DBA Butler Pty Ltd
Lawyers

NEWS

May 2008

Capital protected borrowing expenses & SMSFs

The much anticipated 2008/09 Federal Budget has now been delivered and despite various rumours that had been circulating in the lead-up to Budget night, there have been no major surprises on the superannuation front. In particular, there have been no announcements made about instalment warrant-type borrowings by SMSFs, indicating that these arrangements will continue to be a major planning opportunity for SMSF trustees and their advisers.

One announcement which may impact borrowing is the lowering of the benchmark interest rate for capital protected borrowings entered into from 13 May 2008, which we explain below.

What are capital protected borrowings?

A borrowing is ‘capital protected’ if the borrower is wholly or partly protected against a fall in the market value of an asset (where the asset is either being acquired via the borrowing, or is being used as security for the borrowing). Often, this is akin to a ‘put option’ (eg, where the borrower is able to force a transfer of the asset to the lender if the asset falls below market value).

Whether a particular borrowing has this element of ‘capital protection’ comes down to the asset being acquired and the terms of the loan agreement.

Under Div 247 of the *Income Tax Assessment Act 1997* (Cth), not all of the interest expenses for a capital protected borrowing may be deductible; for some loans, any amount of interest above the ‘benchmark’ interest rate is treated as a payment for a ‘put option’ and is therefore not deductible.

The Federal Government announced that this rate is to be lowered from the RBA’s variable indicator rate for personal unsecured loans (which is broadly the current rate of 14.55%) to the RBA’s variable indicator rate for standard housing loans (currently 9.35%). This means that a greater number of capital protected borrowings are likely to be captured by this new, lower benchmark rate.

Does this affect instalment warrant-type loans?

It should firstly be noted that Div 247 only applies where the asset is an interest in a share, a unit in a unit trust or a stapled security (or an interest in an entity that holds an interest in these). Therefore, Div 247 will not apply in respect of instalment warrant-type loans to acquire real estate and other assets.

Where, eg, shares are involved in an instalment warrant-type product with ‘capital protection’, Div 247 will apply and deny a deduction for any interest above the benchmark (currently 9.35%). The excess is included in the asset’s cost base for calculating any future capital gain or loss.

SMSF borrowings under the SISA must be limited in recourse to the underlying asset. ‘Capital protection’ is interpreted broadly by industry to include any limited-recourse loan: because a borrower can walk away and force the asset back to the lender, they are ‘capital protected’, even if there is no express protection for a fall in market value. While it is not entirely clear whether Div 247 is to be interpreted this way, the safest approach is that Div 247 potentially applies to all limited-recourse borrowings if the asset acquired is a share, unit or stapled security (or interest in an entity holding same).

Note that some components are not taken into account for the purposes of Div 247, eg, application fees and brokerage commission.

Trustees undertaking SMSF borrowings should therefore seek expert advice as to the deductibility of borrowing expenses, as well as the CGT, GST, stamp duty and land tax implications.

Focus on SMSFs & unit trusts

Recent material from the ATO suggests SMSF investment in unit trusts (‘UT’) will be under scrutiny. Draft Ruling SMSFR 2008/D1 indicates the ATO may consider an unpaid present entitlement (‘UPE’) owing to an SMSF unitholder for which payment is not sought to be a ‘loan’ from the SMSF to the UT. SMSFs with UPEs owing must be alert to this and seek timely receipt of any UPEs.

Concerns are raised in Taxpayer Alert TA2008/4 that SMSF income derived from ‘hybrid’ UTs may be 'non-arm's length income' (ie, taxed at 45%) if the income is disproportionate to what would be expected if dealing at arm’s length. UT deeds should therefore be reviewed for any ‘hybrid’ or non-fixed element.

SMSFD 2007/1 confirms when a distribution from a pre-1999 geared UT is ‘received’ by an SMSF, which affects when and whether the amount can be reinvested in the UT in the lead up to the deadline for reinvestment in such trusts (broadly a receipt must be reinvested by 30/6/2009).

End of financial year super checklist

Another 30 June is fast approaching. Advisers must ensure they have these items ticked-off before year's end!

Ensure all super interests have been crystallised. From 1/7/2007, all super interests have 'taxable' and 'tax free' components: the 'tax free' component contains a crystallised segment which must be calculated. Trustees who have not calculated the necessary crystallised amounts by 30/6/2008 are liable to a $500 penalty (for advisers that means $500 per fund!) • Accumulation interests: have crystallised segment as at 30/6/2007. Must be calculated by 30/6/2008. • Pensions commenced before 1/7/2007 for which **no** pension payment was made before 1/7/2007: also have crystallised segment as at 30/6/2007. This must be calculated by 30/6/2008. • Pensions commenced before 1/7/2007 where a payment **was** made before 1/7/2007: do not have crystallised segment until a 'triggering' event occurs, eg, partial commutation or attaining 60 years.	
Ensure all clients with pensions have received the minimum annual pension payments (where a pension commenced after 1/7/2007 this will be pro-rated). For pensions commenced in June 2008, no payment is required to be made for 2007/08. Ensure any other sundry fund creditors have been paid.	
Before making any further contributions before year end, confirm with clients what contributions have already been made in 2007/08 to ensure caps are not inadvertently breached.	
Do you have clients who turned or will turn 65 in 2007/08? If so, this is their last year to utilise the 'bring-forward' arrangement to contribute up to $450,000 in non-concessional contributions over 3 years.	
It is good practice for self-employed persons to ensure a notice of intention to deduct concessional contributions is given to trustees within 30 days, or possibly risk this being counted as a non-concessional contribution.	
Ensure the trustee has sufficient minutes documenting its activities in the past year and preferably a revised investment strategy.	
For SMSFs with investments in pre-11/8/1999 unit trusts, consider the looming deadline of 30/6/2009, after which time no further reinvestment in the trust can be made (so maximise reinvestments now).	
Allocated Pensioners may wish to convert to the new Account-Based Pension. The start of a new fiscal year is an ideal time to convert as documenting and calculating minimum annual payments is simpler.	

Spotlight on end-of-year SMSF documentation

Crystallisation Kit ($330) ☐

Guidance on calculating a member's crystallised segment as at 30 June 2007. This includes resolutions to record the pre-July 83 component and saves considerable time.

Conversion Kit ($440, single use licence) ☐

Documentation needed to convert an Allocated Pension to the new Account-Based Pension, including PDS, resolutions, member summary, instructions and more.

SPECIAL Those who order both a Crystallisation Kit and a Conversion Kit receive a $80 discount (total: $690).

Name of person ordering__________________________ Firm ____________________________________

Postal address ____ State _________Postcode _________

Tel _______________________ Fax ____________________ Email _______________________________

All prices include GST but exclude courier costs. Payment upon receipt of invoice.

DBA BUTLER PTY LTD, Lawyers, 23 Union Street, South Melbourne Vic 3205 (ABN 74 120 513 037)

Ph 03 9682 0903 Fax 03 9682 0907 dba@dbabutler.com.au www.dbabutler.com.au

DBA News contains general information only and is no substitute for expert advice. Further, DBA is not licensed under the *Corporations Act 2001* (Cth) to give financial product advice. We therefore disclaim all liability howsoever arising from reliance on any information herein unless you are a client of DBA that has specifically requested our advice.

✓ **Superannuation** ✓ **Tax** ✓ **Succession Planning** ✓ **Business**