



## **PRODUCT DISCLOSURE STATEMENT**

### **EDEN HERMITAGE CUSTODY TRUST**

The SMSF Strategies Holding Trust is a key document to allow the trustee of a SMSF to borrow to acquire Property. The Trustee of the Holding Trust acts as a Holding Trustee for the absolute benefit of the Beneficiary – the trustee of the SMSF. The terms and conditions of the Holding Trust are incorporated within the Deed.

# Product Disclosure Statement

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## 1. Introduction

The superannuation laws were amended in 2007 to formally allow the trustee of a superannuation fund to borrow monies to acquire an asset – provided the asset is one that the trustee of the fund can legally acquire under the SIS Act 1993. This means that a trustee of a fund can now go to a bank or other lender, and provided that the conditions laid out under the superannuation laws are met, borrow funds at competitive rates to acquire commercial and residential property and in some limited cases shares or managed funds. Although it should be noted that effective from 7 July 2010 only single acquirable assets may be subject to a SMSF limited recourse lending arrangement pursuant to section 67A of the SIS Act 1993 and that these may not be improved.

This Product Disclosure Statement (“PDS”) is designed to provide a trustee of a SMSF with an understanding of the laws in relation to superannuation fund borrowing, the amended laws allowing superannuation fund borrowing, some practical examples and also a formal Holding Trust Deed enabling the trustee of the relevant SMSF to borrow to acquire a single acquirable asset.

## 2. The History of Borrowing by the Trustee of a SMSF

Prior to 1 July 2007 the superannuation laws provided that the trustees of a SMSF must not borrow or maintain an existing borrowing of money, except in limited circumstances – section 67 of the SIS Act 1993, see below. A breach of section 67 can result in a fine of up to \$220,000 and will render the fund a non-complying SMSF.

***In the Commissioner of Taxation’s book for SMSF trustees, “DIY super — It’s your money ... but not yet!” he states the following:***

*“Self-managed super funds are prohibited from borrowing money, except in some limited circumstances. This is to ensure that there is money available to pay out all member benefits when members retire. Not allowing funds to borrow reduces the risk of members losing their benefits.*

The SMSF Strategies Holding Trust is a key document to allow the trustee of a SMSF to borrow to acquire Property. The Trustee of the Holding Trust acts as a Holding Trustee for the absolute benefit of the Beneficiary – the trustee of the SMSF. The terms and conditions of the Holding Trust are incorporated within the Deed.

*The limited circumstances in which self managed super funds can borrow money are:*

- ☒ *trustees can borrow for a maximum of 90 days to meet benefit payments due to members or to meet a surcharge liability as long as the borrowing does not exceed 10% of the fund's total assets; and*
- ☒ *trustees can borrow for a maximum of seven days to settle security transactions if the borrowing does not exceed 10% of the fund's total assets (although this can only be done where it was unlikely that the borrowing would have been needed at the time the transaction was entered into).*

**Do:**

- ☒ *ensure your fund has enough money to pay bills;*
- ☒ *put in place procedures to monitor cash flow and the use of cheque books;*
- ☒ *ensure the fund's bank accounts are easily identified to avoid confusion.*

**Don't:**

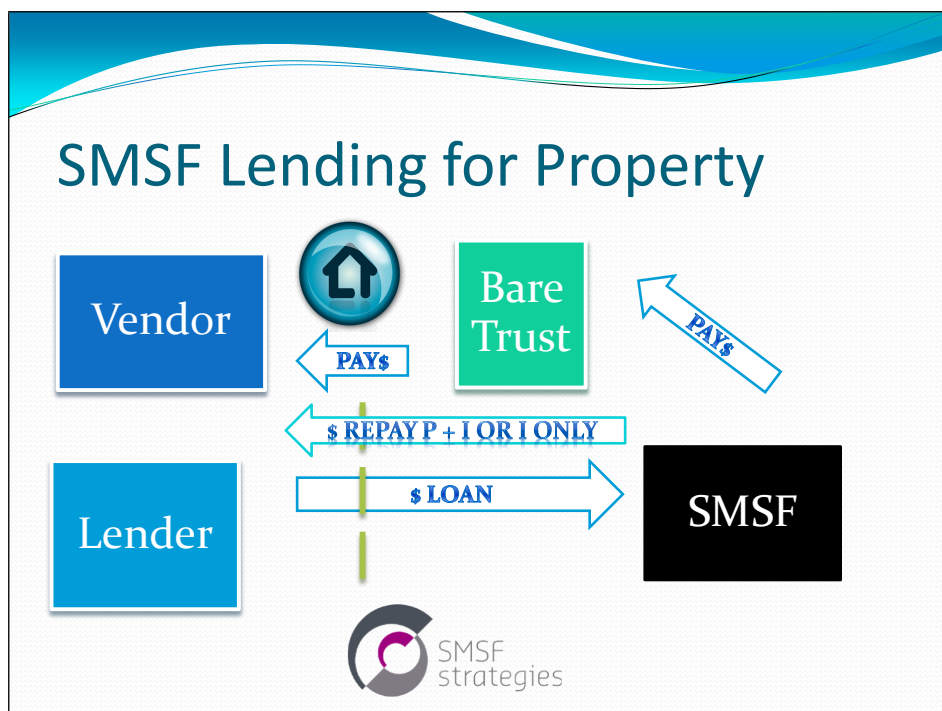
- ☒ *borrow money;*
- ☒ *use assets of your fund as security;*
- ☒ *allow your fund's bank account to go into overdraft.*

### **3. Post 7 July 2010 SMSF Borrowing Laws**

Notwithstanding the SMSF borrowing restrictions in section 67 of the SIS Act, the government introduced exemptions to the general rules in 2007 which have since been amended to include the new limited recourse lending exemptions in section 67A and 67B of the SIS Act 1993 which took effect from 7 July 2010.

**Note:** *Any SMSF Trustee with a borrowing that pre-dates 7 July 2010 should see their professional adviser to ensure that their SMSF borrowing is grandfathered rather than be subject to the limitations of section 67A of the SIS Act 1993.*

#### **3.1 Diagram of Limited Recourse SMSF Loan**



**The Key Features of the SMSF Limited Recourse Lending arrangements under section 67A are:**

- a single acquirable asset (one able to be acquired under the SIS Act 1993) is acquired under a borrowing arrangement and held on trust (“Holding Trust”) with recourse by the lender limited to the asset in the Holding Trust.
- super fund trustees cannot borrow to improve an asset (for example, real property)
- the borrowing is permitted only over a single asset or a collection of identical assets that have the same market value
- the asset within the arrangement is not subjected to a charge other than to the lender in respect of the borrowing by the super fund trustee
- the asset within the arrangement can only be replaced by a different asset in very limited circumstances specified in the law.

### **3.2 SMSF Limited Recourse Lending Advantages**

There are a number of important advantages to a SMSF entering into a borrowing arrangement:

- ★ It potentially maximises the wealth effect in the SMSF in times when assets of the fund are rising.
- ★ The borrowing can be for a short period or for a period of up to 20 plus years allowing it to be structured to the underlying circumstances of the fund members.

- ★ Members and related businesses can act as lenders provided that all lending is at arm's length although the Commissioner has ruled that discounted interest rates may be acceptable if from a related party.
- ★ It increases the flow of non-contributions funds into the SMSF.

### 3.3 New SMSF Borrowing Laws - the good side

Some of the good areas of the measures post 7 July 2010 include:

**1. Refinancing:** section 67A(1)(a)(ii) provides that a trustee can refinance an existing limited recourse borrowing. However, a change in lenders or material terms of the contract will not be a refinancing but a change in SMSF loans.

**2. Maintain and repair the asset:** costs incurred by the trustee of the fund to maintain and repair the property can be incorporated into the SMSF borrowing or drawn down from any borrowing facility. However, improvements are specifically excluded under section 67A(1) of the *SIS Act* 1993.

**3. Guarantees allowed:** the lender may request members, individuals acting as trustee, family trusts or other related entities to provide for a guarantee in the event of default by the SMSF trustee on the loan. Guarantees are acceptable, however, the laws have been included to ensure that no guarantee arrangement can be enforceable against the trustee other than the rights relating to the acquirable asset.

### 3.4 The Restrictions under the SMSF Borrowing Laws

The government has been closely monitoring the marketplace and decided to tighten up the prudential side of the SMSF borrowing laws. Some of the changes, which will severely restrict the use of SMSF borrowing for shares include:

**1. SMSF borrowing over single asset only:** Section 67(4A) of the *SIS Act* allowed multiple assets such as shares to be placed under the same bare trust arrangement, however, the new section 67A(1) only allows a single acquirable asset or a collection of "identical assets". A collection is defined to be a collection of assets that are identical and have the same market value. The explanatory memorandum (EM) provides an example of a collection – *a collection of shares of the same type in a single company*. The single asset provision limits the SMSF borrowing flexibility in terms of shares as it would require a separate bare trust arrangement for each share or unit or collection of shares or units. As an aside, if a property is purchased, the house and land for example is an acquirable asset, but any non-fixtures such as furnishings could be acquired by the SMSF directly or by way of a new SMSF loan.

**2. Collection must be sold as a collection:** As another dampener, the EM provides that to ensure that assets are to be seen as identical "a collection of shares must be acquired and disposed of as a collection and could not, for example, be sold down over time".

**3. Limited replacement assets:** To prevent the bare trust becoming a trading vehicle, replacing assets for original assets subject to the SMSF borrowing arrangement are limited to where shares or units are exchanged on takeover, merger and of the same market value at the time of changeover. Examples of asset transactions that would **not** be replacement assets

would include securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy or the replacement by way of improvement of real property.

**4. Limited recourse:** Lenders, guarantors and other persons have limited recourse to the acquirable asset only and cannot take action against the trustee who can then be indemnified from assets of the fund.

**5. No Improvements:** As noted above the Trustee of a Fund cannot improve a property while it is under a limited recourse lending arrangement and this includes where the Trustee uses monies from the Fund to complete the improvement rather than borrowings.

**6. Trustees can be sued by members:** Where a trustee breaches the SMSF borrowing rules and a member's benefits are reduced as a result, the member may recover from the trustee any loss and if their adviser is complicit in the breach also against the adviser. The limited recourse rules do not prevent the payment of damages to a member from a trustee or adviser.

## 4. Capital Gains Tax and SMSF Borrowing

The requirement for a SMSF Borrowing or traditional instalment warrant to be via a Holding Trust arrangement works well to ensure that the loan to the trustee of the fund is non-recourse however it has created a number of taxation problems for the SMSF trustee. Primarily, where any trust is operative including a Holding Trust arrangement under section 67A of the SIS Act 1993 the trust provisions of the Income Tax Assessment Act 1936 may apply. As such the trustee of the bare trust would need to include rents as assessable income and distribute net income to the trust beneficiary – the SMSF on an annual basis. Furthermore there may be a capital gains tax issue where the underlying asset is transferred from the bare trust to the trustee of the SMSF - except where the trustee of the SMSF is absolutely entitled to the underlying asset. In addition as the SMSF holds an interest in the bare trust – the Holding Trust there may be a capital gains tax issue when the bare trust is terminated on the transfer of the underlying asset to the trustee of the SMSF at the end of the borrowing arrangement.

The government, seeking to overcome the above taxation problems has proposed two separate taxation approaches to SMSF Borrowings – one for traditional instalment warrants and another for SMSF Borrowings, particularly those that are directed toward property.

### 4.1 Traditional Instalment Warrants

A look-through approach for traditional instalment warrants has been proposed by government that will result in the following:

- the SMSF trustee will be assessed on any distributions, and entitled to any associated franking credits.
- the SMSF trustee will be treated as having acquired the underlying asset when they enter into the instalment warrant for the amount paid by the trustee to acquire it.

