

SMSF Borrowing Hot Topics

Following amendments to the SIS Act in September 2007, there has been great interest in the instalment warrant-type borrowing arrangements which are now permitted for regulated super funds. Our October 2007 edition outlined the key features of these.

Since that time a surprising number of technical issues have surfaced and the complexity of correct implementation, particularly for do-it-yourself arrangements, has now become apparent.

Superannuation compliance issues

Several issues have been put to the ATO and we await clarification. Below are two key concerns:

Related party loans

Section 66 prohibits the acquisition of assets from related parties (subject to some limited exceptions).

While there are sound legal arguments that s 66 does not apply to a borrowing of money because this is not an 'acquisition' (ie, it is expressly provided for in the legislation that 'acquire an asset' does not include 'accept money'), we are seeking confirmation from the ATO and other regulatory authorities that this section does not apply to a mere borrowing of money from a related party.

This issue is of significance for those SMSFs who wish to borrow from related family trusts which may in turn already have established loan facilities with financial institutions. Related party loans must fulfil the requirement to deal at arm's length, bearing in mind any premium interest rate and/or restricted loan-to-value ratio ('LVR') which may typically be imposed by commercial lenders for non-recourse loans.

Guarantees

It has been suggested that the giving of a third party guarantee could overcome the need for a higher interest rate and/or lower LVR.

The new borrowing exception requires that the lender's rights against the *super fund trustee* be restricted to the underlying asset, and on this basis it appears that a third party could offer a guarantee because this does not give the lender any further rights against the SMSF trustee.

We would also like to obtain ATO confirmation that this is permitted, and whether a related party such as a member may give the guarantee.

Watch out for the tax traps

In addition to the above compliance concerns, these borrowings present a number of complex tax issues which, if not properly planned for, could significantly impact the transaction costs of these arrangements.

Stamp duty

The new laws require that the asset being acquired be held on trust for the SMSF trustee before the loan is repaid. Some models now permeating the market place suggest that a 'security trustee' who performs this role should also undertake operational activities, eg, by collecting rent or other income from the asset and making repayments to the lender.

In some States it is possible to obtain concessional stamp duty treatment for both a declaration of trust by an 'apparent purchaser' who holds property on trust for a 'real purchaser', and also for the eventual transfer of legal title to the 'real purchaser' (here, on repayment of the loan). The overall role and activities of the security trustee will affect whether stamp duty and other tax concessions will be available; if a security trustee is more than a mere 'apparent purchaser', stamp duty relief may be denied, potentially exposing the transaction to two rounds of duty.

GST

A trust (whether bare or not) is a GST entity and the involvement of an intermediate security trust therefore exposes the arrangement to additional GST risk. However, the ATO are likely to accept that a true bare trustee with no or minimal activities to perform will not carry on an enterprise in its own capacity for GST purposes. Again, a security trust with an operational role could be 'carrying on an enterprise' in its own capacity and the transfers to and from that trust could therefore be taxable supplies.

As evidenced by the above, the tax implications of these borrowings can be significant. Furthermore, CGT, income tax and land tax issues may arise. The nuances of these tax laws may be overlooked and expert tax advice should therefore be obtained before proceeding with any arrangement.

Investment Reserving

Reserving may offer advantages for SMSFs, provided trustees and their advisers have effective strategies in place for the prudent establishment, maintenance and allocation of reserves.

From 1 July 2007, new laws provide that allocations to members' accounts will generally be counted towards the receiving member's concessional contributions cap. This can result in excess concessional contributions tax if the cap is exceeded and any excess will also count towards that member's non-concessional cap (thereby risking a possible breach of that cap as well, in some cases).

However, allocations may not count towards a member's caps where certain criteria are satisfied: broadly, an allocation which is 'fair and reasonable' and less than 5% of the receiving member's interest, will not count towards their caps. Therefore, provided reserve allocations are managed prudently, reserves can form part of a sound planning strategy.

Estate planning advantages

SMSFs may claim a deduction when paying a superannuation lump sum on the death of a member to the member's estate or dependants if it increases the lump sum by an extra amount. This amount is broadly equal to the contributions tax payable on the contributions which funded the lump sum.

SMSFs with reserves may finance this additional amount from a reserve account, whereas funds without reserves may have difficulty meeting the extra payment, especially for sole member SMSFs.

Other advantages

Reserves can assist in funding temporary incapacity benefits or other unforeseen expenses, eg, a loss on an investment which diminishes the member's account just before they are paid their benefit.

DBA now offers an Investment Reserving Kit which provides detailed guidance on the establishment and maintenance of reserves, including worked examples. The Kit also offers sample reserving resolutions to save time for trustees and advisers.

Converting APs into ABPs

The ATO has recently confirmed that allocated pensions can be converted into the new account-based pensions without the need to commute and start a new pension (see the ATO's SuperUpdate November 2007). The ATO do caution that the fund's governing rules must allow for such a conversion.

DBA Butler provides Conversion Kits, which include all the documentation needed to convert an allocated pension into an account-based pension (eg, trustee minutes, member application, PDS, etc). Visit: www.dbabutler.com.au/index.php?p=pensions. DBA Butler can also update SMSF deeds to ensure conversions are allowed by the fund's rules.

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Leading new SMSF documentation from DBA

<p><i>SMSF Borrowing Memo (\$440)</i> <input type="checkbox"/></p> <p>This explains in detail the new laws which now permit an SMSF trustee to borrow in order to acquire assets. It outlines what is and is not allowed and describes tips and traps to look out for.</p> <p>Name of person ordering _____</p> <p>Postal address _____ State _____ Postcode _____</p> <p>Tel _____ Fax _____ Email _____</p>	<p><i>Reserving Kit (\$440)</i> <input type="checkbox"/></p> <p>The Reserving Kit provides guidance, examples and sample resolutions for the management of investment reserves. Includes guidance on the new laws applying to allocations from reserves after 1 July 2007.</p> <p>Firm _____</p>
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All prices include GST but exclude courier costs. Payment upon receipt of invoice.

For further Information please contact:

DBA BUTLER PTY LTD, Lawyers, 23 Union Street, South Melbourne Vic 3205 (ABN 74 120 513 037)

Ph 03 9682 0903 Fax 03 9682 0907 dba@dbabutler.com.au www.dbabutler.com.au

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