

New super borrowing rules

The government has proposed key changes for the super fund borrowing rules in the *Superannuation Industry (Supervision) Amendment Bill 2010* (Cth) ('Bill').

How will the changes affect my SMSF?

Refinancing Allowed

A big question under the current borrowing rules was whether refinancing was allowable. The ATO stated in a ruling last year that refinancing constitutes a new borrowing and thus refinancing was not allowable. This was bad news for SMSFs who borrowed from one lender as they would be stuck with that lender for the life of the loan, even if other more favourable loans later became available.

Under the proposed new law, an SMSF will be expressly allowed to refinance a borrowing arrangement.

This change will apply to all borrowing arrangements (even those entered into before the changes are enacted). Thus, borrowings entered into under current law can restructure to the new rules once the law is finalised.

Only a single asset may be acquired

The Bill proposes to limit borrowing arrangements to be used only to acquire a single asset or to acquire a collection of identical assets that have the same market value as each other together which are treated as a single asset (eg, a collection of ordinary shares in a publicly listed company).

A collection of buildings each under separate strata title, irrespective of whether the buildings are substantially the same at the time of acquisition, are not to be treated as a collection of assets. Also, a collection of shares in different companies would not be permissible.

Practically, this means that an SMSF will be allowed to borrow to acquire 10,000 BHP shares. However, a super fund will not be allowed to borrow to acquire 5,000 BHP shares and 5,000 Rio Tinto shares: instead, two borrowing arrangements would be required.

Further, if an SMSF wanted to borrow to acquire two identical apartments in the same building, it would need two separate borrowings.

No borrowing to fund property development

Many SMSFs wish to borrow not just to acquire real estate but also to develop or improve the property. For example, an SMSF fund may borrow to buy land and build on that land. Under the current law, the ATO has recently stated that an SMSF may borrow money to make improvements to real property and if the improvement materially alters the character of the property this creates a replacement asset.

Under the proposed new law, an SMSF will not be permitted to borrow to pay for improvements but will be permitted to borrow to maintain or repair the asset.

'Replacement Asset' clarification

The current law talks about borrowing to acquire both assets and 'replacement assets'. The ATO's view is that some people incorrectly believe that an SMSF can have a share facility that can buy and sell shares under the arrangement.

However, the proposed changes make it clear that the concept of a 'replacement asset' is strictly limited. No share trading facilities will be possible under the new law.

The proposed new law states what assets can be replaced, and under what circumstances. Broadly, in order to be a 'replacement asset', an asset must be a share in the same company as the original share and must be worth the same amount as the original share. There is also some scope for the replacement asset rules to apply where the replacement occurs as a result of a takeover, merger, demerger, or restructure of the original company or unit trust.

There is no scope for the replacement asset rule to apply to real estate.

Personal Guarantees

A big question mark over limited recourse borrowing arrangements is whether related parties may give personal guarantees. Many large lenders require them and this has concerned the ATO as reflected in Taxpayer Alert 2008/5.

Under the concept of a 'limited recourse borrowing', if a default occurs, the recourse that the lender should have against the SMSF trustee should be limited to the asset being acquired.

However, assume a member gives a personal guarantee on behalf of the fund and that member had

to make a payment under the guarantee. In this scenario, the member would have a right to recover the amount from the SMSF's trustee who in turn would be indemnified out of the fund's assets. This could result in all fund assets being exposed and the payment by the guarantor being counted as a contribution see: TR 2010/1.

The new law seeks to protect fund assets from this outcome. If a member or related party gives a guarantee, the lender or any other person (eg, the member who provides the guarantee) will be limited to have recourse only against the asset being acquired.

Practical issues with real estate

SMSFs will only be able to acquire a 'single asset' with borrowings unless the assets are identical and have the same market value. The Explanatory Memorandum to the Bill provide an example that a collection of buildings each under separate strata title, irrespective of whether the buildings are substantially the same at the time of acquisition as not being identical. Thus, two separate real estate titles would not constitute a single asset.

The draft legislation will result in practical hurdles as many properties are now sold with separate but related rights to the car park, storage room or body corporate entitlements to the main property title. Strictly speaking four borrowings would be required in such a scenario. Hopefully this aspect will be amended before it is enacted.

Transitional rules

The proposed changes take effect after the Bill is approved and obtains royal assent. Arrangements entered into after that time will be subject to the new provisions. As discussed above, arrangements entered into prior to royal assent will be subject to the current law unless there is refinancing of the current arrangement to bring it under the new provisions.

Year end super planning

The following items should be reviewed in the lead up to 30 June 2010:

- Relevant contributions have been paid into the fund within each member's contribution caps. Check all contributions against their caps.
- The minimum pension payment has been made for each member and under each pension. The ATO consider the fund's pension exemption for the entire financial year could be at risk unless the minimum has been paid.
- Review the fund's investment strategy and cash flow and revise the fund's investment strategy in line with changed circumstances.
- If there are any reserves, the fund's reserving strategy should also be reviewed and revised as needed. Will reserves augment earnings to boost member accounts or will some earnings be allocated to reserves instead?
- If the SMSF has any investment in a unit trust that has an unpaid present entitlement as at 30 June 2009, seek to have this amount paid prior to 30 June 2010. Also, should an interim distribution be paid before 30 June 2010?
- Where an SMSF has assets leased to a related party that all rents and other amounts have been paid on time. Is there any third party evidence to support these being at arms-length?
- Consider whether any expense or other payment needs to be made prior to 30 June 2010 including any tax payment, operating cost or insurance premium.
- Are all transactions relating to the fund at arms-length and make sure there is no breach of the in-house asset rules especially given the current market value of assets.

Keep SMSF trust deeds up to date

Note that ongoing changes are being made to tax and super rules and further changes are expected following the implementation of the Henry Review, Cooper Review, the 2010 Federal Budget and other reform measures currently in the pipeline. Moreover the new borrowing rules are currently before Parliament. The Annual Update Service is a cost effective solution to keep your SMSF deeds current and to drive efficiencies in your firm having one deed to refer to for all funds on the service for the entire financial year. For more information visit www.smsf.com.au.

For further Information please contact:

DBA LAWYERS PTY LTD, Level 1, 290 Coventry Street, South Melbourne Vic 3205

Ph 03 9092 9400 Fax 03 9092 9440 dba@dbalawyers.com.au www.dbalawyers.com.au

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