Sladen Legal

An A to Z of Limited Recourse Borrowing Arrangements

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1. Introduction

Traditionally, the trustee of a superannuation fund (referred to in this paper as a **super fund**) has been prohibited from borrowing except under limited circumstances. With effect from 24 September 2007, this all changed with the insertion of section 67(4A) of the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**). Section 67(4A) of the SIS Act (referred to in this paper as the **Old Law**) gave a super fund trustee power to borrow provided the requirements of that subsection were met.

After a slow start, borrowing by super fund trustees took off in the financial years ending 30 June 2009 and 30 June 2010. As borrowing by super fund trustees increased, concerns were raised by the Government resulting in the repeal of section 67(4A) of the SIS Act and its replacement with sections 67A and 67B of the SIS Act, effective from 7 July 2010. According to the explanatory memorandum (**EM**) to the Bill[1] that introduced sections 67A and 67B of the SIS Act (referred to in this paper as the **New Law**), the purpose of the Bill was to reduce 'the risks for superannuation funds investing in limited recourse borrowing arrangements'.[2]

In recent times, borrowing by super fund trustees has again increased and so too has the attention of the press and the regulators. Concerns have been raised about the increase in borrowing by super fund trustees by the Australian Taxation Office (**ATO**), the Australian Securities & Investment Commission (**ASIC**) and even the Reserve Bank of Australia.

As the title suggests, the purpose of this paper is to give a broad overview of the law in relation to super fund borrowing (also referred to as **limited recourse borrowing arrangements** and **LRBAs**). After a brief review of the background to the introduction to the New Law, this paper will broadly look at the lifecycle of a LRBA, including:

1. Choosing the right asset;
2. Setting up the structure correctly;
3. Acquiring the asset correctly;
4. Structuring the loan correctly;
5. Applying the borrowed funds correctly;
6. Dealing with the asset correctly;
7. Disposing of the asset correctly;
8. Documentation in relation to the asset;
9. How to deal with the trust at the end of the borrowing; and
10. How to protect the fund against unexpected events.

This paper will generally confine itself to the application of the New Law, but will refer to the Old Law where relevant to the New Law. It is not a detailed review into the tax, duty and GST issues that may arise under LRBAs.

Many of the issues identified below are complicated and involve detailed analysis of legal and taxation principles. In order to contain the scope of this paper, some of the issues have been raised in a general manner. A super fund trustee entering into a LRBA should ensure all issues, including those raised in this paper, are considered and dealt with in the appropriate manner.

All references in this paper are to the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) unless otherwise stated.

[1] *Superannuation Industry (Supervision) Amendment Bill 2010.*
[2] EM paragraph 1.1.

2. Why was the New Law introduced?

According to the EM that introduced sections 67A and 67B of the SIS Act, one reason for the repeal of section 67(4A) of the SIS Act and its replacement with sections 67A and 67B of the SIS Act was for the purpose of 'reducing the risks for superannuation funds investing in limited recourse borrowing arrangements.'[3] These perceived risks were due to 'developments in the superannuation borrowing market' that 'have led to products and practices which raise concerns for superannuation funds'.[4] The EM gives the following examples of such developments:

1. the use of personal guarantees to underwrite the lender's risk in the borrowing arrangement;[5]
2. borrowing arrangements over multiple assets which can potentially allow the lender to choose which assets are sold in the event of a default on the loan;[6]
3. borrowing arrangements over multiple differentiated assets could expose super funds to greater risk than if a trustee took out a number of discrete loans, each relating to, and only enforceable against, a single asset (or a group of identical assets treated collectively as a single asset);[7] and
4. arrangements where the asset subject to the borrowing can be replaced at the discretion of the trustee or the lender.[8]

The other purpose given in the EM for the change is 'to resolve uncertainty with the application of the borrowing exemption in light of concerns raised in consultations on the Bill.'[9]

Although these purposes are valid, as will be seen below, the effect of the New Law has created additional uncertainty in some areas.

3. Choosing the right asset – single acquirable assets

The New Law introduced the concept of "single acquirable assets". Under the New Law, super fund trustees may only enter into LRBAs if the borrowed money is used to acquire a single acquirable asset.

This requirement was introduced in order to address the perceived problem of super fund trustees acquiring multiple assets under the one borrowing arrangement.

What is a single acquirable asset?

Under section 67A(3) of the SIS Act, a single acquirable asset is not defined but is deemed to include:

- a collection of assets in the same way as they apply to a single asset, if:
  - the assets in the collection have the same market value as each other; and
  - the assets in the collection are identical to each other.

Multiple assets that will be a 'single acquirable asset' include:

- a collection of shares of the same type in the same company; and

[3] EM page 1.
[4] EM paragraph 1.4.
[5] Ibid.
[6] Ibid.
[7] EM paragraph 1.8.
[8] EM paragraph 1.4.
[9] EM page 1.

- a collection of economically equal and identical commodities (an example given in the EM includes gold bars[10]).

According to the EM, and the ATO's initial view, the following will not be a single acquirable asset:

- a collection of shares in the same company that have different rights (for example, you could not borrow to acquire a mix of ordinary and preference shares in the same company. The two different classes of shares would have to be acquired under separate borrowing arrangements); [11]
- a collection of buildings each under separate strata title, irrespective of whether the buildings are substantially the same;[12]
- capital improvements to real property;[13] and
- real property on multiple titles.[14]

With the release of the Commissioner's ruling, SMSFR 2012/1, the ATO's view on what constitutes a single acquirable asset has significantly softened. This is primarily based on the Commissioner's view of the meaning of the terms "asset" and "property". This is relevant because section 10(1) of the SIS Act defines asset to mean 'any form of property'.

SMSFR 2012/1 states that the meaning of 'property' should be considered as relating to both 'proprietary rights' and to the object of these rights (that is, the actual physical asset). Accordingly, SMSFR 2012/1 suggests that a trustee may be acquiring a single acquirable asset if it is acquiring a single object of property notwithstanding that this is 'comprised of two or more proprietary rights' (for example a factory over two titles).

SMSFR 2012/1 states that in determining if there is more than one asset, the Commissioner will consider:

- the existence of a unifying physical object, such as a fixture attached to the land which is permanent in nature and not easily removed and is significant in value relative to the value of the asset; and
- if there is any law that requires the assets to be sold together. If so, this means there would be one asset for borrowing purposes.[15]

The following table sets out the Commissioner's view as expressed in SMSFR 2012/1 as to whether particular assets are single acquirable assets.

