



EXPLANATORY MEMORANDUM SMSF GEARED INVESTMENT

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SMSFs MAY NOW BORROW

Background

Section 67(1) of the Superannuation Industry (Supervision) Act 1993 (the "Act") contains a general prohibition against a super fund borrowing. For some years, however, many super funds invested in instalment warrants under which they could access all of the benefits of ownership of underlying shares or other securities without the need to pay their full value. This meant that the fund could acquire a warrant using available cash in the fund and pay off the full purchase price over time as cash became available while still receiving all dividends declared and other rights attached.

In recent times both the ATO and APRA concluded that these types of arrangements were in breach of Section 67(1) and also that such instalment warrants were in-house assets under Section 71 of the Act.

After consulting with the superannuation industry, the Federal Government passed an amendment to the Act which became effective from 24 September 2007 and which authorised certain borrowings by a super fund. Further amendments were passed through Parliament in July 2010 new Section 67A has been inserted. This section sets out the conditions under which a borrowing by a super fund will be allowed.

IMPORTANT NOTE

It is possible that the government or the ATO will eventually attempt to limit the ways in which these changes are used in practice or the interpretation of the amendments to the Act. It is also possible that the ATO may issue a Public Ruling which affects the ways in which "instalment warrants" are used or the asset classes which may be accessed using them. Any limitations or Public Rulings may have retrospective affect. It is essential therefore to seek professional accounting and legal advice before utilising any of the structures mentioned in this material.

The Conditions

Section 67A allows a super fund to borrow or maintain a borrowing if:

1. the borrowed money is or has been applied for the acquisition of an "acquirable asset". An acquirable asset is defined to include any asset that the fund not prohibited from acquiring under the Act or under any other legislation or regulation i.e. the fund can only borrow to acquire an asset by this method if the fund would be permitted to acquire or not prohibited from acquiring it directly without borrowing. This widens the prohibition on the assets that may be acquired by extending to assets that the fund might be prevented from acquiring under any other law, for example, the Trustee Acts which exist in all States;
2. the asset is held on trust so that the fund acquires a beneficial interest in the acquirable asset;
3. the fund trustee has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and/or
4. the rights of the lender or any other person against the fund trustee for default on the borrowing, or on the sum of the borrowing and charges relating to the borrowing, are limited to rights relating to the acquirable asset.

Under the forerunner of Section 67A, the fund could also acquire any allowable asset as a replacement for the first and could acquire multiple assets in a single borrowing arrangement/structure. The new Section 67B only permits a limited replacement of the original asset and effectively restricts replacements to shares in companies or units in unit trusts where the shares or units acquired as a replacement are shares or units in the same entity, same class and of the same market value as the original asset. Section 67A otherwise prohibits the acquisition of multiple assets except if they are a collection of assets (eg shares) and the assets in the collection are identical and have the same market value. For example the acquisition of:

1. a collection of shares in a single listed company is permitted provided all shares in the collection are the same class (e.g. ordinary shares);
2. a collection of shares in a single listed company is not permitted if all shares in the collection are not the same class (e.g. ordinary shares and preference shares);
3. a collection of shares in more than one listed company is not permitted;
4. several properties is not permitted in a single borrowing arrangement even if all properties being acquired are in the same building or are adjacent to each other.

The focus in the Act is on the limited recourse nature of the borrowings. The changes mean that the fund can borrow provided any other assets in the fund are not exposed to the liability incurred by that borrowing.

In addition, the fund may grant security over the acquirable asset in order to secure the borrowings but no other security is permitted except if associated with the borrowing arrangement.

The Act stipulates that the borrowings must be used to acquire an asset. The forerunner of Section 67A, did not expressly extend to using borrowed funds to develop or maintain the asset. Section 67A now provides that the fund can use borrowed money for:

- expenses incurred in the acquisition of the asset (eg stamp duty, conveyancing fees, brokerage and loan establishment costs);
- expenses incurred in maintaining or repairing the acquirable asset. Importantly, borrowed money cannot be used for improvements to the acquirable asset - property development or capital extension would not be permitted using borrowed funds;
- refinancing an existing complying borrowing.