- there will be no CGT consequences for a ‘roll-over applicant’ who rolls over an instalment warrant into a new warrant over the same asset. Any top up (refund) payment, such as to maintain an agreed leverage ratio, will be treated as a decrease (increase) in the loan amount.
- there will be no CGT consequences for the trustee or investor when the investor pays the final instalment or if the trustee transfers the asset to the investor.
- an act done by the trustee of the instalment warrant trust in relation to the asset will be treated as if it had been done by the investor directly. For example, if the trustee sells the asset (such as at the direction of the investor or because the investor defaults), the investor will be treated as having sold the asset and be subject to CGT as appropriate.

At this stage the government has announced that a “traditional instalment warrant” is to be defined as an arrangement where:

- there is a non-recourse borrowing by the investor and no other guarantee from the investor (or associates) to the lender (a ‘non-recourse’ borrowing means that the lender has no recourse other than to the underlying asset.)
- a trust exists, primarily to provide security for the outstanding loan (but only over the underlying asset).
- the investor receives the benefits of ownership of the underlying asset, such as income derived from the asset (whether received at the time or directed on their behalf to reduce outstanding instalments) and capital growth.

Most SMSF Bank Loans will not meet the criteria of a traditional instalment warrant as banks generally require personal guarantees. However related party loans, depending upon the final laws when released, may be structured to fit the proposed traditional instalment warrant rules.

## **4.2 SMSF Loans for Property and other Investment**

SMSF Loan arrangements that meet the conditions of section 67(4A) and the new section 67A and 67B of the SIS Act 1993 will have a “look through” approach apply to ensure that the trustee of the SMSF is treated as the owner for taxation purposes. This would include SMSF Bank Loans where a member or related party provides a personal guarantee. In terms of a SMSF Loan arrangement to acquire property the following is to apply:

- the SMSF trustee will be assessed on any income earned on the underlying asset, such as rental income.
- the SMSF trustee will be able to claim any relevant deductions, such as capital allowance for the decline in value of property and where relevant, the investor will also have to adjust the underlying asset’s cost base.
- if the underlying asset is a depreciating asset, there will be no balancing adjustment when the trustee transfers it to the investor.

## 5. ATO Rulings

### 5.1 Updated ATO View – post section 67A and 67B

#### Background

From 24 September 2007 super funds could invest in certain limited recourse borrowing arrangements involving borrowing money to acquire a permitted asset. Those arrangements must meet the conditions stipulated by the law in former subsection 67(4A) of the SISA. Those rules continue to apply to limited recourse borrowing arrangements that were entered into before 7 July 2010, but new rules apply to new arrangements.

The rules apply to all regulated funds, not just SMSFs; however, this document only provides guidance in respect of the application of the law to SMSFs.

- **How is the ATO dealing with those SMSFs that invested in instalment warrant products before 24 September 2007?**

If you are a trustee or director of an SMSF and you invested before 24 September 2007 in an instalment warrant that former subsection 67(4A) of the SISA allows, we will not issue a notice stating your fund is a non-complying fund solely on the basis of the investment.

However, if you invested before 24 September 2007 in an instalment warrant product that does not meet the requirements of former subsection 67(4A), we will decide on a case-by-case basis what action will be taken.

- **Amendments to the super law that apply from 7 July 2010 – changes for limited recourse borrowing arrangements**

The super laws have been amended for limited recourse borrowing arrangements by super funds entered into on or after 7 July 2010 so that:

- *super fund assets are better protected in the event of a default on a borrowing*
  - *the asset within the arrangement can only be replaced by a different asset in very limited circumstances specified in the law*
  - *super fund trustees cannot borrow to improve an asset (for example, real property)*
  - *the borrowing is permitted only over a single asset or a collection of identical assets that have the same market value*
  - *the asset within the arrangement is not subjected to a charge other than to the lender in respect of the borrowing by the super fund trustee.*
- **When can an acquirable asset be replaced in an arrangement that commenced on or after 7 July 2010?**

The circumstances when an acquirable asset in a limited recourse borrowing arrangement can be replaced are listed in section 67B of the SISA. Regulations can be made to allow for



replacement in additional circumstances, but as at 26 July 2010 no regulations have been made for this purpose. The circumstances listed in section 67B are:

1. A share in a company (or collection of such shares) can be replaced by a share (or collection of such shares) in the same company if, at the time of replacement, the original asset and replacement have the same market value (for example, if there is a share split). (Subsection 67B(3)).
2. A unit in a unit trust (or collection of such units) can be replaced by a unit (or collection of such units) in the same unit trust if, at the time of replacement, the original asset and replacement have the same market value. (Subsection 67B(3)).
3. If the original asset is an instalment receipt that converts to a share or collection of shares in a company, then that share (or collection of shares) is allowable as a replacement asset. (Subsection 67B(4)). For these purposes an 'instalment receipt' is defined to mean an investment under which a listed security is held in a trust until the purchase price of the security is fully paid and the security, and property derived from the security, is the only property of that trust. (Subsection 10(1)).
4. A share in a company (or collection of such shares) can be replaced by a share (or a collection of such shares) in another company if the replacement occurs because of a takeover, merger, demerger or restructure of the first company. (Subsection 67B(5)).
5. A unit in a unit trust (or collection of such units) can be replaced by a unit (or collection of units) in another unit trust if the replacement occurs because of a takeover, merger, demerger or restructure of the first trust. (Subsection 67B(5)).
6. A share in a company (or collection of such shares) can be replaced by a stapled security (or collection of such securities) if the replacement occurs under a scheme of arrangement of the company – for example, as part of a restructure. The stapled security must consist of a share (or a single collection of shares of the same class) stapled together with a unit (or a single collection of units of the same class) in a unit trust. (Subsection 67B(6)).
7. A unit in a unit trust (or collection of such units) can be replaced by a unit (or collection of units) in that trust if the replacement occurs as a result of an exercise of a discretion granted to the trustee of that unit trust under the trust deed (for example, a managed investment scheme trustee exercises a discretion to split or consolidate units). (Subsection 67B(7)).

- **Explanatory Memorandum on replacement assets**

The Explanatory Memorandum circulated in Parliament for the amended rules applying to limited recourse borrowing arrangements entered into on or after 7 July 2010 gives the following additional information about replacement assets (at paragraph 1.29):

1.29 Examples of circumstances not permitting a replacement asset include:

- securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy

- money or cash is not eligible as a replacement asset under **any** circumstances - includes circumstances where the original asset would otherwise be replaced with an eligible replacement asset plus cash – for example, shares in X Ltd replaced by shares in Y Ltd and a pool of cash as a result of a takeover of X Ltd by Y Ltd
  - replacement asset arising from an insurance claim covering the loss to the original asset
  - the replacement by way of improvement of real property
  - a series of titles over land replacing a single title over land that has been subdivided, and
  - a replacement of a title over real property as a result of Government action such as the resumption of all or part of a property or re-zoning.
- **What changes to a borrowing or other attributes of a limited recourse borrowing arrangement result in a new arrangement for the purposes of the super law?**

If the parties adopt a change to the terms or conditions of an arrangement (either expressly or by inference) that goes to the root of the arrangement – that is, it alters the character of the arrangement in a significant way – then there is a new arrangement from that time and the earlier arrangement has come to an end. If that change happened after 7 July 2010, the requirements of section 67A of the SISA apply to the arrangement.

Changes resulting in a new arrangement include:

- the borrowing under the original arrangement is refinanced – refer to ATO rulings:
  - **Can an SMSF trustee refinance a limited recourse borrowing without contravening the superannuation law?**
  - **Is every variation to the terms of a limited recourse borrowing regarded as a refinancing?**
- there is a borrowing (drawdown) that is inconsistent with the earlier arrangement – for example, borrowing to acquire an asset or class of asset clearly not contemplated under the original arrangement
- there has been a change to the ultimate beneficiaries of the arrangement resulting from selling a structure involving a pre-existing arrangement.

#### **Example: New arrangement**

There is a limited recourse borrowing arrangement that meets the requirements of former subsection 67(4A) of the SISA entered into by a corporate SMSF trustee and a private company lender before 7 July 2010. On or after 7 July 2010, new directors of the corporate SMSF trustee (and members of the SMSF) and new directors of the private company lender are appointed, replacing all of the former members. The Commissioner will treat the limited recourse borrowing arrangement now controlled by the new ultimate beneficiaries as a new arrangement. The new arrangement must meet the requirements of section 67A of the SISA.

#### **Example: No new arrangement**

There is a limited recourse borrowing arrangement that meets the requirements of former subsection 67(4A) of the SISA entered into by a corporate SMSF trustee and a private company lender before 7 July 2010. On or after 7 July 2010 two new members of the SMSF

are admitted as a result of changing family circumstances. The Commissioner will not treat the limited recourse borrowing arrangement as a new arrangement on this basis alone.

- ***Can an SMSF trustee refinance a limited recourse borrowing without contravening the super law?***
- **Arrangements entered into on or after 24 September 2007 and before 7 July 2010, then refinanced on or after 7 July 2010.**

*Yes, SMSF trustees can refinance the borrowing, but the refinanced arrangement must meet the requirements of the law applying to limited recourse borrowing arrangements entered into on or after 7 July 2010.*

A new borrowing that takes the place of the old borrowing, such that the application of the new borrowing is solely to extinguish the previous borrowing and meet associated costs, satisfies the requirement that borrowed funds are applied for the acquisition of the relevant asset.

*However, refinancing the borrowing is entering into a new limited recourse borrowing arrangement at the time of refinancing. Any arrangement refinanced on or after 7 July 2010 must meet the requirements of the super law (section 67A of the SISA) applying to arrangements entered into on or after 7 July 2010.*

- **Where a new trust is created to hold the asset**, SMSF trustees must ensure that the asset is transferred directly to that new trust and that the SMSF does not temporarily obtain title to the asset at that time, otherwise a contravention of the super law will occur.
- **Arrangements entered into on or after 7 July 2010 and then refinanced at a later date.**

Yes, provided the re-financed arrangement meets the requirements of section 67A of the SISA.

Section 67A explicitly allows re-financing of a borrowing (including any accrued interest) under an arrangement if the new borrowing arrangement is over the acquirable asset from the first arrangement (including an asset from the first arrangement that is a replacement asset under section 67B of the SISA) and no other acquirable asset.

Where a new trust is created to hold the asset, SMSF trustees must ensure that the asset is transferred directly to that new trust and that the SMSF does not temporarily obtain title to the asset at that time, otherwise a contravention of the super law will occur.

- **Is every variation to the terms of a limited recourse borrowing regarded as a refinancing?**

No. The question is whether a variation to the contract of borrowing led to the extinguishment of the previous borrowing and the creation in its stead of a new and different borrowing (a refinancing). This depends upon the nature and extent of the variation and the intention of the parties.

### **Example: Extension of borrowing**

Suppose a borrowing is extended by a variation to the terms of a contract. An agreement to extend the period of the borrowing could be so inconsistent with the original agreement that it results in a new contract for borrowing. Some factors which are relevant in deciding this question are:

- whether the original loan agreement provided for the parties to agree to extend the term
- the period of the extension in relation to the period of the original loan
- whether other terms of the loan were changed by the later agreement.

In *Roberts v I.A.C (Finance) Pty Ltd* (1967) VR 231, the parties agreed to extend a three-year borrowing for a further two months. It was held the extension was not totally inconsistent with the terms of the original agreement as the variation left the terms and conditions of the original agreement intact, except to the limited extent that the due date was extended by two months. As the contract was modified to a limited extent, the rights and obligations of the parties were not affected by the variation. In these circumstances, the loan extension did not discharge the original obligation to pay and create a new obligation to pay in its place.

- **Does a drawdown from a credit facility give rise to a new borrowing?**

Yes. The Commissioner considers that each drawdown of funds from a loan facility or similar arrangement constitutes a separate borrowing, even if the facility or arrangement makes provision for redraws arising from earlier repayments. This view is more fully explained in paragraph 93 of self-managed super funds ruling [SMSFR 2009/2](#) *Self-Managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the Superannuation Industry (Supervision) Act 1993*.

