

# ***SPR 2014/1 - Explanatory statement -***



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# Self Managed Superannuation Funds (Limited Recourse Borrowing Arrangements – In-House Asset Exclusion) Determination 2014

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## Explanatory Statement

### General Outline of Instrument

1. This instrument is made under paragraph 71(1)(f) of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).
2. This instrument ensures that an investment in a related trust held by a self managed superannuation fund (SMSF) as a required part of a limited recourse borrowing arrangement (LRBA) is excluded from being an in-house asset of the SMSF in the circumstances described in the instrument.
3. This instrument is a legislative instrument for the purposes of the *Legislative Instruments Act 2003* (LIA).
4. All legislative references in this explanatory statement are to provisions in the SIS Act unless otherwise specified.

### Commencement

5. This instrument is taken to have commenced on 24 September 2007. This aligns with the date of effect of the introduction of provisions in the SIS Act allowing trustees of regulated superannuation funds to enter into LRBAs. This ensures SMSFs that entered into LRBAs prior to the making of this instrument are not disadvantaged as compared with SMSFs that enter into LRBAs after the making of this instrument.
6. The effect of this instrument is to the advantage of affected parties.
7. Therefore, subsection 12(2) of the LIA does not prevent this instrument taking effect from its specified commencement date.

### What is this instrument about?

8. This instrument relates to certain circumstances (which are described below under 'Background') where an investment in a related trust held by an SMSF as a

required part of an LRBA is not excluded, through the operation of subsection 71(8), from being an in-house asset of the SMSF at a time.

## **What is the effect of this instrument?**

9. The effect of this instrument is that in those circumstances such an investment by an SMSF is excluded from being an in-house asset of the SMSF.
10. An assessment of the compliance cost impact indicates that the impact will be minor for both implementation and on-going compliance costs. The new instrument is of a minor or machinery nature.

## **Background**

11. Section 67 prohibits a trustee of a regulated superannuation fund from borrowing money or maintaining an existing borrowing of money, subject to certain exceptions including where money is borrowed under an LRBA that meets the conditions set out in the SIS Act.
12. Different conditions apply for LRBAs entered between 24 September 2007 and 6 July 2010 inclusive and arrangements entered into on or after 7 July 2010. These conditions are set out in subsection 67(4A) (now repealed) and section 67A respectively.
13. Under an LRBA, an SMSF's trustees may borrow money to acquire an asset provided that the lender only has recourse in the event of default to the asset acquired using the borrowed money. While the borrowing remains outstanding, the asset is to be held on trust so that the trustee of the SMSF acquires a beneficial interest in that asset.
14. The trust that holds the legal title to the asset under an LRBA is generally known as a holding trust. In many cases, the holding trust will be a 'related trust' of the SMSF as defined in subsection 10(1). An investment in a related trust of the SMSF is an 'in-house asset' of the SMSF as defined in subsection 71(1), unless a relevant exception applies.
15. The in-house asset rules contained in Part 8 impose a limit on the value of in-house assets that an SMSF can hold. This limit as set out in section 82 is currently 5% of the total market value of the fund's assets.
16. Section 83 prohibits an SMSF trustee from acquiring an in-house asset if the value of the fund's in-house assets already exceeds the 5% limit or if the acquisition would cause the fund to exceed the 5% limit. Section 84 provides for civil and criminal penalties for contravention of these rules.
17. Subsection 71(8) provides an exception to the definition of 'in-house asset' that is particularly relevant to an SMSF's investment in the holding trust as part of an LRBA. That subsection provides that if, at a time:
  - an asset (the investment asset) of a superannuation fund is an investment in a related trust of the fund; and

- the related trust is one described in paragraph 67A(1)(b) in connection with a borrowing, by the trustee of the fund, that is covered by subsection 67A(1)<sup>1</sup>; and
- the only property of the related trust is the acquirable asset mentioned in paragraph 67A(1)(b)<sup>2</sup>,

the investment asset is an in-house asset of the fund at the time only if the acquirable asset would be an in-house asset of the fund if it were an asset of the fund at the time.