Interest may be capitalised under the borrowing arrangement provided the interest relates to the original asset acquired. Interest capitalised otherwise may result in the arrangement failing to meet the requirements of Section 67A of the Act.

An SMSF must not transfer existing fund assets into a limited recourse borrowing using this method. The exception in Section 67A applies only to borrowing for the purpose of the acquisition of the asset. Borrowing to fund the transfer of existing fund assets into an "instalment warrant" structure will breach the general prohibition against borrowing.

Continuing SIS obligations

Trustees must consider the additional requirements imposed by the Act:

1. The asset being acquired must be one in which the fund could invest and hold directly;
2. The transaction and the acquisition of the asset must comply with the fund's investment strategy and its trust deed;
3. The trustee's duties imposed by the Act and/or the general law – such as due diligence and care;
4. The sole purpose test;
5. The transaction must not breach the rules against acquisitions from related parties or comply with them to the extent they are allowed; and
6. The increased risk associated with gearing and the effect of an adverse movement in interest rates.

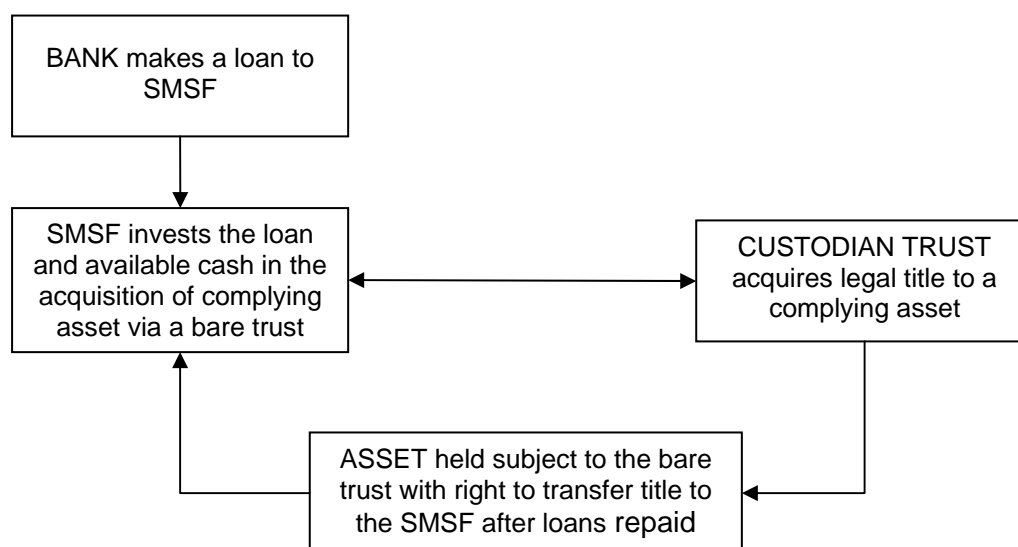
Benefits

Many super fund trustees will appreciate that the new rules will allow the fund to invest in assets which may not have been accessible due to insufficient cash e.g. direct real estate investment.

Possibilities

Under our standard documentation, the SMSF borrows from the nominated lender and invests the borrowed funds plus any available cash held by the SMSF in the acquisition of an acquirable asset. A custodian trustee holds the legal title to the acquirable asset as illustrated in Fig. 1.

FIG. 1



Where the SMSF is unable to arrange finance from an institutional lender, a related party may borrow the required funds and on lend them to the SMSF (See Fig. 2). Alternatively, a related party having sufficient cash may simply lend to the SMSF (See Fig. 3). In those cases we can also supply a loan agreement and associated security documents.