The terms of a single limited recourse borrowing arrangement may allow multiple drawdowns by the investor. Each drawdown must be reviewed to determine whether the borrowing meets the requirements of the super law applying to the particular arrangement.

If a drawdown is put to a purpose that does not meet the requirements of the super law - for example, the cash is put into a member's account – there is a contravention of the super law (specifically, subsection 67(1) of the SISA). *Conversely, if the drawdown is put to a permitted purpose, such as the capitalisation of interest, then it does not result in a contravention of the super law.*

- **For real property held by the holding trust in a limited recourse borrowing arrangement, can an SMSF trustee draw down under the arrangement to make capital improvements to the real property without contravening the super law?**

- **Arrangements entered into on or after 7 July 2010**

No. The super law applying to these arrangements specifically prohibits borrowing to make improvements under subparagraph 67A(1)(a)(i) of the SISA. *However, drawdowns to capitalise interest, maintain the asset and meet other costs of the arrangement continue to be allowed.*

- **Does an arrangement that permits capitalisation of interest or other borrowing charges satisfy the super laws?**
- **Arrangements entered into on or after 7 July 2010**

Yes. The super law (specifically, subparagraph 67A(1)(a)(i) of the SISA) applying to these arrangements explicitly provides that, under a limited recourse borrowing arrangement, the SMSF trustee can apply borrowed money towards expenses incurred in connection with the borrowing.

**Example: Dividend income to reduce loan principal**

Under an arrangement that otherwise meets the requirements of the super law, any dividend income on the underlying share is applied first in reducing the loan principal amount. At one point in the year, the loan principal amount is increased by the capitalisation of the interest amount. This is permitted under subsection 67(4A) applying to arrangements entered into before 7 July 2010, because each amount so drawn down is applied as a cost of acquiring the underlying share. It is also permitted under section 67A applying to arrangements entered into on or after 7 July 2010.

**Example: Dividend income paid to the investor**

Under an arrangement that otherwise meets the requirements of the super law, all dividend income on the underlying share is paid to the investor. The loan is drawn down annually and applied to pay the interest amount. This is permitted under subsection 67(4A) applying to arrangements entered into before 7 July 2010, because each amount so drawn down is applied as a cost of acquiring the underlying share. It is also permitted under section 67A applying to arrangements entered into on or after 7 July 2010.

- **Will granting the lender a right of recourse over the underlying asset lead to a contravention of the prohibition against charging a fund asset?**

*The granting to the lender of a right of recourse to the underlying asset at the same time that the trustee of an SMSF acquires the beneficial interest in the asset is a necessary feature of a limited recourse borrowing arrangement contemplated by the super law.* Granting of such a right in these circumstances will not contravene the existing prohibition in the law against giving a charge over a fund asset, provided that the arrangement complies with all the conditions of the super law.

- **Can an SMSF member provide a personal guarantee to the lender in a limited recourse borrowing arrangement?**
- **Arrangements entered into on or after 7 July 2010**

Yes, provided the guarantors rights against the principal debtor (the SMSF trustee) are limited to rights relating to the asset being acquired under the arrangement. Under the super law applying to these arrangements, the recourse of the lender **or any other person** against the SMSF trustees in connection with, or as a result of, a default on the borrowing (either directly or indirectly) must be limited to rights relating to the asset that is being acquired under the arrangement.

This means, for example, that for an arrangement to meet the requirements of the super law, any guarantor must not have general rights of indemnity against the principal debtor (the SMSF trustee) that might crystallise in the event of a call on the guarantee. However, the

guarantor may have rights of subrogation of the lender's rights (that is, the right to exercise the lender's limited rights of recourse to the asset being acquired under the arrangement) that might crystallise in the event of a call on the guarantee.

- **Personal guarantees and contributions to the SMSF**

If a guarantor makes a payment to the lender under an arrangement where they have foregone their usual rights of indemnity against the principal debtor (the SMSF trustee) in respect of the guarantee, this is a contribution to the SMSF if it satisfies a liability of the SMSF. This might happen, for example, if the guarantor paid the borrowing and the acquirable asset was transferred to the SMSF trustee under the arrangement.

In contrast, there is no contribution if the SMSF trustee has exercised a right to 'walk away' from the arrangement (and has lost the acquirable asset to the lender) and has no further liability, but the lender still exercises a right to call on the guarantee for a shortfall after disposal of the original asset.

- **Can a related party to the SMSF give a mortgage to the lender over an asset of the related party?**

- **Arrangements entered into on or after 7 July 2010**

Yes, provided the related party or any other person has no rights of recourse against the SMSF trustee in the event that the mortgage is exercised by the lender (for example, if the SMSF trustee defaults on the borrowing), other than rights relating to the asset being acquired under the arrangement.

- **Can the asset being acquired be used as security other than in respect of the borrowing by the SMSF trustee?**

- **Arrangements entered into on or after 7 July 2010**

No. The super law (specifically, paragraph 67A(1)(f) of the SISA) applying to these arrangements prohibits any charge over the asset other than in respect of the borrowing by the SMSF trustee under the arrangement.

- **Is an SMSF trustee allowed to acquire the underlying asset from a related party vendor?**

The laws which prohibit the acquisition of assets from related parties apply to limited recourse borrowing arrangements. However, the exceptions provided for in the rules against the acquisition of assets from related parties, such as those allowing for the market value acquisition of listed securities or business real property, continue to apply.

This question is different to that where the legal ownership of the asset is transferred from the holding trust to the SMSF once all the instalments are paid.

- **Does the requirement that the asset be held on trust for the SMSF mean that the fund acquires an asset from a related party on repaying the borrowing?**

It is a necessary feature of an arrangement contemplated that the SMSF be able to acquire full ownership rights over the underlying asset once the borrowing is repaid. The holding trust which holds the asset underlying a limited recourse borrowing arrangement will generally be a related party of an SMSF investor. In these circumstances, the legal interest in the asset may be considered to be acquired from the holding trust when the borrowing is repaid. The ATO considers that, under the new laws, this would not contravene the existing prohibition on



acquiring assets from related parties. This question is different to that where the original vendor of the asset is a related party.

- **Is an SMSF trustee allowed to put an existing fund asset into a limited recourse borrowing arrangement?**

No. The money borrowed must be used to acquire a new asset (or replacement asset). This means, for example, that investments under ‘shareholder application’ or ‘cash extraction’ arrangements are not allowed. The giving of a charge over an existing asset of the fund, as would generally occur under such arrangements, would result in a contravention of the super law.

- **Can an SMSF trustee borrow under a limited recourse borrowing arrangement to build a house on vacant land owned by the fund?**

No. An existing SMSF asset cannot be put into a limited recourse borrowing arrangement. The giving of a charge over an existing asset of the fund (the vacant land), as would generally occur under such arrangements, would contravene the super law.

- **Under the super law can cash, representing borrowed money and/or a deposit, be transferred to the holding trust trustee?**
- **Arrangements entered into on or after 7 July 2010**

Yes, provided the transactions are to facilitate the acquisition of the acquirable asset. This is consistent with the Commissioner’s approach to acquisitions in general – refer to paragraph 111 of self-managed super funds ruling **SMSFR 2010/1** Self-Managed Superannuation Funds: the application of subsection 66(1) of the *Superannuation Industry (Supervision) Act 1993* to the acquisition of an asset by a self-managed super fund from a related party. The super law that applies to these arrangements specifically prohibits the acquirable asset from being money.

- **Can the holding trust trustee operate a cash account for an arrangement entered into on or after 7 July 2010?**

Yes, provided the cash account is not part of the acquirable asset. That is, it is acceptable for the holding trust trustee to operate a cash account to deal with income, expenses and the like. It would not be acceptable for the holding trust to operate a cash account as a trading account for investment purposes.

- **Are SMSFs permitted to use a limited recourse borrowing arrangement to buy a spread of blue-chip shares or is a separate borrowing required for each shareholding?**
- **Arrangements entered into on or after 7 July 2010**

Separate arrangements must be used for shares in different companies or different classes of shares in a company. The asset being acquired under one arrangement must be:

- a single asset
- a collection of assets that are identical, have the same market value as each other, and are treated as a single asset (that is, bought and sold together as a collection) – for example, a collection of shares of the same class in a single company.

- **Can an SMSF use a limited recourse borrowing arrangement to purchase exchange traded options over shares?**
- **Arrangements entered into on or after 7 July 2010**

*Yes, however the arrangement must be brought to an end at or before the time the options are replaced by another asset (such as cash or shares).* The conversion of an option to another asset is not a permitted replacement asset within a limited recourse borrowing arrangement.

- **Can assets be sold and bought on behalf of the investor within the holding trust of a limited recourse borrowing arrangement?**
- **Arrangements entered into on or after 7 July 2010**

No. The super law applying to these arrangements restricts replacement of the asset (or collection of identical assets) within an arrangement to circumstances specifically listed in the law. It is not permitted for a portfolio of assets to be managed within a limited recourse borrowing arrangement.

- **Can shares issued under a dividend reinvestment plan be retained in the arrangement?**
- **Arrangements entered into on or after 7 July 2010**

No. For an arrangement over a collection of shares, if additional or bonus shares are issued in respect of that collection of shares, they cannot simply be added to the collection as that is not a permitted replacement asset. If the arrangement is to continue, the additional shares need to be transferred out of the arrangement – for example, in a similar way that a cash dividend might be.

- **Can an SMSF trustee acquire more than one real property title under a single limited recourse borrowing arrangement?**
- **Arrangements entered into on or after 7 July 2010**

No. The asset being acquired under one arrangement must be:

- a single asset
- a collection of assets that are identical, have the same market value as each other, and are treated as a single asset (that is, bought and sold together as a collection).

Real property on separate titles is not allowed, even if the properties are substantially the same at the time of acquisition.

## **The in-house asset rules**

- **What is the purpose of the special in-house asset rule for limited recourse borrowing arrangements?**

The holding trust in a limited recourse borrowing arrangement will generally be a related trust of the SMSF. An investment by an SMSF in a related trust is an in-house asset of the SMSF unless an exemption applies.

The special rule ensures that a limited recourse borrowing arrangement entered into by an SMSF which meets the other requirements of the super law will not automatically result in an in-house asset arising from the investment made in the holding trust. Such an investment will



only be an in-house asset where the underlying asset would itself be an in-house asset of the SMSF if held directly.

- **Can the holding trust trustee continue to hold the property for the investor after the borrowing has ended?**

Yes, but the SMSF's interest in the holding trust will be an in-house asset of the SMSF if the interest represents an investment of the SMSF trustee in the holding trust. This is because, under subsection 71(8) of the SISA, once a limited recourse borrowing arrangement has ended, even if there are other amounts outstanding, the in-house asset exception ceases to apply.

There is a contravention of the super law if:

- the asset is not transferred to the SMSF or the interest in the holding trust does not otherwise end once the borrowing comes to an end
- the interest in the holding trust becomes an in-house asset of the SMSF and this causes the SMSF to exceed the permitted 5% level of in-house assets.

- **If the property owned by the holding trustee is leased to a related party of the SMSF investor, is the SMSF's interest in the holding trust an in-house asset?**

Yes, unless the leased asset would not be an in-house asset of the SMSF if it were owned by the SMSF directly. For example, if the leased asset would be business real property of the SMSF if owned directly, then the SMSF's interest in the holding trust is not an in-house asset as long as the limited recourse borrowing arrangement meets all of the requirements of the super law.

In the case of real property that is being leased by the holding trust trustee (for example, so that rent flows to the SMSF trustee) while the borrowing is paid off, the Commissioner takes the view that the existence of the lease does not cause the investment to fail the tests for the **special in-house asset rule** to apply.

## **The holding trust**

- **Does the super law specify the type of trust that must be used as the holding trust in a limited recourse borrowing arrangement?**

No. The law specifies only that the SMSF trustee must have a beneficial interest in the asset being held in the holding 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 holding trust.

