



SMALL INDEPENDENT SUPERANNUATION FUNDS ASSOCIATION

Discussion items for ATO workshop on SMSF borrowing 8 November 2010

1. Off the plan purchases

Common scenario:

A SMSF trustee wishes to enter a contract to buy an apartment off the plan. Completion and settlement will not take place for another 2 years.

The SMSF trustee pays the deposit using existing cash. It intends to borrow from a bank to help pay the balance on settlement. It will not sign any loan documents or draw down any money from the bank until settlement, ie, after completion when the title to the property has been issued.

The SMSF directs a bare trustee to execute the sale contract as purchaser.

Questions for discussion:

1. Can the ATO confirm that this arrangement is capable of complying with section 67A because the SMSF trustee will not borrow until after completion when the title has issued?
2. The parties wish to prepare a bare trust deed now to confirm that the bare trustee has entered the contract as bare trustee for the SMSF trustee. Although this is arguably not yet required to comply with section 67A (because there has been no borrowing at this point), the SMSF trustee wishes to ensure its arrangement with the bare trustee is documented.

Although the title to the apartment will not issue for some time, the bare trust deed is prepared now using the lot number and address to identify the apartment.

Can the ATO confirm whether, in its view, a new trust deed would need to be prepared after the title is issued in order to ensure the SMSF's borrowing complies with the requirement in section 67A(1)(b) that the "asset" be held on trust for the SMSF trustee?

2. Accessory or multiple titles

Common scenarios:

- A commercial premises that consists of one building constructed over two or more titles for historical or other reasons.
- A commercial building is purchased and it has a number of strata titles for each of its levels.
- An apartment with an accessory car park on a separate title. Depending on the particular jurisdiction:
 - the titles to the apartment and accessory car park can only be transferred together; or
 - alternatively, the titles may be dealt with separately.

We note that in Victoria, for example, car parks would now be stapled to the apartment and could not be dealt with separately. However, the position might be different for older titles or in other jurisdictions.

Questions for discussion:

Does the ATO regard the above scenarios as involving one or multiple assets?

From a practical perspective, greater certainty can be achieved if some general guidelines are developed so that SMSFs need not seek advice from the ATO on a case-by-case basis.

Implications:

If any of the above scenarios are considered to involve multiple “assets” for the purposes of section 67A, this has the following consequences:

- Separate borrowings need to be undertaken and separate loan documents are required.
- Separate trust deeds (ie, declaring a trust over each “single acquirable asset”) are also required.
- If the SMSF defaults on a particular loan, the lender’s security will be limited to the particular title. It will not be able to take security over the interest in the land comprised in the other title(s).

Practically, this means:

- The legal fees involved in documenting the SMSF borrowing will increase significantly.
- The ongoing accounting and audit fees incurred by the SMSF as a result of having to maintain two or more separate borrowings could also increase.

- Lenders might charge additional fees for the establishment and maintenance of multiple loans.
- Lenders might be reluctant to lend at all if they cannot effectively take security over what for all practical purposes is a single asset but is comprised in more than one title.

It is submitted that this interpretation of the law produces an unfair and unintended result. For example, if the titles to a property were consolidated into one title by the vendor, the SMSF would be able to borrow to buy the same property without giving rise to any of the above complications. This supports the view that an “asset” for the purposes of the SISA is not meant to be defined by its technical legal title.

Further, based on this interpretation of the law it may be that the asset being considered is land consisting of two crown allotments which are comprised in one certificate of title. Absent any relevant planning restrictions each of the crown allotments could be sold separately even though they are comprised in the one title. However, based on the interpretation of Treasury in the Explanatory Memorandum to sections 67A and 67B SISA and of the ATO it would seem that the two crown allotments would be treated as a single acquirable asset.

In addition to the authorities cited in the submission made prior to the NTLG meeting of 7 September 2010 we also note that from an accounting point of view, the scenarios raised above would be classified as one “asset” (eg, in the balance sheet of the SMSF).

It is submitted that accounting standards should be taken into account when considering the meaning of “asset” for the purposes of the SISA. Many of the activities regulated by the SISA (including section 67A borrowings) involve economic transactions, ie, the SISA regulates the commercial and economic activities being undertaken by superannuation funds. In this context, it is appropriate to have regard to how an “asset” is defined from an accounting viewpoint.

3. Improvements

Common scenario:

A SMSF trustee borrows to buy land via a limited recourse borrowing arrangement. Another entity uses its own money to develop the land under an agreement with the SMSF trustee. (Alternatively, the SMSF uses its own non-borrowed money to develop the land.)