18. The opening words of subsection 71(8), 'If at a time....' refer to a specific point in time at which the requirements of paragraphs 71(8)(a),(b) and (c) must be satisfied in order for the exception provided by that subsection to apply in respect of that particular time.
19. Therefore, pursuant to paragraph 71(8)(b), a borrowing covered by the relevant provision must be in place at a particular time for subsection 71(8) to apply in respect of that time. However, there may be a period where a contract for the acquisition of the acquirable asset has been entered into and a substantial deposit paid under that contract, but a borrowing (to fund payment of the balance of the acquisition cost of the acquirable asset) will not be in place until near or on settlement of that contract. Similarly, the acquirable asset may continue to be held in the holding trust after the borrowing covered by the relevant provision has been repaid.
20. In such cases, the exclusion provided by subsection 71(8) does not apply to any investment in the related holding trust by the SMSF during such a period when there is no borrowing that is covered by subsection 67A(1) (or, as relevant, former subsection 67(4A)).
21. Additionally, paragraph 71(8)(c) requires that, at the particular time being tested, the only property of the related trust is the asset mentioned in paragraph 67A(1)(b) (or, as relevant, former subsection 67(4A)). Even if a borrowing covered by the relevant provision has begun (such as where the borrowing funds the payment of a deposit under the contract for the acquisition of the acquirable asset), there may be a delay in the related trust holding the asset referred to in paragraph 71(8)(c) (such as where a strata-titled unit is being acquired 'off the plan').
22. In such cases, the exclusion provided by subsection 71(8) does not apply to any investment in the related trust by the SMSF during such a period when the related trust does not yet hold the acquirable asset.
23. To provide certainty for SMSF trustees in the circumstances described, this instrument is made by the Regulator pursuant to paragraph 71(1)(f) and will potentially apply to exclude an SMSF's investment in such a related holding trust from being an in-house asset of the fund in those circumstances during affected periods.
24. The Regulator will periodically review this instrument to ensure it is applying as intended. The Regulator has the ability to withdraw this instrument if its terms are exploited or are not being applied as intended.

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<sup>1</sup> For arrangements entered into between 24 September 2007 and 6 July 2010 the references to paragraph 67A(1)(b) and subsection 67A(1) were instead to former paragraph 67(4A)(b) and subsection 67(4A).

<sup>2</sup> For arrangements entered into between 24 September 2007 and 6 July 2010 the reference to the acquirable asset mentioned in paragraph 67A(1)(b) was instead to the original asset or replacement described in former subsection 67(4A).

### **Clause 3.1 – in-house asset exemption at the commencement of an LRBA**

25. Under particular LRBAs, there may be periods of time at the beginning of these arrangements where subsection 71(8) does not apply to ensure an SMSF's investment in the related holding trust is not an in-house asset of the fund during those periods. Paragraphs 19 and 21 describe how this may occur.
26. Clause 3.1 operates in those circumstances. Specifically, clause 3.1 provides that an asset (the investment asset) of an SMSF (the fund) that is an investment in a related trust of the fund is not an in-house asset of the fund at a time (the test time) where:
- the application of subsection 71(8) would result in the investment asset not being an in-house asset of the fund at the test time but for the fact that:
    - if a borrowing referred to in paragraph 71(8)(b) has not yet begun – such a borrowing has not yet begun; and
    - the related trust does not yet hold the asset referred to in paragraph 71(8)(c); and
  - it is reasonable to conclude at the test time that:
    - if a borrowing referred to in paragraph 71(8)(b) has not yet begun – such a borrowing will occur; and
    - the related trust will hold the asset referred to in paragraph 71(8)(c); and
    - the application of subsection 71(8) would result in the investment asset not being an in-house asset of the fund from the time the related trust begins to hold the asset referred to in paragraph 71(8)(c).
27. Clause 3.1(a) potentially applies where an SMSF holds the investment asset prior to both the commencement of a borrowing referred to in paragraph 71(8)(b) and the related trust beginning to hold the asset referred to in paragraph 71(8)(c). This includes where it is intended for there to be more than one such borrowing under one LRBA (such as a borrowing to fund the payment of a deposit under the contract for the acquisition of the acquirable asset and another borrowing to fund payment of the balance of the acquisition cost of the acquirable asset), but none of those borrowings has yet begun and the related trust does not yet hold the asset referred to in paragraph 71(8)(c).
28. Clause 3.1(a) potentially also applies at a time when the related trust does not yet hold the asset referred to in paragraph 71(8)(c) even though one or more borrowings referred to in paragraph 71(8)(b) have begun. Once the related trust begins to hold the asset referred to in paragraph 71(8)(c), the investment asset will be excluded from being an in-house asset of the fund from that time onwards through the operation of subsection 71(8), provided the requirements of that subsection are met from that time onwards.
29. Whether the requirements of clause 3.1(b) are met will depend on the facts and circumstances of each case. As an example, it would not be reasonable to conclude at a particular time that a borrowing referred to in paragraph 71(8)(b) will occur or that the related trust will hold the asset referred to in paragraph 71(8)(c), if the trustees of the relevant SMSF do not at that time have reasonable prospects of obtaining the necessary finance to complete the purchase of the asset referred to in paragraph 71(8)(c).
30. To satisfy clause 3.1(b)(iii), it must be reasonable to conclude at the test time that from the time the related trust begins to hold the asset referred to in paragraph 71(8)(c), the application of subsection 71(8) would result in the investment asset

not being an in-house asset of the fund from that time. Given the requirements of subsection 71(8), this means it must be reasonable to conclude, for example, that:

- the only property of the related trust will be the asset referred to in paragraph 71(8)(c); and
- that asset would not be an in-house asset of the fund if directly held by the SMSF.