More complex trusts are unlikely to satisfy the requirement that the SMSF trustee has the necessary interest in a particular asset of the holding trust. For example, a discretionary trust could not be used, nor could the SMSF trustee be one of a number of unit holders in a unit trust.

## **5.2 Grandfathering instalment warrant and SMSF Borrowing arrangements**

### **NTLG Minutes: Grandfathering**

- **Issue raised**

What is the meaning of ‘arrangement’ in item 14 of the Superannuation Industry (Supervision) Amendment Act 2010?

- **Background information**

Item 14 of the Superannuation Industry (Supervision) Amendment Act 2010 provides that the new borrowing laws apply to an arrangement entered into on or after the commencement of the laws (which was 7 July 2010).

It is noted that this does not refer to a ‘borrowing’ but rather an ‘arrangement’. It is unclear what is meant by ‘arrangement’. This timing issue might impact some trustees who had agreed to the terms of an arrangement (which complies with the former section 67(4A)) but who had not completed all of the necessary paperwork by 7 July 2010.

- **Industry view/suggested treatment**

‘Arrangement’ is not defined in the SISA. However, the term ‘lease arrangement’ is defined in section 10 to mean ‘any agreement, arrangement or understanding in the nature of a lease (other than a lease) between a trustee of a superannuation fund and another person, under which the other person is to use, or control the use, property owned by the fund, whether or not the agreement, arrangement or understanding is enforceable, or intended to be enforceable, by legal proceedings’.

This suggests that the term ‘arrangement’ has a very broad meaning in the context of the SISA and that it is intended to cover an informal agreement or understanding, including whether or not it is enforceable.

The following cases offer guidance on the term ‘arrangement’:

- An arrangement is ‘an understanding or plan between two or more persons which may not be enforceable in law and comprehends the legally effective acts done in carrying it out’ (Taxation Commissioner v. Porter (K) & Co Pty Ltd (1973) 22 FLR 344).
- There needs to be ‘reciprocity of commitment’ for the parties to have entered into an arrangement or come to an understanding (Trade Practices Commission v. Email Ltd (1980) 31 ALR 54).
- An arrangement is ‘something less than a binding agreement’, or a ‘promise not in vague terms but in ascertained terms leading to the reasonable expectation of completion’ (Dunsford v. Tate [1971] NZLR 861).

It is therefore submitted that an ‘arrangement’ has been entered into if there is an understanding between the parties of the key terms of the loan and an expectation that these will be formalised into binding loan documents. For example, if a lender has agreed to provide finance to a trustee on certain terms but formal loan documentation has not been prepared by a certain date, it appears that those parties entered an ‘arrangement’ before that date and therefore the new section 67A and 2 67B will not apply to that arrangement when formal documents are executed.

- **ATO initial response**

The application provision of the Superannuation Industry (Supervision) Amendment Act 2010 (the amending Act) provides that section 67A applies 'to an arrangement entered into on or after the commencement of this item'. The date of commencement is 7 July 2010. The E to the amending Act states that the purpose of the application provision is 'to avoid any reduction in the value of the 'property' owned under limited recourse borrowing arrangements entered into prior to the day after the Bill receives the Royal Assent'.

A borrowing of money, and hence any application of either section 67A or former subsection 67(4A) of the SISA as an exception to the borrowing prohibition in subsection 67(1) of the SISA, does not occur until money is transferred from the lender to the SMSF trustee as borrower. The Commissioner's view is confirmed in Self Managed Superannuation Funds Ruling SMSFR 2009/2 at paragraph 10.

The meaning of 'arrangement' is taken from the context in which the word is used. We do not think the wide meaning of 'lease arrangement' in the SISA is particularly relevant. In the context of the application provision of the amending Act the arrangement has been 'entered into' at a particular time if valuable property (such as a contractual right) has come into existence in respect of the arrangement. This may occur at a time before there has been any transfer of money.

We accept that there may be several borrowings made under a single limited recourse borrowing arrangement. However, a mere future transfer of money in circumstances where there is a credit facility, overdraft facility or similar facility in existence before 7 July 2010 does not of itself establish that the transfer of money was made under a pre-existing limited recourse borrowing arrangement to which former subsection 67(4A) applies. It will need to be established that there had come into existence before 7 July 2010 valuable rights as part of a limited recourse borrowing arrangement if former subsection 67(4A) is to apply. There must be something more than a mere expectancy. The relevant inquiry relates to the limited recourse borrowing arrangement as a whole.

### **5.3 Initial Repairs**

Does the Commissioner make any distinction between an initial repair or an ongoing repair (for example, one incurred after the acquirable asset becomes income producing)?

If a draw down of an existing loan is undertaken to fund a repair, would this need to be a separate borrowing arrangement or one that merely needs to satisfy section 67A(1)(a)?

- **Background information**

The new section 67A of the SIS Act requires certain criteria to be satisfied for a borrowing. If an asset that has been acquired requires a repair to be undertaken, the criteria in each of paragraphs (1)(b) to (f) may not be satisfied. This is because SMSFR 2009/2 treats each draw down as a separate borrowing, and a separate borrowing entered into to fund the repair may not satisfy the requirement that the underlying asset be held on trust (section 67A(1)(b)) and not be subject to a charge other than as specified (section 67A(1)(f)) at the time that the

borrowing is entered into (for example, because the asset say the real estate is already held on bare trust and is subject to a charge).

Also, an initial repair may possibly be undertaken so that at the time of drawing down the funds at settlement, the repairs are then paid for. In comparison, ongoing repairs are incurred along the way and may be a number of years after settlement.

Industry view/suggested treatment

The legislation clearly intends to cover borrowings made for repairs. We feel that:

- initial and ongoing repairs should be covered by the new provisions
- the borrowing should be able to occur by way of a draw down on a separate facility
- a borrowing for a repair will generally require a draw down from an existing loan facility. Thus we ask for the withdrawal of SMSFR 2009/2 (as it appears to be inconsistent with this principle) and if needed a revised ruling to make this workable, and
- super funds should be in a position to maintain the form and function of an asset that has been acquired and the borrowing rules need to be given some flexibility to allow this.

- **ATO initial response**

- **Drawdown of existing borrowing**

A drawdown to fund a repair to an acquirable asset within a limited recourse borrowing arrangement is a new borrowing: see Self Managed Superannuation Funds Ruling SMSFR 2009/2 at paragraph 93:

93. The Commissioner also considers that each drawdown of funds from a loan facility or similar arrangement constitutes a separate borrowing, even if the facility or arrangement makes provision for redraws arising from earlier repayments.

We agree that it follows that each borrowing under the arrangement must meet the requirements of paragraphs 67A(1)(a) to (f). However in applying those tests the arrangement as a whole should be considered, rather than each separate borrowing under that one arrangement. We do not think there is a particular difficulty in treating a drawdown to make repairs to the acquirable asset as a separate borrowing as long as the arrangement as a whole meets those requirements.

In respect of the application of the test in paragraph 67A(1)(a), the word ‘including’ indicates that subparagraph (i) operates to expand the ordinary meaning of paragraph (a). For the purposes of satisfying paragraph 67A(1)(a) it is sufficient if the borrowed money is used to repair the acquirable asset, whether the money is borrowed at the commencement of the arrangement or subsequently.

Consistently with looking at the arrangement as a whole, the references to the ‘acquirable asset’ in paragraphs 67A(1)(b) to (f) in these circumstances are references to the original asset (or its replacement) under the arrangement. We do not regard the repair, or any

materials or services used as an incident of that repair, to be an acquirable asset in their own right.

- **Initial repairs**

The EM to the Superannuation Industry (Supervision) Amendment Act 2010, which inserted the new sections 67A and 67B, says (at paragraphs 1.31 and 1.32):

1.31 Item 8 inserts subparagraph 67A(1)(a)(i) to clarify that money under a limited recourse borrowing arrangement applied for the acquisition of an asset can be used for expenses incurred in maintaining or repairing the asset, to ensure that its functional value is not diminished, but not to improve the asset, as this would fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the fund.

1.32 The terms ‘maintain’, ‘repair’ and ‘improve’ have their ordinary meanings.

The discussion of ‘initial repairs’ in Taxation Ruling TR 97/23 Income Tax: deductions for repairs concerns the tax deductibility of putting in good order a capital asset acquired for income producing purposes (in respect of deterioration which occurred before acquisition). The primary issue in the discussion is differentiating capital and revenue expenditure for tax purposes. We do not think that whether the deterioration occurred before or after the time acquisition is determinative of whether the SISA permits a borrowing to rectify that deterioration.

Rather, we should look at whether the activity is a repair according to its ordinary meaning as compared to an improvement. The discussion in TR 97/23 on the ordinary meaning of ‘repair’ at paragraphs 83 to 87 is relevant:

83. The word ‘repairs’ is not defined in the Act. In its context in section 25-10, the word ‘repairs’ bears its ordinary meaning. According to The Shorter Oxford English dictionary, ‘repair’ means:

‘Restoration of some material thing or structure by the renewal of decayed or worn out parts, by refixing what has become loose or detached; the result of this.’

84. Osborn’s Concise Law dictionary, 8th edition, defines ‘repair’ as:

‘The making good of defects in a property which has deteriorated from its original state. The work required may involve curing defects arising from the defective design or construction of the building, but it must fall short of effectively reconstructing the premises or improving them.’

85. Many judicial decisions make it plain that ‘repair’ involves the making good of defects, damage or deterioration including the renewal of parts and that the word does not imply a total reconstruction: see Stroud’s Judicial dictionary. In BP Oil Refinery (Bulwer Island) Ltd v. FC of T 92 ATC 4031 at 4039; (1992) 23 ATR 65 at 73, the Federal Court of Australia (Jenkinson J) expressed the opinion that ‘work will not be considered repair unless it includes some restoration of something lost or damaged, whether function or substance or some other quality or characteristic’.

86. Repair, as the word is commonly understood, does not depend on whether much is done or only a little. Lord Macnaghten said in the House of Lords decision in *Hoddinott v. Newton, Chambers & Co Ltd* [1901] AC 49 at 54:

‘A man does not usually wait to repair his house until it is altogether ruinous and on the point of falling to pieces.’

87. What is a ‘repair’ for the purposes of section 25-10 is a question of fact and degree in each case having regard to the form, state and condition of the particular property and its functional efficiency when the expenditure is incurred (per Buckley LJ in *Lurcott v. Wakely & Wheeler* [1911] 1 KB 905 at 924) and to the nature and extent of the work done. ‘Repair’ may involve renewal or replacement of subsidiary parts to some degree and may involve improvement but only to a minor and incidental extent.

- **Meeting discussion**

The chair explained the ATO’s initial response and opened it up for discussion.

One member suggested that this question raises a policy issue concerning the reason for treating repairs and improvements differently. Whether a particular outlay repairs an asset or improves an asset, the money spent is necessarily subjected to the risks arising from any future default on the loan. As such it isn’t clear why a repair is acceptable and an improvement is not.

The ATO stated that, nevertheless, the law states clearly that you can’t use borrowed funds to make improvements to a property but can use borrowed money in maintaining or repairing the asset.

The ATO was then asked if you can use the SMSF’s own money to make improvements.

A member asked if the ATO’s interpretation was that if you improve your asset it is a new asset. The ATO stated that an improvement may change the state or nature of the asset such that it will give rise to different asset to the single acquirable asset that was the subject of the arrangement. This would be the outcome regardless of the source of the funds used to improve the asset. As the rights of the lender under the arrangement must be limited to rights relating to the single acquirable asset, or a replacement asset (as defined in section 67B) no money can be used to improve the asset if the improvement results in a different asset.

A member asked what happens if the asset acquired with the loan is land and building and the building burns down?

The ATO suggested that it would have expected the insurance money to be used to pay out or reduce the loan. The parties would then need to consider their rights under the existing arrangement or starting a new arrangement for any new asset to replace the destroyed asset.

A member suggested that the insurance contract may prohibit the use of the policy proceeds in that way and that the insurance company may require construction of a new building.

