The Dover Guide to SMSFs and limited recourse borrowing arrangements

DOVER FINANCIAL ADVISERS

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Introduction

This guide considers the background and history of self-managed superannuation funds (SMSFs) borrowing to invest, and looks at the restrictions created by changes introduced to Parliament in May 2010 and passed as law in early July 2010. It considers some of the practical problems, suggests alternatives, and settles on one (very) simple strategy that could work very well for a large number of clients of average age and financial circumstances.

The guide is current as at 1 September 2010. No responsibility is taken for any error or omission in it and it should not be acted on without specific legal advice from the Dover legal team.

Executive summary

The law regarding SMSF borrowings changed on 7 July 2010. Arrangements entered into before this date are controlled by the former sub-section 67(4A) of the Superannuation Industry (Supervision) Act 1993, and arrangements entered into after this date are controlled by the new sections 67A and 67B of this Act. Borrowings may be refinanced, and a refinancing may, depending on its detail, create a new borrowing that brings the arrangement within the new rules.

Instalment trust arrangements are now known as "limited recourse borrowing arrangements".

First, some perspective

Anecdotally there is only a very low incidence of SMSFs investing in instalment warrants. The Cooper Review observed that:

"Initial interest in instalment warrants was modest with only 0.9% of the SMSF population having a derivative or instalment warrant at 30 June 2008. There are, however, indications that this trend might have changed in recent times. Data from Investment Trends' survey suggest more than five per cent of SMSFs already invest in such instruments[1]."

Assuming there are 350,000 SMSFs in Australia this translates to about 17,500 incidents of SMSFs borrowing through instalment trust arrangements. Dover's experience suggests most of these will involve packaged arrangements to buy shares, facilitated by large financial institutions, and few will involve property transactions.

This is not a significant incidence and readers should keep perspective: SMSF borrowing is not common and is unlikely to become common in the short to medium term future.

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[1] Australian Government, Self-Managed Super Solutions A preliminary report of the Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System http://www.supersystemreview.gov.au/content/downloads/self_managed_solutions/self_managed_super_solutions.pdf

Second, some background

SMSFs have always had a limited ability to borrow. However, the power to borrow was so limited that most SMSF advisors have never encountered it. Section 67 of the Superannuation Industry (Supervision) Act 1993[2] (SISA) allows SMSFs to borrow in certain limited circumstances; that is:

(i) where the borrowing is necessary to pay a member an amount due under the law, provided the borrowing is for a period of no more than 90 days and the borrowing is not more than 10% of the market value of the assets of the fund;

(ii) where the borrowing is necessary to allow the SMSF to pay the (now defunct) surcharge, provided the borrowing is for a period of no more than 90 days and the borrowing is not more than 10% of the market value of the assets of the fund;

(iii) where the borrowing is necessary to settle the purchase of shares and similar securities, provided the borrowing is for a period of no more than 7 days and the borrowing is not more than 10% of the market value of the assets of the fund, and provided that at the time the purchase contract was signed it was likely that the borrowing was not needed.

Section 67 did not allow borrowing to fund investments.

The policy behind this situation is clear: the government considered SMSF borrowing to be risky, and contrary to the conservative long term interests of Australia's retirement incomes policy.

Creative advisors sought to circumvent these rules. Up to August 1999 it was easy for a SMSF to set up a controlled unit trust to effectively circumvent section 67. The practice was widespread at the time, and ended with the government extending the definition of an in-house asset to include most controlled trusts (subject to a 10 year moratorium for existing controlled trusts).

Never underestimate the ingenuity of the financial planning profession, because before long new arrangements sprung up which appeared to neatly side-step the 1999 controlled trust rules.

Instalment warrant arrangements were introduced, based on shares and other financial securities marketed by large product providers, which claimed to not be a borrowing for SMSF purposes. The position was very confusing: the arrangements looked like debt, and used the language of debt, including words like "borrowing", "interest" and 'principal", but the promoters produced ATO rulings saying they were not debt, and that SMSFs could invest in them.

In 2006 the ATO and APRA got together and decided that instalment warrants were in fact a form of borrowing not permitted by section 67 and that therefore SMSFs could not invest in them.

Never underestimate the political punch of the financial planning profession. Eventually the government decided that since the (illegal) instalment warrants had become quite common, the law should be changed to allow them, and that existing (illegal) arrangements could continue until the new laws saw the light of day. Evidently the non-recourse aspect of instalment warrants nullified concerns about default, and the risk this creates for Australia's retirement income policy.

(It is also interesting to see what happens to a law if enough people break it...but let's leave that there for now.)