FIG. 2

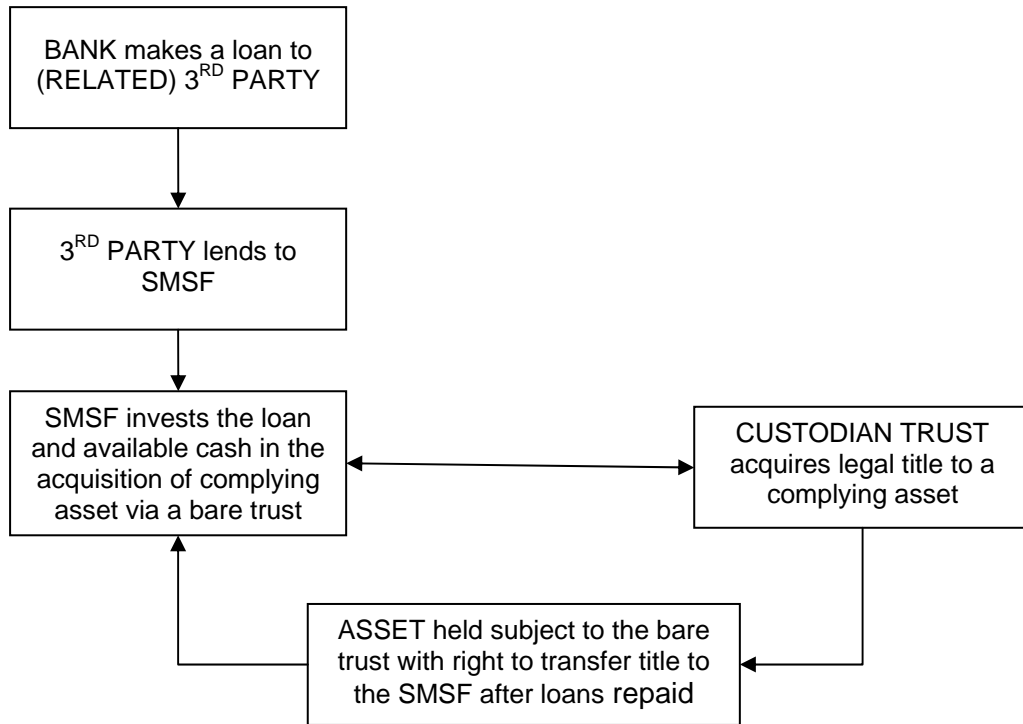
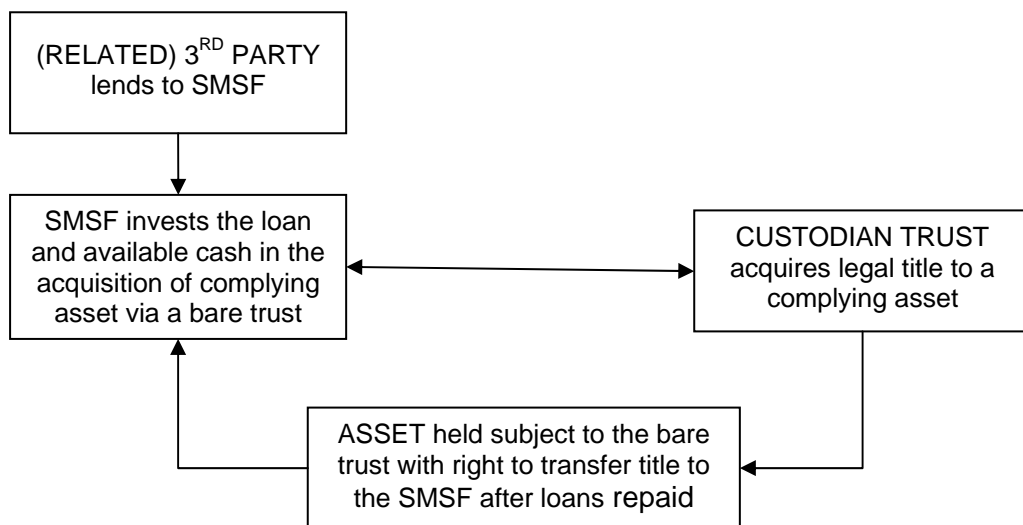


FIG. 3



Corporate custodian

It is strongly recommended in all cases that the custodian trustee should be a corporate trustee established for the purpose of holding the asset being acquired and should not undertake any other activities.