Another member pondered how tenant’s improvements might affect the situation. There was then some discussion amongst members of the respective rights of landlords and tenants to improvements made by tenants.

The ATO reiterated that once you acquire the relevant single acquirable asset, the law clearly states you cannot borrow further money to improve the asset. Further, the Explanatory Memorandum clearly states that the rationale for this approach is that the improved asset becomes a replacement asset: see paragraph 1.29. There is a clear policy intention not to allow borrowed funds to be used for improvements.

## **5.4 What is a Single Acquirable Asset**

- **Issue raised**

What is meant by the requirement that borrowed money be used to purchase a ‘single acquirable asset’ or ‘collection of identical assets’?

- **Background information**

The new s 67A requires that the borrowed money is used to acquire a ‘single acquirable asset’.

Real property sometimes comprises several legal titles. For example, a strata title unit might also have an accessory car park. In some jurisdictions it might not be possible to deal with one title without also dealing with the accessory titles.

Similarly, a commercial premises that is effectively one asset might be comprised of several titles for historical or other reasons. Commonly the property will be sold under one contract of sale between the vendor and purchaser as part of the same dealing.

If a narrow interpretation of ‘asset’ is adopted, this means that a trustee must take out a separate loan for each title to the property. There would also need to be a separate declaration of trust prepared for each title.

- **Industry view/suggested treatment**

For the reasons outlined under question 1 above, it is submitted that ‘asset’ should be given an in substance meaning.

A strata title with an accessory car park, or commercial premises comprising multiple titles, is practically and commercially treated as one asset. It is arguably not the intention of the SISA to require parties to maintain separate borrowings and trusts due to technicalities in legal title where the thing being acquired is effectively one asset. A narrow interpretation of the legislation produces an extreme outcome for a trustee who simply borrows to purchase real estate in an arm’s length transaction conducted in accordance with usual commercial practices.

- **ATO initial response**

We agree that we should take a practical approach to the test in paragraph 67A(1)(a).

That is not to say that we think it is possible to create a limited recourse borrowing arrangement so that separate assets are drawn together into a permitted single acquirable asset through the force of the terms of the arrangement. As noted in the response to question 1, we



do not think sub-divided land satisfies the test in section 67A whatever the terms of the limited recourse borrowing arrangement.

However in cases where assets are for practical purposes indissociable (inseparable), or where there is an incidental ancillary asset of a very small value, we will not treat the test in paragraph 67A(1)(a) as violated.

For example, the ATO accepts that, for an arrangement to acquire real property, the fact that the property acquired is subject to a lease should not be taken to cause the arrangement to fail the requirements of section 67A. This approach is supported by paragraph 1.14 of the Explanatory Memorandum (the EM) to the Superannuation Industry (Supervision) Amendment Act 2010 which says:

‘For the purposes of section 67A, the lease itself should not be considered as a separate asset as long as it is dealt with together with the property under the arrangement (and therefore does not need to satisfy the requirements of subsection 67A(3))’.

Similarly, the ATO takes the view that the existence of a lease in these circumstances should not be taken to cause the ‘only property’ test in paragraph 71(8)(c) to be failed.

We do not think that the examples given (a strata title with an accessory car park, and a commercial premises over more than one title) necessarily fall into a particular category. We would need to consider the facts of a particular case to make a decision. In cases where the test in paragraph 67A(1)(a) is not satisfied there would need to be separate limited recourse borrowing arrangements in respect of each acquirable asset.

- **Meeting discussion**

The chair summarised the ATO’s initial response and invited discussion on those aspects of the issue that had not already been addressed to some extent in the discussion of agenda item 6.1.

A member again referred to the example of commercial premises where there is a building on one title and a car park, as required by zoning laws, on an adjoining lot under a separate title and asked if the car park would be treated as a separate asset.

Another member referred to the example of one building across two separate titles.

The ATO noted its responses to similar scenarios at agenda item 6.1 and again noted that the question of whether certain assets would be treated as a single acquirable asset would depend on the facts and circumstances of the individual case.

## **5.5 Subdivision of Land and SMSF Borrowing - NTLG Minutes**

- **Issue raised**

Whether a single title to land which has been purchased under a limited recourse borrowing may be sub-divided while the loan is still being repaid and while the land continues to be held on trust?



- **Background information**

The explanatory memorandum (EM) to the Superannuation Industry (Supervision) Amendment Act 2010 (SISA), which inserted the new sections 67A and 67B, states that a series of titles over land replacing a single title over land that has been sub-divided is not a permitted ‘replacement asset’.

This implies or assumes that land sub-division creates a new and different ‘asset’. However, there is no discussion in the EM of what is an ‘asset’ for SISA purposes.

If the sub-division lots are a different asset to the original land, this might cause non-compliance with section 67A(1)(b) to (f) because those features of the arrangement are no longer in respect of ‘the acquirable asset’. The in-house assets exemption in section 71(8) could also be jeopardised as the only property of the trust is no longer ‘the acquirable asset’.

It is accepted that real estate cannot meet any of the permitted ‘replacement assets’ in section 67B, which are limited to certain shares and units. The issue is whether sub-division of land creates a new or different ‘asset’ in the first place.

- **Industry view/suggested treatment**

Asset is defined in section 10 of the SISA as ‘any form of property’. Case law indicates that the meaning of ‘property’ depends on the relevant statutory context. Stamp duty cases suggest that land, once sub-divided, is not the same property as the original land (*Sportingcorp Australia Pty Ltd v. Chief Commissioner of State Revenue* (2004) 213 ALR 795; *Growing Wealth Pty Ltd v. Commissioner of Stamp Duties* [2000] QCA 418; *Commissioner of State Revenue v. Pattison* (2001) 3 VR 520).

This is due to a difference in the property rights before and after sub-division (that is, the legal rights in the old land are cancelled and new rights in the sub-divided land are created). It is submitted that this technical property law analysis is not what is meant by ‘asset’ for SISA purposes.

On the other hand, cases on the GST margin scheme treated sub-divided lots as the same property as the original land (*Brady King Pty Ltd v. Commissioner of Taxation* (2008) FCAFC 118, *Sterling Guardian Pty Ltd v. Commissioner of Taxation* (2005) 220 ALR 550). This is in the context of the definition of ‘real property’ in the GST legislation (to which the courts appear to take a more practical and commercial approach).

It is submitted that ‘asset’ (and the associated term ‘property’) in the SISA are terms which refer to the substance of the thing being acquired and not its strict technical legal form. The object of the SISA is the prudent management of superannuation funds. It is consistent with this object that ‘property’ and ‘asset’ have an in substance meaning so that activities of fund trustees that involve what are effectively ‘assets’ are properly regulated (and so that the SISA does not inadvertently apply to activities which technically involve dealings in property in a strict legal sense but not in any commercial or practical sense).

The Commissioner has previously stated that property has ‘a very wide meaning’ and includes ‘every type of right, interest or thing of value that is legally capable of ownership’ (paragraph 10 of SMSFR 2010/1). However, in administering the provisions of the SISA, the

Commissioner, correctly, appears to take an in substance approach as to what constitutes an asset or property. For example, in analysing whether an asset is acquired for section 66 purposes, the Commissioner states ‘it is appropriate to characterise the acquisition by considering the substance of the transaction rather than taking an overly legalistic approach to the transaction’ and this includes not ‘unduly focussing on any rights acquired’. He also states that ‘while many transactions involve rights, an acquisition is of rights only if the substance of the transaction is rights’ (paragraph 110 to 113 of SMSFR 2010/1).

Consistent with the above comments, it is submitted that sub-divided land is, in substance, the same ‘asset’ as its original title. If the regulators focus on the technical difference in the property rights before and after sub-division, this could arguably amount to ‘unduly focussing on any rights acquired’.

It is further noted that there is no mischief in sub-dividing property which is the subject of a limited recourse borrowing arrangement, provided the consent of the lender can be obtained and the fund’s trustee complies with all other superannuation laws (such as ensuring the activities give effect to the fund’s properly formulated investment strategy).

As a related matter, there is an argument that section 71(8) is not relevant to many common borrowing arrangements and therefore does not need to be met. That section provides an exception if the fund’s investment in the trust holding the asset would otherwise be an in-house asset. One view is that if the land is held on ‘bare trust’, section 71(8) is not relevant because the fund trustee has not ‘invested in’ a trust and there is no possible in-house asset. The fund trustee does not hold any interest in the trust (but instead the land is simply held by another entity on bare trust).

- **ATO initial response**

A single title to land which has been purchased under a limited recourse borrowing arrangement entered into on or after 7 July 2010 if sub-divided while the loan is still being repaid and while the land continues to be held on trust in the arrangement would cause a contravention of subsection 67(1) of the SISA in respect of the maintenance of the borrowing.

## **Explanation**

- **Sub-division of land**

We agree that the ATO should look to adopt an available interpretation of the law that best promotes its underlying policy intent. The ATO may have regard to EM to confirm the meaning of a provision taking into account its context and the underlying purpose or object of the relevant law.

That purposive approach to interpreting the law is the basis for adopting the ‘in substance’ approach referred to above in relation to Self Managed Superannuation Funds Ruling SMSFR 2010/1 concerning acquisitions from related parties.

Section 67A of the SISA requires that the asset within a limited recourse borrowing arrangement to be a ‘single acquirable asset’ and that the reference to the single acquirable asset does not include a reference to an asset or assets that replace the original asset except as

provided for in subsections 67B(3) to (8) (none of which apply to sub-division of land). The legislation provides that a 'single acquirable asset' may consist of a collection of identical assets that have the same market value that 'within the arrangement are seen and treated as a whole' (refer to subsection 67A(3) and the Explanatory Memorandum (the EM) to the Superannuation Industry (Supervision) Amendment Act 2010, which inserted the new sections 67A and 67B, at paragraph 1.13).

In the submission it is suggested that sub-divided land could potentially be viewed as still being the original asset, at least in circumstances where the sub-divided land is treated together within the arrangement as a whole, based on an 'in substance' approach together with a wide meaning of 'asset'. It is suggested that to do otherwise may, at least in some cases, be unduly focussing on any rights acquired and not in accordance with policy intent. However we do not think that interpretation of section 67A of the SISA is available in respect of sub-divided land, nor do we think that such a result would be in accordance with stated policy.

The EM states that the intent of the new legislation is, among other things, to address the practice of 'borrowing arrangements over multiple assets which can potentially allow the lender to choose which assets are sold in the event of a default on the loan'. (paragraph 1.4) The EM states that 'asset' should be read so that 'it is not interpreted as permitting borrowing arrangements over multiple non-identical assets' (paragraph 1.10). There is nothing in the statute or the EM to suggest that prosecuting an arrangement in such a fashion that multiple non-identical assets are treated together as a whole is to be regarded as itself sufficient to bring the arrangement within the requirements of section 67A. There are, however, statements in the EM that suggest a contrary intention. For example paragraph 1.13 of EM suggests that for a collection of assets to be acceptable it must be treated as a whole and each member of the collection must be identical and have the same market value at any given time and that the collection must be dealt with as a whole (for example, a collection of identical shares must be sold as a whole and not sold down over time). Holding title to several pieces of real property is not regarded as meeting this test. At paragraph 1.12 the EM cites 'a collection of buildings each under separate strata title, irrespective of whether the buildings are substantially the same at the time of acquisition' as an example of a collection of assets that are not permitted and notes that 'a collection of such assets would rarely have the same market value over time'.

These statements and others in the EM indicate that sub-division of land within a limited recourse borrowing arrangement (that commenced on or after 7 July 2010) is not permitted. The fact that the term 'asset' is widely defined for the purposes of the SISA (subsection 10(1)) does not of itself suggest that a collection of assets which the parties to an arrangement agree to treat as a whole should necessarily be treated as a 'single acquirable asset' for the purposes of section 67A.

#### • Subdivision of land

One member stated that while he did not necessarily disagree with the ATO's answer, he thought it interesting that the EM to the limited recourse borrowing amendments equated title to land as an asset. He said the issue should not be whether there are separate titles as the title merely describes a particular asset. So when one parcel of land with a particular description (that is, described by reference to one title) is subdivided, the subdivision results in the

creation of several different titles which is simply a different way to describe the original asset.

