SMSF BORROWING – 3 KEY CONCEPTS

This article examines the three key concepts relating to SMSF borrowing arrangements as per ruling SMSFR 2012/1.

Summary

The ATO ruling SMSFR 2012/1 provides a common sense approach to assets held in a SMSF borrowing arrangement. The general outcomes of SMSFR 2012/1 are as follows:

- The definition of the term 'Single Acquirable Asset' has been extended compared to the initial position taken by the ATO;
- Assets subject to a SMSF borrowing arrangement may be improved (to a degree) with existing SMSF monies; and
- Repairs and maintenance of an asset held within a SMSF borrowing arrangement may be undertaken with either the loan proceeds or with SMSF money.

SMSFR 2012/1

On 23 May 2012, the ATO released its long awaited final ruling on SMSF borrowing arrangements, Self Managed Superannuation Funds Ruling, SMSFR 2012/1 'Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts'. SMSFR 2012/1 replaced an earlier draft ruling, SMSFR 2011/D1, which was released in September 2011.

Overall, the changes from SMSFR 2011/D1 to SMSFR 2012/1 appear to enhance the previous guidance provided, rather than take away some of the major understandings gleaned from SMSFR 2011/D1. It indicates that the ATO has listened to industry concerns and generally adopted a fairly pragmatic approach when providing its interpretation of the legislation.

SMSFR 2012/1 does not introduce major changes to the restrictions and/or interpretations which were contained in the draft ruling. In fact, the greater number of examples provided in SMSFR 2012/1, in comparison to the draft ruling, assist in providing further clarity surrounding acquirable assets and in regards to what work is permitted to be done to assets under SMSF borrowing arrangements:

- using borrowed money; and
- using funds held within the SMSF.

Key Concepts

As the title to the ruling indicates, the purpose is to explain the key concepts in relation to the legislative provisions, sections 67A & 67B of the SIS Act, permitting SMSF borrowing arrangements to occur.

The three key concepts covered are:

1. acquirable asset and single acquirable asset;
2. maintaining, repairing or improving an asset; and
3. replacement asset.

1. Acquirable Asset and Single Acquirable Asset

Being the first of the key concepts explained, this sets the scene in explaining which assets may be acquired by the trustee of a SMSF under a borrowing arrangement.

Acquirable Asset

For advisers used to dealing with SMSFs, the term 'acquirable asset' will be relatively straight forward - it is any asset, excluding money, that a trustee of a SMSF is not otherwise prohibited, either under the provisions of the SIS Act or any other law, from acquiring.

The basis, therefore, is that if the trustee could ordinarily acquire the asset using SMSF money, then it could acquire the same asset using borrowed money.

Single Acquirable Asset

Having ascertained that an asset may be purchased under a SMSF borrowing arrangement, it is then necessary to ensure that the asset may be purchased under a single borrowing arrangement, or whether multiple borrowing arrangements are required - in other words, if it meets the single acquirable asset test.

- Shares and Units

SMSFR 2012/1 provides very little coverage of investments other than real estate. Reference is made in the ruling to the actual sections of the SIS Act, sections 67A & 67B, which

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suggests that a collection of assets, such as shares in a company or units in a unit trust, may meet the single acquirable asset test if they:

- have the same market value;
- are identical to each other; and
- are replaced only in specific circumstances, as set out in the legislation.

- Real Estate

The bulk of the ruling concerns investment in real estate. In many cases, the real estate which a SMSF would acquire would be on a single title and would, therefore, meet the single acquirable asset test. A house on land in a suburb or a country town is a common example of that.

However, there are instances where what is regarded as a single investment may not meet the single acquirable asset test, as it comprises more than one title. Examples include:

- a factory complex over multiple titles; or
- a farm comprising a number of titles; or
- an office or apartment with car parking identified through separate titles.

In SMSFR 2012/1, the ATO suggests it would be reasonable to conclude an asset being acquired is a 'single object of property' with the existence of factors such as:

- the presence of a 'unifying physical object'; or
- whether the titles must be dealt with together, as required under the law of a State or Territory.

- Unifying physical object

The concept of a 'unifying physical object' is a structure which sits across one or more titles and:

- is permanent in nature;
- is not easily removed; and
- is significant in value relative to the value of the land.

One of the ATO examples in the ruling provided details of a farm, comprising multiple titles, which operates as a piggery. On the farm, across multiple titles, sits a shed with infrastructure which houses the main operations of the farm. According to the ATO in the ruling: "Assuming that the piggery adds considerably to the value of the land and thus is a significant part of the value of the asset it would be a single acquirable asset."

The 'significant in value' test was an addition between SMSFR 2011/D1 and SMSFR 2012/1, presumably to preclude attempts to bring assets within the definition of single acquirable asset by, for example, the erection of a hayshed over the common boundaries of multiple titles. Whilst it could be argued that a hayshed is relatively permanent in nature and not easily removed, it would be difficult to argue that the shed itself was significant in value relative to the overall value of the property.

The ATO provided further clarity of the unifying physical object test by reference to a land-locked title - property on one title which may only be accessed by crossing land under a separate title. That would not be sufficient, according to the ATO for the 2 titles to be considered a single acquirable asset under the unifying physical object test.

- - State or Territory Law

The ATO ruling also contains an example of the purchase of an apartment with a separate car park, on a strata plan which contains a restriction that the titles are to be transferred together. As the transfer could not be registered under State or Territory law if not transferred together, the apartment and car park will represent a single acquirable asset.