The asset being purchased must be held in a trust which is completely separate from the super fund. This is one critical element of the ability of a super fund to borrow and:

- the Trustee of the custodian trust must not be the same as the Trustee of the SMSF - the ATO has expressly indicated that to do so is inappropriate as this would breach the requirement that the asset acquired be held in a separate trust. The interest of the trustee and the interest of the beneficiary merge. The custodian trust would cease to exist and the borrowing and the fund become non complying;
- similarly, if the custodian trustee is an individual and is potentially a beneficiary (member) under the SMSF then there may be a merger of the interest of the trustee and the beneficiary. The custodian trust may cease to exist and the borrowing and the fund become non complying;
- if the custodian trustee is an individual and, for example, dies or becomes bankrupt, the interest held in the bare trust would likely devolve to the beneficiary or the legal personal representative of the trustee or the trustee in bankruptcy. The custodian trust may cease to exist or the custodian trust falls under the control of other persons and/or the borrowing and the fund becomes non complying.

Therefore to avoid any suggestion that the custodian trust might be adversely affected by the identity of the trustee, the custodian trustee should be a company which does nothing but hold the property. It is, however, possible to have the members of the SMSF as directors/shareholders of that company.

Other considerations

- Borrowing arrangements which are in place prior to the commencement of Section 67A are not affected by the changes. However, where the original borrowing is rescinded or replaced, the new rules will apply. This means that any existing borrowing which is refinanced or varied to a significant extent will be caught.
- The amendments to the Act potentially allow many other variables – for example:
 1. The Act does not require any qualification for the custodian i.e. the custodian trustee may be a related party.
 2. The Act does not require the lender to be a recognised financial institution or bank. The lender may be a related party or member of the fund.
 3. The Act does not prevent parties other than the super fund from undertaking full liability for the borrowings in order to achieve full recourse if required.
 4. Additional security might be provided by third parties.
 5. The Act does not stipulate the interest rate which is to apply to the lending, the term of the loan or the amount of any instalments which form the basis of the arrangement. However, care must be taken in setting these if Div 7A is an issue.

- The SMSF Trustee must consider and comply with:
 1. the sole purpose test;
 2. in-house assets rules;
 3. it's investment strategy; and
 4. related party acquisition restrictions.
- All transactions including the borrowing arrangements (particularly if self funded) must be commercially arms length. Particular attention should be paid to the rate of interest to be paid under the borrowing arrangement. For example:
 1. monies advanced by a member or related party at zero or less than a commercial rate of interest could be characterised as a contribution to the SMSF. This may result in the trustee/member having to pay excess non-concessional contributions tax under Division 292 of the *Income Tax Assessment Act 1997*;
 2. monies advanced by a member or related party at greater than a commercial interest rate of interest may result in:
 - (i) a breach of the sole purpose test outlined in section 62 of the Act, on the basis that the excessive interest rate may mean that the SMSF is not being maintained solely for the purpose of providing superannuation benefits; and/or
 - (ii) the trustee breaching Section 65(1)(b) of the Act, which prohibits the trustee from giving financial assistance to a member of the SMSF or to a relative of such a member using the resources of the SMSF.
- Where additional security is required by a lender, that security should not result in effective recourse to the other assets of the SMSF. In particular, where a personal guarantee for the borrowing is given by a third party (particularly where the guarantee is given by a member or a related party of the SMSF), this may result in recourse being made to the assets of the SMSF other than the asset acquired if the guarantee is enforced.
- The trust deed for the SMSF should be reviewed to ensure that the borrowing and the investment by way of an instalment warrant is permitted. We recommend upgrading your trust deed to ensure the required powers exist.
- The Investment Strategy for the SMSF must be reviewed and amended to account for the borrowings and the risk and returns expected from the investment.
- Some lenders may only lend to a fairly low loan/value ratio where the loan is limited recourse. Interest rates may be higher for the same reason.
- Some lenders may require additional security other than the asset being acquired or third party security in the case of borrowings by a related third party and on-lending to the SMSF.
- A loan by a company to fund the acquisition may be caught by Div 7A of the Income Tax Assessment Act 1936. As such, any loan agreement evidencing loans between related parties may need to comply with Div 7A.

