SMSF CIRCULAR
LATEST DEVELOPMENTS
12 JANUARY 2015

MJHC LEGAL
LAWYERS
Superannuation · Property · Wills · Commercial

Suite 5, Level 2
Monash Corporate Centre
750 Blackburn Road
Clayton VIC 3168
t: +61 3 9543 5544

All correspondence to:
PO Box 412
Mount Waverley VIC 3149
www.mjhclegal.com
f: +61 3 9543 5133

This circular outlines some of the implications and consequences arising from:

- the Financial Services Inquiry's (FSI) final report recommending that superannuation funds should not be permitted to borrow; and
- the ATO's views on the structuring of related party borrowings by an SMSF.

Restrictions on Limited Recourse Borrowings.
The FSI final report made a recommendation that all superannuation borrowing arrangements (LRBAs) be banned. This circular does not intend to discuss the detail of the FSI report as there is plenty of other available commentary. Suffice to say that at MJHC Legal the view is that the stated reasons for banning LRBAs apply as much to non-superannuation borrowings which can indirectly have an adverse impact on retirement savings.

The emphasis in this circular is to address the potential issues and implications in the event of a future ban on LRBAs for SMSFs which have entered into binding contractual obligations to acquire property but which have not settled when the ban comes into effect.

The FSI final report did recommend that funds with existing borrowings should be permitted to maintain those borrowings. Consequently, it is most unlikely that any ban on LRBAs will affect a property already acquired and settled.

The position is less certain for SMSFs which have entered into contracts to purchase a property but which have not settled or completed by the time an LRBA ban comes into effect. In this respect off the plan (OTP) purchases could be significantly impacted by a ban. Whilst some grandfathering and transitional arrangements might be expected, funds and their advisors should anticipate that grandfathering and transitional provisions may only apply if a loan agreement has been entered into between fund and lender.

This could be problematic for funds as the traditional bank lenders do not normally prepare loan agreements or loan offers capable of acceptance until loan and mortgage documents are prepared at a time much closer to settlement and such loan agreements and offers are only valid for a limited period of time. This could be quite serious for OTP purchases which are not due to settle for 3 or 4 or more years.

Of course, there is no certainty that borrowings by funds will be banned. Nevertheless, funds and their advisors need to consider strategies and options in the event that they have contractually committed to purchases which have not yet been completed. It is unlikely that any ban would be introduced within the next 3 to 6 months. Consequently, funds with borrowings which are completing purchases within that timeframe are unlikely to be affected by any changes to the law.

For those funds who intend to purchase in the future or who have a long term contractual commitment such as an OTP purchase should have in place "Plan B". That is; the fund and its members should ensure they are in a position to exit the purchase and/or nominate an alternative purchaser who is permitted to borrow. This may mean that members will have to purchase the property in their own names or through some other appropriate entity such as a family trust so that the purchase is ultimately not one made by a superannuation fund. This should not come as a surprise as it is already the case that prudent funds and members should have a Plan B in the event the fund is unable to obtain loan approval from its lender.

Fortunately, for properties purchased in Victoria there are no adverse duty implications associated with nominating an alternative purchaser to a fund that is named as purchaser in a contract of sale. If a fund is purchasing property outside of Victoria then appropriate advice must be sought about substitution of alternative purchasers in the State or Territory in which the property is located.

Subject to a fund still satisfying its lender's loan approval requirements, for those funds which are to purchase and/or settle at some future time, the best course of action to take prior to any borrowing ban or restriction coming into effect is for the time being to ensure steps have been taken to put in place:-

- a property holding trustee and bare trust deed documentation which has been fully executed.
- a contract of sale with the property holding trustee as purchaser or if not the named purchaser, appropriate paperwork is in place nominating the property holding trustee as transferee.
- a signed loan agreement between the lender and the fund as borrower.

For funds purchasing with completion still some years away, it may be necessary for the parties to contemplate putting in place a related party borrowing arrangement if a third party lender is not available. However, not every fund will be in a position to put in place a related party borrowing arrangement. There is potentially a significant number of funds, especially those purchasing OTP, who will in breach of contract and not be able to complete because no borrowing arrangement can

be put in place and thus are likely to forfeit deposits and be exposed to other losses.

