

### Warnings on funds "borrowing"

Our February/March edition focussed on the relatively new concept of funds undertaking borrowings pursuant to section 67(4A) of the *Superannuation Industry (Supervision) Act 1993* ("SIS"). This provision was introduced by the former Liberal coalition government to allow self-managed funds to subscribe for Telstra T3 instalment warrants.

Since the legislation was introduced in September 2007, investment managers, fund managers and mortgage brokers have been hawking so-called "products" to self-managed funds based on the new section 67(4A) provisions. Some of these products do not actually comply with section 67(4A)! The self interest groups representing master and public offer funds have raised a massive awareness campaign in an endeavour to persuade the current government to repeal the ability of self-managed funds to utilise the borrowing provisions of section 67(4A). Senator Sherry has promised "to respond". It could be that the new provision is so "over-utilised" that the response will be repeal of the borrowing provisions. In the last week the Tax Office has launched two publications highlighting the importance of absolute compliance with the section itself - "*Taxpayer Alert TA 2008/5*" and "*Instalment warrants and super funds - questions and answers*".

### Taxpayer Alert TA 2008/5:

The Alert describes five situations where in its view, the provisions of section 67(4A) are breached:

- (i) interest at less than commercial rates advanced by a member or related party;
- (ii) interest at greater than commercial rates advanced by a member or related party giving rise to a breach of the sole purpose test and giving financial assistance to a fund member or relative;
- (iii) capitalised interest arrangements;
- (iv) security taken by a lender which exceeds the requirements of section 67(4A) - for example, the giving of a personal guarantee by a third party or a related party (there are a number of "products" that fall within this category); and
- (v) an asset acquired utilising borrowing is otherwise, a prohibited asset. For instance, acquiring a residential property from a fund member or related party.

### Instalment warrants and super funds - questions and answers:

Whilst the publication agrees that the provisions of section 67(4A) are not limited to just "instalment warrants", it also examines a number of areas where the Tax Office believes funds are transgressing the narrow limits of the section. The following important issues identified by the Tax Office can be drawn from the Questions and Answers publication:

- If the conditions set out in section 67(4A) are not strictly satisfied, funds will be in breach of SIS;
- A unit trust cannot be used as the security trustee to hold the asset until a fund becomes legally entitled to it;
- An existing asset of a fund cannot be used in an instalment warrant type arrangement. The purpose of the section is to enable funds to "acquire" an asset;
- Whilst there is no direct prohibition on a fund borrowing from a related party, such borrowing must be on commercial terms - [see (i) and (ii) above re the Taxpayer Alert];
- Documents must evidence that a fund has made a genuine borrowing to acquire an asset; and
- The governing rules of a fund and its investment strategy must allow a fund to borrow.

The Tax Office has stressed that the conditions prescribed by section 67(4A) must be met - nothing more and, nothing less. Be aware, anything more or, anything less could spell disaster and a non-complying fund! Briefly, the conditions prescribed by section 67(4A) are:

1. A security trustee acquires an asset (including an instalment warrant) provided the asset is one which a fund could otherwise, legitimately acquire directly;
2. A security trustee (as an interposed entity) must hold legal interest in the asset on trust for the trustees of a fund until the fund has discharged the loan;
3. Whilst the borrowings undertaken by a fund are being repaid, the fund trustees must at all times maintain a beneficial interest in the acquired asset;
4. If fund trustees default on a loan, the lender's recourse is limited to the asset acquired by the security trustee and no other form of security or recourse to a fund's other assets; and
5. At the end of the loan arrangement, a fund trustee must have the right to acquire legal ownership of the asset from the security trustee.

### Property held by a fund as a tenant in common with others

*Draft Self Managed Funds Ruling SMSFR 2008/D2* provides useful insight into the Tax Office view in relation to the contribution of in-specie assets to a fund. Business real property (as defined in section 66 of SIS) is one of the two exceptions to the rule that a fund cannot acquire assets from a member, relative of a member or associate of a fund.

If business real property is proposed held by a fund as a tenant in common with a related party, the issue frequently arose as to whether a fund's share could be held with a related party. In the Draft Ruling, the Tax Office says:

*"The law is that the exceptions apply in the normal way to this type of asset. That is, the trustee or investment manager does not contravene subsection 66(1) by accepting a contribution of an interest in real property from a related party, that results in the SMSF and another related party of the SMSF holding the property as tenants in common, if:*

- *the interest acquired is business real property of the contributing related party; it is acquired by the SMSF at market value and the SMSF has fewer than five members (that is, the exception in paragraph 66(2)(b)) applies); or*
- *the interest acquired in the property is an in-house asset because it is subject to a lease or lease arrangement between the trustee of the SMSF and a related party, the interest is acquired at market value<sup>20</sup> and the acquisition of the interest does not cause the SMSF to exceed the 5% market value ratio limit for in-house assets (that is, subparagraph 66(2A)(a)(i) applies)."*

Whilst the Draft Ruling deals primarily with in-specie contributions, there is at least some guidance as to business real property held by a related party as a tenant in common with a fund. But, please remember, the Draft Ruling is not law.

### Funds claiming interest deductions

We are aware that there are a number of self-managed funds which have interests in "uncommercial trust arrangements". *Taxpayer Alert TA 2008/3* explains the Tax Office view in relation to fund related parties using borrowed monies to obtain an interest in certain types of discretionary and unit trusts, used to purchase income producing property.

Fund related parties claim interest deductions and borrowing costs, but income and in some cases, capital gains, are derived by other trust beneficiaries, including self-managed funds. The arrangement is more commonly used with discretionary trusts but we know of certain unit/hybrid trust arrangements which are being marketed. The dangers in these arrangements are twofold. Firstly, the clear danger of their being no nexus between taxable income and deductions in the one entity and secondly, the "special income" provisions of the *Income Tax Assessment Act 1997*. For the uninitiated, the special income provisions impose tax at normal, marginal rates on a fund in relation to trust distributions earned other than on an arm's length basis.

## "Products"

Why is this edition plagued with negativity not otherwise seen in what is always an enjoyable and informative publication?

Each of the areas discussed in this Newsletter is the subject of one or more "products" being pedalled by mortgage brokers, finance brokers, financial planners, managed investment houses, banks and others. Many of the products are without substance and as outlined above, some can cause a fund to become non-complying.

Extreme care needs to be taken in considering any of these areas as suitable for superannuation fund investment. The famous catch-cry "*but, it was sold to us by the Bank*" is in hindsight, a poor substitute for what should have been sound professional advice. In one case, a bank has just admitted that its product will cause a fund to become non-complying!

Take great care with any of these "products". Treat them like acid. Inevitably, they will burn you. Our tip - within six months, the scope of section 67(4A) will be confined to instalment warrants listed on an Australian Securities Exchange and will exclude real property and other types of assets acquired by funds.

The contents of this Newsletter are not intended to constitute the provision or rendering of legal or other advice. Accordingly, we can accept no responsibility for loss or damage (howsoever arising) to persons who act solely on the basis of this Newsletter without first seeking our professional advice.