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NEWS

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Tax effective SMSF borrowing structures

Most will be aware that since September 2007, it has been possible for SMSF trustees to borrow to acquire an asset, subject to certain conditions. One condition is that the asset acquired must be held on trust for the SMSF trustee. This trust is often referred to by many different names: eg, an instalment warrant trust, a bare trust, a debt instalment trust, a security trust or a custodian trust, depending on the supplier's documents.

Ultimately, the name of this trust is not important. Instead, it is the legal structure (as detailed in the provisions in the trust documentation) that is critical. This is important as the structure may have a significant impact on the tax effectiveness of the arrangement.

This edition of DBA news sets out the key issues on these arrangements: what is required by law, how does the structure impact the tax outcome of the arrangement and what practical steps can advisers take to maximise tax effectiveness?

What the SIS Act requires

The borrowing legislation (see s 67(4A) of the SIS Act) does not specify what type of trust must be used. It only specifies that the asset must be 'held on trust' so that the SMSF trustee has a beneficial interest in the asset (with the trustee of the 'instalment warrant' arrangement holding the legal title).

Therefore, the trust could take a variety of forms. This has been borne out in the market place, with a wide variety of documents available. While these structures might comply with SIS, the tax effectiveness of these structures needs to be considered. (Note also that while a bank will closely review the trust document, this is largely to ensure its security is protected and the arrangement is valid; the bank is generally not concerned about or responsible for the tax effectiveness of the trust.)

For example, a popular type of trust is a 'bare trust'. As explained in this newsletter, a true bare trust offers tax planning advantages. However, it is important to ensure that a trust which claims to be a 'bare trust' is in fact really a bare trust. DBA has reviewed some deeds which claim to establish a bare trust, but which contain numerous provisions that establish something quite different.

Why are 'bare trusts' so popular?

Goods and services tax ('GST')

One reason is GST. The Commissioner now accepts that the beneficiary of a bare trust (in this case, the SMSF trustee) may carry on an enterprise involving the use or exploitation of real property, even though the title to the property is registered in the name of a bare trustee. Related to this, the Commissioner confirms that an entity which acts as a mere bare trustee does not carry on its own enterprise. In other words, all GST activity is at the beneficiary level (ie, the SMSF trustee). Refer to the ATO's GSTR 2008/3.

This is important where the property is commercial and the GST turnover is greater than $75,000. This means that, rather than having to register the bare trust for GST, only the SMSF needs to be registered.

This also means that when the property is transferred to the SMSF trustee (ie, when the SMSF's loan is repaid), this does not constitute a taxable supply and thus does not give rise to a GST liability.

Income tax

Another reason is income tax efficiency. The trustee of a 'transparent trust' such as a bare trust is not required to furnish an income tax return, because it does not earn any income of its own. (Rather, the beneficiary, ie, SMSF trustee, is entitled to the income). Therefore, if a true bare trust is used, only the SMSF needs to furnish an income tax return.

Capital gains tax ('CGT')

Finally, a bare trust minimises CGT exposure when an SMSF's loan is repaid. The ATO's views in this area are not finalised (see, eg, TR 2004/D25). However, steps can be taken to make the structure as CGT-effective as possible.

There are sound arguments that an SMSF trustee is absolutely entitled to the asset from the commencement of the bare trust. On this basis, no CGT event would arise when the loan is repaid or when the property is transferred to the beneficiary (ie, SMSF trustee). Hopefully, the ATO will provide practical clarification on its views shortly.

Getting the bare trust right

As mentioned, a trust must truly be a bare trust for the above to apply. The ATO broadly considers a trust to be a bare trust where the trustee is obliged to transfer legal title to the asset as directed by the

beneficiary, and where the trustee has no other active duties to perform. In other words, the activities of the bare trustee should be essentially passive in nature and it should have either no active duties to perform, or only very minor active duties.

Accordingly, the deed should not grant the trustee broad powers to deal with the property or undertake other acts at its own discretion. Unlike other trustees (eg, discretionary or unit trust trustees) the bare trustee should be quite restricted.

As a result, many good bare trust deeds are often brief documents (DBA has even reviewed deeds with only one page). On the other hand, DBA has reviewed some deeds that claim to create 'bare' trusts with 'absolute entitlement', but which create much more substantial trusts (eg, they grant trustee powers beyond a bare trustee's basic duties, or the SMSF trustee has an interest in the trust rather than the asset). In these cases, the tax treatment discussed above may be jeopardised.

Further, wherever possible, the SMSF trustee should sign any documentation in relation to the property. Sometimes the bare trustee will have to sign documentation in order for it to be effective (or at the insistence of a third party – eg, an insurer might require that an insurance policy be held in the name of the title holder). In this case, it should be recorded that the bare trustee is merely acting on the instructions of the beneficiary (ie, the SMSF trustee).

A common mistake is for the bare trustee to have its own ABN, TFN, bank account or public officer. While not necessarily fatal, these things suggest that the trustee has active duties (or is a taxpayer in its own right, earning income from the property). The bare trustee should therefore have none of these things. Instead, the SMSF's ABN, TFN and bank account should be used.

DBA has also reviewed some documents which require the bare trustee to prepare its own annual financial statements. This is certainly not consistent with a 'bare trust', because a true bare trustee does not have any beneficial interest in the income or the asset and does not need its own accounts.

Conclusion

When setting up SMSF borrowing, advisers can add value for their clients by ensuring that tax efficiency is maximised. This includes:

- Ensuring that documents are sourced from a firm with taxation expertise.
- Taking care of practical steps, such as ensuring that the bare trustee does not obtain its own TFN, ABN or bank account for the arrangement, that the bare trustee does not prepare its own financial statements and that any paperwork which must be signed by the bare trustee is done merely on instruction from the SMSF trustee.

Finally, advisers should seek State or Territory-specific advice on how stamp duty applies (eg, will duty be payable on a future transfer from the trust, and whether duty is payable on the trust deed now). In some jurisdictions, exemptions or concessions exist but certain requirements must be met to qualify.

DBA Lawyers will provide an update on the latest news on SMSF borrowing at seminars around Australia in February 2010. For more details or to register, visit the 'Seminars' section of our website.

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