Type of asset(s)	Is it a single acquirable asset?	Why?
Two adjacent blocks of land. The vendor will only sell them together	No	The two blocks could be dealt with separately, and it is irrelevant that the vendor will only sell them together
A factory built over three titles	Yes	The factory adds considerable value to the land

[10] EM paragraph 1.11.
[11] EM paragraph 1.12.
[12] EM paragraph 1.23.
[13] Q&A see question 'For real property held by the holding trust in a limited recourse borrowing arrangement, can an SMSF trustee draw down under the arrangement to make capital improvements to the real property without contravening the super law?'
[14] Q&A see question 'Can a SMSF trustee acquire more than one real property under a single limited recourse borrowing arrangement?
[15] SMSFR 2011/D1 para 104

Type of asset(s)	Is it a single acquirable asset?	Why?
		and is therefore a unifying physical object. However, if the factory was derelict, and not of significant value, it would not be a single acquirable asset
Farm land over multiple titles. Spanning the titles are agricultural crops, fencing and irrigation systems	No	There is no physical or legal impediment to dealing with the titles separately
Farm land over two titles used as a piggery. A large shed housing the pigs spans across both titles	Yes	As the piggery adds considerably to the value of the land it is a significant part of the value of the asset and would be a single acquirable asset
Off the plan apartment	Yes	The completed apartment and title constitute a single asset. Both the deposit and the balance can be financed by the borrowed funds
Building a residence on a fund's existing vacant land	No	The residence cannot be a separate asset from the land once it is fixed to the land. Therefore the residence cannot be a single asset
Apartment with a separate carpark title. The carpark title cannot by law be disposed of separately	Yes	As the titles cannot be disposed of separately they constitute a single asset. However, if the carpark title could be disposed of separately this would be a separate asset
Serviced apartment with furnishings	No	The furnishings are separate assets and require separate LRBAs for each furnishing
Purchase of vacant land and a separate contract for the construction of a residence	No	The vacant land is a single acquirable asset. While the LRBA cannot be used for improving the land (i.e. applied for the building contract). Even if the building contract was financed directly by the super fund, this would be a non-permitted replacement asset (discussed below)
Purchase of a house and land package	Yes	This is the acquisition of the completed residential property that will be a single acquirable asset. This is contrasted with the previous example where there are two assets, the vacant land and the building contract

The Commissioner's view allows him to avoid some apparent inappropriate outcomes, for example, by allowing a building situated across more than one title to be treated as a single acquirable asset. Although super fund trustees will welcome this clarification with regards to

properties with buildings spanning multiple titles or with carpark titles, it leaves them with some uncertainty as to the application of the 'single acquirable asset' concept to multiple title properties. For example, although a property over two titles can be a single acquirable asset, would that cover a situation where there is a readily demountable building affixed across two titles?

Additionally, that view does nothing to address the difficulties that exist where a property spanning multiple titles can, for practical purposes, be dealt with only as a single asset (such as where the land comprised in one of the titles has no direct road access, or planning restrictions would effectively prevent it from being used for a commercial purpose). In such cases, super fund trustees will be obliged to enter into multiple borrowing arrangements (assuming that a willing lender can be found).

Is the Commissioner's view on single acquirable assets correct?

'Asset' is defined in section 10 of the SIS Act as 'any form of property'. Therefore, the key to determining what is an asset is to determine what is 'property'? As property is not defined in the SIS Act, the term must be considered using general law concepts.

To that end, in SMSFR 2012/1, the Commissioner relies principally on a quote from a 1945 New South Wales Supreme Court stamp duty decision, *McCaughey v CSD*[16], in determining that property (and therefore assets) for the purposes of the SIS Act, requires the consideration of both proprietary rights (i.e. the legal rights to the property) and the object of those rights (i.e. the physical aspects of the property). Interestingly, in the decision of *McCaughey*, the Court (at 206) ultimately took a legal/proprietary rights view on what the term property meant under the *Stamp Duties Act 1920* (NSW).

With respect, the Commissioner seems to be 'hedging his bets' with this interpretation. It allows him to ignore unfair outcomes that would result if a strict proprietary/legal rights view was taken. For example, by allowing a factory built over multiple titles to be treated as a single asset. This view also allows him to interpret the law in line with the perceived policy behind the borrowing rules, where the strict proprietary/legal rights view would suggest a single asset, for example building a premises on vacant land. As a result of this view, any form of substantial property development of land and/or buildings subject to a borrowing will be very difficult without causing the borrowing to become non-compliant (as discussed below).

In the authors' view, the use of the phrase 'any form of property' suggests that Parliament meant that property is to be interpreted under its proprietary/legal rights definition. However, this is clouded by the use of the term 'asset' in the phrase 'single acquirable asset' in the body of the SIS Act which may have been inserted on the basis of its 'ordinary meaning' that is more synonymous with its physical characteristics than its legal proprietary rights. This is borne out in the confusion created by some of the references in the explanatory memorandum that introduced the current borrowing rules.

Additionally, it may be difficult to apply the Commissioner's approach in all circumstances that arise, as there is no clear legal principle underpinning the proposed approach. Further, the emphasis on the ability to deal with assets separately is very restrictive. It appears that, notwithstanding the indication that both proprietary rights and the 'object' of those rights should be considered, only the proprietary rights should be examined when determining whether assets can be dealt with separately.[17]

The result of this is that we now have a view of asset that contains very significant grey areas; especially in regard to what is a single acquirable asset and when an asset changes to a new

[16] (1945) 46 SR (NSW) 192
[17] Gray, H *The Opportunities and Traps for SMSF Investments*, presented to The Tax Institutes' 50th Victorian State Convention, 2011, Creswick, Victoria

asset. Although, it must also be noted that this view also has some positive outcomes in relation to what kind of assets can be acquired and what works can be done to an asset under a borrowing arrangement.

4. Setting up the structure correctly

One of the unusual requirements of LRBAs is that the asset must be held on a separate trust. This requirement was presumably incorporated into the LRBA rules as a measure designed to mirror the structure of "instalment warrants".

Paragraph 67A(1)(b) of the SIS Act requires that the asset acquired under the borrowing arrangement be "held on trust so that the [super fund] trustee acquires a beneficial interest in the acquirable asset".

The SIS Act is silent on who is to hold the asset on trust, what type of trust relationship must be established and what documentation (if any) is required to evidence the trust relationship.

Who should hold the asset on trust?

As the SIS Act does not specify who will be the trustee/custodian (**Custodian**)[18] of the trust, the Custodian can be anyone other than the individuals or corporation who is the trustee(s) of the super fund. This later restriction is required to ensure that the trust exists because people cannot hold an asset on trust for themselves.

Under what type of trust relationship will the Custodian hold the asset?

Section 67A of the SIS Act does not specify on what type of trust relationship the Custodian will hold the asset. It simply requires the asset be "held on trust so that the [super fund] trustee acquires a beneficial interest in the original asset". In addition, it does not provide that the super fund must have all of the beneficial interest in the asset, just "a beneficial interest".

Interestingly, the ATO believes that the trust relationship cannot be a unit trust[19]. Presumably this is on the basis that the super fund will not have a beneficial interest in the asset. As acknowledged by the High Court in *CPT Custodian*[20]*,* every trust described as a unit trust must be reviewed on its terms. Therefore, it is possible that the terms of a unit trust could allow for an asset to be "held on trust so that the [super fund] trustee acquires a beneficial interest in the original asset".

However, in practice the majority, if not all trusts, used in a borrowing arrangement will be a bare trust or a fixed trust. This is consistent with the policy of the exception to the borrowing prohibition under s67A of the SIS Act that the borrowing arrangements were to replicate "instalment warrant arrangements" for financial products.

Bare Trusts

A bare trustee has been described as:

> 'a trustee who has no interest in the trust assets other than that existing by reason of the office of trustee and the holding of the legal title and who never has had active

[18] The term "Custodian" will be used in this paper to describe the trustee of the trust to avoid confusion when referring to the super fund and the trustee of the trust. Other names include, the property trustee, the holding trustee and the security trustee. A person who holds the asset on trust to satisfy s67(1)(b) will necessarily be a trustee but will only be custodian, as that term is known at law, if that person is appointed under a custodial relationship.
[19] Q&A see question 'Does the super law specify the type of trust that must be used as the holding trust in a limited recourse borrowing arrangement?'
[20] *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98

> duties to perform…with the result that…the property awaits transfer to the beneficiaries or at their direction.'[21]

As such, if the trustee has any active duties, for example duties granted under a declaration of trust, the trust relationship will arguably be a fixed trust, rather than a bare trust.

