30 May 2012

On 23 May 2012, the Australian Taxation Office (ATO) issued its final ruling on key concepts for limited recourse borrowing arrangements in superannuation Self Managed Superannuation Funds Ruling SMSFR 2012/1 (Ruling).

The Ruling deals with limited recourse borrowing arrangements (LRBAs) entered into from 7 July 2010. It explains:

- the concepts of ‘acquirable asset’ and ‘single acquirable asset’
- the distinction between ‘maintaining’ or ‘repairing’ an acquirable asset and ‘improving’ it, and
- when an acquirable asset is changed such that it becomes a different (i.e. replacement) asset.

The release of the Ruling follows ATO consultation on a Draft Ruling on limited recourse borrowing arrangements issued in September last year which provided welcomed guidance to the industry. The views expressed in the Ruling largely reflect those expressed in the Draft Ruling but with a number of clarifications and additions.

This article provides a summary of the key points of the Ruling.

Key concepts – ‘acquirable asset’ and ‘single acquirable asset’

The money from a limited recourse borrowing arrangement may only be applied for the acquisition of a ‘single acquirable asset’. The Ruling clarifies the Commissioner’s views on the meaning of ‘acquirable asset’ and ‘single acquirable asset’.

The Commissioner will give consideration to both the legal form and substance of the asset acquired. This is welcomed because an approach based purely on legal title (e.g. a land title), would present a number of challenging issues, particularly where multiple titles are concerned.

Multiple titles

The Commissioner considers that a single acquirable asset may exist over more than one legal title if the titles cannot be sold separately.

If there is a ‘unifying physical object’, such as a permanent fixture attached to the land which is not easily removed and that is significant in value relative to the value of the asset, the Commissioner may consider that more than one title comprises a single asset.
For example, where a factory or a house is situated over more than one legal title, the Commissioner has taken the view in the Ruling that a single acquirable asset may exist, which can be the subject of a complying LRBA (see Example 2).

However if the house, for example, is subsequently relocated to just one of the titles, then two assets would result as one of the titles may be separately sold, and the LRBA would no longer comply (see Example 11).

The Commissioner will also consider two titles to be a single acquirable asset where there is a State or Territory law that requires the two assets to be sold together. Example 4 of the Ruling indicates that an apartment with a car park on a separate title will be considered one asset if State laws do not allow the titles to be disposed of separately.

The Commissioner will not regard multiple titles as a single asset if:

- there is a physical object situated across two or more titles that is not significant in value relative to the value of the land or is not permanent (or otherwise able to be relocated or removed)
- a business is being conducted on two or more titles, or
- the assets are being acquired under a single contract because the vendor wants to deal with the assets as a package or the lender will only lend over a group of assets.

The Ruling provides examples of situations where more than one asset will not be considered to be a single acquirable asset:

- two adjacent blocks of land only offered for sale together
- serviced apartment and furnishings
- a farm business operating on two titles. In these circumstances the existence of agricultural crops, fencing or irrigation systems that span the two titles are not considered impediments to selling the titles separately.

It is therefore important that SMSF trustees investigate the reasons for more than one title being sold together prior to acquiring the asset(s) under one LRBA.

Key concepts – ‘maintaining’ or ‘repairing’, versus ‘improving’

A key issue for SMSF trustees considering the purchase of real property via an SMSF LRBA is the distinction between maintenance and repairs, and improvements. This distinction is important because SMSF trustees may use LRBA borrowings to maintain or repair the property, but not to improve it. The Ruling clarifies the distinction.

"Maintaining" involves "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" involves "remedying or making good defects in, damage to, or deterioration of, an asset and contemplates the continued existence of the asset."

These descriptions contrast with ‘improving’, which involves significantly altering the state of function of the asset for the better, through substantial alterations, or the addition of further substantial features or rights, to the asset.

Ascertaining whether an improvement has been made, rather than maintenance or a repair, is a question of fact and degree, having regard to the condition and characteristics of the property at the time of acquisition.

