
- **i.** a fixed entitlement to more than 50% of the capital or income of the trust, OR
- **ii.** the trustee is accustomed or under an obligation, or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a member of an SMSF, OR
- **iii.** the members of an SMSF are able to remove or appoint the trustees of the unit trust.

a. **Example 1 - SMSF has 100% of units in unit trust**



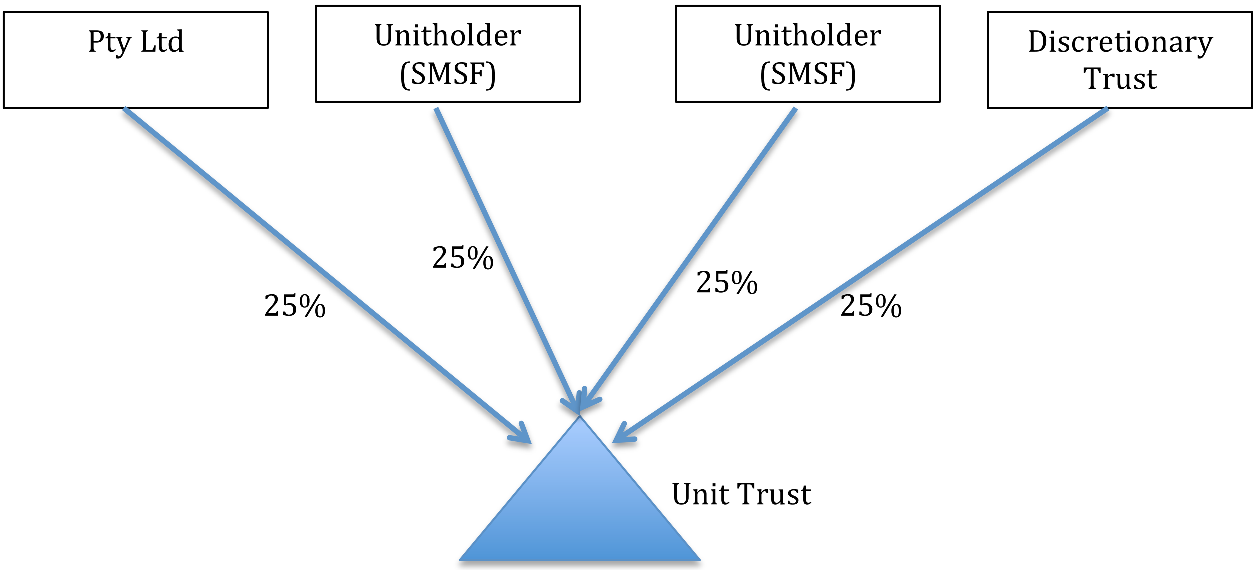

In this example, the SMSF has a 100% entitlement to capital and income, it has the ability to remove and appoint the trustee of the unit trust and the trustee of the unit trust is under an obligation to act according to its wishes. Therefore, it unquestionably has control of the unit trust and its units are in-house assets.

b. **Example 2 - 2 SMSFs each with 50% of units in unit trust**




In this example neither SMSF is entitled to *more than 50%* of the income and capital. It is likely the case that neither SMSF can remove or appoint the trustee of the unit trust. However, in order to confirm this it may be necessary to look at the unit trust deed. Further, if the trustee of the unit trust is a corporate entity with two directors, one appointed by each SMSF, it is necessary to determine whether either of them has a casting vote, as this would put control in the hands of one SMSF. Therefore, a 50% holding can be structured so that the units held by each SMSF are not in-house units but some attention to detail is required. Further, it must be ensured that in practice, the trustee of the unit trust does not simply act in accordance with the wishes of one SMSF.

### c. Example 3 - 4 unitholders each with 25% of units in unit trust




In this example it is likely that the units held by the SMSFs in the unit trust are not in-house assets, although it must be considered whether any two or more unitholders would be aggregated due to connections between them.

As mentioned, generally 5% by market value in-house assets are allowed. There is also an exception for units held since before 11 August 1999. These "pre-99" unit trust structures are therefore valuable in the SMSF space as they can enable a normal borrowing arrangement to be undertaken by a unit trust, even if the SMSF is in full control of that unit trust. There are transitional rules with respect to unit trusts created pre-99 where there have been further units issued in the interim.

With respect to lenders to unit trusts, their loan is not invalid or unenforceable if the units are in-house assets for an SMSF. Therefore, in one respect they do not need to concern themselves with whether or not the arrangement is in breach of the SIS Act.

However, a breach of the SIS Act involving a breach of the in-house asset rules will require the SMSF trustee to create a plan to sell off excess in-house assets. Thus the SMSF may be forced to dispose of its unit-holding meaning that the whole arrangement has to be unwound and the lender loses any benefit anticipated from the loan.