The ATO confirmed that its initial response adopted a similar approach to that in the EM, that is, that the legal title is relevant. It does not matter that all of the titles of the subdivided land together describe the same physical asset as the land described by the original title. Further, once a parcel of land is subdivided, the subdivision results in a number of separate assets which were not identical to each other. They cannot be a replacement asset as defined in the law.

The chair went through the ATO's initial response and opened it up for discussion.

A member posed a question concerning rural property, particularly farm land. The member pointed out that what is commonly perceived to be one farm is often actually comprised of two or more different parcels of land and the title to one parcel may be of a different kind to that of another parcel.

The ATO stated that as farms may comprise of a number of separate assets, it is likely to be necessary to consider whether separate limited recourse borrowing arrangements must be constructed around each asset.

Members identified a range of situations where what might be considered in common parlance to be one asset actually comprises the aggregation of different legal titles including:

It is not uncommon to find a factory or other commercial premises built over 2 separate titles of land yet a purchaser would consider that they are acquiring one asset.

It is not uncommon to find that a residential property is built over two separate freehold or leasehold interests in land

- o a client recently acquired 1 floor of a commercial building but the single floor comprised 2 separate titles
- o a car park in an apartment building is usually on a separate title from the apartment
- o a marina linked to an apartment or other residential property may constitute a separate asset.

The ATO stated that each case has to be considered on its individual circumstances. Whether the assets are to be treated as a single asset or as separate assets could only be determined on a case by case basis. There are some scenarios in relation to indissociable assets discussed in the response to agenda item 6.3.

## **5.6 Holding Trust = Bare Trust or Fixed Trust**

- **Bare trust**

The submission makes reference to the application of subsection 71(8) of the SISA and states that 'One view is that if the land is held on 'bare trust', section 71(8) is not relevant because the fund trustee has not 'invested in' a trust and there is no possible in-house asset.'

The concept of a bare trustee was described by Gummow J in *Herdegen v. Federal Commissioner of Taxation* 88 ATC 4995 (the *Herdegen* case) at 5003 as follows ‘those trustees who have no interest in the trust assets other than that existing by reason of the office and legal title as trustee and who never have had active duties to perform or who have ceased to have those duties, such that in either case the property awaits transfer to the beneficiaries or at their direction.’

Under general law the consideration of whether a trust is a bare trust is relevant to whether the beneficiary is entitled to take possession of the trust property. The expression is also used in various statutes where it must be read in context. In particular statutory contexts the term has been read down to include trusts that, while not strictly a bare trust based on the concept expressed by Gummow J, are in the nature of a bare trust. The term is not used in the SISA.

A holding trust in a limited recourse borrowing arrangement that has a feature that the holding trust trustee has granted a charge over the land (the acquirable asset) to the lender under the arrangement is not strictly a bare trust for that reason alone. This is because contingencies exist, beyond the trustee’s lien over the trust property for costs properly incurred in performance of the obligation to safeguard the trust property, which are relevant to transferring the trust property to or at the direction of the SMSF trustee.

The scope of the term ‘investment in a related trust’ in subsection 71(1) of the SISA is broad. For example, the specific exclusion for excluded instalment trusts in the SISA (relating to investments in instalment receipts) implies that an interest in an excluded instalment trust is otherwise an investment in a related trust for the purposes of the SISA.

Without implying that the answer necessarily hinges on whether a holding trust is a bare trust, the term ‘investment in a related trust’ encompasses an SMSF trustee’s interest in a holding trust under a limited recourse borrowing arrangement to acquire land.

- **Meeting discussion**

- **Bare trust**

One member strongly urged the ATO to reconsider its view that the security trust is not a bare trust. In support of the alternative view, it was submitted that the security trustee’s duty is only to act according to the terms of the trust and this therefore makes the security trust a bare trust.

The existence of a charge over the asset held in the security trust does not alter the nature of the trustee’s duties to the beneficiary. This is so even while the loan is on foot. The security trustee owes a duty only to the trustee of the superannuation fund and not to the lender. The trustee of the superannuation fund could demand the transfer of the asset at any time. If the asset was transferred, the title to the asset would remain subject to the lender’s charge.

The ATO should also review its position that there is an investment in the trust. The trust is a relationship not an investment. This issue is particularly significant for large funds which hold assets through nominee entities that are related parties.

## **5.7 Granting a Charge over a Holding Trust Asset – ATO ID 2010/185**

- **Issue**

If the trustee of the holding trust in a limited recourse borrowing arrangement grants a charge over the asset in the holding trust in favour of a person other than the lender under the arrangement, does that result in the trustee of the self managed superannuation fund (SMSF) contravening subsection 67(1) of the Superannuation Industry (Supervision) Act 1993 (SISA)?

- **Decision**

Yes because the arrangement, which was entered into on or after 7 July 2010, fails to meet requirements of section 67A of the SISA.

- **Facts**

The trustees of an SMSF enter into a borrowing arrangement on 15 July 2010. Under the terms of the arrangement, a corporate trustee of a holding trust will acquire a residential property from a party unrelated to the SMSF. The trustees (that is, members) of the SMSF will be the directors of the corporate trustee of the holding trust.

To facilitate the acquisition one member of the fund borrows money from a financial institution and on-lends the money to the SMSF for investment into the holding trust.

Under the terms of the arrangement the corporate trustee of the holding trust holds the residential property on trust for the SMSF subject to a charge in favour of the financial institution to secure the loan to the member.

- **Reasons for Decision**

Regulated superannuation funds are generally prohibited from borrowing money or maintaining a borrowing of money by subsection 67(1) of the SISA unless the borrowing satisfies one of the exceptions provided for by section 67 of the SISA.

One such exception is provided for by section 67A of the SISA (applying to limited recourse borrowing arrangements entered into on or after 7 July 2010).

As this arrangement was entered into on 15 July 2010 the requirements of section 67A of the SISA apply. Paragraph 67A(1)(f) of the SISA requires that the asset being acquired under the arrangement must not be subject to a charge other than in relation to the borrowing by the SMSF trustee. The charge is granted to secure the borrowing by the member from the financial institution, rather than the borrowing by the SMSF trustee from the member. Therefore, the arrangement in this case fails the requirement of paragraph 67A(1)(f) of the SISA.

Date of decision: 20 July 2010

## **15.8 Joint Borrowers - ATO ID 2010/172**

- **Issue**

Did the trustees of two self managed superannuation funds (SMSFs) who jointly borrowed under a limited recourse borrowing arrangement involving a single holding trust, contravene subsection 67(1) of the Superannuation Industry (Supervision) Act 1993 (SISA)?

- **Decision**

Yes, because the arrangement, entered into before 7 July 2010, did not meet the requirements of former subsection 67(4A) of the SISA.

- **Facts**

The corporate trustees of two SMSFs jointly borrowed money under a limited recourse borrowing arrangement. The arrangement was entered into on 15 June 2009.

Under the arrangement, legal title to a residential property is acquired by the trustee of a holding trust from a party that is not related to either SMSF using the money provided from the SMSF trustees. The property is leased to a party not related to either of the SMSFs.

The property is mortgaged to the lender.

Each SMSF trustee is an equal beneficiary of the holding trust and is entitled to an equal share of the income of the trust.

Each SMSF trustee has repayment obligations. It is a term of the arrangement that in the event of a default by either of the SMSF trustees the arrangement is terminated. On termination the property is sold with any excess proceeds, after meeting the obligations to the lender and other costs of the arrangement, returned to the investors. The lender has no recourse other than to the real property in the arrangement.

On completion of the arrangement (repayment of the borrowing), the SMSF trustees acquire joint legal title to the real property held as tenants in common.

- **Reasons for Decision**

Regulated superannuation funds are generally prohibited from borrowing money or maintaining a borrowing of money by subsection 67(1) of the SISA unless the borrowing satisfies one of the exceptions provided for by section 67 of the SISA. One such exception is provided for by former subsection 67(4A) of the SISA (applying to limited recourse borrowing arrangements entered into before 7 July 2010).

Former subsection 67(4A) of the SISA requires an arrangement with a structure that meets the conditions listed in former paragraphs 67(4A)(a) to (e) of the SISA. Former paragraphs 67(4A)(a) and (b) require that under the arrangement the original asset or its replacement is held on trust and that the SMSF trustee must have acquired a beneficial interest in that asset.

Former paragraph 67(4A)(c) of the SISA further requires that the SMSF trustee must have the right to acquire legal ownership of that asset on making one or more payments. This requires a structure where the investor has an interest through the holding trust in the trust asset ultimately to be acquired by the SMSF trustee under the arrangement.



In this particular arrangement, the asset held by the holding trust is sole title to the residential property. However, the asset that the SMSF trustee intends ultimately to acquire is a partial interest in that residential property, namely an interest as tenant in common with the other SMSF investor.

The arrangement fails to meet the test in former paragraphs 67(4A)(a) and (b) of the SISA because the interest ultimately to be acquired as a tenant in common with the other SMSF trustee is not the same interest that is acquired and held on trust by the holding trust trustee.

The arrangement also fails to meet the requirements of former paragraph 67(4A)(c) of the SISA because the SMSF trustee does not have a right to acquire sole legal ownership of the real property held in the holding trust on making one or more payments. Rather, the SMSF trustee has a right, contingent on repayment of the borrowings by both investors, to acquire legal ownership of a partial interest in the property held as tenant in common with the other investor.

The decision would be the same under section 67A of the SISA for an arrangement entered into on or after 7 July 2010.

Date of decision: 15 July 2010

## **5.9 Borrowing on favourable terms**

### **• Issue**

Does a self managed superannuation fund (SMSF) trustee contravene section 109 of the Superannuation Industry (Supervision) Act 1993 (SISA) if it borrows money from a related party of the SMSF under a limited recourse borrowing arrangement on terms favourable to the SMSF?

### **• Decision**

No. The terms cannot be more favourable to the related party than would have been the case had the parties been dealing at arm's length, but there is no contravention of section 109 of the SISA if the terms are more favourable to the SMSF.

### **• Facts**

An SMSF trustee has entered into a limited recourse borrowing arrangement on 1 June 2009. The arrangement meets the requirements of former subsection 67(4A) of the SISA.

- The arrangement is to acquire an income producing asset for the SMSF.
- The lender under the borrowing arrangement is a related party of the SMSF.
- The interest rate imposed under the borrowing arrangement is lower than the rate that would be available to the SMSF from an arm's length lender for an otherwise similar loan.



- Apart from the interest rate charged, the borrowing is on arm's length terms and conditions and is supported by appropriate documentation and record keeping.

- **Reasons for Decision**

'Invest[0]' is defined in subsection 10(1) of the SISA to mean applying assets in any way, or making a contract, for the purpose of gaining interest, income, profit or gain.

When entering into the limited recourse borrowing arrangement the SMSF trustee is investing for the purposes of section 109 of the SISA.

Subsection 109(1) of the SISA imposes requirements with respect to relevant transactions for investments made by SMSFs.

In particular paragraph 109(1)(b) of the SISA applies where the other party to the transaction is not at arm's length to the SMSF. The provision requires 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.

Borrowing money under the limited recourse borrowing arrangement is a transaction entered into in the course of making an investment by the SMSF. It is therefore a transaction to which paragraph 109(1)(b) of the SISA applies where the other party is not at arm's length to the SMSF.

It is expected that establishing the arrangement, including establishing the borrowing, would be documented and conducted in a business-like manner in the same way as an arrangement when dealing with an arm's length lender.

The borrowing entered into by the SMSF trustee in this case entails no contravention of paragraph 109(1)(b) of the SISA because the terms and conditions of the borrowing are not more favourable to the other party than would be reasonably expected if the parties were dealing with each other at arm's length.