A bare trust can be an express trust or a resulting trust.

A bare trust will be an express trust if the trust relationship is created under a written deed or declaration under which the creator expresses an intention to create a trust.[22]

A resulting trust is established not by the creator's express words but is implied from the imperfectly expressed words and/or conduct of the creator.[23] Although it is not strictly necessary that a resulting bare trust be in writing, it would be prudent to prepare a declaration/acknowledgement of trust to ensure there is no presumption of advancement.[24.]

Fixed trusts

Fixed trusts have been described as:

> "trusts expressly created containing provisions requiring the trustee to distribute property among beneficiaries without the trustee having any discretion as to who is to be a distributee or as to the amount which each is to be given"[25]

As bare trusts generally do not grant the trustee discretion to as to which beneficiary it will distribute property, most bare trusts will be a type of fixed trust.

Therefore, a trust established for a borrowing arrangement will be a type of fixed trust whether that is a bare fixed trust or a non-bare fixed trust. The latter category will occur where the trustee has active duties to perform. For the purposes of simplicity, this paper will refer to a bare fixed trust as a bare trust and a non-bare fixed trust as a fixed trust.

Documenting the trust

There is no SIS Act or common law requirement for the trust to be evidenced in writing.

However section 53 of the *Property Law Act 1958 (Vic)* requires that a trust over land be evidenced in writing. Accordingly, any borrowing arrangement used to acquire land in Victoria will require the trust to be evidenced in writing. This does not necessarily need to be a declaration of trust, but could be an acknowledgement of trust (for example to acknowledge the existence of a resulting bare trust).

In practice most, if not all, trusts created for a borrowing arrangement will be established, or their existence acknowledged, under an instrument in writing. The existence of an executed deed will assist in satisfying the ATO, the applicable State Revenue Office and the auditor of the existence of the trust to which the deed relates.

Declaration of trust vs deed of acknowledgement

Commonly the document establishing a trust under a borrowing arrangement will be a declaration of trust. However, if the parties wish to evidence the existence of a resulting bare trust, it may be more appropriate to evidence the trust under a deed of acknowledgement.

This will be so where a resulting bare trust is created at law by a super fund trustee transferring cash (and directing the lender to advance the principal of the loan) to the Custodian to purchase the asset which is to be held on trust for the super fund.

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[21] J D Heydon and M J Leeming, *Jacobs' Law of Trusts in Australia*, (7th edition, 2006) , see also *Herdegen v FCT* (1988) 84 ALR 271 at 281-2.
[22] Above n 22 J D Heydon and M J Leeming para 306
[23] Above n 6 J D Heydon and M J Leeming para 307
[24] *Westdeutsche Landesbak Girozentrale v Islington London Borough Council* [1996] AC 669
[25] H A Ford and W A Lee *Principles of the Laws of Trusts* (online edition,1995)

At law, documentation is not required to create a resulting trust. On that basis, the execution by the super fund and the Custodian of a deed of acknowledgement will, in effect, confirm and acknowledge the creation of the trust.

When should the trust documents be signed?

An acknowledgement will be signed after the resulting bare trust is established. For example, if the Custodian signs a contract to purchase land and the super fund pays to the Custodian the deposit, the resulting bare trust is created and the deed of acknowledgment can then be signed.

With a declaration of trust, it is the declaration that creates the trust and the trustee must have an interest in the trust property when the declaration is made. This can create a timing issue if the declaration of trust is over real property. For example, if the Custodian signs the contract and then executes the declaration of trust it can be argued that the Custodian initially purchased the asset in its own right and then transferred the asset to a fixed trust. This could have stamp duty and taxation consequences. In addition, it could be argued that the declaration of trust results in the super fund acquiring an asset from a related party (i.e. the Custodian) rather than the third party vendor. Therefore, this may breach the prohibition against acquiring assets from a related party under s66 of the SIS Act.

Alternatively, a fixed trust could be established before the contract is signed (for example by a declaration of trust over a sum of cash, such as $100) and then the Custodian could sign the contract as trustee of the fixed trust. The asset acquired will then form part of the assets of the fixed trust and the initial sum of cash could be put towards the purchase of the asset.

5. Structuring the loan correctly

The only specific requirement under the SIS Act as to the form, or provisions, of the loan and security documentation is that “the rights of the lender or any other person against the [super fund] trustee for, or in connection, or as a result of, (whether directly or indirectly), default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the acquirable asset”[26]. That is, the loan and security documentation must be limited recourse.

Other provisions of the SIS Act that may apply to the borrowing documentation include the requirement to deal with investments on an arm’s length basis[27] (although it could be argued that the borrowing is not an investment and therefore not covered by this requirement) and the sole purpose test[28].

A lender can achieve the limited recourse requirement in two ways.

Limiting the lender’s rights to the asset

The most obvious way to comply with the limited recourse requirement, is to limit the lender’s rights against the super fund trustee to the asset, as this mirrors the requirement in s67A(1)(d) of the SIS Act.

Some loan documents drafted in this manner retain an ability to sue the super fund in limited circumstances. For example, the ability to enforce rights against the super fund for fraud or misrepresentation. This raises the question as to whether this would breach the limited recourse requirement.

In the author’s view, the retention of a right to sue the trustee does not necessarily breach the limited recourse requirement provided that the rights of the lender against the super fund for “default on the borrowing” are limited to the asset. In the example in the previous paragraph, it

[26] s67A(1)(d) SIS Act
[27] s109 SIS Act
[28] s62 SIS Act

can be argued that the rights of the lender to sue for fraud or misrepresentation do not arise from the default on the borrowing but rather as a separate cause of action unrelated to any default.

Limiting the lender's rights to sue the super fund

The second way to comply with the limited recourse requirement, is to prohibit the lender from suing the super fund trustee other than under the security documentation.

This method will be effective in limiting the rights of the lender to rights relating to the asset, provided that the security documentation does not permit the lender to seek recourse against any of the super fund's other assets.

To ensure that this is not the case, the lender's loan and security documentation must be reviewed carefully. For example, most bank security documents are drafted very widely and may permit the bank to have recourse against the super fund's other assets.

Guarantees – all other parties' rights must be limited recourse

Under the New Law, guarantees are permitted[29] but the rights of 'other persons' including a guarantor against the super fund trustee, must be limited to the asset acquired under the borrowing (i.e. must also be limited recourse).[30]

At common law, a guarantor has a right of indemnity, so that if the guarantor is required to pay the borrower's debt to the lender, that the guarantor can seek to recover its loss from the borrower. This would potentially cause a breach of the LRBA rules if, in addition to having rights against the single acquirable assets, the guarantor could seek recourse against the super fund's other assets.

The general position at common law is that the guarantor's right of indemnity against the borrower is only as good as the lender's rights against the borrower. Therefore, a guarantor's right of indemnity under a LRBA should be limited to the asset (presuming that the lender's rights are so limited). For the avoidance of doubt, in the author's view, the guarantee documentation should specifically limit the guarantor's right of indemnity to the single acquirable asset.

