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# THE CURRENT STATE OF LIMITED RECOURSE BORROWING

**Michael Garrone**

**Partner - UHY Haines Norton**

# Background



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- Commenced 24 September 2007
- On 24 September 2007 – “Instalment Warrants” borrowing allowed for the first time - section 67(4A) of the SIS Act (**Old Law**)
  - Applied from 24 September 2007 to 6 July 2010
  - Continues to apply to pre 7 July 2010 arrangements (subject to a ‘refinance’ occurring)



# Background (cont.)

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- The new borrowing exception – sections 67A and 67B (New Law)
- Applies from 7 July 2010 onwards
- “Limited Recourse Borrowing”
- Can apply to pre 7 July 2010 arrangements where:
  - There is a refinance or
  - Deemed refinance - A change to the terms and conditions of the arrangement significantly alters its character

# Background (cont.)

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- Purpose of the New Law according to the EM:
  - Reducing the risks for superannuation funds
  - Resolve uncertainty
  
- Risks identified in the EM:
  - The use of personal guarantees
  - Multiple asset purchases – allowing lender to choose assets sold in the event of a default
  - Multiple differentiated assets could expose superannuation funds to greater risk
  - Arrangements where the asset subject to the borrowing can be replaced at the discretion of the SMSF or the lender



# Background (cont.)

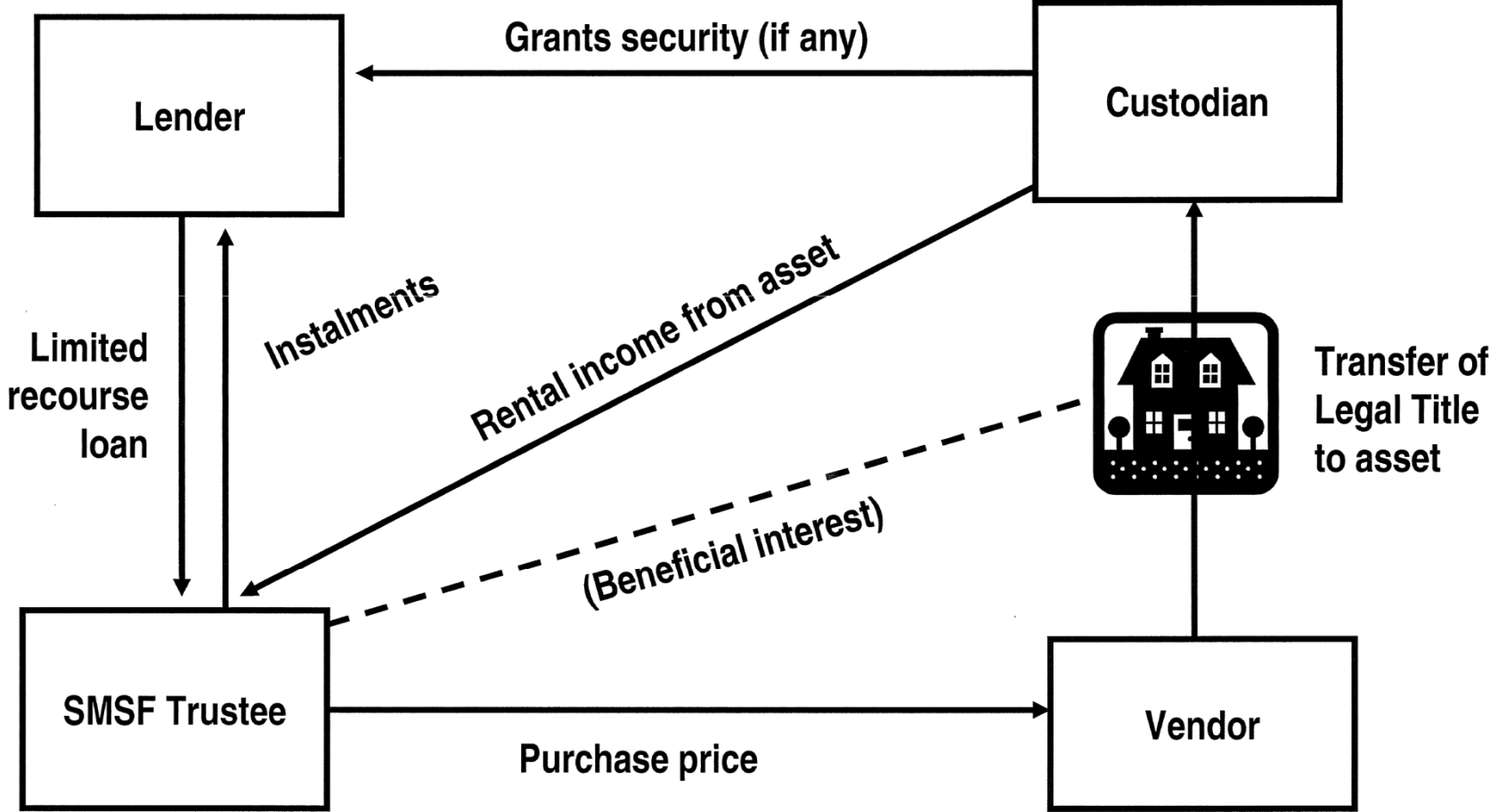
What else has happened

- ATO Q & A document last updated 29 July 2010
- Government announcements – Trust look through
- NTLG Minutes
- SMSFR 2011/D1
  - What is an “asset”
  - Borrowing for repairs
  - Improvements allowed
  - Examples of what you can and cannot do

# Typical structure – direct borrowing



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# The borrowing exceptions – old and new



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| <b>Old Law (section 67(4A))</b>  | <b>New Law (s 67A and 67B)</b>   |
|--|--|
| SMSF Trustee borrows money (or maintains a borrowing of money)           | No change  |
| Borrowed money must be applied for the acquisition of an asset ((assets) | Borrowed money must be applied for the acquisition of a <b>single acquirable</b> asset   |