Date of decision: 9 September 2010

## **6. Stamp Duty on SMSF Borrowings**

### **6.1 Victoria State Revenue Office advice**

The SRO has recently reviewed the stamp duty implications of 'instalment warrant' arrangements. It is expected that instalment warrants will be extensively used by the superannuation industry (in particular, self managed superannuation funds) to purchase dutiable property.

These arrangements have evolved as a result of amendments to the Commonwealth legislation controlling self managed superannuation funds (SMSF), which now permit a SMSF to borrow money for the purpose of purchasing real estate.

The SRO has reviewed a number of sample deeds and documents used to effect such arrangements and is of the view that they do not necessarily effect an instalment warrant

arrangement as it is normally understood for the purposes of the Superannuation Industry (Supervision) Act 1993 (SIS Act). Rather, the SRO is of the view that the sample documents it has sighted effect a traditional financing arrangement in the purchase of real estate.

Whilst there are a number of different methods by which financing arrangements of this type may be effected, the SRO understands that one of the more common structures involves:

- The SMSF provides all of the deposit monies and the balance of the purchase price for the land (the Property) from a combination of SMSF assets and borrowings from a financial institution (the Lender).
- The trustee of the SMSF is the only borrower under a finance agreement.
- A person other than the trustee of the SMSF (the Custodian) acquires the Property using the money provided by the SMSF, pays duty on the acquisition and is registered as the legal freehold owner on title.
- The Custodian executes a declaration/acknowledgment of trust that the Custodian holds the Property on a fixed trust or bare trust for the SMSF.
- The Custodian grants the Lender a limited recourse mortgage on the terms required by the Lender over the Property.
- The Custodian retains legal title to the Property until the borrowing from and mortgage to the Lender is fully discharged by the SMSF and then the unencumbered title is transferred absolutely to the trustee of the SMSF.

The Property is post-2006 land as defined in section 3 of the Land Tax Act 2005, as section 67A(4A) of the SIS Act only came into effect from 24 September 2007.

Whilst all matters submitted to the SRO for assessment are assessed on their specific facts, it is anticipated that any deed or document used to effect the type of arrangement that is described above will be assessed for duty on the following basis:

The initial purchase of the Property by the Custodian on behalf of a SMSF is a dutiable transaction pursuant to section 7(1)(a) of the Duties Act 2000 (the Duties Act). Accordingly it will attract duty at ad valorem rates at the time the Property is transferred to the Custodian.

Subsequently, the Custodian will declare that it is holding the Property on trust for the trustee of the SMSF. In this instance, section 7(1)(b)(i) of the Duties Act charges duty on declaration of trust relating to dutiable property the specification of which forms part of the declaration of trust or part of the transaction constituted by the declaration of trust. Accordingly, in the absence of an exemption, section 7(1)(b)(i) of the Duties Act would apply separately to charge duty on the declaration of trust made by the Custodian.

However, section 7(1)(b)(i) will not apply if it can be shown that the Custodian is merely holding the Property for the SMSF under a fixed or bare trust, in which case section 34(1)(a)(i) of the Duties Act will apply to exempt the declaration of trust from duty.

In order for section 34(1)(a)(i) of the Duties Act to apply, it must be shown that all monies for the purchase of a particular property have been provided by the 'real purchaser', as this

provides confirmation of the resulting trust relationship between the ‘apparent purchaser’ and the ‘real purchaser’. Information pertaining to the role of the ‘apparent purchaser’ in the transaction, the nature of the relationship between the parties and the specific wording of the trust deed may also be relevant in making a final determination.

Alternatively, if the transfer of the Property to the Custodian and the declaration of trust occurred contemporaneously, section 17 of the Duties Act may apply to exempt the declaration of trust from duty.

The final step of the arrangement is the ultimate transfer of the Property from the Custodian to the SMSF which is likely to occur upon discharge of the borrowings.

Depending on the particular facts of the arrangement, there are two possible exemptions which may apply at this stage:

Firstly, if the Commissioner has applied section 34(1)(a)(i) of the Duties Act to exempt the declaration of trust from duty, then section 34(1)(b) of the Duties Act would apply to the subsequent transfer of the Property to the SMSF.

Alternatively, section 36 of the Duties Act, may apply to exempt a subsequent transfer of the Property from the Custodian to the trustee of the SMSF if evidence is produced which proves that:

- duty was paid when the Property was acquired by the Custodian, and
- for the whole period from the time the trust was declared by the Custodian to the time when the Property was transferred to the trustee of the SMSF:
- the trustee of the SMSF was always the only beneficiary, and
  - the beneficiaries (who are natural persons) of the SMSF were always the only beneficiaries of the SMSF.

In addition, before section 36 could apply, the Commissioner of State Revenue must be satisfied that the transfer is not part of a sale or other arrangement under which there exists any consideration for the transfer.

## **6.2 WA Stamp Duty advice - Office of State Revenue**

A transfer of, or agreement for the transfer of, dutiable property to a superannuation fund, between superannuation funds, or from a superannuation fund to a member of the fund, may be chargeable with nominal duty under the Duties Act 2008 (‘Duties Act’) if certain conditions are satisfied.

The transaction record for the dutiable transaction should be lodged with the Commissioner of State Revenue and be accompanied by an application form – Application For Nominal Duty – Superannuation Fund Transactions, which is available from the Office of State Revenue website at [www.osr.wa.gov.au](http://www.osr.wa.gov.au).. (Please note: an application form is NOT required to be lodged for transfers from a superannuation fund to a member.)

### **Superannuation funds**

For the purposes of the Duties Act, the following bodies are superannuation funds:

- a complying approved deposit fund;
- a complying superannuation fund;
- an eligible rollover fund; and
- a pooled superannuation trust.

Definitions of the above bodies are included in the Duties Act and are taken from the Superannuation Industry (Supervision) Act 1993 (Commonwealth).

### **Transfer to a superannuation fund for consideration**

Where there is a transfer of, or an agreement for the transfer of, dutiable property to the trustee of a superannuation fund, nominal duty will be chargeable where the following conditions are satisfied:

- consideration is paid, or will be paid, for the transaction;
- either the transferor is the only member of the superannuation fund, or the property is held by the fund on behalf of the transferor such that no other member can obtain an interest in the property; and
- the property is held in the fund only to be provided to the transferor as a retirement benefit.

### **Subsequent liability**

A subsequent liability may arise where a transaction has met these conditions and a transaction record for the transaction has been duty endorsed, but at some time later an event takes place that means one (1) or more of the conditions cease to be satisfied ('the event'). If the superannuation fund still holds any of the dutiable property that was the subject of the transaction charged with nominal duty, the event will be taken to be a transfer of the dutiable property which is still held as part of the superannuation fund, and will be chargeable with duty.

The trustee of the superannuation fund must lodge a transfer duty statement for the event within two (2) months of the event. Contravention of this requirement is an offence which carries a maximum penalty of \$20,000.

### **Transfer to a superannuation fund without consideration**

A transfer of, or agreement for the transfer of, dutiable property to the trustee of an employer sponsored superannuation fund (as defined by the Superannuation Industry (Supervision) Act 1993 (Commonwealth)) is chargeable with nominal duty, provided that there is no consideration paid for the transfer. A transfer of, or agreement for the transfer of, dutiable property to the trustee of a self managed superannuation fund for no consideration will be chargeable with nominal duty if the fund is an employer-sponsored superannuation fund.

### **Transfer between superannuation funds without consideration**

A transfer of dutiable property from the trustee, or custodian of the trustee, of one superannuation fund to another, or between the trustee and the custodian of the trustee of a superannuation fund, may be chargeable with nominal duty, where the following conditions have been satisfied:

- the transfer is in connection with a person ceasing to be a member of, or otherwise losing their entitlement to a benefit from, a superannuation fund or an entity that was a superannuation fund in the period of 12 months prior to the transfer;
- the transfer is in connection with a person becoming a member of, or otherwise gaining an entitlement to a benefit from, a superannuation fund or an entity that will be a superannuation fund within 12 months of the transfer; and
- no consideration is paid for the transfer.

If the entity that is receiving the property is not a superannuation fund at the time liability to duty on the transfer arises, the application must be accompanied by a statutory declaration from the trustee (or a director of the trustee if it is a corporation) that in the opinion of the trustee (or director), the entity will be a superannuation fund within 12 months of the property being transferred.

However, the general rate of transfer duty will apply where the superannuation fund is a pooled superannuation trust.

### **Transfer between trustee and custodian of a superannuation fund**

Nominal duty is chargeable on a transfer of, or agreement for the transfer of, dutiable property between a trustee of a superannuation fund and a custodian of the trustee of that fund, or between custodians of a trustee of a superannuation fund, providing there is no change in the beneficial ownership of the property.

Nominal duty is also chargeable if the entity is not a superannuation fund at the time of the transaction, but will be within 12 months of the property being transferred. In this case, the application must be accompanied by a statutory declaration from the trustee (or a director of the trustee if it is a corporation) that, in the opinion of the trustee (or director), the entity will be a superannuation fund within 12 months of the property being transferred.

### **Transfer from a superannuation fund to a member**

Please note: an application form is NOT required to be lodged for a transfer from a superannuation fund to a member. Nominal duty is chargeable on a transfer of, or agreement for the transfer of, dutiable property from the trustee of a superannuation fund to a member of the fund if the following conditions are satisfied:

- the member was a member of the fund when the property was acquired; and
- the value of the property transferred does not exceed the member's entitlement in the fund;

and

- there is, or will be, no consideration for the transfer or agreement.

The general rate of transfer duty is chargeable on the amount that the unencumbered value of the dutiable property exceeds the value of the member's entitlement in the fund.

For example, if a member of a superannuation fund were to receive land from the fund with an unencumbered value of \$100,000 and the member's interest in the fund was \$75,000, the dutiable value for the transaction would be \$25,000.

### **6.3 NSW Stamp Duty Advice - OSR**

#### **Transferring Property into a SMSF including via a Holding Trust**

An amendment to section 54 extends a duty concession that applies to certain transfers of dutiable property that are made as a consequence of the retirement of a trustee or the appointment of a new trustee. Duty of \$50 will be charged on such a transfer that is made to a trustee of a self managed superannuation fund if the Chief Commissioner is satisfied that the transfer is not part of a scheme for conferring an interest on a new trustee or other person to the detriment of the beneficial interest or potential beneficial interest of any person. This amendment is taken to have commenced on 1 July 2010.

Amendments to section 61:

(i) extend an existing duty concession that applies to certain transfers of dutiable property that are made in connection with a person changing superannuation funds. The amendment provides for payment of duty at the concessional rate of \$500 on a transfer of marketable securities from the trustee of a superannuation fund, or a custodian of the trustee of a superannuation fund, made in exchange for the issue of units in a pooled superannuation trust to a trustee of the pooled superannuation trust where the transfer is made in connection with changing superannuation funds,

(ii) make it clear that the same concessions that apply to a transfer made in connection with a person changing superannuation funds also apply in respect of an agreement to transfer that is made in that regard, and that duty will be charged on both the agreement and the transfer at the concessional rate of \$500 (or the ad valorem rate, if lower).

The amendments to section 61 commence on 1 January 2011.

#### **Section 62A - Nominal Duty for Property Transfer**

New section 62A provides that duty of \$50 is payable on a transfer or an agreement to transfer dutiable property from a person to the trustee of a self managed superannuation fund, if:

- a) the transferor is the only member of the superannuation fund or the property is to be held by the trustee of the superannuation fund solely for the benefit of the transferor, and
- b) the property is to be used solely for the purpose of providing a retirement benefit to the transferor.

An amendment to section 62A provides for a concession in respect of a transfer of, or an agreement to transfer, dutiable property that is made to the custodian of the trustee of a self managed superannuation fund by the sole member of that superannuation fund. Duty is charged at the concessional rate of \$500. A further amendment provides that the concessional rate for transfers to a self managed superannuation fund does not apply if, as a result of the transfer, the fund ceases to be a complying superannuation fund. These amendments commence on 1 January 2011.