[2] Section 67 of the SISA

In summary, the Government decided SMSF debt was OK after all.

This crystallised on 24 September 2007, when a new sub-section 67(4A) headed "Exception – Instalment Warrants" came into play. This exception legitimised the instalment warrant arrangements on the market, but also surprised all concerned by not being limited to instalment warrants, despite the tag "Exception - Instalment Warrants". The exception goes well beyond what most regarded to be an "instalment warrant" and allows other types of borrowing as well, provided certain conditions are met. Evidently Treasury formed the view, against ATO submissions, that there was no logical reason to limit the exception to the narrow class of assets found in traditional instalment trust arrangements, and assets like property should also be included.

Many predicted that the new sub-section 67(4A) would trigger a boom in SMSF borrowing. Some people even set up websites dealing specifically with the issue, and some solicitors tried to charge as much as $20,000 a go for their standardised (and often plagiarised) SMSF borrowing "kit".

The SMSF borrowing boom never came.

September 2007, and the following months, saw world finance markets freeze as the GFC spread from the burst bubble of the USA residential property market to contaminate virtually all world markets. Credit disappeared, and asset values fell. The ASX dropped as much as 50%. SMSF investors had no appetite for debt, which was just as well because the banks had none to offer, unless it was at rip-off rates as high as 12% per annum, with LVRs limited to 50%, at a time when standard home loan rates were just 6% or even less.

The ATO made it clear it disagreed with Treasury, and would take a hard line on technical breaches of the law, which caused many advisors to prudently steer clear of the new rules until they had settled down and further guidance was available.

A few realised the idea was not as attractive as it first sounded anyway. SMSF borrowing can be very tax inefficient. Gearing strategies, particular for residential property, rely on tax benefits for a significant part of their return. With SMSF borrowings the tax rate is never more than 15%, and may be less due to the one third exemption on capital gains while the member is in accumulation mode, and the 100% exemption once the member is in pension mode.

It's important to appreciate that sub-section 67(1) of the SISA general prohibits SMSFs from borrowing, unless the limited exceptions set out in the following sub-sections apply. The ATO will take a restrictive view of the scope of these exceptions, in order to give effect to what it sees as the proper construction of section 67.

Uncertainties in the law

Since September 2007 practitioners have encountered uncertainties in both the application of the law, and the ATO's view of the law. These uncertainties contributed to the low incidence, or take-up, of geared SMSF arrangements. The Government also believed that some interpretations of section 67 of the SISA were creating undue risk for SMSFs, particularly:

- personal guarantees by SMSF trustees;

- borrowing arrangements extending to other assets, to achieve increased security for the lender, and hence create greater risk for the borrower (ie the SMSF); and
- borrowing arrangements extending to replacement assets.

On 26 May 2010 The Government introduced into Parliament the Superannuation Industry (Supervision) Bill 2010 to, as the explanatory memorandum said:

(i) make sure SMSF assets are protected against the consequences of a default under the borrowing contract; and

(ii) resolve "uncertainties" in the operation of section 67, by:

a. introducing the concept of a single "acquirable asset", or a collection of identical assets that have the same market value and are treated as one asset;
b. prohibiting borrowing to improve properties;
c. ensuring the recourse of lenders does not cover other SMSF assets and only the specific asset can be charged; and
d. ensuring the specific asset can only be replaced in limited specified circumstances.

You can read the Bills Digest for this Bill here: Bills Digest Superannuation Industry (Supervision) Amendment Bill 2010.

On 27 May 2010, one day later, the ATO expressed its own views on the operation of the SMSF borrowing rules, when it published "Limited recourse borrowing arrangements by self-managed super funds - questions and answers[3]" which has since been up dated for the new effect of the new SISA provisions concerning SMSF borrowings.

The current state of the law

The Superannuation Industry (Supervision) Amendment Bill 2010 became law on 7 July 2010.

You can read the amended SISA provisions here: section 67A of the SISA and section 67B of the SISA. And you can read the ATO's summary of the new rules here: Limited recourse borrowing arrangements by self-managed superannuation funds.

The old rules (ie section 67(4A)) apply to borrowings entered into before 7 July 2010.

