

ATO releases first significant guidance on SMSF borrowing

Following intense interest in the laws of September 2007 which permit SMSF trustees to borrow under instalment warrant-type arrangements, on 4 April 2008 the ATO released a 'Questions and Answers' guide and Taxpayer Alert TA 2008/5 on this topic.

Note, these are not legally binding and trustees and advisers should not solely rely on their contents. However, the releases provide some guidance on the ATO's approach to a number of technical issues.

Some of the key points to take from the releases:

- The ATO acknowledges that the giving of a personal guarantee may cause the arrangement to breach the borrowing laws because this may expose the fund to more than just the asset being acquired in the event of a default. Further clarification is required from the ATO on exactly when, if at all, a guarantee is acceptable.
- The releases confirm the view that loans from related parties must have arm's length (ie, commercial) terms. A borrowing from a related party at less than commercial rates of interest may raise concerns as to whether the payment received is not a borrowing but in fact a contribution, while borrowing at interest rates exceeding commercial rates may raise concerns as to whether the fund is being maintained solely for the purpose of providing superannuation benefits.
- Where a property trustee is a related party, the ATO does not consider that the eventual transfer of legal title from the property trustee to the SMSF trustee is an 'acquisition' by the SMSF and therefore, in the case of non-business real property, this should not breach s 66 (the prohibition against related party acquisitions).
- These arrangements must be properly documented. If it is unclear that there is a genuine borrowing from, eg, a related party, the arrangement could be deemed a contribution (possibly leading to excess contributions tax).

These releases indicate that SMSF borrowings can be a legitimate strategy if properly documented and implemented. It is clear that these arrangements can by no means be implemented as 'standard' products: these are complex transactions and each SMSF's proposed borrowing must be carefully considered in

light of the technical superannuation and tax issues that invariably arise.

What issues still require clarification?

The ATO flags the following as issues under consideration:

- Guarantees: when will they be acceptable?
- Can SMSF trustees re-finance their loan?
- Can interest be capitalised?
- Can a trustee have multiple drawdowns from a single loan facility?

DBA recommends extreme caution in respect of these issues given their current unsettled status.

Does my investment property make me gainfully employed?

Members over 65 years must satisfy the 'work test' to make super contributions, ie, the member must be gainfully employed on at least a part-time basis for a period of at least 40 hours over a period not exceeding 30 days (aka 'the 40/30 test'). 'Gainfully employed' means employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment.

Often this comes down to whether the member could be said to carry on a 'business' and in many cases this will involve income derived from investment properties owned by the member. It is clear that passive income earned from rental properties will not qualify as a 'business' and therefore will not satisfy the work test. However, if the member is sufficiently involved in the management of the rental property, this may qualify as gainful employment.

Generally, the level of involvement needed to qualify is high. Most investors have a profit motive and may even be involved in a 'business-like manner', but more is required.

- Regulatory/repetition: a 'one-off' period in which the member is involved (eg, in renovating a property) is unlikely to constitute a 'business', even if the purpose is to increase the rental income. In *Carson v Commissioner of Taxation*, the taxpayers spent 1 week, twice per year, refurbishing and repairing a property and this was held not to be an active asset for small business CGT purposes (analogous to carrying on a business).

- Size, scale and permanency of the operations: it is more likely that there is a business where the member is involved in managing many properties rather than a few.
- Extent of the activities: involvement in day-to-day tasks such as rent collection, interviewing of tenants and day-to-day repairs suggest a business is carried on, while involvement in longer term projects only (refurbishment, etc) make it difficult to prove there is a 'business'.

Good documentation avoids litigation: a cautionary tale

A recent case from the Supreme Court of Queensland has highlighted the benefits of well drafted documentation.

In *Jenkins v Ellett* the parties disputed the identity of the appointor and trustee of a discretionary trust.

As is common in litigation, the dispute arose following from the death of a key family member (George Jenkins).

George was the co-trustee and appointor of the George Jenkins Family Trust. The trust deed contained a vague variation power. It provided that the trustee may vary all or any of the trusts declared.

George and the other co-trustee executed a deed of variation. This deed of variation purported to remove George as the appointor and appoint a new appointor.

It was held that it would be 'very odd and self-defeating' if the trustee could amend a deed to remove an appointor. Accordingly, the court declared the variation to be invalid.

Don't let this happen to you or your clients

This case could have been avoided if the original deed provided that a variation required the appointor's approval.

Alternatively, this case could have been avoided if the original deed expressly dealt with appointor succession. For example, better quality discretionary trust deeds allow:

- 'up front' nomination of the original appointor and a 'successor appointor'. A successor appointor is the appointor upon the death or incapacitation of the original appointor, and
- appointors to retire and nominate a successor.

DBA Butler's discretionary trust deeds contain both these strategies. For more information, visit www.dbabutler.com.au/index.php?p=products5



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Every July, new governing rules and accompanying PDS materials are placed on the homepage, along with tailored trustee resolutions adopting the new governing rules. This provides advisers with efficiency and the invaluable knowledge that all SMSF clients have the same governing rules that are up-to-date with the most current laws.

To register an SMSF to receive governing rules updates just tick the appropriate box on the new super fund/deed upgrade order form. For a small annual fee of \$150, you can ensure the fund always has up-to-date governing rules.

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