

SMSF Borrowing Arrangements

7 July 2010 Changes to the Law



With effect from 7 July 2010, the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) has been amended by the *Superannuation Industry (Supervision) Amendment Act 2010* (**Amending Act**), according to an *Explanatory Memorandum* circulated by the Minister for Superannuation, Chris Bowen:

- to make sure that superannuation fund assets are protected in the event of a default on a limited recourse borrowing arrangement; and
- to resolve uncertainty with the application of the pre-7 July borrowing exemption.

Less than a fortnight before the amendments took effect, the Australian Taxation Office (**ATO**) published *Limited recourse borrowing arrangements by self-managed super funds – questions and answers*, an 11 page document providing general guidance on the ATO's views regarding the application of the SIS Act and related super rules to limited recourse borrowing by self-managed super funds before the amendments took effect.

In this article, experienced superannuation lawyer and Director of Topdocs Legal, Ian Waters examines the changes in the context of the ATO's views before the changes took effect.

Changes to the law

The SIS Act has been amended in respect of limited recourse borrowing arrangements by super funds so that:

- borrowing is now permitted only to acquire a single asset or a collection of identical assets that have the same market value and are treated together as a whole;
- super fund trustees cannot borrow to improve real property (or any other class of asset);
- the rights of any person against the super fund trustee arising out of or in connection with (ie directly or indirectly) a default on the borrowing are now limited to rights relating to the asset within the arrangement;
- the asset within the arrangement cannot be subjected to a charge other than in respect of the borrowing by the super fund trustee; and
- the asset within the arrangement can now only be replaced in very limited circumstances specified in the law.

The asset being acquired

Old law

The ATO acknowledged that pre-7 July, more than one asset could be acquired under a particular arrangement and the assets acquired did not all have to be of the same form or type. Thus, a portfolio of shares in different companies or more than one title over real property could be acquired under a single limited recourse borrowing arrangement.

New law

Under the amended law, however, the original asset being acquired must be a single asset or collection of identical assets that have the same market value (eg a collection of ordinary shares in a single company).

According to the *Explanatory Memorandum*:

- examples of collections that are now allowed include:
 - shares of the same type (eg ordinary shares) in a single company;
 - units in a unit trust that have the same fixed rights attached to them; and
 - economically equal and identical commodities, eg gold bars, irrespective of whether they might, for example, have different serial numbers; and

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- examples of collections that are now **not** allowed include:
 - shares in a single company that have different rights, eg ordinary and preference shares;
 - units in a unit trust of different classes that have different rights attached to them or are potentially subject to differing trustee discretion;
 - shares in different entities; and
 - buildings each under separate strata title, irrespective of whether the buildings are substantially the same at the time of acquisition.

Further, to ensure that an acquirable asset is always interpreted in the singular, the words 'collection' and 'identical' should be interpreted as ensuring that an acquirable asset is one or more things that within the arrangement are seen and treated as a whole, eg a collection of shares must be acquired and disposed of as a collection and cannot, for example, be sold down over time.

In the case of the purchase of real property, a single title over land and the house on it will be considered a single acquirable asset, but additional items such as furnishings cannot be purchased through the same limited recourse borrowing arrangement.

The definition of 'acquirable asset' excludes limited recourse borrowing arrangements that involve money as an asset (ie Australian currency or currency from any other country). This addresses concerns with limited recourse borrowing arrangements over multiple assets that are traded for money and managed in a similar fashion to margin accounts.

Capital improvements and associated expenses

Old law

The ATO considered that a fund trustee could draw down under a limited recourse borrowing arrangement to make capital improvements to real property held by the custodian trust under that arrangement, maintain the asset and meet other costs of the arrangement without contravening the pre-7 July law. However, a fund trustee could not make a drawdown to extract cash from the arrangement.

New law

The amendments 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, according to the *Explanatory Memorandum*, fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the fund. Hence, a borrowing cannot, under the amended law, be used to construct a building on land or to renovate, other than to make repairs which do no more than ensure that the functional value of the property is not diminished.

Associated expenses that are considered to be intrinsically linked to the purchase of the acquirable asset can, under the amended law, also be included as part of the borrowing. The examples provided in the Amending Act (ie conveyancing fees, stamp duty, brokerage or loan establishment costs) are specifically allowed as part of the borrowing arrangement.

Limited recourse and charging the asset being acquired

Old law

The ATO accepted that pre-7 July, a fund member could provide a personal guarantee to the lender in a limited recourse borrowing arrangement. While recourse of the lender against the fund trustee in the event of a default on the borrowing had to be limited to the asset that was being acquired under the arrangement, the ATO accepted that a third party could put up their own assets as a guarantee or mortgage one of their assets (in which the fund did not have an interest) to the lender to provide additional security to the lender and, significantly, that a third party guarantor was not required to waive their usual rights of indemnity against the principal debtor (the fund trustee) in the event of a call on the guarantee.