The application of State or Territory law extends not only to covenants on titles that one must be transferred with the other, but also to instances where registered bodies corporate have particular rules in regards to the transfer of property and accessory units, such as car parks. That would be predicated on the law of the State or Territory acknowledging the authority of the relevant body corporate.

2. Repair or Maintenance or Improvement

The concept of repairing, maintaining or improving an asset under a SMSF borrowing arrangement has significance in that, according to the ruling:

- repairs and maintenance may be carried out using either borrowed funds or SMSF money; whilst
- improvements must only be done using SMSF money.

Additionally, the extent of the improvements will determine whether the replacement asset provisions have been triggered.

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The ATO defines each of the relevant terms as:

- maintain - work undertaken "… to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration, provided that the work merely ensures the continued functioning of the asset in its present state."
- repair - "… remedying or making good defects in, damage to, or deterioration of an asset and contemplates the continued existence of the asset. A repair is usually occasional and partial. A repair restores the function of the asset without changing its character …"
- improve - "… if the state or function of the asset is significantly altered for the better, through substantial alterations, or the addition of further substantial features … to the asset."

As both repairs and maintenance can be carried out using either borrowed or SMSF money, they tend to be grouped together for reference purposes. That is borne out in some examples provided by the ATO in SMSFR 2012/1, as follows:

Repair or maintenance example	Improvement example
A fire destroys a three bedroom residential house. Rebuilding a broadly comparable house is not an improvement as it restores the asset to what it was before the fire. If superior materials, fittings or appliances are used it is a question of degree as to whether the changes significantly improve the state or function of the asset as a whole.	Rebuilding a residential house that is not broadly comparable to that destroyed is an improvement. However, if the funds to rebuild are from an insurance company and not from borrowings this does not affect the LRBA.
A residential house is acquired under an LRBA and is rented out for a number of years. As the area is now a real estate hot spot a decision is taken to renew the kitchen which, although functional, is significantly out of date and showing wear and tear. The design of the kitchen is improved and modern equivalent, rather than superior, materials and appliances are used. The changes made do not significantly improve the state or function of the asset as a whole.	A residential house is acquired under an LRBA and is rented out for a number of years. As the area is now a real estate hot spot a decision is taken to demolish the house. Rebuilding a residential house that is not broadly comparable to that demolished is an improvement. However, if the funds to rebuild are not from borrowings this does not affect the LRBA.

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3. Replacement Asset

In the context of improvements, and whether they will constitute a replacement asset, the reference changed from 'altering the functional efficiency of the asset' and/or 'a substantial increase in the value of the asset' in SMSFR 2011/D1 to 'whether its state or function is significantly altered for the better' in SMSFR 2012/1.

Whilst many of the examples from SMSFR 2011/D1 were unchanged, SMSFR 2012/1 saw the addition of a number of new examples from the ATO. Some of the new examples, which assist in understanding the ATO's position, are detailed as follows:

Single acquirable asset	Whether it is a different asset(s)
Residential house and land	A residential house is converted into a restaurant by renovations which include fitting out a fully functioning commercial kitchen. As a result of the renovation the character of the asset has fundamentally changed from residential premises to restaurant premises. **This is a different asset**.
Residential house and land	One bedroom of a residential house is converted to a home office. This would not ordinarily result in a change in the overall character of the asset as a residential house. **The conversion of the bedroom into an office does not result in a different asset**.
Residential house and land	While each of the following changes would be improvements each (or all) **of the changes would not result in a different asset**: • an extension to add two bedrooms; • the addition of a swimming pool; • an extension consisting of an outdoor entertainment area; • the addition of a garage shed and driveway; • the addition of a garden shed.
Residential house and land	A 'granny flat' is to be constructed in the backyard of a property which already has a four bedroom residence established on it. The granny flat will have two bedrooms, a family room, a kitchen and a bathroom and will be connected to utilities such as electricity, water and sewage. **The character of the asset would remain residential premises** and thus the construction of the granny flat would not result in there being a different asset.

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Single Acquirable Asset	Whether it is a different asset(s)
Cattle property (single acquirable asset)	A **large shed** is constructed, using SMSF money, to provide shelter to the cattle. The shed is an improvement. However, the shed does not result in the property becoming a different asset as **the character of the asset as a cattle property has not fundamentally changed**. Should a **residence** also be built on the property to allow the owner or a manager to live on site this would not result in the property becoming a different asset as **the character of the asset as a cattle property would not fundamentally change**.
Hobby farm	A four bedroom house is built on the property, using accumulated funds held by the SMSF, with the intention of the property being leased to an unrelated party as a residence. **The building of the house results in the character of the property fundamentally changing** from that of being solely a small scale hobby farm to also being a residential property.
Commercial building extension	The facility is leased to a tenant who operates a car washing business. The trustees decide to expand the facility by extending the back of the building to double the number of wash bays. The extension will be funded from accumulated funds held by the SMSF. Although there is an improvement to the asset, that **improvement does not result in the commercial property becoming a different asset**. The fundamental character of the property remains a car wash facility.

The common theme arising from the examples provided by the ATO in SMSFR 2012/1 is that **some improvements** are permitted to be made to those assets subject to SMSF borrowing arrangements, provided that:

- SMSF (non-borrowed) money is used; and
- the state or function of the assets is not significantly altered.

Overall, SMSFR 2012/1 has provided greater clarity on a number of aspects central to SMSF borrowing arrangements.

More information

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

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