Examples given of improvements in the Ruling include:

- the construction of a house on a vacant block of land
- adding a pool, a garage or a second storey to an existing house
- substantial renovations of a property, including adding a bathroom during that process, and
- an additional shed, set of cattle yards, tank windmill or additional fencing on a farming property.

Alterations will not amount to an improvement if the state or function of the acquirable asset is only bettered to a minor or trifling extent as compared to the asset as a whole.

For example, repairing broken windows immediately following acquisition is provided as an example where a SMSF trustee could use LRBA funds.
However, trustees should take care with how much initial repair to an acquired property will be tolerated. The Ruling states that the greater the level of deterioration at acquisition, the more likely it is that alterations and changes will be considered improvements. Substantial renovation of a run down house is likely to be considered an improvement.

Key concept – when an acquirable asset becomes a different asset

Although improvements to the LRBA asset cannot be funded by borrowings, the Ruling confirms that improvements can be made if funded from other sources. For example, that funding could arise from existing SMSF cash holdings or from a related party to the SMSF.

However, care should be taken by SMSF trustees that the asset is not improved to a degree that it becomes a different asset. The LRBA provisions require that a borrowing is applied to acquire a single acquirable asset and that asset is to be held on trust for the duration of the borrowing. If the asset is improved such that it is no longer the original single acquirable asset, the LRBA provisions will generally be breached. While the LRBA provisions do permit borrowing arrangements to exist in relation to replacement assets in limited circumstances, these typically relate to replacement shares in companies or units in a unit trust (for example, where they arise in the context of a corporate action), but not real property.

In determining whether a different asset has arisen, the Commissioner has regard to whether the character of the asset as a whole has fundamentally changed. Examples of creating a different asset are provided in the Ruling and include:

- subdividing vacant land
- building a residential house on vacant land
- demolishing a house and replacing it with three strata titled units
- renovating a residential house into commercial premises, and
- construction of a four bedroom residence on a small farm.

The Ruling clarifies that whether or not a different asset has arisen from an improvement is not affected by the identity of whoever made the changes, for example a tenant or an SMSF member.

Improvements that are considered in the Ruling not to constitute a change in the character of the asset:

- a house extension
- the addition of a pool or garage to a house
- the addition of a second storey to a house
- commercial building extensions using SMSF funds which do not change the character of the property, and
- construction of a shed on a cattle property.

This is important as prior to the Draft Ruling, it was unclear whether any improvements could be made to real property purchased via LRBAs, which was potentially a significant deterrent for long term investors and lenders. Both the Draft Ruling and Final Ruling confirm that although improvements cannot be funded by LRBA borrowings, modest improvements can be funded from other sources.

Off-the-plan purchases

The Ruling provides greater guidance in relation to property developments and off-the-plan purchases compared to the Draft Ruling.

In the Ruling, the Commissioner draws a distinction between a contract entered into for the purchase of an off-the-plan property and an option for an off-the-plan purchase.

For example, in the case of an off-the-plan purchase of a strata titled unit where the contract requires a deposit upon entering into the contract and the balance payable at settlement (after the unit has been built and strata titled), both the deposit and the balance can be funded under a single LRBA.

The Commissioner takes a similar view in relation to a contract for the purchase of a single title vacant block of land along with the construction of a house on that land before settlement occurs.

However, if an option is acquired for an off-the-plan purchase of a house on a single title block of land or a strata titled unit, the relevant single acquirable asset is the option. If the money applied to acquire the option is funded under an LRBA and the option is exercised, the subsequent acquisition of the house and land or
the strata titled unit would need to be funded under a separate LRBA. The option could not be replaced with the house or unit within an LRBA because of the limited scope in the provisions to replace assets.

Conclusion

The Ruling confirms a number of positive developments in the Commissioner’s views on SMSF LRBA, especially with respect to real property acquisitions.

However, SMSF trustees should exercise caution in this area. If considering purchasing a property on multiple titles, trustees need to understand the reasons for the titles being sold together. Trustees should also consider how improvements to real property are to be funded and the extent of the improvements. These considerations could be critical if breaching the SIS provisions is to be avoided.

Clients need to ensure that they receive expert advice, not only in relation to the compliant establishment of LRBA, but also on an ongoing basis.

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