The new rules (ie section 67A and 67B) apply to borrowings entered into after 7 July 2010, to restrict the form of the borrowings as follows:

(i) **single acquirable asset**. Only one asset, or set of identical assets (example a parcel of shares in a listed company, listed trust, or other assets that have economically identical qualities) is permitted in each instalment trust arrangement, and which must be dealt with as if they are one asset (for example, that parcel of shares cannot be sold gradually over time, and if sold

[3] Limited recourse borrowing arrangements by self-managed super funds

all must be sold; it's all or nothing). This rule is very restrictive for shares and similar securities but of no real effect for real estate;

(ii) **capital improvements.** Borrowings cannot improve the asset, but can be used to maintain or repair the asset to maintain its functional value. This is particularly relevant to real estate and, for example, an SMSF cannot borrow to buy an old run down building and then borrow again to knock it down and build a new one. But a SMSF can borrow to repair or maintain a property to maintain its functional value;

(iii) **lender's recourse**. This is limited to the particular asset. Other assets cannot be charged in any way. In summary, a charge may be given over an asset acquired through a borrowing arrangement to secure that borrowing, but no other charge is permitted. This effects both shares and similar assets, and real estate;

(iv) **replacement assets**. Replacement is limited to where instalment receipts are replaced with shares or units under a takeover, merger, demerger or a similar reconstruction; and

(v) **refinancing**. Loans may be refinanced, and where the loan is re-financed such that a new loan is effectively created, the new loan will be brought within the new rules. "Lesser" refinances may not be new loans and will not be brought within the new rules, but advice is needed each time to make sure the refinancing has not created a new loan. Particular care is needed when refinancing old borrowings for more than one asset, such as a parcel of shares in listed companies. The refinancing may create a new borrowing, and therefore breach the single acquirable asset rule.

The new rules do not use the phrase "Instalment Warrants", which makes sense because the old section 67(4A), which did use the phrase "Instalment Warrants" in its caption, was not limited to instalment warrants and covered all types of borrowings.

Possible planning options

One can expect some great minds to devote a lot of time and thought to how to best use these new rules. Preliminary ideas from a lesser mind include:

(i) consider whether a SMSF borrowing is the best way to proceed. Is it possible that the asset can be acquired through some other less restrictive mode, perhaps in the client's own name, or in a trust based structure? This basic test is our preferred option: the consequences of a SMSF becoming non-compliant are very serious and we believe it is wisest to stay away from complicated areas with a high probability of causing problems;

(ii) commercial banks will introduce/emphasise gearing strategies based on derivatives, and/ diversified assets such as a listed investment companies and index funds, where the single acquirable asset rule will be less of a problem;

(iii) consider an uncontrolled unit trust, with the client's share of the units (less than 50% and no deemed control) owned by the SMSF and the debt held at the unit trust level (specific legal advice should be sought before proceeding here);

(iv) if a geared SMSF property redevelopment is contemplated, consider a higher debt to equity ratio, and preserve existing cash balances and future contributions (concessional and non-concessional) for the redevelopment part of the exercise. Joint venture arrangements may also be considered, although these can be very messy;

(v) consider gearing into certain unit trusts which acquire the property and then borrow at the trust level to complete the renovation/redevelopment (specific legal advice should be sought before proceeding here);

(vi) consider whether SMSFs may be better off gearing in large geared share trusts where the trust borrows, and is not subject to the restrictive SMSF borrowing rules; and

(vii) expect to see slick arrangements where the one document creates two or more loans and trusts, to allow SMSFs to create geared portfolios with more than one share without breaching the single acquirable asset rule.

Quarantined SMSFs

It is always a good idea to consider using a separate, special purpose SMSF for a specific transaction, such as buying a property using debt. The SMSF only holds the minimum amount of benefits needed to complete the transaction, and the clients' other benefits are held in another super fund.

Doing this limits risk, and means any non-compliance penalties are less than otherwise may have been the case.

Guarantees

There were concerns that rights of subrogation, ie the right of a guarantor to recover all or part of any amount paid under the guarantee from the debtor/SMSF, could extend to other fund assets.

The new provisions make it clear this cannot happen.

Any payment under a guarantee may be treated as contribution, and this may create its own issues.

Capitalised interest and related party borrowings

The new rules do not impact capitalised interest arrangements, or related party borrowings. Both are permitted, provided all relevant rules are observed.

However, we strongly recommend interest be paid when it is due and not capitalised, particularly with related party borrowings, to preserve the commerciality of the arrangement and to maintain an arm's length quality at all times. This arm's length quality will be needed to comply with other aspects of the SMSF law, and is consistent with the ATO's views as expressed in TA 2008/5.

A warning

The new rules are particularly restrictive for shares, and do not allow a parcel of shares in different companies to be held under the one instalment arrangement, and do not allow a progressive sell down of shares. For obvious reasons the "single acquirable asset" rule is less of a problem with real estate assets, which tend to be bought singularly, with far few properties owned relative to shares.

