

Draft Ruling SMSFR 2011/D1



Changes to the ATOs interpretations of the Super Fund Borrowing legislation

In an exciting development for SMSF Trustees, the ATO is looking to soften its interpretation of the Super Fund borrowing legislation with the release of its recent draft ruling SMSFR 2011/D1.

Whilst this is only a draft ruling, it does demonstrate that the ATO is listening to the industry's concerns relating to its interpretation of the SMSF Borrowing legislation, most particularly in relation to improvements and what constitutes a 'single acquirable asset'.

The outcomes, should this draft ruling become the ATO's official view, are very beneficial to SMSF Trustees, and open up another stream of options from which to select a 'single acquirable asset'.

SMSFR 2011/D1 outlines the following possible changes in policy by the ATO:

What constitutes a 'single acquirable asset?'

'Single acquirable asset' is the term used in sections 67A and 67B of the SIS Act to describe what a Super Fund can actually acquire via a Super Fund Borrowing. This term has caused much grief over time, firstly, due to a lack of clarity from the ATO as to its meaning (from September 07 to 7 July 2010), and following the SIS Act amendment in July 2010, its strict interpretation of a single acquirable asset in relation to real property.

What the ATO currently says:

To this point, and until the ATO officially changes its interpretation, a single acquirable asset in relation to real property acquired via a Super Fund borrowing is a property that the Fund is not otherwise prohibited from acquiring outright, that is held over a *single title*. This interpretation provides the following limitations in respect to property acquisitions via Super Fund Loans:

a) Rural Property

As rural property is often held over multiple titles, if an SMSF Trustee wishes to acquire rural property via a Super Fund Borrowing, they would need to set up separate borrowing arrangements for each title the rural property is held over. So far our record in this regard is 7 Bare Trust and Loan Packages for the one acquisition!

b) Offices, Apartments and Factories

The strict interpretation of one title = one property means factories straddling multiple titles, and offices or apartments with car parks on separate titles that cannot be dealt with separately from the office/apartment cannot be practically acquired via a Super Fund Borrowing without contravening the ATOs interpretation.

What the new draft ruling SMSFR 2011/D1 says:

SMSFR 2011/D1 expands the ATOs interpretation of a *single acquirable asset* by stating that if asset cannot be dealt with separately, or there is a state or territory law that requires assets to be sold together so that they cannot be sold separately without contravening the law, then the asset in question would be considered a single asset for the purposes of a Super Fund Borrowing. SMSFR 2011/D1 gives the following practical examples of this interpretation:

Assets considered 'single assets'

- A factory complex covering more than one title – for example, if a factory straddles three separate titles
- Off the Plan apartments – however, the draft ruling specifically states that in this scenario, the trustees of the SMSF would pay an amount to secure the purchase, and enter into the Super Fund borrowing arrangement *at the time the apartment is completed and strata titled*.
- Apartments with a car park that cannot be dealt with separately

Assets considered 'multiple assets'

- Farmland held over multiple titles (consistent with their present view)
- Adjacent blocks of land that do not have any physical or legal impediments to being sold independently
- A house built in situ
- A serviced apartment with furnishings – in this example, the apartment could be acquired via a Super Fund Borrowing, but the furnishings could not be acquired under the same borrowing arrangement.

SMSFR 2011/D1 views on asset repairs and improvements

SMSFR 2011/D1 reinforces the ATOs present view that proceeds from a Super Fund borrowing arrangement can be applied to expenses incurred in maintaining or repairing the asset acquired. However, money borrowed under a Super Fund borrowing arrangement *cannot* be applied to improve the asset.

A new view on repairs outlined in the draft ruling is the ability to repair an asset, which at the time of being acquired was in some part defective, damaged or suffering from deterioration, to bring it back to its normal level of 'functional efficiency'. However, care would have to be taken to ensure the repairs do not extend to improvements.

Possibly the most interesting aspect of the draft ruling is the ability to make improvements to an asset with existing monies of the Super Fund held outside of the borrowing arrangement, something that has not been allowed for previously. However, consideration of whether a change to the asset is an improvement, or a replacement, must be made.

What is a repair and what is an improvement?

Loan proceeds can be applied to repair or maintain an asset held in a borrowing arrangement, but cannot be applied to improve the asset. Therefore, determining if a change to an asset is a repair or maintenance or an improvement is important to ensure the Super Fund complies with the Super Fund borrowing provisions.

In this respect, an improvement is considered a change to the asset which involves 'the addition of new and substantial features or rights' that 'substantially increase the asset's value or functional efficiency'.

A repair on the other hand, both in this draft ruling and TR 97/23, means 'the remedying or making good of defects in, damage to, or deterioration of, property to be repaired (being defects, damage or deterioration in a mechanical and physical sense) and contemplates the continued existence of the property.'

Some practical examples of this determination outlined in SMSFR 2011D/1 include:

Repair or Improvement?

Repair	Improvement
The guttering on a house is replaced and the house is repainted. A fence is replaced, and fire alarms are installed	The addition of a pool or new garage would be considered an improvement
A fire damages a kitchen. Restoration of the damaged part of the kitchen would constitute a repair	If the kitchen was also extended by extension of the house, it would constitute an improvement.
A cyclone damages the roof of a house and the roof is replaced in its entirety	The additional of a second storey to the house at the same time as replacing the damaged roof
A farm that includes one set of cattle yards, four bores including windmills, tanks and troughs and three kilometres of fencing. Replacing a section of cattle yards would be a repair, and ensuring the bores could continue in working order, including the laying of new pipes would be considered maintenance	The additional of a new set of cattle yards, a new bore, dam or additional kilometres of fencing would be considered improvements.

When is an improvement a replacement?

The draft ruling provides for the improvement of an asset with existing Super Fund monies outside of the borrowing arrangement. Note however that care would need to be taken to ensure the improvement does not go so far as to constitute a replacement of the asset.

Section 67B of the SIS act allows for the replacement of an asset in a Super Fund borrowing arrangement in very specific and limited circumstances, and these circumstances do not extend to real property in any form. Therefore, it is important to determine the line where a change to a property would be classified as an improvement, and when it would be classified as a replacement.

A change to an asset that constitutes a replacement of that asset is a change that fundamentally changes the character of the asset.

Practical examples of what would constitute a replacement asset in relation to real property outlined in SMSFR 2011/D1 include:

- Subdividing a vacant block of land that was previously held on a single title, so that it spans multiple titles
- Constructing a house via a Super Fund borrowing on existing land held by the Super Fund
- Demolishing a house and replacing it with three strata titled units
- Rezoning the land a house resides on and renovating the house so that it constitutes commercial premises

Each of the examples above fundamentally changes the character of the asset, and therefore, is considered to constitute replacements assets, rather than improvements.

Summary

Whilst only a draft ruling, SMSFR 2011/D1 provides a common sense approach to assets held in a Super Fund borrowing arrangement. The draft ruling is presently open for comment, with a due date of 28 October 2011.

The general outcomes of SMSFR 2011/D1 are as follows:

- *Single Acquirable Asset* has been extended to include assets that cannot be dealt with separately or cannot be separated without contravening a state or territory law;
- Trustees would be able to improve assets held within a Super Fund borrowing arrangement with existing Super Fund monies that are outside of the borrowing arrangement, as long as the improvement doesn't constitute a replacement asset; and
- Trustees could fund the repair and maintenance of an asset held within a Super Fund Borrowing arrangement with the loan proceeds of the arrangement, as long as the repair does not constitute an improvement

For more information on Super Fund Borrowing, please contact a Topdocs consultant on 1300 659 242.