



SMSF Borrowing Arrangement Certainty

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Overview

On 10 March 2010 in the context of an 'instalment warrant' borrowing by the trustee of a super fund the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, announced a number of changes.

The announcements resolve the uncertainty of an asset transfer from the instalment warrant trustee to the super fund trustee will not trigger a CGT event. There had been different views on whether a beneficiary became absolutely entitled on repayment of the loan, therefore resulting in CGT event E5 at that time.

Further, the announcement stated that Super Fund Trustees "will be assessed on any income earned on the underlying asset, such as rental income."

Further, Super Fund Trustees "will be able to claim any relevant deductions, such as capital allowance for the decline in value of property." This means only one tax return will need to be lodged for the Super Fund and not for the instalment warrant trust as well. Moreover, this clarifies that the custodian or bare trustee does not require an ABN or a TFN.

The proposed legislation is set to apply retrospectively from 1 July 2007. Note that the "instalment warrant" exception, which was introduced several months afterwards, on 24 September 2007. Accordingly, all super funds should be covered.

Financial Product Advice

Furthermore the Government also announced the provision of an instalment warrant will require the recipient to Trustee of a Superannuation Fund to be given Financial Advice in accordance with the Corporations Act. Advisers will be given three months from when these changes are made to transition to this new requirement.

As of writing the proposed regulations had not been passed. However there is likely to be a requirement for specific product disclosure document to be issued with each SMSF borrowing package.

Instalment Warrant - Background

By way of background schedule 3 to the 2007 Act, the Government amended the Superannuation Industry Supervision Act 1993 (SIS Act) in two fundamental respects, namely:

- To provide in respect of instalment warrants an exception to the prohibition in s 67 upon borrowings by superannuation funds;
- To amend the restrictions on investments in in-house assets to remove the security trust created by an instalment warrant from the meaning of an in-house asset.

What follows is a review of the implications of the new amendments to schedule 3 and the issues that need to be considered in respect of using Complying Loans in a self managed superannuation fund (SMSF). Furthermore, consideration will also be



given to whether or not a business real property can be used as an appropriate asset in respect to a Complying Loan within a SMSF.

Complying Loan Exemption

Rather than specifically referring to instalment warrants the new s 67(4A) of the SIS Act describes the features which an arrangement must have in order to fall within the borrowing exception. These features match typical instalment warrant arrangements. Specifically, a regulated superannuation fund is not prohibited 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 an asset ('the original assets') other than the one the RSF Trustee is prohibited by this Act or any other law from acquiring; and:

(b) the original asset, or another asset ('the replacement') that:

(i) is an asset replacing the original asset or any other asset that met the conditions in this sub-para and sub-para (ii); and

(ii) is not an asset the RSF Trustee is prohibited by this Act or any other law from acquiring:

is held on trust that the RSF Trustee acquired a beneficial interest in the original asset or the replacement; and

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

(d) the rights of the lender against the RSF Trustee for default on the borrowing of on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the original asset or the replacement; and

(e) if under the arrangement the RSF Trustee has a right relating to the original asset or the replacement (other than a right described in para (c)) - the rights of the lender against the RSF Trustee for the RSF Trustee's exercise of the RSF Trustee's right are limited to rights relating to the original asset or replacement.'

In-house assets exception

The amendments to the definition of in-house assets are contained in new subss 71(8) and (9) of the SIS Act as follows:

'(8) if at a time:

(a) an asset (the investment asset) of a superannuation fund is an investment in a related trust of the fund;

(b) the related trust is one described in para 97(4A(b)) in connection with a borrowing by the trustee of the fund



that is covered by sub 67(4A); and

- (c) the only property of the related trust is the original asset or replacement described in the subsection;*

The investment asset is an in-house asset of the fund at the time only if the original asset or replacement described in subs 67(4A) would be an in-house asset of the fund if it were an asset of the fund at the time;

(9) Subs (1), (2) and (4) have effect subject to subs (8).'

Issues to Consider

Assets

(a) The arrangements described in the amendments to s 67 of the SIS Act, while describing an instalment warrant typically created over listed company shares are not limited to listed securities as defined in Section 92 of the Corporations Act. In this way, the amendments reflect the policy contained in the announcement by the Minister for Revenue and Assistant Treasurer in May 2007 that superannuation funds will be allowed to invest in instalment warrants of a limited resource nature over any asset a fund may under the SIS Act invest in. Section 67(4A)(a) ensures that assets which would otherwise be in-house assets, for example, may not be the subject of a borrowing within this new exemption. However, any other asset in which a regulated superannuation fund trustee might invest may now be the subject of an instalment warrant borrowing and investment. Even before the end of November 2006 property investments structured as instalment warrants were being

offered by some Issuers to the trustees of regulated superannuation funds. It may be expected with the passage of the amendments to s67 and s 71, a range of product offerings in different asset classes using the instalment warrant structure will become available for superannuation fund trustees to consider.

(b) The amendments to s 71 do not alter the existing definition of a 'related trust' or an 'excluded instalment trust' of a superannuation fund.

Acquisition of an Asset

Complying Loans by way of cash extraction are still not permitted. This arises from the requirement in section 67(4A)(a) that the borrowed money must be 'applied for the acquisition of an asset'.

Limited Recourse Loan

The loan must be a limited recourse loan (limited to rights relating to the asset in respect or the replacement asset in respect of the borrowing and charges related to the borrowing).

Date of Effect

The amendments to s 67 and s 71 took effect from 24 September 2007. The Explanatory Memorandum specifies that existing technical breaches arising by investment in Complying Loans by regulated superannuation fund trustees will be managed through the discretionary powers of the Commissioner and APRA of 16 December 2002 and 3 November 2006 in relation to the exercise of the discretions of those Regulators may provide some guidance.

Trustee Duties

The amendments to s 67 and s 71 do not alter the obligation of the trustee of a regulated



superannuation fund consider a Complying Loan the trustee's powers of investment. Any investment in instalment warrants in any asset class would still require a determination by the Trustee that the investment and Complying Loan:

- (i) satisfies the sole purpose test;
- (ii) is within the investment powers of the trustee under the superannuation fund trust deed;
- (iii) is within the investment strategy previously determined by the trustee;
- (iv) is in all other respects an appropriate investment for the fund;
- (v) does not breach the in-house asset rules and so on.

Checklist of Issues to consider re Complying Loans

1. Is the Financial Product a permissible investment under the Superannuation Industry (Supervision) Act?
2. Is the underlying Asset a permitted investment under

the Superannuation Industry (Supervision) Act?

3. Has the Sole Purpose Test been satisfied?
4. Is the underlying investment and the Complying Loan in all other respects an appropriate investment for the particular fund?
5. Is the underlying investment and the Complying Loan within the SMSF investment strategy previously determined by the Trustee?
6. Does the underlying investment and strategy breach the borrowing rules of the SIS Act? Does the underlying investment and strategy breach the in-house asset rules of the SIS Act?
7. Does the underlying investment and strategy breach any other provisions of the SIS Act?
8. Is there a risk management statement in place?

Summary

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