| No express equivalent  | Borrowing can be applied for <ul style="list-style-type: none"><li>▪ Expenses incurred in connection with the borrowing or acquisition</li><li>▪ Expenses incurred in maintaining or repairing the asset but not improving the asset</li><li>▪ Refinancing an existing borrowing</li></ul> |

# The borrowing exceptions – old and new (cont.)



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| <b>Old Law (section 67(4A))</b>   | <b>New Law (s 67A and 67B)</b> |
|---|--------------------------------|
| The asset must be one which the Trustee could acquire directly under SIS and other law  | No change                      |
| No express equivalent   | The asset cannot be money      |
| The asset must be held by another party ( <b>Custodian</b> ) on trust so that the SMSF Trustee acquires a beneficial interest in the asset (or replacement asset) | No change                      |

# The borrowing exceptions – old and new (cont.)



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| <b>Old Law (section 67(4A))</b>  | <b>New Law (s 67A and 67B)</b>  |
|--|---|
| The SMSF Trustee must have a right (but need not be obliged) to acquire legal ownership of the asset by making one or more payments  | No change   |
| The rights of the Lender against the SMSF Trustee for default on the borrowing (including charges relating to the borrowing) must be limited to rights relating to the original asset (or replacement asset) | The rights of the Lender <b>or any other person</b> against the SMSF Trustee for, <b>or in connection with, or as a result of, (directly or indirectly)</b> default on the borrowing (including charges relating to the borrowing) must be limited to rights relating to the acquirable asset |

# The borrowing exceptions – old and new (cont.)



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| <b>Old Law (section 67(4A))</b>                                      | <b>New Law (s 67A and 67B)</b>  |
|--|---|
| No express equivalent  | Guarantor's right of indemnity against the SMSF Trustee must be limited to the acquirable asset   |
| No express restrictions on granting a charge over the original asset | Acquirable asset not subject to any charge unless under the lender's limited recourse loan, or other person's right of indemnity from a guarantee                                   |
| Replacement asset not defined  | Replacement asset limited to shares in companies and units in unit trusts in certain circumstances – eg, mergers, takeovers, restructures, deeds of arrangements or trustee actions |