### **Holding Trust and Related Party Loan Agreements**

The Holding Trust needs to be stamped and the Trustee is liable for duty on trust property unless you can satisfy the commissioner that the SMSF has provided the funds to the Holding Trust. The OSR needs the letter of offer from the bank showing the SMSF is paying the funds or if related party loan the loan agreement.

### **6.4 Queensland Stamp Duty**

The creation or acquisition of a trust of dutiable property is liable for duty. However, a trust created by declaration or settlement of cash only, will not be liable for duty as the transaction does not involve dutiable property. Similarly, a trust deed establishing a superannuation fund without any dutiable property being settled upon the trustee will not be dutiable.

While deeds to these particular trusts verify their creation, the deeds do not need to be presented to us for stamping as they do not relate to dutiable transactions. Consequently, the Register of Titles has been advised that these deeds may be lodged directly with them, without a stamping notation.

Trusts or superannuation funds that are created with dutiable property are liable for duty, and should be lodged with us in the usual manner.

### **Qld Duties Act 2001 - \$500 Concession**

Section 123 Exemption—particular distribution of dutiable property to a beneficiary

(1) Transfer duty is not imposed on a dutiable transaction that is the transfer, or agreement for the transfer, of dutiable property to a beneficiary, or the surrender of a trust interest of a beneficiary, to the extent it represents the beneficiary's trust interest on a distribution by the trustee under a trust.

(2) However, subsection (1) applies only if the commissioner is satisfied—

(a) the dutiable property being distributed to the beneficiary—

(i) is the same property held on trust at the time the beneficiary acquired the beneficiary's trust interest; or

(ii) represents the proceeds of re-investment of property held on trust when the beneficiary acquired the beneficiary's trust interest in the trust;



and

(b) under this chapter—

(i) transfer duty imposed has been paid for the dutiable transactions that are the creation of a trust of the dutiable property or the trust acquisition of the beneficiary's trust interest; or

(ii) the transactions are exempt from transfer duty.

## 7. Press on SMSF Borrowing

### **SMSF gearing strategies on the rise - Set for 40pc growth over next year**

By Darin Tyson-Chan

SMSF Magazine

A new industry report has found the use of gearing in self-managed superannuation funds (SMSFs) more than doubled over the past two years and is expected to increase by a further 40 per cent in the coming year.

The Investment Trends 2010 SMSF Borrowing Report found in April 2010, 29,000 SMSFs were employing a gearing strategy compared to a total 13,500 SMSFs that were using gearing in July 2008. The jump represents a 115 per cent increase in under two years.

In looking towards the future, 75,500 SMSFs admitted they intended to acquire assets through the use of borrowings in the next 12 months. Investment Trends calculated this to mean around 41,000 SMSFs will have a gearing product in place in the next year, representing a rise of around 41 per cent compared to current levels.

“Gearing within SMSFs is a rapidly growing niche which appeals to between a fifth and a quarter of SMSFs,” Investment Trends analyst Recep Peker said. “While only a minority of SMSFs currently use geared investments, around 7 per cent, that proportion looks set to hit double digits over the next couple of years,” he added.

Of the assets SMSF members are purchasing through their gearing strategies, property remains the favourite.

Of those members already using gearing, 41 per cent have used it to invest in property with 30 per cent employing it to buy shares.

Of those people who indicated they will use gearing in the coming year, 50 per cent said they would acquire property with the borrowings and 27 per cent said they would buy shares.

Financial planners are becoming keener on recommending gearing strategies as well, with 67 per cent of respondents saying they intended to place at least one SMSF client into a



borrowing product in the coming year, up from 60 per cent of positive respondents to this question in June 2009.

The online study was conducted between March and June of this year and involved 1900 SMSF trustees, 470 financial planners and 470 accountants.

## **8. SMSF Borrowing and Estate Planning**

### **SMSF Borrowing is a Liability - What Happens on Death**

**By Shane Ellis – SMSF Law**

Please have a look at the diagram on the prior page. It shows in pictorial form what a SMSF Limited Recourse Borrowing arrangement looks like.

A SISA S67A borrowing has to:-

1. Apply the money to acquire a single acquirable asset including expenses like loan costs, expensive lawyer's fees, government stamp duty and registration fees, loan establishment fees (the banks never miss out) & any mortgage brokerage fees;
2. The single acquirable asset is held on trust so that the SMSF has a beneficial interest in it;
3. The Holding Trust has the legal ownership to the single acquirable asset which it holds as trustee for the SMSF;
4. The SMSF has the right to get legal ownership after making one or more payments after getting its beneficial interest;
5. The Lenders rights & anyone else are limited to the single acquirable asset;
6. The single acquirable asset is not subject to any other mortgage, lien, or encumbrance.

Banks never miss out. To lend anyone money in most instances banks take what is called "security" over the asset. In relation to real property that security is called a mortgage. They register their mortgage on the title to the land. The mortgage works together with the loan terms and conditions. Being a secured loan, if the SMSF doesn't pay, the bank can exercise its powers under the mortgage, and the state laws governing mortgages, by selling the single acquirable real estate asset to recover the monies owed to it. If it wasn't a limited recourse borrowing arrangement loan they could chase the person/entity who/which borrowed the money for any shortfall. They can't do this with SMSF's. Because it is a limited recourse borrowing arrangement the bank can't recover against the SMSF for any shortfall on the sale. They can only recover from the guarantors, who are usually the Mum & Dad who are members of the SMSF. Mum & Dad have to pay the shortfall out of their own pockets, or from selling their own assets.

So what happens from an SMSF Estate position if Mum or Dad die whilst the SMSF owns real estate that has limited recourse borrowings on it?

Well one of three things can occur. If there is NO insurance over the life of the deceased member then the loan continues on. If payments are met there is not a problem. If payments cannot be met then the bank will sell the property up to recover their loan monies. If there is a shortfall they will rely on their guarantee and ask the surviving member for the shortfall out of his/her own back pocket because the bank cannot make a further claim against the other SMSF assets that are not the single acquirable asset that has been sold. If there IS insurance over the life of the deceased member then the most common occurrence is for the insurance money to come in and to be applied to paying the loan off to the bank and getting legal ownership of the single acquirable asset transferred from the holding trust to the SMSF. Be careful as to where the insurance proceeds are paid in the SMSF. If they go to an insurance reserve they can be applied for the benefit of the SMSF members as is fair & reasonable. The surviving trustees would make such decisions because they would control the SMSF at that time. If though the funds went into the SMSF deceased members account they need to be applied in accordance with the deceased members SMSF Will or Binding Death Benefit Nomination. This may mean that the insurance funds may or may not be available to the surviving member's to pay out the SMSF bank loans. Care needs to be taken when setting up the SMSF limited recourse borrowing that member's life insurance is considered, as is the member's SMSF Estate Planning. What do Mum & Dad want to happen if one or both of them die, and do the SMSF Estate documents support their wishes or do they need to be amended to do so? The third alternative is of course for the SMSF to choose to sell the single acquirable asset and pay the bank back. Any shortfall the surviving members will pay for out of their back pocket, and any surplus gets paid into the SMSF as a capital gain on the sale of the asset. (Let's hope the SMSF is in pensions phase and pays no CGT!)

### **Is insurance necessary & what type?**

I would say that it would always be prudent for the SMSF to consider carrying insurance. Mortgage protection insurance paid at the time of establishing the loan sounds good but it covers the bank if the borrower defaults; it doesn't cover the borrower [SMSF] if they can't pay. You are basically paying the bank's insurance for them over your loan as part of the loan establishment costs and their terms & conditions of lending to you.

The SMSF should have fire & loss insurance over the single acquirable asset with a reputable insurer. Look at what some Queenslanders are putting up with after the floods. Did the insurance cover them or did the fine print win out! The bank usually notes their interest over this policy so that if the asset is lost and insurance is claimed and paid, the bank gets its share first to pay off the loan. Any surplus after the loan is repaid is paid to the SMSF. Same story as above if there is any shortfall. The loan guarantors' get called upon to pay.

Life insurance over the life of the members of the SMSF equal to or in excess of the SMSF borrowings is a wise thing if the cost of the policy is affordable. Unfortunately the older you get the more expensive the life policy is. If it can be afforded by the SMSF it might be a great idea. As noted above, what is to happen when this insurance is received must be considered NOW. The surviving members may have the ability to choose to pay out the loan from the

insurance proceeds and transfer the single acquirable asset outright from the holding trust to the SMSF. With no loan in existence the rent and other income goes into the fund and if in pension phase is usually tax free income.

### **If the liability can't be paid what happens?**

The single acquirable asset is a secured asset by the bank - for example real estate has a mortgage over it. If the SMSF doesn't pay the single acquirable asset gets sold to recover the loan monies. The only big difference between the limited recourse loan with SMSFs and other loans outside of SMSFs is that the bank cannot recover against the further assets of the fund if there is a shortfall. They recover from the guarantors own back pocket from assets outside of the SMSF.

The banks MUST comply with the laws of the state where the single acquirable asset exists. For example in Queensland the Property Law Act, 1974 provides for a document called a "Notice of Exercise of Power of Sale" to be served on the borrower giving them 30 days to rectify their default in relation to a mortgage over real estate or get sold up. Same old story then, any shortfall is recovered from the guarantors or surplus funds paid to the SMSF.

**A word of warning!** From our experience at SMSF Law it is always better to have the SMSF negotiate with the bank to sell the single acquirable asset rather than the bank selling it. The latter can be a fire sale and when potential buyers see the words, "Mortgagee Sale" they all turn into sharks! The property could be sold at a public auction with a return that could be less than via private treaty.

### **Related party loans- Estate –v- SMSF**

Basically transpose what was said above in relation to banks by replacing the word "Estate" for the word "bank". Sure family estates may be more sympathetic to deal with! Call me cynical, but about as sympathetic as an artichoke heart. Just look at the facts of Katz-v-Grossman where the sister took the whole of her father's \$1M SMSF estate to the exclusion of her brother by virtue of being the controlling trustee, OR Donovan-v-Donovan where the wife from the second marriage didn't have the warm & fuzzies for the deceased member's kids of the first marriage who missed out on the estate because the second wife was the controlling trustee of the SMSF.

The upside is that if the SMSF is not in default it can continue with the loan for the full term of the loan if it chooses to do so. The loan is a legal contract. Both the Estate & the SMSF would have to comply with the contractual terms of the loan documents. The downside is that often related party transactions can have some pretty favourable terms including low or no interest being paid by the SMSF, & sometimes these favourable terms can fall to the wayside by those who control the loan, namely the Estate. Be careful that the loan cannot be called up at any time by the Estate, or for the Estate to be able to call for a commercial rate of interest on what was previously an interest free/low interest arrangement. Prudent parties must really

think the worst could and will happen at the time the loan documents are created between related parties. Good lawyers are pessimists when advising their clients!

Apart from that the same story applies with insurance, default, etc in a related party loan as with a bank loan. You just have to carefully read what was agreed to as it may very well be applied when one of the members dies.

### **SMSF Law's Advice on SMSF Borrowing**

Our best advice is to prepare all documents if there are related party loans as if they will revert to arm's length commercial terms on a triggering event such as when Mum or Dad dies, or both passing away. The surviving member/s or Legal Personal Representative can then decide if they want to keep the property under such terms or sell it up.

Our best advice is to have life insurance to cover the loan amounts borrowed if it can be afforded by the SMSF, and of course for the SMSF Estate to cover what happens with the insurance proceeds when received.

Our best advice is to have your SMSF Advising Accountants & Financial Planners to work with a lawyer on the limited recourse borrowing as you may not be covered under their professional indemnity insurance to do such documents or to assist the SMSF Trustees put them in place. Shane said don't forget about the strict liability provisions of SISA S55. Make sure the SMSF Deed is up to date and covers the recent changes to the limited recourse borrowing laws. Use SMSF Strategies deed for this. His deed is up to date, as are his borrowing pack documents.

## **9. Section 67A and section 67B Legislation**

### **Section 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.