- Since the super fund would hold the sole beneficial interest in the asset by way of the custodian trustee, there should be no disposal for CGT purposes upon a transfer of the legal title to the asset to the super fund. This is supported by the Minister for Financial Services who has announced that the super fund is to be treated as the “owner” of the acquirable asset for CGT purposes. Therefore, no CGT should be payable on a transfer to the super fund or on repayment of the borrowing. However, these announcements have not been legislated and you are strongly urged to seek confirmation of this from taxation professionals and the ATO before executing a transfer of the legal title under these arrangements.
- Each State imposes stamp duty on the acquisition of certain types of asset or property. In virtually all cases, that duty (where applicable) will be payable upon the initial acquisition of the legal title to the acquirable asset by the custodian trust. Stamp duty may also be payable in relation to the Custodian Trust at ad valorem rates. There may or may not be relief given where ad valorem duty is also paid on the value of the acquirable asset. Some states may impose double stamp duty in some cases. In each case, you are strongly urged to seek confirmation of this from your legal advisers and the relevant State authority before deciding on a structure and before executing any documents under these arrangements.
- Under each State jurisdiction there are also rules relating to the imposition of stamp duty on the transfer of title from a trustee to a beneficiary and in certain circumstances there may or may not be a liability to stamp duty when the acquirable asset is transferred from the custodian trust to the SMSF. In each case, you are strongly urged to seek confirmation of this from your legal advisers and the relevant State authority before deciding on a structure and before executing a transfer of the legal title under these arrangements.
- Some consideration should also be given to the financing structure required to achieve the desired outcome. Consider the implications of negatively gearing the property and the custodian trust structure.
- The SMSF will need to generate sufficient cash flow from the asset being acquired and from other investments to service the borrowing costs/interest payments.
- Trustees of SMSFs should carefully consider the commercial advantages and disadvantages of borrowing to acquire complying assets and the commercial risks associated with gearing. If the projected investment returns do not indicate a commercially acceptable result, issues may arise in relation to the Fund’s Investment Strategy and/or the sole purpose test (amongst others).

IMPORTANT NOTE:

- This publication is intended to convey general information only in relation to its subject matter. It is not intended nor should it be treated as legal advice by the reader. Any specific questions or issues should be directed to your accountant or qualified legal practitioner.
- We do not provide advice in relation to superannuation matters, superannuation borrowings or instalment warrants.
- We do not provide legal, accounting, taxation, superannuation or investment advice or advice regarding stamp duty or other state or territory taxes nor in respect of any other matter.
- Please note that superannuation laws and practice, taxation laws and practice, trust laws and stamp duty laws are continually changing and that significant fees, taxes, duties and penalties can be imposed when entering into arrangements of this type.
- You must satisfy yourself that all documents comply with the relevant legislation and the law regarding arrangements of this type particularly the Superannuation Industry (Supervision) Act 1993 and Regulations.
- Advice should be obtained from qualified and licensed professionals before signing any documents.
- We disclaim all liability for anything done or omitted to be done in respect of any documents supplied or arrangements entered into by you or your clients.

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