Charges - the single acquirable asset cannot be subject to a charge other than under the LRBA

Unlike the Old Law, the New Law, by implication, permits charges over the single acquirable asset[31], but only if they relate to the LRBA and the lender's, or other parties', rights are limited recourse. That is, a lender could be granted a charge over the asset, provided it relates to the LRBA and the lender's rights are limited to the single acquirable asset. The same goes for other parties, for example guarantors.

An example of a breach of the New Law is set out in ATO ID 2010/185.[32] In that ATO ID, a member of the super fund borrowed from an arm's length bank and on lent that money to the super fund trustee under section 67A. However, the Custodian granted the bank a charge over its asset to support the bank's loan to the member. As the bank was not a party to the LRBA, the mortgage granted in favour of the bank breached section 67A(1)(d) of the SIS Act.

Related and unrelated lenders

The SIS Act does not govern the identity of the lender under a LRBA. Therefore, a lender can be a related or unrelated party.

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[29] The example under Section 67A(1)(d) SIS Act expressly refers to guarantees.
[30] Section 67A(1)(d) SIS Act. See also ATO ID 2010/170 Superannuation: Self managed superannuation fund: limited recourse borrowing arrangement – third party guarantee.
[31] Section 67A1(e).
[32] ID 2010/185 Superannuation: Self managed superannuation fund: limited recourse borrowing arrangement – charge.

Unrelated lenders

As LRBAs have been around for a while now, there are a number of lenders in the market. This ranges from the big banks to alternative financiers. Although, especially with the large banks, it is often assumed that the LRBA documents are compliant, it is not always the case. For example, the author has seen situations where a "branch employee" has used the bank's "standard loan documentation" rather than the bank's "LRBA documents".

For smaller lenders that do not fund many LRBAs it is important to review the loan documentation, as, in the author's experience, they sometimes do not comply with all of the LRBA requirements.

Related lenders

There is no prohibition against related parties making LRBA loans to a SMSF. However, the general SIS Act requirements continue to apply to the SMSF. For example, the sole purpose test and the obligation to make and maintain investments on an arm's length basis.

Again, it is important that loan and security documents comply with the LRBA requirements, specifically, that they are "limited recourse". Super fund trustees should therefore ensure that they use documents specifically tailored for LRBAs rather than "standard" loan and security documents.

Related party lenders also raise issues in relation to low interest or zero interest loans and the application of Division 7A, both of which are discussed below.

Multiple loans and multiple charges

Some concerns had been raised about the ability to have multiple loans under a single LRBA. Multiple loans are most common in situations where a bank will provide a loan under a LRBA to fund some of the purchase price of the single acquirable asset, but the super fund trustee requires an additional loan (invariably a related party lender) to fully finance the acquisition.

In the author's experience these concerns were raised by some of the lawyers of the large banks that refused to consent to a second loan.

The ATO has now confirmed that there can be two loans under a LRBA[33] and that each lender can have a charge over the asset.[34]

Low interest or zero interest loans

Another issue that has raised significant concerns is whether a related party can lend to a super fund trustee under a LRBA at a low interest rate or on nil interest terms.

Low interest or interest free LRBAs raise a number of issues, including whether:

- it breaches the arm's length dealing requirements in section 109 of the SIS Act or other SIS Act requirements;
- it would cause the discounted interest or the increase in income under the arrangement to be treated as non-arm's length income and consequently be taxed at 45%; and
- the anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* would apply.

Although a lot could be written in analysing the above elements, the short answer is, in the ATO's view, none of those provisions will apply. This was confirmed by the ATO in the following paragraph of the minutes of the NTLG meeting in December 2012:

[33] See the NTLG Superannuation Technical Sub-group meeting minutes, June 2012 – item 7.5
[34] See the NTLG Superannuation Technical Sub-group meeting minutes, 3 September 2013 – item 7.1

> The ATO position on low rate loan arrangements and LRBA is that that they do not generally invoke a contravention of the SIS Act, do not give rise to non-arm's length income under section 295-550 of the Income Tax Assessment Act 1997 (ITAA), do not invoke Part IVA of the ITAA 1936 and are not considered to give rise to contributions to the SMSF just from that one fact alone.

However, it should be noted that the ATO also made the following comments in the same minutes in relation to such arrangements which suggest there may be future legislative amendments to close down this “loophole”:

> Issues and concerns of low rate loans and LRBA will be submitted to the review of borrowing. The ATO will be providing comments for the review when it commences.

Drawdowns

Another area of uncertainty was the ability to draw down the principal of the LRBA loan in a number of separate drawdowns. This situation could arise where:

1. there is a drawdown for the deposit and a drawdown for the payment of the balance of the purchase price; and
2. after the purchase was completed there were additional drawdowns that were applied in maintaining or repairing the single acquirable asset.

The ATO has confirmed that each drawdown is considered to be an additional borrowing.[35] However, the ATO has also confirmed that drawdowns for the payment of deposits[36] and repairs[37] can comply with the requirements of the New Law.

In relation to repairs, the ATO’s view that drawdowns are permitted is conditional upon there being a power to do drawdowns under the terms of the LRBA. Silence as to draw downs will not be enough, an express power is required.[38] Where the LRBA terms are silent as to the ability to make drawdowns, the ATO will permit a refinance to a new LRBA that permits drawdowns provided that the amount of the new borrowing is no more than the sum of:

1. the amount needed to repay the existing borrowing,
2. expenses incurred in connection with the new borrowing,
3. expenses incurred in maintaining or repairing (but not improving) the acquirable asset, and
4. the amount the new borrowing is applied to those things and only those things.[39]

Capitalisation of interest

The ATO has confirmed that capitalisation is permitted under the New Law in the following paragraph from the ATO’s question and answer document.

> Does an arrangement that permits capitalisation of interest or other borrowing charges satisfy the super laws? ...
>
> Yes. The super law (specifically, subparagraph 67A(1)(a)(i) of the SIS Act) applying to these arrangements explicitly provides that, under a limited recourse borrowing arrangement, the

[35] See paragraph 20 of Self Managed Superannuation Funds SMSFR 2012/1 SMSFR 2012/1 and paragraphs 65 and 93 of Self Managed Superannuation Funds SMSFR 2012/1 SMSFR 2009/2 Self Managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the Superannuation Industry (Supervision) Act 1993.

[36] See paragraph 39 of Self Managed Superannuation Funds SMSFR 2012/1 SMSFR 2012/1

[37] See paragraph 20 of Self Managed Superannuation Funds SMSFR 2012/1 SMSFR 2012/1 and the NTLG Superannuation Technical Sub-group meeting minutes, December 2012 – item 7.6

[38] See NTLG Superannuation Technical Sub-group meeting minutes, December 2012 – item 7.6

[39] See NTLG Superannuation Technical Sub-group meeting minutes, December 2012 – item 7.6

SMSF trustee can apply borrowed money towards expenses incurred in connection with the borrowing.

Contributions - forgiveness of loans or failure to seek indemnity by the guarantor

Where a lender forgives a LRBA loan or the lender exercises its rights against a guarantor, and that guarantor fails to seek indemnification from the super fund trustee, then, in the ATO's view, the amount forgiven or the amount not indemnified can be treated as a contribution of the super fund.[40]

However, in the ATO's view, there will be no contribution if the guarantor exercises its rights of indemnity or where the value of the single acquirable asset is insufficient to meet the debt to the lender or the guarantor.[41]

Division 7A

The application of Division 7A is a topic in itself. Therefore, the following is a high level overview of its application to LRBAs. If in doubt, advice should be sought in relation to its application.