Related Party Borrowings – Commercial and Arms Length

In December 2014, the ATO issued ATO ID 2014/39 and ID 2014/40 which outline the circumstances in which income on borrowing arrangements associated with real estate and shares would result in income from such investments being treated as non-arms length income for taxation purposes. The IDs dealt with borrowing arrangements which were on lending terms that were favourable to the funds (eg. nil interest rates) which the ATO considered to be non-commercial and not at arms length.

Funds and their advisors will be aware that non-arms length income received by a fund is not taxed at the concessional rate of 15% but at the highest marginal taxation rate. In simplistic terms, the ATO has taken the view that where, for example, a fund is not to be charged an interest rate on borrowings, the fund is receiving higher amount of net income than would be the case if it was borrowing on commercial terms from a 3rd party lender.

The ATO's position is not surprising as a superannuation fund should not get 'a free ride' just because it can enter into a borrowing arrangement with a 'friendly lender' such as a related party. Interest rates need to be benchmarked and a bit like the porridge in the tale of Goldilocks and the 3 bears – it cannot be too high or too low but it must be 'just right'. It is not difficult to benchmark borrowings on real estate transaction and the terms are, in principle, not difficult to determine. In simple terms funds and their advisors might look at it in this way – if the fund was instead lending money to an unrelated borrower, what would be the terms and conditions in which it would lend to that borrower. Suffice to say, it would most likely not be at a nil interest rate or on terms that particularly favoured the borrower.

The loan agreement documentation prepared by MJHC Legal and its associates for related party borrowings contemplate that the borrowing arrangement will be on commercial terms and on an arms length basis. It is critical to ensure ongoing compliance with the superannuation law and to avoid the ATO treating income from investments as non arms length income that the arms length and commercial borrowing arrangement must be so on an ongoing basis.

In addition to the ATO IDs, the ATO has issued some further guidance for related party limited recourse borrowing arrangements and has confirmed that in determining whether non arms length rental income arises, the ATO will be considering:-

- the nature of the acquirable asset,
- the amount borrowed,
- the terms of the loan,
- the loan to value ratio,
- the interest rate charged; or any other means by which the lender is compensated for the opportunity cost in lending the principal,
- the regularity and frequency of principal repayments required,
- the security taken for the borrower's performance under the loan, given the limited recourse nature of the loan – for example, mortgages and personal guarantees by SMSF members,
- the extent to which the loan has operated in accordance with its terms.

Prior to the issue of the ATO's guide on limited recourse borrowing arrangements, it has been the view of MJHC Legal that a complying superannuation law borrowing arrangement did not expressly require a registered mortgage over the property acquired. This continues to be the MJHC Legal view. Nevertheless, the ATO guidance does raise concern that rental from properties purchased with borrowings might be treated as non arms length income if there is no mortgage in place.

Where MJHC Legal acted for the SMSF on the property purchase and was also responsible for preparation of the related party loan agreement, the borrowing arrangement ought to be considered by the ATO to be commercial and arms length even though a registered mortgage is not in place because:-

- the loan agreement prepared by MJHC Legal provides for the parties to enter into a formal mortgage if required at any time by the related party lender;
- a caveat is recorded on the Land Title Register giving notice of the lender's interest in the property as lender under a borrowing arrangement; and
- the title is held in escrow by MJHC Legal on behalf of the lender pending repayment of the loan monies.

However, in the absence of absolute certainty arising because of the ATO's recent guidelines, it would be prudent for Funds and their advisors to seek a private ruling from the ATO that the lending arrangement and supporting documentation is sufficient for the ATO to treat the LRBA as commercial and arms length even without a formal mortgage in place. If an adverse ruling is obtained then steps can subsequently be taken to prepare and register a mortgage on title in favour of the related party lender. Alternatively, Funds may find it more convenient and cost effective to arrange for mortgage preparation and registration without seeking an ATO private ruling.

Fund advisors should note that it may be prudent or desirable to obtain a private ruling to ensure the other terms of the loan (e.g. interest rate and repayment terms) are acceptable even if there is a registered mortgage in place.

Liability limited by a scheme approved under Professional Standards Legislation