Further, the most serious risk to the lender of such an arrangement is reputational risk. If they are involved in lending to unit trust structures that are impugned for a breach of the SIS Act then their customers will no doubt be unhappy and the lender may be associated with civil and/or criminal breaches of the SIS Act. Banks are very cautious in this space as they are very mindful of the need to preserve their reputation.

## 12. Conclusion

There are a surprising number of issues to be aware of when lending or borrowing in the SMSF space. Unintentional slip-ups are likely to result in administrative penalties - at least for first-time offenders. However, the prospect of hefty civil penalties and even criminal prosecutions is something that must be kept in mind. Even aside from penalties, non-compliant borrowing arrangements can be costly for the client as a non-compliant arrangement may need to be un-wound. Therefore, its a good idea to spend some money up-front to ensure compliance and to consider stamp duty and taxation issues before diving in.

# Annexure

## Extracts from Superannuation Industry (Supervision) Act 1993 (Cth)

### 67 Borrowing

*Prohibition*

(1) Subject to this section and section 67A, a trustee of a regulated superannuation fund must not:
- (a) borrow money; or
- (b) maintain an existing borrowing of money.

Note 1: Section 67A contains an exception for certain limited recourse borrowing arrangements.

Note 2: Section 166 imposes an administrative penalty for a contravention of subsection (1) in relation to a self managed superannuation fund.

*Exception—temporary borrowing to pay beneficiary*

(2) Subsection (1) does not prohibit a trustee of a regulated superannuation fund from borrowing money if:
- (a) the purpose of the borrowing is to enable the trustee to make a payment to a beneficiary which the trustee is required to make by law or by the governing rules and which, apart from the borrowing, the trustee would not be able to make; and
- (b) the period of the borrowing does not exceed 90 days; and
- (c) if the borrowing were to take place, the total amount borrowed by the trustee would not exceed 10% of the value of the assets of the fund.

(2A) Subsection (1) does not prohibit a trustee of a regulated superannuation fund from borrowing money if:
- (a) the purpose of the borrowing is to enable the trustee to make a payment of surcharge or advance instalment which the trustee is required to make under the *Superannuation Contributions Tax (Assessment and Collection) Act 1997* and which, apart from the borrowing, the trustee would not be able to make; and
- (b) the period of the borrowing does not exceed 90 days; and
- (c) if the borrowing were to take place, the total amount borrowed by the trustee would not exceed 10% of the value of the assets of the fund.

*Exception—temporary borrowing to cover settlement of securities transactions*

(3) Subsection (1) does not prohibit a trustee of a regulated superannuation fund from borrowing money if:
- (a) the purpose of the borrowing is to enable the trustee to cover settlement of a transaction for the acquisition of any of the following:
  - (i) bonds, debentures, stock, bills of exchange or other securities;
  - (ii) shares in a company;
  - (iii) units in a unit trust;
  - (iv) futures contracts;
  - (v) forward contracts;
  - (vi) interest rates swap contracts;
  - (vii) currency swap contracts;
  - (viii) forward exchange rate contracts;
  - (ix) forward interest rate contracts;
  - (x) a right or option in respect of such a security, share, unit, contract or policy;

(xi) any similar financial instrument;
(xii) foreign currency; and
(b) both:
(i) at the time the relevant investment decision was made, it was likely that the borrowing would not be needed; and
(ii) the borrowing is not taken, under a determination made, by legislative instrument, by the Regulator, to be exempt from this paragraph; and
(c) the period of the borrowing does not exceed 7 days; and
(d) if the borrowing were to take place, the total amount borrowed by the trustee would not exceed 10% of the value of the assets of the fund.

*Exception—private sector funds*

(5) Subsection (1) does not prohibit a trustee of a private sector fund from maintaining an existing borrowing of money if:
(a) the trustee had, at a time before 12 June 1986, borrowed the money in circumstances that did not comply with the standard set out in paragraph 16(1)(b) of the Occupational Superannuation Standards Regulations; and
(b) the maintenance occurs before whichever is the earliest of the following:
(i) the day on which the trustee made such arrangements as were necessary to comply with that standard;
(ii) the day on which the trustee makes such arrangements as are necessary to comply with subsection (1);
(iii) 1 July 1995.

*Exception—public sector funds*

(6) Subsection (1) does not prohibit the trustee of a public sector fund from maintaining an existing borrowing of money if:
(a) the trustee had, at a time before 2 July 1990, borrowed the money in circumstances that did not comply with the standard set out in paragraph 16(1)(b) of the Occupational Superannuation Standards Regulations; and
(b) the maintenance occurs before whichever is the earliest of the following:
(i) the day on which the trustee made such arrangements as were necessary to comply with that standard;
(ii) the day on which the trustee makes such arrangements as are necessary to comply with subsection (1);
(iii) 1 July 2000.

*Civil penalty provision*

(7) Subsection (1) is a civil penalty provision as defined by section 193, and Part 21 therefore provides for civil and criminal consequences of contravening, or of being involved in a contravention of, that subsection.