Questions for discussion:

Can the ATO clarify its view as to whether improving an asset creates a replacement asset?

We note that “improving” an asset necessarily implies taking an existing asset and making improvements such that the same asset is then “improved”. That is, the concept of improving implies that the same thing continues to exist, but in an enhanced state.

If an “improvement” is regarded as creating a replacement asset, this suggests that the former asset comes to an end and the new asset begins to exist. This is inconsistent with the concept of improvement.

Further, for property law purposes, fixtures become part of the land and can pass with the land. We submit that this does not create a new or replacement asset.

If the ATO regards improvement as giving rise to a replacement asset, further questions arise:

1. When does an improved asset become a replacement asset such that it does not retain its original characteristics and can no longer be said to be the “single acquirable asset” acquired at the time of the borrowing?

In a Goods and Services Tax (GST) context, GSTR 2003/3 discusses when a sale of real property is a sale of a new residential premises. In particular, it looks at the issue of “substantial renovations”. Where substantial renovations affect the whole of a building, a new residential property may be created for GST purposes.

If improvements are gradually made over, eg, 2 years (eg, as construction takes place) at what point does the new asset arise and the borrowing therefore fails to meet the requirements of section 67A?

2. Alternatively, assume that farm land is acquired via a borrowing arrangement. Fences and sheds are established, a crop is grown on the land and pipes are placed in the ground. The land is leased in part to different tenants. Are the pipes, fences, and sheds improvements? Will the fact that the land is leased to various tenants create a new asset (ie, leasehold interest) and will this fact alone mean that the asset has not retained its original characteristics (and no longer meets the definition of a “single acquirable asset”)?
3. What is the difference between a “repair” and an “improvement”? For example, if a building burns down, would the reconstruction be a “repair” or an “improvement”?

Even if a SMSF trustee uses non-borrowed money to rebuild the structure (eg, if it uses insurance proceeds), if this is seen as an “improvement” the reconstruction might result in the same land with a new building on it being treated as a new “asset” which would cause the SMSF trustee to breach section 67A.

It is submitted from a property law perspective the “asset” is the land acquired including all fixtures/improvements whether they be the fixtures/improvements at the time of purchase or at some future date.

It is further submitted that if vacant land is acquired by a superannuation fund which borrowed money the installation of water, sewerage and gas piping and facilities and power facilities on the land would not create a new asset. Nor would the construction of a shed, tennis court or swimming pool.

4. “Arrangements”

We refer to the initial response at the NLTG meeting of 7 September 2010 to questions about the meaning of “arrangement”.

It is submitted that the question of when the arrangement was entered into is secondary to establishing that an arrangement exists. This is because a person must be subject to the arrangement to have entered into it.

The response also refers to the issue of whether or not a “valuable right” had been created. It suggests that if so, an arrangement exists. It is submitted that at law this is not correct. Rather, there must be two parties who have an understanding about a situation, are ad idem, or have a meeting of the minds. It is this “meeting of the minds” that will be the entering into the arrangement by the parties to it. We refer to the case law cited in our submission made prior to that NTLG meeting.

Where land is acquired via a limited recourse borrowing arrangement, the contract to purchase creates “valuable rights” as does the granting of a lease over land. Neither of these bundles of rights is relevant to the question of whether an “arrangement” exists between the holding trustee as purchaser and the lender.

Bare trusts

We wish to make several comments regarding bare trusts. This was not originally raised as a key issue, but we wish to respond to the ATO's comments in the NTLG meeting of 7 September 2010.

Mortgage over the asset

The fact that an asset is mortgaged to a lender by a holding trust trustee does not preclude the existence of a bare trust relationship.

To consider this in a non-SMSF context: if an individual borrows to buy a property and the lender takes a mortgage over the property as security, that individual might request that someone else hold the legal title on bare trust for the purchaser. The mortgage will place some restrictions on the purchaser, but the purchaser is still absolutely entitled to the property as against the bare trustee.

The bare trustee grants the mortgage to the lender but it does so simply as bare trustee for the purchaser. In doing so the bare trustee does not therefore create any restriction that detracts from its bare trust relationship with the purchaser.

The same applies to a limited recourse SMSF borrowing. We therefore disagree with the suggestion that the charge granted by the holding trust trustee over the property means the trust cannot be a bare trust.

The comments of Gummow J in *Herdegen & Anor v. Federal Commissioner of Taxation* are not inconsistent with this analysis. If a beneficiary is absolutely entitled as against the bare trustee, it does not matter that the beneficiary is itself restricted under some other relationship with another party (ie, pursuant to a mortgage). The source of the restriction is the mortgage and not the trust relationship.

