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SMSF borrowing ruling

The ATO has recently released SMSFR 2012/1 (being the final version of draft ruling SMSFR 2011/D1). It outlines the ATO's views on certain aspects of limited recourse borrowing arrangements ('LRBAs') including improvements, multiple assets and off-the-plan purchases.

Single acquirable asset

In determining whether an asset will be deemed to be a 'single acquirable asset', the following must be considered:

- Is there a unifying physical object attached to an asset which is permanent in nature.
- Whether, under state or territory laws, assets must be dealt with together.

ATO Examples

A strata titled apartment and car space on separate title are a single asset if there is a 'notice of restriction' that requires them to be sold together.

A factory that physically spans more than one title and considerably enhances the value of the land is considered a single asset. However, if that factory is derelict (and not of significant value compared to the land), there is no 'unifying physical object'. Therefore, each title would be a considered as a separate asset.

Farming land on two separate titles will be considered as two assets unless there was a unifying physical object, such as a piggery with a large shed spread over both titles. The ATO also state that an inability to access land by one title, other than through another title, is not of itself sufficient to prohibit the titles being dealt with separately.

Repairs v improvements

Money borrowed under an LRBA can be applied to carry out repairs and maintenance to the asset acquired. The definition of repair includes maintaining the asset and remedying defects to the asset.

Improvements must not however be funded from borrowings. They must be funded from other sources such as contributions or proceeds from the sale of fund assets. An asset is improved if the state or function of the asset is significantly altered for the better. Moreover, as discussed further below, improvements must not fundamentally change the nature of the asset as a whole.

ATO Examples

Repairs include the restoration of a fire damaged kitchen, replacing gutters, repainting and replacing a fence post. Even renewing a kitchen with modern equivalents (as opposed to superior appliances) is a repair, unless the superior materials significantly enhance the state or function of the asset.

Improvements include adding a pergola, swimming pool, bathroom extension, home security system or second storey to a house. Interestingly, the ATO use an example of a house situated in a real estate hot spot that is demolished and replaced with a superior house. This is an improvement as opposed to a replacement asset. Thus, SMSFs are given some latitude to improve an asset under an LRBA provided there are no borrowings funding the improvements.

Replacement assets

Care is needed, however, as an asset can be improved to such an extent that it 'trips over the line' and becomes a different asset (having regard to the proprietary rights and physical object). In this instance, the SMSF may contravene the general borrowing prohibition and may be required to immediately unwind its LRBA. The ATO test for this is whether the character of the asset as a whole has fundamentally changed.

ATO Examples

A vacant block subdivided into two separate blocks is a different asset.

A residential house built on vacant land is a different asset (although, see off the plan below).

A residential house that is converted into a restaurant (with a commercial kitchen) is a different asset.

Establishment of a home office in a residential house does not result in a different asset.

Off-the-plan

Borrowing to acquire a house or apartment off-the-plan is allowable, subject to certain provisos. The construction of the building (eg, house or strata titled apartment) and title registration must happen before settlement. Finally, the balance of the payment under the contract must be due at settlement.

Conclusion

The ATO ruling is great news as it clarifies a number of prior uncertainties. Naturally, our LRBA documents have been updated accordingly.

Investment strategies

Draft regulations have recently issued that will soon require every SMSF to update their investment strategy. For many SMSFs this is likely to require a change in habit. Many SMSFs only have a basic strategy prepared some years ago which allows them to obtain their annual tick of approval from their auditor.

Additional review requirements

In short the current reg 4.09(2) of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') only requires an SMSF trustee to formulate and give effect to an investment strategy.

However, the new reg 4.09(2) will require every SMSF trustee to formulate, *review regularly* and give effect to an investment strategy (emphasis added).

Thus trustees will soon be required to regularly review their investment strategies. Currently this review is required to be undertaken at least on an annual basis under most of Australia's state and territory trustee legislation (unless the SMSF deed precludes this requirement). However, SISR currently has no express requirement to review regularly.

Thus when new reg 4.09(2) takes effect, SMSF trustees will be required to undertake more regular reviews than merely complying with state trustee law. In certain cases such as where an SMSF is actively trading investments or dealing in derivatives, a review quarterly, half yearly or 'as needed' could be appropriate.

SMSF trustees should check their deeds to see if they are covered by trustee legislation or other requirements and get ready to set in place a 'regular' review that is appropriate to their circumstances.

Insurance requirements

Moreover, SMSF trustees will also be required to determine when establishing or reviewing their investment strategies whether they should hold insurance cover for their members under proposed new reg 4.09(2)(e).

SMSF Trustees may evidence this by documenting the fund's policy regarding insurance in their investment strategy or in trustee resolutions that record their regular review of their strategy.

The Cooper Review's Statistical Summary of SMSFs in December 2009 confirmed that fewer than 13% of SMSFs hold insurance. The reason for this may be due to the hurdles in getting insurance for an older age group and the higher costs.

Market value requirements

SMSF trustees will also need to ensure that, from the 2012-13 income year, their accounts reflect the net market value of assets under proposed new reg 8.02B of SISR. This may require extra supporting evidence to be collected each year and improved recording systems by certain SMSFs. At least an annual review of values will therefore be needed.

Conclusion

SMSF trustees will need to comply with these new requirements as soon as they become law. We are revising our Investment Strategy Kit for release as soon as the new regulations become law: refer http://www.dbalawyers.com.au/strategy-compliance-kits

Contribution Reserving Kit

DBA Lawyers will soon be launching a contribution reserving kit. 30 June is fast approaching and this kit provides documentation that is consistent with the strategy in ATO ID 2012/16. The kit contains a detailed memo outlining the practical 'how to', pros, cons and inherent risks of contribution reserving as well as template resolutions for those wishing to implement such a strategy.

To order the kit, please visit: www.dbalawyers.com.au/strategy-compliance-kits

SMSF Online Update — 13 July 2012 — it's now easy to keep up to date!

DBA Network's next SMSF Online Update is on Friday 13 July 2012 from 12 noon to 1.30pm (AEST). The session will cover some hot topics including the latest cases, legislation, regulatory developments and other SMSF tips and traps. For more information or to register visit www.dbanetwork.com.au. Alternatively, contact Marie Zarifis on (03) 9092 9400 or dba@dbanetwork.com.au.

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