LIMITED RECOURSE BORROWING - RELIEF FROM IN-HOUSE ASSET CONCERNS

Since the introduction of limited recourse borrowing legislation, debate has raged over the interpretation by the ATO of part of the legislation which deals with the transfer of the acquired asset from the bare trust to the SMSF, following repayment of the loan

This paper considers proposed legislative changes which will see the arguments put forward by the industry recognised by the ATO, resulting in a practical solution.

Background

The answers to 2 questions included by the ATO in its publication titled 'Limited recourse borrowing arrangements by self-managed super funds - questions and answers' ('ATO Q & As'), first published following the introduction of sections 67A & 67B of the SIS Act in 2010, caused a significant amount of surprise amongst practitioners and led to regular debate with the ATO, regarding the Commissioner's interpretation of the relevant part of the law.

Basically, the ATO's interpretation of the legislation caused it to determine that, unless an asset acquired under a limited recourse borrowing arrangement (LRBA) was promptly transferred by the bare trustee to the SMSF trustee, following clearance of the loan, the asset held by the bare trustee would be an in-house asset of the SMSF and, potentially, breach the 5% in-house assets limit.

Interpretation

The relevant questions contained in the ATO Q & As, and the answers provided by the ATO, were:

- What is the purpose of the special in-house asset rule for limited recourse borrowing arrangements?

  The holding trust in a limited recourse borrowing arrangement will generally be a related trust of the SMSF. An investment by an SMSF in a related trust is an in-house asset of the SMSF unless an exemption applies.

  The special rule ensures that a limited recourse borrowing arrangement entered into by an SMSF which meets the other requirements of the super law will not automatically result in an in-house asset arising from the investment made in the holding trust. Such an investment will only be an in-house asset where the underlying asset would itself be an in-house asset of the SMSF if held directly.

- Can the holding trust trustee continue to hold the property for the investor after the borrowing has ended?

  Yes, but the SMSF's interest in the holding trust will be an in-house asset of the SMSF if the interest represents an investment of the SMSF trustee in the holding trust. This is because, under subsection 71(8) of the SISA, once a limited recourse borrowing arrangement has ended, even if there are other amounts outstanding, the in-house asset exception ceases to apply.

  There is a contravention of the super law if:

  - the asset is not transferred to the SMSF or the interest in the holding trust does not otherwise end once the borrowing comes to an end
  - the interest in the holding trust becomes an in-house asset of the SMSF and this causes the SMSF to exceed the permitted 5% level of in-house assets.

The ATO appears to have reached its conclusion by interpreting s 71(8) of the SIS Act differently to most industry practitioners.

Section 71(8) was introduced to the SIS Act in 2007, as part of the initial 'instalment warrant' legislation and was amended in 2010 when sections 67A and 67B were introduced, so it clearly relates to the LRBA provisions.

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However, whilst many have interpreted the provisions to indicate that there will not be any in-house asset issues whilst the loan is in place, the ATO had interpreted that to mean there **will be** in-house asset issues once the loan has been repaid, if the bare trustee continues to hold the asset.

Argument

The main argument put forward by the industry representatives at many meetings was based around the ATO suggestion that the value of any interest an SMSF held in the bare (holding) trust equated to the value of the asset held by the bare trustee.

Countering that interpretation, industry representatives argued that, in many instances, the value of the holding trust was minimal, at best. The argument continued that the asset was held **in trust** by the bare trustee in a custodial role, in much the same way many public offer funds use a custodian to hold their assets, and was not an actual investment in the bare trust.

Potential resolution

The ATO, in December 2013, released a draft 'legislative instrument', currently titled 'Self Managed Superannuation Funds (Limited Recourse Borrowing Arrangements - In-house Asset Exclusion) Determination 20xx', issued under the provisions of s 71(1)(f) of the SIS Act.

Section 71(1)(f) permits the Regulator to made Determinations to exclude particular investments from the reaches of the in-house assets definition.

In this instance, the legislative instrument will not be a disallowable instrument, meaning that the final Determination contained in the legislative instrument will become law following release by the ATO.

As the closing date for submissions in respect of the legislative instrument is 31 January 2014, it is possible the final Determination may be released shortly after that date, depending on the responses the ATO receives.

It is apparent from the draft Determination that the ATO has taken a practical approach to the argument, by excluding an investment in a related trust, held by an SMSF as a required part of an LRBA, from being an in-house asset:

- following creation of the trust but before the asset is acquired;
- during the term of the borrowing; and
- where the asset continues to be held by the bare trustee after the borrowing has been repaid.

Incidentally, the draft Determination proposes that it be effective from 24 September 2007, the date of introduction of the 'instalment warrant' legislation.

What does that mean?

SMSF trustees will no longer be compelled, through in-house asset concerns, to require the bare trustee to transfer the asset, following clearance of the borrowing.

One of the major considerations at the time of clearance of the borrowing is whether certain taxes will apply in relation to the transfer to the SMSF trustee, possibly as a result of poorly drafted documentation at commencement of the LRBA.

Most importantly, whether stamp duty will be assessed by the relevant revenue office in the jurisdiction of the particular asset.

Additionally, the question as to whether other taxes such as GST and capital gains tax will apply may, in certain circumstances, be reasons to have the bare trustee continue to hold the asset.

Alternatively, the SMSF trustee may plan to sell the asset in the near future and, rather than incur costs to transfer the asset to the SMSF, it arranges for the bare trustee to hold the asset pending negotiation of a sale.

> "SMSF trustees will no longer be compelled to require the bare trustee to transfer the asset to it, following clearance of the borrowing"

Regardless of the reason why SMSF trustees may wish to delay the transfer, the proposed Determination is a welcome resolution of the argument which has, for some time, left SMSF trustees and their advisers uncertain as to their obligations following repayment of the borrowing.