Division 7A deems loans from companies as dividends where the loan is made to a shareholder of that company or to associates of the shareholder(s).[42] Although a super fund trustee will generally not be a shareholder of the lender company, where the members (or the relatives of the members and/or entities controlled by members or relatives of the members) of the super fund are directors or shareholders of the company then the super fund trustee is likely to be an associate of the company's shareholder(s).[43]

In addition to loans from companies, loans from trusts that have an unpaid present entitlement owing to a corporate beneficiary (either directly or through a chain of trusts) to the shareholders of that corporate beneficiary or associates of such shareholder/s will also be caught by Division 7A.[44]

In either of the above circumstances, in order to avoid the application of a deemed dividend, a LRBA should be place on the terms of a compliant Division 7A loan. Broadly this will be either:

1. a 7 year principal and interest loan with the interest rate set at the benchmark rate (currently 6.2%); or
2. a 25 year principal and interest loan, with the interest rate set at the benchmark rate and security given to the lender in the form of a registered mortgage over real property.[45]

In relation to the second option, the security granted must cover at least 110% of the loan. The security could be granted from the Custodian under the LRBA documentation or another party (e.g. a related guarantor). However, the super fund trustee cannot give security over any of its other properties that that would breach the prohibition against charging the assets of the super fund.[46]

Even if a LRBA is put on a complying loan basis, Division 7A could still apply where:

1. the loan is forgiven;[47] or
2. the super fund trustee fails to make a payment of principal or interest by the due date.

[40] See Taxation SMSFR 2012/1 TR 2010/1 paragraphs 175 to 180
[41] See Taxation SMSFR 2012/1 TR 2010/1 paragraphs 179 to 180
[42] See section 109D of the *Income Tax Assessment Act 1936*
[43] See section 318 of the *Income Tax Assessment Act 1936*
[44] See section 109XA of the *Income Tax Assessment Act 1936*
[45] See section 109N of the *Income Tax Assessment Act 1936*
[46] See regulation 13.14 of the *Superannuation Industry Supervision Regulations 1994*
[47] See section 109F of the *Income Tax Assessment Act 1936*

Refinancing

Refinancing of LRBA loans is permitted for Old Law and New Law arrangements, the latter expressly[48] and the former under the ATO's view.[49] However, any refinance of an Old Law arrangement must comply with the New Law requirements. In some cases, changes to an Old Law arrangement will be deemed to be a refinance.

When will an Old Law arrangement be deemed to be a refinance?

The EM provides that:[50]

> A re–negotiation of a borrowing with the same lender that is simply a variation of a loan contract that continues to exist will not be subject to the Bill [i.e. the New Law]. However, where the re–negotiation amounts to a rescission or replacement of the original contract this is to be regarded as a refinancing and the application provision and therefore the amended legislation will apply to the arrangement.

According to the ATO, to determine whether an amendment to the terms is a refinance 'the question is whether a variation to the contract of borrowing led to the extinguishment of the previous borrowing and the creation in its stead of a new and different borrowing (a refinancing) [and] this depends upon the nature and extent of the variation and the intention of the parties.'[51] According to the ATO, situations that can give rise to a refinance include:[52]

- the borrowing under the original arrangement is refinanced;
- there is a borrowing (drawdown) that is inconsistent with the earlier arrangement – for example, borrowing to acquire an asset or class of asset clearly not contemplated under the original arrangement; and
- there has been a change to the ultimate beneficiaries of the arrangement resulting from selling a structure involving a pre–existing arrangement [discussed below].

The following is an example given by the ATO in relation to whether the extension of a borrowing is a refinance:[53]

> **Example: Extension of borrowing**
>
> Suppose a borrowing is extended by a variation to the terms of a contract. An agreement to extend the period of the borrowing could be so inconsistent with the original agreement that it results in a new contract for borrowing. Some factors which are relevant in deciding this question are:
>
> - whether the original loan agreement provided for the parties to agree to extend the term
> - the period of the extension in relation to the period of the original loan
> - whether other terms of the loan were changed by the later agreement.
>
> In *Roberts v I.A.C (Finance) Pty Ltd* (1967) VR 231, the parties agreed to extend a threeyear borrowing for a further two months. It was held the extension was not totally inconsistent with the terms of the original agreement as the variation left the terms and conditions of the original agreement in intact, except to the limited extent that the due date was extended by two months. As the contract was modified to a limited extent, the rights and obligations of the parties were not affected by the variation. In these circumstances, the loan extension did not discharge the original obligation to pay and create a new obligation to pay in its place.

[48] Section 67A(1)(a)(i)
[49] Q&A see question 'Can an SMSF trustee refinance a limited recourse borrowing without contravening the super law?'
[50] EM paragraph 1.50.
[51] Q&A see question 'Is every variation to the terms of a limited recourse borrowing regarded as a refinancing?'
[52] Q&A see question 'What changes to a borrowing or other attributes of a limited recourse borrowing arrangement result in a new arrangement for the purposes of the super law?'
[53] Q&A see question 'Is every variation to the terms of a limited recourse borrowing regarded as a refinancing?'

This will be important where a super fund trustee wants to retain an Old Law loan but needs to alter the terms of the loan. If the super fund trustee alters the terms it should be very careful to consider whether it will result in a refinancing under the view of the EM or the Q&A.

Will introducing new members to a super fund with an Old Law arrangement be deemed to be a refinance?

Not only will alterations to the terms of an Old Law arrangement be deemed to be a refinance, but also, in the ATO's view, the change of membership can result in a refinance. Two ATO examples are reproduced below:[54]

Example: New arrangement

There is a limited recourse borrowing arrangement that meets the requirements of former subsection 67(4A) of the SIS Act entered into by a corporate SMSF trustee and a private company lender before 7 July 2010. On or after 7 July 2010, new directors of the corporate SMSF trustee (and members of the SMSF) and new directors of the private company lender are appointed, replacing all of the former members. The Commissioner will treat the limited recourse borrowing arrangement now controlled by the new ultimate beneficiaries as a new arrangement. The new arrangement must meet the requirements of section 67A of the SIS Act.

Example: No new arrangement

There is a limited recourse borrowing arrangement that meets the requirements of former subsection 67(4A) of the SIS Act entered into by a corporate SMSF trustee and a private company lender before 7 July 2010. On or after 7 July 2010, two new members of the SMSF are admitted as a result of changing family circumstances. The Commissioner will not treat the limited recourse borrowing arrangement as a new arrangement on this basis alone.

Obviously the ATO has taken this view in order to prevent the 'transfer' or 'sale' of Old Law arrangements by replacing the existing super fund members with new super fund members. Where such a 'transfer' does not result in the alteration of the terms of the Old Law arrangement, it is debatable whether there is a refinance in accordance with the ATO's view.

6. Applying the borrowed funds correctly?

What can the borrowed funds be applied for?

The New Law provides that the borrowed money must be applied for the acquisition of a single acquirable asset (discussed above). Additionally, it expressly allows the borrowed money to be applied for 'expenses incurred in connection with the borrowing or acquisition, or in repairing the acquirable asset (but not expenses incurred in improving the acquirable asset).'[55]

Examples of these additional expenses set out in the section include 'conveyancing fees, stamp duty, brokerage or loan establishment costs'.[56]

The ability to use the borrowed money for acquisition expenses is a welcome change that addresses the uncertainty of the Old Law. However, an additional uncertainty has now arisen as to what is maintaining or repairing the acquirable asset (which the borrowed money can be applied against) and what is an expense incurred in improving the acquirable asset (which borrowed money cannot be applied against). This is discussed below.