# Uncertainties with the New Law



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- The New Law (through the EM and the Tao's Q&A) has created the following uncertainties
  - Can a single borrowing arrangement cover a property contained on multiple titles?
  - Can a property be developed or improved (even with the fund's own money)?
  - Can insurance proceeds be used to rebuild a property?
  - Can a property be subdivided?
  - A collection of assets (eg, shares) must be sold together and cannot be sold separately

# Uncertainties resolved?

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- SMSFR 2011/D1
  - Practical help
  - Allows a lot more
  - Cannot solve all problems
  - What is a “single acquirable asset”
  - What is a repair
  - What is an improvement
  - When can you borrow for repairs
  - What type of improvements are allowed
  - What is a replacement asset

# Borrowing to acquire which assets?



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- Both Old Law and New Law apply to any assets that can be acquired by the Trustee, including:
  - Securities
  - Residential premises
  - Commercial premises
  - Art
  - Units and shares in unlisted trusts and companies
- Usual SIS rules apply
  - eg, cannot acquire residential property from related parties
  - eg, 1 July 2011 new collectable and personal use rules

# Borrowing to acquire how many assets? (cont.)

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- New Law applies to a 'single acquirable asset'
- Multiple Assets - only if identical with same market value
  - eg, parcel of 1000 BHP shares
  - Eg, collection of gold bars
  
- Multiple assets (eg, shares) must be sold together – no partial sell down

- Single Acquirable Asset
  - Asset defined at 10(1) SIS – any form of property
  - Property is not defined – ordinary and legal meaning
    - Proprietary rights
    - Physical objects of proprietary rights  
(para 10)
  - What does this mean?  
Consider both “legal form & substance of the asset”  
(para 11)

# SMSFR 2011/D1 – Asset (cont.)



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- Can be a Single asset comprised of two rights – BUT must be distinctly identifiable as a single asset (para 12)
- Not a single asset if able to deal with separately (para 13)
- Practical approach by ATO – tries to deal with:
  - (i) Reality
  - (ii) 67A & 67B
  - (ii) Give context to the EM examples
  - (iii) Constrain developments
- No one is likely to complain

# Repairs and improvements



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- New Law
- Expressly allows for repairs and maintenance
- Expressly prohibits borrowing for improvements
- What is maintain/repair or an improvement?
- TR 97/23 (guidance found – but different context to 67A and 67B)
  - A repair means remedying or making good of defects in, damage to, or deterioration of, property to be repaired and contemplates the continued existence of the property
  - If the work amounts to a substantial improvement, addition or alteration it is an improvement and not a repair
  - Replacement or substantial reconstruction of the entirety, as distinct from the subsidiary parts of the whole, is an improvement

# Repairs and improvements (cont.)

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- TR 97/23
  - More concerned with revenue and capital distinction  
(eg) initial repairs are capital but still a repair in SMSFR 2011/D1 context – BUT not a major renovation
  - “Entirety” – very different  
(eg) roof is an entirety but land and building is an entirety in SMSFR 2011/D1 context (para 23)
  - Is the distinction important?
    - Practically – only if redrawing on loan
    - Most repairs or improvements likely to use SMSF funds

# Repairs and Improvements (cont.)



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- SMSF can use its own money for improvements (para 30)
  - pool
  - garage
  - extensions – decks, second floor
  
- BUT must still be the same “asset”  
(i.e.) entirety, and  
no change in rights in underlying asset

# SMSFR 2011/D1 – “Same Asset”



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- Same asset – consider legal rights and substance including character of change
  
- Cannot
  - build on vacant lot
  - subdivide
  - build a substantially different home on a demolished property
    - what is substantial?
  
  - cannot strata title
  - replace equipment – would be a “replacement asset”

# SMSFR 2011/D1 – “Same Asset” (cont.)

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- Cannot
  - rezoning – on its own a change?
  - rezoning and renovating home into commercial premises?
  - separate car park – if able to be dealt with separately
  - cannot buy non-fixed assets with primary asset (eg) furnishings – as separate asset  
BUT will you always know, eg, farm, property
  
  - be resumed?

(cont.)