Transfer from the holding trust after the loan is repaid

Arguably the only aspect of a limited recourse SMSF borrowing that possibly differs to a non-SMSF borrowing in this respect is section 67A(1)(c), which provides that the SMSF trustee must have "a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest".

Some have queried whether this prevents the SMSF from being absolutely entitled because it cannot immediately call for a transfer of the property (and that it becomes absolutely entitled at a later point when the loan is repaid). We do not propose to discuss "absolute entitlement" or the associated tax implications in any detail (and we note in any event that Treasury has proposed to pass specific legislation to ensure the SMSF trustee is treated as the owner of the asset for tax purposes.)

However, it is relevant that when the loan is repaid, the SMSF trustee is absolutely entitled to the asset and there is no doubt at that point that the asset is held on bare trust (provided the terms of the particular trust deed reflect a bare trust).

An asset held on bare trust does not give rise to an “investment in” the trust. The beneficiary has an interest in the asset only. We disagree with the suggestion that section 71(1) should be interpreted broadly so that “investment in” a trust could be taken to include a bare trust arrangement. “Investment in” a trust involves having an interest in the trust, which does not exist in a bare trust relationship.

(We also do not agree with the comment that the exception for “excluded instalment trusts” in section 10 implies that the expression “investment in” a trust includes a bare trust. This exception relates to traditional instalment warrants over listed securities. The exception existed before limited recourse borrowings were possible and in the context of commercially available warrant products. In these situations, the trust in which the SMSF investor holds an interest is often much more than a bare trust, hence the need for a specific exemption from the in-house asset rules.)

Therefore, after the loan is repaid and there is no doubt that the asset is held on bare trust, the bare trustee can continue to hold the asset because there is no “investment in” a trust and therefore the arrangement does not create any potential in-house asset.

5. ATO ID 2010/162

We welcome the ATO's clarification that the expression "invest" used in section 109 of SISA includes entering an limited recourse borrowing.

However, the discussion about arm's length dealings has created some confusion. Can the ATO please clarify its views regarding SMSF borrowings from related parties that are on terms more favourable to the SMSF than might be expected if the parties were at arm's length?

- Section 109(1)(b) provides that the terms and conditions of the transaction must not be more favourable *to the other party* than would be reasonably expected if the parties were at arm's length. We agree that an arrangement which is favourable to the SMSF would not therefore breach section 109(1)(b).

However, the ID does not discuss section 109(1A), which provides that an SMSF trustee is required to deal in respect of any investment with another party that is not at arm's length in the same manner as if they were at arm's length.

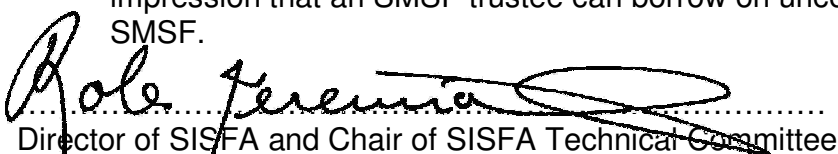
Does the ATO agree that section 109(1A) would effectively require an SMSF trustee to deal with a related party lender as if they were at arm's length and that this would require the terms of their arrangement to reflect arm's length terms (ie, that are no more or no less favourable to the SMSF than an arm's length arrangement)?

If so, we submit that this should be added to the ID because the ID potentially creates an impression that an SMSF who borrows from a related party on terms more favourable to the SMSF than an arm's length arrangement would not give rise to any breach of section 109.

- The ID does not mention that a borrowing from a related party on terms more favourable to the SMSF than an arm's length arrangement could potentially give rise to other issues. The ATO has emphasised in its Questions and Answers guide to limited recourse borrowings that SMSFs must borrow from related parties on arm's length terms and that if the terms are overly favourable to the SMSF, the loan might actually be a contribution. It has also been suggested by some in the industry that the arrangement could lead to the SMSF deriving non-arm's length income.

The ID is potentially misleading to readers because it does not mention that there could be other consequences of borrowing from a related party on non-arm's length terms that favour the SMSF. The statement in the ID that the ATO expects the borrowing to be "documented and conducted in a business-like manner in the same way as an arrangement when dealing with an arm's length lender" does not sufficiently convey the requirement for the terms to reflect arm's length terms.

We request that the ID be withdrawn or amended because it could create a misleading impression that an SMSF trustee can borrow on uncommercial terms which favour the SMSF.


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Director of SISFA and Chair of SISFA Technical Committee

Date: 8 October 2010