What is a repair, maintenance and an improvement?

Money borrowed under the New Law can be used for repairs and maintenance but not for the improvement of an asset. According to the EM those terms are to be given their 'ordinary meanings'.[57]

[54] Q&A see question 'What changes to a borrowing or other attributes of a limited recourse borrowing arrangement result in a new arrangement for the purposes of the super law?'
[55] Section 67A(1)(a)(i)
[56] See for example under section 67A(1)(a)(i)

In TR 97/23[58] the Commissioner of Taxation (**Commissioner**), in the context of the *Income Tax Assessment Act 1997* (**ITAA97**), distinguishes between a repair and an improvement as follows:

> 44. The meaning of 'repair' or 'repairs' is considered in paragraphs 12 to 30 of this SMSFR 2012/1. In the case of a 'repair', broadly speaking, the work restores the efficiency of function of the property without changing its character. An 'improvement', on the other hand, provides a greater efficiency of function in the property – usually in some existing function. It involves bringing a thing or structure into a more valuable or desirable form, state or condition than a mere repair would do. Some factors that point to work done to property being an improvement include whether the work will extend the property's income producing ability, significantly enhance its saleability or market value or extend the property's expected life.
>
> 45. To distinguish between a 'repair' and an 'improvement' to property, one needs to consider the effect that the work done on the property has on its efficiency of function. This is the determinative test.
>
> 46. If the work entails the replacement or restoration of some defective, damaged or deteriorated part of the property, one does not focus on the effect the work has on the efficiency of function of the part. That is not determinative of whether the property is repaired or improved. It is a relevant factor to take into account, however, in considering the effect of the work on the property's efficiency of function. It is possible, for instance, that the replacement of a subsidiary part of property with a part better in some ways than the original is a repair to the property without the work being an improvement to the property.
>
> 47. Replacement or substantial reconstruction of the entirety, as distinct from the subsidiary parts of the whole, is an improvement.

In SMSFR 2012/1 the Commissioner states that a determination of whether an asset has been repaired or maintained, or whether it has been improved, requires reference to the asset's qualities and characteristics at the time it is acquired under the borrowing arrangement. The Commissioner goes on to state that while the views expressed in TR 97/23 are informative, they are not determinative in a superannuation borrowing context.

In relation to maintaining, repairing and improving, SMSFR 2012/1 states:

> *Maintaining the acquirable asset*
>
> 19. The term 'maintaining' ordinarily means work done to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration, provided that the work merely ensures the continued functioning of the asset in its present state.
>
> *Repairing the acquirable asset*
>
> 20. The term 'repairing' ordinarily means remedying or making good defects in, damage to, or deterioration of an asset and contemplates the continued existence of the asset.
>
> 21. A repair is usually occasional and partial. A repair restores the function of the asset without changing its character and may include restoration to its former appearance, form, state or condition. A repair merely replaces a part of something or corrects something that is already there and has become worn out or dilapidated through ordinary wear and tear, or is damaged whether accidentally or deliberately or by natural causes.
>
> 22. As to whether the repair is partial and restorative it is the entire asset that is held under an LRBA that is relevant. For example, if it is a house and land held under the LRBA, then in determining if the asset is maintained, repaired or restored, or whether it has been improved, it is necessary to consider the overall effect of the work (or expenditure) on both the house and the land and the qualities and characteristics of the asset at the time it was acquired under the LRBA. If work on the asset restores the function of the asset to what it was at the time it was acquired, and uses similar or modern equivalent materials, it is a repair.

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[57] EM paragraph 1.32.

[58] Taxation SMSFR 2012/1 TR 97/23 Income tax: deductions for repairs.

Improving the acquirable asset

> 23. In contrast to repair, an asset is improved if the state or function of the asset is significantly altered for the better, through substantial alterations, or the addition of further substantial features or rights, to the asset.

Further, in SMSFR 2012/1, the ATO has outlined a number of examples that compare repairs and maintenance with improvements.[59]

Additional issues regarding 'improvements' and the use of existing super fund money (rather than borrowed money) are discussed further below.

7. Dealing with the asset correctly

What is a replacement asset?

Under the New Law, the term replacement asset is specifically defined in section 67B. It is limited to shares in companies and units in unit trusts in certain circumstances – e.g. mergers, takeovers, restructures, deeds of arrangements or trustee actions.

This is consistent with the policy described in the EM that the New Law was designed to stamp out arrangements where the asset subject to the borrowing can be replaced at the discretion of the super fund trustee or the lender.

However, the EM goes further, it provides the following examples of what will not be a replacement asset:[60]

1. securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy;
2. money or cash is not eligible as a replacement asset under any circumstances;
3. replacement asset arising from an insurance claim covering the loss to the original asset;
4. the replacement by way of improvement of real property;
5. a series of titles over land replacing a single title over land that has been subdivided; and
6. a replacement of a title over real property as a result of Government action such as the resumption of all or part of a property or re–zoning.

The matters referred to in the EM are somewhat problematic in that they seem to assume that certain actions in respect of real property (improvement (including rebuilding after destruction of buildings), subdivision, replacement of title) necessarily create a different asset.

In SMSFR 2012/1, the Commissioner takes a more conciliatory view as to what changes in the asset will be permitted and what changes will result in a new replacement asset (and therefore cause the LRBA to be defective). For example, in SMSFR 2012/1, the Commissioner states that:

> 33. If alterations or additions are made to the physical object or the proprietary rights that comprise an asset held under an LRBA and, having regard to both the object and the proprietary rights, those alterations or additions fundamentally change the character of that asset, this results in a different asset being held on trust under the LRBA. It is consistent with the approach at paragraphs 10 and 11 of this SMSFR 2012/1, to consider both the characteristics of the physical object (assuming it is not an intangible asset) and the attributes of the proprietary rights comprising the asset, to determine if the character of the asset as a whole has fundamentally changed.
>
> 34 If the character of the asset as a whole has fundamentally changed, the exception under section 67A to the borrowing prohibition ceases to be satisfied from the time the alterations or additions are made to the asset. If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).

[59] Paragraph 25 of the SMSFR 2012/1
[60] EM paragraph 1.29.

Therefore, in the ATO's view, the test is whether changes to the asset have resulted in that asset fundamentally changing. Again this is to be considered in light of any changes to characteristics of the physical object and the attributes of the proprietary rights comprising the asset

Advisers and super fund trustees will welcome the confirmation that the mere improvement of property (discussed further below), using the super fund's own money, will not cause the property to be a different asset. The acknowledgement that super fund trustees can rebuild properties that have been destroyed without creating a replacement asset is also helpful.

However, the Commissioner has made it clear that he does not consider that it is open to super fund trustees to undertake any form of substantive property development while super fund property remains subject to a borrowing. This will significantly reduce the situations in which borrowing to acquire real property will be attractive to self managed superannuation super funds, and may be problematic for those that have acquired property with development in mind since the rules last changed on 7 July 2010.

Examples of whether improvements will constitute a new asset

The following table sets out the Commissioner's view in relation to whether particular assets have become new assets or not.

