

Financial System Inquiry & SMSF Borrowing - What to do now?

The findings of the Financial System (Murray) Inquiry included a recommendation that limited recourse borrowing by superannuation funds be stopped. Where does that leave SMSF trustees and their advisers with their longer term planning?

Financial System Inquiry

On 7 December 2014, the Government released the final report of the Financial System Inquiry (FSI). The objective of the FSI was to examine "... how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth."¹

Although SMSFs received minimal coverage (a positive sign) amongst the 44 recommendations contained in the report, one recommendation (**Recommendation 8**) potentially creates a negative impact - the FSI report suggested that the Government:

Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

The FSI recommended that the temporary borrowing exemption, a feature of superannuation for many years, be permitted to continue - it was the limited recourse borrowing arrangements (LRBAs) which were the focus of Recommendation 8.

In its conclusion to Recommendation 8, the FSI noted that some of the options put forward in submissions to the Inquiry suggested permitting

LRBAs to continue, but with further limitations imposed on the borrowing arrangements. However, the FSI felt that additional regulation would impose further complexity and compliance costs on the superannuation system.

The FSI panel therefore opted to recommend the removal of the LRBA exception from the prohibition on borrowing.

Where to from here?

The FSI report contained many recommendations across the broad range of its Terms of Reference. Each of those recommendations, including Recommendation 8, will need to be considered by Government before any decision whether or not to implement each recommendation is taken.

Additionally, submissions from interested parties have been called for and will be considered along with the FSI recommendations.

Following that, any decisions by the Government to change legislation will need to be presented to Parliament for consideration and approval.

Therefore, it could be expected that considerable time will elapse before the SMSF industry has a clear

understanding of the future of LRBAs.

What do we advise our clients?

Until any announcement has been made by the Government regarding the future of LRBAs, we do not see any reason to not continue on a 'business as usual' basis.

In other words, if an investment made with the assistance of borrowed funds would have been considered prudent before any considerations or recommendations evolved from the FSI, such an investment would not necessarily cease to be prudent purely because of Recommendation 8.

What is the likely outcome?

That is a question to which we do not have an answer, although it could reasonably be expected that any adverse announcement will take place prospectively, rather than retrospectively.

So, purchases which have settled are unlikely to be affected. The impact on those situations where a contract has been signed, but settlement has not taken place, is a greater unknown. Should the Government announce it is proceeding as per

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Recommendation 8 of the FSI, it is those in 'transition stage' which could be adversely impacted. That would, of course, depend on the content of the eventual announcement and the timing restrictions imposed.

Additionally, the announcement may have a different impact from one SMSF to another, depending on the stage of their asset acquisition. For example, an SMSF trustee may have:

- established a bare trust, had the bare trustee sign a contract to purchase, arranged finance and be awaiting settlement; or
- established a bare trust, had the bare trustee sign a contract to purchase but has not yet arranged finance; or
- signed a contract to purchase off the plan but has not yet established the bare trust nor commenced the finance application²; or
- signed a contract to purchase off the plan but has not yet established either the SMSF or the bare trust, nor commenced the finance application².

Any adverse announcement by the Government regarding LRBAs could, most likely, not impact the SMSF in the 1st scenario, possibly not impact the SMSF in the 2nd scenario, but could leave the SMSF in the 3rd scenario and the proposed SMSF in the 4th scenario significantly exposed.

What documentation should be put in place?

If SMSF trustees decide to proceed with an investment, using finance under a LRBA, there are some

specific considerations which existing or potential SMSF trustees and their advisers would be wise to take into account, namely ensure that:

- the SMSF has been established;
- the corporate trustee of the bare trust has been registered;
- the bare trust documentation has been prepared and signed at the appropriate time;
- a contract to purchase the asset has been signed by the trustee of the bare trust;
- appropriate resolutions documenting the decision to proceed with the purchase under a LRBA are in place; and
- application for finance, whether from a commercial lender or a related party, has commenced.

In other words, all steps necessary to complete a purchase by a SMSF under a LRBA should be completed **sooner rather than later**.

Why the rush?

Basically, if the Government does decide to remove the LRBA exemption, it is likely (hoped) that it will permit any purchases 'in the pipeline' to continue to settlement.

However, if:

- an entity, the bare trustee, has contracted to purchase an asset but the SMSF trustee has not applied for finance; or
- an off the plan contract has been entered into with the intention of transferring ownership to a bare trustee at a later date;

such arrangements may not meet the 'in the pipeline' criteria set down

at the time, as they are not totally indicative that the SMSF trustee intended to purchase under a LRBA.

Conclusion

Not knowing the end result of Recommendation 8, whether it will be accepted by Government as is or in a different format, and whether any changes will get through Parliament, makes planning difficult.

Until such time as an announcement is made, there is no reason not to proceed on a 'business as usual' approach, **provided all resolutions, applications, actions and intentions are properly documented**.

Ensuring loan applications have been commenced will assist in proving the intent to acquire the asset under a LRBA, should that prove necessary in the event of an adverse decision prior to settlement occurring.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

Notes:

- ¹ The Treasurer, the Hon Joe Hockey, announced the final terms of reference for the Financial System Inquiry on 20 December 2013.
- ² Some jurisdictions, Victoria in particular, permit the contract to be signed by (say) a person or entity with the eventual purchaser nominated prior to settlement.

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