## 67A Limited recourse borrowing arrangements

*Exception*

(1) Subsection 67(1) does not prohibit a trustee of a regulated superannuation fund (the ***RSF trustee***) from borrowing money, or maintaining a borrowing of money, under an arrangement under which:
(a) the money is or has been applied for the acquisition of a single acquirable asset, including:

(i) expenses incurred in connection with the borrowing or acquisition, or in maintaining or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset); and

Example: Conveyancing fees, stamp duty, brokerage or loan establishment costs.

(ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and

(b) the acquirable asset is held on trust so that the RSF trustee acquires a beneficial interest in the acquirable asset; and

(c) the RSF trustee has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and

(d) the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) default on:

(i) the borrowing; or

(ii) the sum of the borrowing and charges related to the borrowing;

are limited to rights relating to the acquirable asset; and

Example: Any right of a person to be indemnified by the RSF trustee because of a personal guarantee given by that person in favour of the lender is limited to rights relating to the acquirable asset.

(e) if, under the arrangement, the RSF trustee has a right relating to the acquirable asset (other than a right described in paragraph (c))—the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the acquirable asset; and

(f) the acquirable asset is not subject to any charge (including a mortgage, lien or other encumbrance) except as provided for in paragraph (d) or (e).

*Meaning of **acquirable asset***

(2) An asset is an ***acquirable asset*** if:

(a) the asset is not money (whether Australian currency or currency of another country); and

(b) neither this Act nor any other law prohibits the RSF trustee from acquiring the asset.

(3) This section and section 67B apply to a collection of assets in the same way as they apply to a single asset, if:

(a) the assets in the collection have the same market value as each other; and

(b) the assets in the collection are identical to each other.

Example: A collection of shares of the same class in a single company.

(4) For the purposes of this section and section 67B, the regulations may provide that, in prescribed circumstances, an acquirable asset ceases to be that particular acquirable asset.

*RSF trustee*

(5) Paragraphs (1)(d) and (e) do not apply to a right of:

(a) a member of the regulated superannuation fund; or

(b) another trustee of the regulated superannuation fund;

to damages against the RSF trustee for a breach by the RSF trustee of any of the RSF trustee's duties as trustee.

(6) A reference in paragraph (1)(d) or (e) (but not in subsection (5)) to a right of any person against the RSF trustee includes a reference to a right of a person who is the RSF trustee, if the person holds the right in another capacity.

## 67B Limited recourse borrowing arrangements—replacement assets

(1) Subsection (2) applies to:

(a) a reference in paragraph 67A(1)(b), (c), (d), (e) or (f) to an acquirable asset (the ***original asset***); or

(b) a reference in subsection 71(8) to an acquirable asset (the ***original asset***) mentioned in paragraph 67A(1)(b);

(including a reference resulting from a previous application of subsection (2) of this section).

(2) Treat the reference as being a reference to another single acquirable asset (the ***replacement asset***) if:

(a) the replacement asset replaces the original asset; and

(b) subsection (3), (4), (5), (6), (7) or (8) applies.

(3) This subsection applies if:

(a) the original asset consists of:

(i) a share in a company, or a collection of shares in a company; or

(ii) a unit in a unit trust, or a collection of units in a unit trust; and

(b) the replacement asset consists of:

(i) a share in that company, or a collection of shares in that company; or

(ii) a unit in that unit trust, or a collection of units in that unit trust; and

(c) at the time the replacement occurs, the original asset and the replacement asset have the same market value.

(4) This subsection applies if:

(a) the original asset consists of an instalment receipt that confers a beneficial interest in:

(i) a share in a company; or

(ii) a collection of shares in a company; and

(b) the replacement asset consists of that share or collection.

(5) This subsection applies if:

(a) the original asset consists of:

(i) a share in a company, or a collection of shares in a company; or

(ii) a unit in a unit trust, or a collection of units in a unit trust; and

(b) the replacement asset consists of:

(i) a share in another company, or a collection of shares in another company; or

(ii) a unit in another unit trust, or a collection of units in another unit trust; and

(c) the replacement occurs as a result of a takeover, merger, demerger or restructure of the company or unit trust mentioned in paragraph (a).

(6) This subsection applies if:

(a) the original asset consists of a share in a company, or a collection of shares in a company; and

(b) the replacement asset consists of a stapled security, or a collection of stapled securities; and

(c) each of those stapled securities consists of a single share, or a single collection of shares of the same class, stapled together with a single unit, or a single collection of units of the same class, in a unit trust; and

(d) the replacement occurs under a scheme of arrangement of the company.

(7) This subsection applies if:

(a) the original asset consists of a unit in a unit trust, or a collection of units in a unit trust; and

(b) the replacement asset consists of a unit in that unit trust, or a collection of units in that unit trust; and

(c) the replacement occurs as a result of an exercise of a discretion granted under the trust deed of that unit trust to the trustee of that unit trust.

(8) This subsection applies in the circumstances (if any) prescribed by the regulations for the purposes of this subsection.