Bear in mind that most clients will shy away from complex matters and do not want to be guinea pigs for some bright spark's great idea to get around these rules. It's perfectly OK to say to your clients "this is too complicated, risky and limited, and you are better off not using your SMSF in this transaction". Sometimes it is best to say "no".

And if it's a good investment for a SMSF it's probably a good investment for the client himself. So there is no burning reason to involve a SMSF in the investment, with the attendant compliance risks.

Investment strategies

The SMSF's investment strategy must include borrowing to acquire investments.

A particularly simple application

One simple application has merit. Consider a forty-five year old couple with, say, $200,000 in superannuation. They are concerned about their long term retirement prospects and, although they are in the 37% tax bracket and have statistically high incomes, they are cash poor because of the high costs of feeding, housing, educating and "holidaying" their family.

It can make sense to set up a SMSF, transfer the existing $200,000 of benefits in, pay future contributions in, and then borrow say $400,000 to complete the purchase of a $600,000 home. The property is then rented out, with the rent income covering the outgoings and the interest, with a bit of help from their contributions. The expected capital gains drive this investment, and the trick is to not realise the capital gains until the SMSF is in pension mode, ie until say age 60 in 15 years time, so that the bulk of the return is capital gains tax free.

This advantage overwhelms the disadvantage of low (or even no) debt deductibility in the SMSF.

This is a simple application of the rules and is unlikely to run into any problems.

If the Reserve Bank predictions on future home prices eventuate, then this will be a very good investment strategy too.

Business premises

This simple strategy can also be a tax effective way to own business premises, which are bought using a geared SMSF arrangement and then leased back on an arm's length basis to the business.

However, here the loss of the active asset exemption for business premises held by a SMSF has to be considered, which makes the arrangement less attractive from a tax point of view than may have been first thought: SMSFs are not eligible for this exemption.

Stamp duty on transfer from the trustee to the SMSF

The transfer of real estate from the trustee to the SMSF at the end of the borrowing contract should not be a stamp dutiable event, since there is no change in beneficial ownership. But care is needed, particularly in South Australia where contrary views have been suggested.

(This is general advice only and is not personal financial advice and it should not be acted on without specific advice in written form from a qualified advisor.)

Appendix: What is an instalment warrant?

Generally an instalment warrant is a financial product that derives its value from the underlying asset, typically a share or a similar security, under which the instalment warrant owner may acquire full rights to the underlying asset (ie the share) by paying instalments.

The ATO defined an instalment warrant as:

"... a form of derivative or financial product that entails borrowing to invest in an asset, such as a share or real property (the underlying asset) with limited recourse to the investor...the underlying asset is held on trust during the life of the loan to provide limited security for the lender[4]."

The new sections 67A and 67B do not refer to "instalment warrants" but the former sub-section 67(4A) included this phrase in its heading, despite having a much broader application than just instalment warrants.

The former sub-section 67(4A) did not explicitly define "instalment warrant", despite using this phrase as a caption, but it did set out conditions which in effect defined instalment warrant for these purposes. The conditions for a SMSF borrowing to be permitted under sub-section 67(4A) were:

- the borrowing was used to acquire an asset held on trust for the SMSF by a trustee, often called an "instalment trust";
- the SMSF owned the beneficial interest in the asset and a right but not an obligation to acquire legal ownership of the asset by paying instalments (ie repaying the borrowings);
- the lender's recourse (ie right of recovery) was limited to the asset, which means other SMSF assets cannot be charged/secured in any way; and
- the asset was otherwise able to be owned directly by a SMSF, and for example was not an in-house asset and is not an asset that has been acquired from a related party (except as permitted by section 66 of the SISA).

The instalment trust was often described as a bare trust, which is the thinnest form of trust recognised at law, and requires the trustee to act in accordance with the directions of the beneficiary and, in particular, to transfer full ownership to the beneficiary when requested to do so. The instalment trust is actually more complex than a bare trust, as conditions must be met before full ownership is transferred to the beneficiary. But this is an academic point only and thinking of the instalment trust as a bare trust is an effective way of understanding the relationship between the trustee of the "instalment trust" and the SMSF, ie the beneficiary of the instalment trust.

The SMSF is the borrower under the loan agreement, and is beneficially entitled to the asset (subject to conditions) and the instalment trustee holds legal title to the asset until all payments are made and other conditions are met, at which time it must transfer legal title to the SMSF.

The relationship is depicted as follows:

[4] Limited recourse borrowing arrangements by self-managed super funds

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