Type of change made to an asset	Is it a new asset?	Why?
A vacant block is subdivided into multiple titles	Yes	One asset has been replaced with several different assets
A vacant block has a building built on it	Yes	Character of the asset changed from vacant land to residential premises
A house on a block is demolished by fire and three strata title units are built in its place	Yes	Character of premises and proprietary rights fundamentally changed from one asset to three
A house is built over two titles and subsequently the house is relocated so that it is only on one title	Yes	Following the relocation the fund holds two assets, one with a house on it and a vacant block
A residential house is converted into a restaurant by renovations which include fitting out a fully functioning commercial kitchen.	Yes	As a result of the renovation the character of the asset has fundamentally changed from residential premises to restaurant premises
One bedroom of a residential house is converted to a home office.	No	The conversion of the bedroom into an office does not result in a different asset.
The following improvements to a residential property • an extension to add two bedrooms; • the addition of a swimming pool;	No	Each (or all) of the changes would not result in a different asset

Type of change made to an asset	Is it a new asset?	Why?
• an extension consisting of an outdoor entertainment area; • the addition of a garage shed and driveway; • the addition of a garden shed		
To allow a road to be widened, a local government authority undertakes the compulsory resumption of a minor portion of the frontage of a residential property which has a residence on it. The resumption results in the existing property title being replaced	No	The minor extent of the resumption is such that the fundamental character of the asset, taking account of not only the proprietary rights but also the object of those proprietary rights, remains that of being the residential property
A 'granny flat' is to be constructed in the backyard of a residential property which already has a four bedroom residence established on it. The granny flat will have two bedrooms, a family room, a kitchen and a bathroom and will be connected to utilities such as electricity, water and sewage	No	The character of the asset would remain residential premises and thus the construction of the granny flat would not result in there being a different asset
A cyclone damages the roof of a house. The roof is replaced, but a second storey is added to the house at the same time	No	The character of the asset and the proprietary rights are not fundamentally changed
A kitchen is extended	No	The character of the asset and the proprietary rights are not fundamentally changed
Repairs and maintenance are carried out, and a pool or a new garage are added to a house property	No	The character of the asset and the proprietary rights are not fundamentally changed
A farm has the following additions: cattle yards; a bore, tank, windmill and trough; a dam and two kilometres of fencing	No	The character of the asset and the proprietary rights are not fundamentally changed
On 10,000 hectare cattle property a large shed is constructed, using SMSF money, to provide shelter to the cattle	No	The shed does not result in the property becoming a different asset as the character of the asset as a cattle property has not fundamentally changed

Type of change made to an asset	Is it a new asset?	Why?
On 10,000 hectare cattle property a residence is built to allow the owner or a manager to live on site	No	This would not result in the property becoming a different asset as the character of the asset as a cattle property would not fundamentally change. The residence would merely facilitate persons working on the property being able to live on site
On a one hectare blueberry hobby farm on a single title with 25 mature blueberry bushes on it as well as a bore and irrigation, a four bedroom house is built on the property, using accumulated funds held by the SMSF, with the intention of the property being leased to an unrelated party as a residence	Yes	The building of the house results in the character of the property fundamentally changing from that of being solely a small scale hobby farm to also being a residential property
A property which has a car washing facility on it, which is leased to a tenant who operates a car washing business, is expanded by extending the back of the building to double the number of wash bays. The extension, which involves concreting, roofing and plumbing work, will result in higher rent being received from the tenant	No	Although there is an improvement to the asset, that improvement does not result in the commercial property becoming a different asset. The fundamental character of the property remains a car wash facility

Is the ATO's view in relation to improvements to real property correct?

The basis of the ATO's views seemed to be the belief that the improvement would change the 'single acquirable asset' (the real property) to a different asset (some other real property). This view may be based in part on the statement in the EM referred to above, that an example of a circumstance not permitting a replacement asset would include the replacement by way of improvement of real property.

Therefore, it seems that those drafting the EM thought there might be circumstances in which the improvement of real property could result in the relevant asset being 'replaced' for the purposes of section 67B.

However, under a strict legal view, an improvement to real property does not change the asset itself.

Where a trustee uses a loan to purchase land, the 'property' it acquires is not the land and any building attached to it but rather all of its powers in relation to the land and fixtures. These powers are generally powers to exclude others from the land, to use the land and to transfer its powers in respect of it. When real property is transferred, the transferor expresses the subject of the transfer not as simply the land itself, but in terms such as the following: 'the estate and interest specified in the land described'. These are the words used in the Transfer of Land form under section 45 of the Transfer of Land Act 1958 (Vic); similar wording is used

in other jurisdictions. Any building or other fixtures on the land are carried along with the estate and interest being transferred, but their existence or otherwise does not have any bearing on the property interest itself.

An improvement to the land or fixtures does not change the trustee's property. Although the value of the trustee's interest in the property may increase, the trustee's powers in respect of the land and fixtures (its real property interest) are the same regardless of the existence of buildings or the state of such buildings. The acquirable asset held on trust will therefore be the same irrespective of whether or not improvements are made to the land or fixtures.

Alternative limited recourse arrangements for development land or multiple assets

In light of the ATO's view on single acquirable assets and replacement assets it would be prudent to consider alternative arrangements in the following circumstances:

- acquiring property that the super fund trustee intends to develop or improve (whether with the super fund's own money or money borrowed); and/or
- acquiring multiple assets (such as land over multiple titles or parcels of shares in different companies).

One such alternative arrangement is for a super fund trustee to borrow to acquire units in a unit trust that satisfies the requirements of reg 13.22C of the *Superannuation Industry (Supervision) Regulations 1994* (**SISR**). Provided that a qualifying limited recourse arrangement (including the Custodian trust) is put in place and that the security for the loan is limited to the units acquired (i.e. the property acquired by the unit trust must be unencumbered) then such a borrowing arrangement will be permitted. The cash used by the super fund trustee to subscribe for units can then be used to acquire, repair and develop a property, provided that the unit trust does not carry on a business.[61]

For example, a super fund trustee could enter into a limited recourse borrowing arrangement to acquire $500,000 worth of units in a unit trust. The trustee of that unit trust could use the $500,000 to acquire a property. The super fund trustee could later acquire a further $400,000 worth of units under a separate limited recourse borrowing arrangement and the trustee could use the further $400,000 to develop or improve the property.

One limiting factor for such an arrangement is that major banks are unlikely to lend to such structures due to the restrictions against using the property held by the unit trust as security. However, smaller lenders and related party lenders could be willing to lend under such a structure.

8. Disposing of the asset correctly

Collections of assets must be bought and sold together

The EM provides that not only must the assets be bought together as a collection they must also be sold as a collection, that is, they cannot be sold separately. The following is an example given in the EM:

> a collection of shares must be acquired and disposed of as a collection and could not, for example, be sold down over time.[62]

In the author's view, although this may have been the intent of the New Law, the New Law has not been drafted to give this effect. However, it is possible that the ATO may feel obliged to administer the law in the manner that is consistent with the policy set out in the EM. Whether the Courts would interpret the law in such a manner is different matter.

[61] Reg 13.22D SISR.
[62] EM paragraph 1.13.

9. Documentation in relation to the asset

The important thing to remember when dealing with the asset after the acquisition has been completed is that the Custodian is the legal owner of the single acquirable asset. Therefore, any dealings with the asset must be undertaken by the Custodian. For example, the lease of the asset, contracting with parties to improve or repair the asset and enforcing legal rights must be done by the Custodian, not the super fund trustee.