- Can
  - rebuild home using insurance proceeds – does it need to be similar?
    - Note: rebuilding is not the same as “replacement”
  - buy a building straddling multiple titles
    - (eg) factory or farm – most farms still likely to require multiple borrowing arrangements

BUT could not later relocate a building on to one title

- Off the plan Apartment – provided SMSF pays deposit
- separate car park – only if legally cannot deal with separately
  - (eg) state/federal law – body corporate impediment?

# SMSFR 2011/D1 – “Same Asset” (cont.)

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- Could you
  - knock a home down and rebuild?  
  
presumably yes – similar to insurance proceeds  
build a similar home initially and then extend it later?
  - replace factory with different commercial premises?

# Replacement assets (cont.)

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- Changes under the New Law
- Replacement assets expressly limited to shares in companies and units in unit trusts in certain circumstances
  - eg, mergers, takeovers, restructures, deeds of arrangements or trustee actions

# Refinancing



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- Old Law did not specifically allow for refinancing
- ATO's prior view appeared to be that you could not refinance – see SMSFR 2009/4
- ATO's current view – old loans can be refinanced but must meet section 67A and 67B requirements – Q&A

# Refinancing



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- New Law
- Expressly allows for refinancing for borrowing (and accrued interest)
- Refinancing will include
  - Renegotiation that amounts to a rescission or replacement of original contract – (EM 1.50 and 1.51)
  - A drawdown inconsistent with the earlier arrangement– Q&A
  - Extension of the term of the loan – Q&A
  - Change in ultimate beneficiaries of the SMSF (i.e., the SMSF is ‘transferred’ to new members with the loan arrangement) – Q&A

# The Custodian and the Custodian trust

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- Old Law and New Law does not expressly provide who can be the Custodian
  - Can be anyone but the Superfund Trustee
  - Bare trust or a fixed trust that is almost a bare trust
  - Only one asset per Custodian trust
  - ATO has queried whether a bare trust can exist where there is a mortgage over the assets

# Compliance issues

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- Investment power - amend trust deed if required
- Investment strategy
- Merits of the investment
  - (i) diversification
  - (ii) gearing – larger losses incurred
- Breaches of lending rules

# Compliance issues

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- Sole purpose test
- In-house assets (note new section 71(8))
  - ATO's view that trust must be vested after the borrowing is repaid 'if the [Sims's] interest [in the holding trust] represents an investment of the SMSF' – Q&A
  - Retain at least \$1 of borrowing – refinance by related party?
  - Only an issue if CGT or stamp duty on transfer
- Acquisition from related parties – business real property
- Leasing to related parties
- Arm's length

# Contract of sale / timing issues - property

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- Trustee Company to receive legal title – must be on contract
- Double stamp duty
- Payment of deposit by Superfund
- SMSF deed allows borrowing – subject to bank review
- Allow further settlement time – bank review
- Cannot gear on a property already owned

# Tax issues and Government's announcement

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- Government announcement -10 March 2010
- 'Look through' approach for income tax
- Commence from 2007/2008
- SMSF assessed on income of the trust
- SMSF able to claim deductions (eg, capital allowances)
- No balancing adjustment on transfer of title from Custodian to the SMSF
- ATO confirmed to be treated as law – BUT no legislation yet released

# Tax issues and Government's announcement (cont.)

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- Issues not raised
- CGT upon declaration and vesting of the trust
  - because of existing exemptions?
  - eg, section 106-50 – but relies on concept of absolute entitlement
- Lodging tax returns
- is presumed that there will be no need
- otherwise there is PS 2000/2 (transparent trusts and secured purchase trusts)

# Tax issues and Government's announcement (cont.)

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- Other issues
  - Stamp duty and land tax
  - GST – see GSTR 2008/3
- Financial Services License requirement
  - Draft Corporations Regulations issued on 9 June 2010
  - No announcements since

# Other structures

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- Unguarded unit trust exemption – borrowing for the units
- Unrelated unit trust – borrow for the units but why bother if trust can borrow
- Jointly purchased assets
  
- Difficulty with bank security for all options

# Questions?

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What's next for borrowing?

- More helpful ATO or Government announcements?
- Cooper Review – review borrowing in 2 years – 2012/2013?
- Questions?