New law

The amendments were designed to protect fund assets from claims in connection with a default on a borrowing to acquire an asset under an arrangement by limiting the rights of the lender or any other person against the fund trustee, for or in connection with or as a result (direct or indirect) of a default on the borrowing or charges related to the borrowing, to rights relating to the asset acquired.

In this way, a guarantor's rights against a fund trustee are limited as the rights of the lender are limited, so that no claim against the fund trustee should arise which could give rise to a claim for indemnity from fund assets.

Further, the asset being acquired under an arrangement cannot be subjected to a charge other than in relation to the fund trustee's borrowing or rights in relation to the asset, eg the asset cannot be used as security for another borrowing.

Replacement assets**Old law**

The ATO acknowledged that pre-7 July, assets could be sold and bought on behalf of a fund within a custodian trust. The replacement assets took the place of the original asset in the arrangement, but all other aspects of the arrangement had to continue to satisfy the requirements of the law. The replacement asset was not limited to any particular type of asset, but had to be an asset that the fund trustee was not prohibited from acquiring. A fund could, for example, use a limited recourse borrowing arrangement to purchase exchange traded options over shares and, if it was permitted under the terms of the particular arrangement, the options could be exercised on behalf of the fund trustee while still within the limited recourse borrowing arrangement.

According to the *Explanatory Memorandum*, the broadness of the pre-7 July definition created uncertainty over what constituted the replacement asset and this uncertainty gave rise to arrangements that could place fund assets at risk, eg a lender could have required a fund trustee to replace an asset within an arrangement if its value fell below a certain level, with an asset of greater value than the outstanding loan.

New law

Consistent with the original policy intention and to provide greater clarity regarding eligible replacement assets, under the amended law, the asset held on trust under the borrowing arrangement can only be replaced by another asset in very limited circumstances listed in the amended SIS Act or its regulations, including:

- where instalment receipts are replaced with shares in company; or
- shares in a company or units in a unit trust are replaced as a result of a takeover, merger, demerger, restructure or trustee action or under a scheme of arrangement.

Significantly, real estate is not mentioned, which means that a fund trustee cannot replace one property with another.

The *Explanatory Memorandum* makes it clear that certain circumstances which might have been thought to bring about the replacement of assets within the meaning of the pre-7 July law are excluded, such as:

- the buying and selling of shares only as a consequence of implementing an investment strategy;
- the replacement of an asset arising from an insurance claim covering loss of original asset;
- the replacement of a title over real property upon subdivision; and
- the replacement of a title over real property as a result of Government action such as the resumption of all or part of the property or re-zoning.

Refinancing**Old law**

The ATO considered that pre-7 July, a fund trustee could refinance a limited recourse borrowing without contravening the law, ie a new borrowing that was made solely to extinguish a previous borrowing and meet the

associated costs of placing the original asset into the new arrangement satisfied the requirement that borrowed funds were applied for the acquisition of the relevant asset.

Where a new trust was created to hold the asset, fund trustees had to ensure that the asset was transferred directly to that new trust and that the fund did not obtain title to the asset at that time, otherwise a contravention of the law would occur.

New law

The amendments clarify that a fund trustee can, indeed, refinance an existing limited recourse borrowing. According to the *Explanatory Memorandum*, refinancing may allow the fund trustee to minimise the risk of default on a borrowing resulting from a temporary inability to make a repayment, eg a fund facing solvency issues due to benefit payment obligations.

An arrangement entered into on or after 7 July, that is a refinancing of a borrowing arrangement entered into before, on or after that date will, however, be subject to the amended law.

A re-negotiation of a borrowing with the same lender that is simply a variation of a loan contract that continues to exist will not be subject to the amended law. However, where the re-negotiation amounts to a rescission or replacement of the original contract this is to be regarded as a refinancing and the application provision and, therefore, the amended law will apply to the arrangement.

Refinancing is not the only way that a new arrangement may arise to which the amended law will apply, eg a change to the terms and conditions of an arrangement that fundamentally alters the character of the arrangement may result in a new arrangement to which the amended law applies.

Application

The amendments apply to all limited recourse borrowing arrangements entered into on or after 7 July 2010, but will generally not apply retrospectively to existing arrangements.

The ATO accepts that, under the amended law, an arrangement entered into before 7 July that met the requirements of subsection 67(4A) of the SIS Act when it was entered into, will be allowed to continue according to its terms until it comes to an end.

If, however, on or after 7 July, a fund trustee refinances a borrowing that is under a pre-existing arrangement, or there are significant changes that go to the root of the arrangement (amounting to a new arrangement being put in place), then the amended law will apply.

Topdocs provides advice and documentation in relation to SMSF borrowing arrangements. Please contact us on 1300 659 242 with any queries that you may have in this regard or in regard to super and estate planning more generally.