Of course, this also means that any legal liabilities in relation to the single acquirable asset will generally fall on the Custodian rather than the super fund trustee. For example, if a tenant sues in relation to a breach of the lease or an injury caused on the premises.

Does the Custodian/trust need to register for GST?

One potential exemption to this rule is whether the Custodian needs to register for an ABN/for GST.

Generally, all trusts that carry on an enterprise and meet the registration turnover threshold must register for GST.

However, in GSTR 2008/3[63] the Commissioner provides that where a beneficiary of a bare trust carries on the enterprise in relation to the asset, it is the beneficiary (i.e. the super fund) that must register for GST not the trustee (i.e. Custodian).

At paragraphs 37 and 38 the Commissioner relevantly provides:

> 37. The activities of a bare trustee are essentially passive in nature. A trustee of the type of trust considered in this Ruling has either no active duties to perform or only minor active duties. A bare trust as that term is used in this Ruling does not carry on an enterprise for GST purposes by virtue of its dealings in the trust property.
>
> 38. On the other hand, a beneficiary of a bare trust may carry on an enterprise involving an asset held on trust for the beneficiary by the bare trustee. For instance, in the example at paragraph 11 of this Ruling, despite legal title to the property being held by T, the property is used by B in carrying on its enterprise.

The Commissioner acknowledges that a trustee of a bare trust has no active duties but merely holds the legal title to the asset and acts in accordance with the directions of the super fund. This would appear to limit the above position to bare trusts. However, the Commissioner will also allow a beneficiary of some fixed trusts to register for GST at the beneficiary level. For example at paragraph 12 of the ruling he states:

> Alternatively, the trust may not strictly be a bare trust, because the trustee has minor active duties to perform, but nevertheless the trustee is required to act at the direction of the beneficiary in dealing with title to the trust property. Where this Ruling refers to 'bare trusts' it should also be taken to refer to trusts of this kind which may not strictly fall within accepted definitions of bare trusts but share similar features. The key point is that the trustee only acts at the direction of the beneficiary in respect of the relevant dealings in the trust property and has no independent role in respect of the trust property.

It is therefore important that if a super fund trustee wishes to deal with an asset at the super fund trustee level for GST purposes that the Custodian only act at the direction of the super fund trustee in respect of the asset and have no independent role in respect of that property. In that respect a bare trust would be preferable to a fixed trust.

[63] Goods and Services Tax Ruling GSTR 2008/3 Goods and services tax: dealings in real property by bare trusts.

10. How to deal with the trust at the end of the borrowing

Winding up of the trust – duty issues?

Once the LRBA loan has been repaid, the trust can be wound up and the asset transferred from the Custodian to the super fund trustee. Usually, the process for the wind-up is governed by the trust deed. Typically, it will be documented by a resolution of the Custodian or a deed between the Custodian and the super fund trustee.

The wind up of the trust and the transfer of the asset from the Custodian to the super fund trustee potentially triggers duty. There are potential duty exemptions or nominal duty for such transfers in each State and Territory[64]. However, each jurisdiction has their own particular requirements in order for such concession to apply. Therefore, expert duty advice should be obtained before such transfers are effected.

Keeping the trust – in-house asset issues?

An alternative to winding up the trust is to keep it. For example, until recent changes to the law in Queensland and South Australia, the vesting of the trust and the transfer of the property to the super fund trustee would trigger duty and therefore, in those jurisdictions, there was previously a strong preference to keep the asset in the trust.

However, up until recently this could potentially have caused the super fund trustee to breach the in-house asset rules. Initially this was not seen as an issue by most advisors given that section 71(8) of the SIS Act specifically excludes that trust from being an in–house asset of the super fund. However, according to the ATO, once the borrowing has been repaid that exception will no longer apply and consequently, the Custodian trust will potentially be an in–house asset. The ATO takes this view because 'under subsection 71(8) of the SIS Act, once a limited recourse borrowing arrangement has ended, even if there are other amounts outstanding, the in–house asset exception ceases to apply.'[65]

Thankfully, this will no longer be an issue as the ATO has issued a draft legislative instrument to deal with this potential issue. Under that instrument the trust will not be an in-house asset:

1. where the trust is established before the LRBA arrangement is implemented – for the period before the LRBA arrangement is in place to the time the LRBA arrangement is in place; and/or

2. where the LRBA loan has been repaid, the period after that repayment.

Therefore, the trust structure can now remain in place after the LRBA loan has been repaid without the trust being caught by the in-house asset rules.

11. How to protect the fund against unexpected events

Unexpected events in relation to a LBRA loan, like all liabilities, should be considered and planned for. This includes:

1. the asset stops deriving income to fund the LRBA interest and principal payments – for example real estate is destroyed or damaged by fire or is unable to be tenanted for a significant period of time;
2. the super fund trustee breaches its loan obligations resulting in the lender calling in the full loan amount; and

[64] For example, in Victoria, the apparent purchaser exemption under section 34 of the *Duties Act 2000* potentially exempts such a transfer from duty.
[65] Q&A see question 'Can the holding trust trustee continue to hold the property for the investor after the borrowing has ended?'

3. one or more of the member's die, forcing the super fund to pay out a significant death benefit and potentially reducing the amount of contributions being made to the super fund.

For the first two events it will generally be known that the event in question will happen or they can potentially be protected against with insurance over the asset, the holding of a buffer of cash and/or realisable assets or ultimately selling the asset.

For the third event, especially where the death of the member is sudden and unexpected, funding the ongoing LRBA loan (or repaying it) as well as funding the member's death benefit can be problematic.

This is best explained through examples:

Ben and Sarah are married and are both the members of the Besa SMSF. The Besa SMSF has net assets of $500K and holds the following assets and liabilities:

1. Real property worth $1M (subject to the LRBA)
2. Cash in terms deposits of $100K
3. Life insurance over Ben's life with coverage of $400K
4. A LRBA liability of $600K

Ben's member account is $400K, while Sarah's is $100K.

Ben dies. The life insurance policy was allocated to Ben's member account and therefore the proceeds form part of the Ben's account. Sarah decides to pay Ben's death benefits to herself in the form of the death benefit account based pension. Sarah has a choice, she can either keep the LRBA loan or use the SMSF's cash (being the term deposits and the insurance proceeds) to pay down some of the loan.

Let's keep the same facts as above, except this time Ben and Sarah are business partners and Ben's death benefit is to be paid to his 2 adult children. In this example, if the insurance is allocated to Ben's account then Sarah has a problem. The SMSF has to pay out a death benefit of $800K, but it only has cash of $500K and unlike the above example Sarah cannot pay a pension benefit to Ben's children. Under this structure, they have the following options:

1. keep the structure as outlined above, in which case Sarah will either have to:
    a. sell the real property to fund the death benefit and repay the LRBA;
    b. inject further cash into the SMSF by making further contributions; or
    c. inject further cash into the SMSF by having a new member rollover benefits into the SMSF;

2. instead of allocating the life insurance to Ben's member's account, allocate it to Sarah's account (for example, Ben and Sarah could "cross insure" each other) or allocate it to an investment reserve (noting that this may affect the ability of the SMSF to deduct the premium and the potential for allocations from a reserve being deemed to be concessional contributions). The insurance proceeds could then stay in the SMSF to fund the ongoing LRBA loan obligations or repay it in part.

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