31. It is not intended for clause 3.1 to provide indefinite relief from the in-house asset rules. SMSF trustees should take all reasonable steps to ensure there are no unreasonable delays to the commencement of the borrowing or the acquisition of the asset by the trustee of the holding trust.

### **Clause 3.2 – in-house asset exemption after a borrowing is repaid**

32. In practice, transfer of the asset referred to in paragraph 71(8)(c) from the holding trust to the SMSF trustee is unlikely to happen at the same time as the borrowing under the LRBA is repaid. The asset may continue to be held in the holding trust after the borrowing referred to in paragraph 71(8)(b) has been repaid. The exclusion provided by subsection 71(8) does not apply to any investment in the related holding trust by the SMSF during such a period when there is no borrowing that is covered by subsection 67A(1) (or, as relevant, former subsection 67(4A)).

33. Clause 3.2 operates in those circumstances. Specifically, clause 3.2 provides that an asset (the investment asset) of an SMSF (the fund) that is an investment in a related trust of the fund is not an in-house asset of the fund at a time (the test time) where:

- the application of subsection 71(8) resulted in the investment asset not being an in-house asset of the fund at all times from when the related trust began to hold the asset referred to in paragraph 71(8)(c) until a borrowing referred to in paragraph 71(8)(b) was repaid: and
- the application of subsection 71(8) would result in the investment asset not being an in-house asset of the fund at the test time but for the fact that that borrowing referred to in paragraph 71(8)(b) has been repaid.

34. In circumstances where there are multiple borrowings covered by subsection 67A(1) (or, as relevant former subsection 67(4A)) under one LRBA, the investment asset will be excluded, through the operation of subsection 71(8), from being an in-house asset of the fund until the last of such borrowings under the LRBA is repaid, provided the requirements of subsection 71(8) are continually met until that time. Clause 3.2 potentially applies once the last of such borrowings under the LRBA is repaid.

35. To satisfy clause 3.2(a), the SMSF's trustees must be able to demonstrate that the application of subsection 71(8) resulted in the investment asset not being an in-house asset of the fund at all times from the time the related trust began to hold the asset referred to in paragraph 71(8)(c) until a borrowing referred to in paragraph 71(8)(b) was repaid. Given the requirements of subsection 71(8), this means, for example, that at all times during that period:

- the only property of the related trust is the asset referred to in paragraph 71(8)(c); and
- that asset would not be an in-house asset of the fund if directly held by the SMSF.

36. To satisfy clause 3.2(b), the SMSF's trustees must be able to demonstrate that the application of subsection 71(8) would result in the investment asset not being an in-house asset of the fund at the test time but for the fact that the borrowing referred to in clause 3.2(a) has been repaid. Given the requirements of subsection 71(8), this means, for example, that at the test time:
- the only property of the related trust is the asset referred to in paragraph 71(8)(c); and
  - that asset would not be an in-house asset of the fund if directly held by the SMSF.

## **Consultation**

37. Section 17 of the LIA requires consultation to be undertaken before the making of a legislative instrument if it is appropriate and reasonably practical to do so.
38. On 12 December 2013, the Australian Taxation Office (ATO) released this instrument and explanatory statement for public consultation for a period of seven weeks. The ATO received eight written submissions from key industry associations and other stakeholders.
39. The vast majority of submissions received, as well as a media release issued by the SMSF Professionals' Association of Australia on 13 December 2013, expressed support for this instrument. Suggestions for a few minor changes to clarify particular aspects have been addressed through minor amendments to this explanatory statement prior to its finalisation.
40. The ATO also consulted with relevant Government agencies during the development of this instrument and explanatory statement.

## **Exemption from disallowance and sunseting regime**

41. Section 42 of the LIA provides for the disallowance of legislative instruments. However, subsection 44(2) of the LIA provides that section 42 does not apply to, among other things, instruments (other than regulations) relating to superannuation (Item 39 of the table in that subsection). As a result, this instrument is not a disallowable legislative instrument under section 42 of the LIA.
42. Part 6 of the LIA provides for the sunseting of legislative instruments. However, subsection 54(2) of the LIA provides that Part 6 of the LIA does not apply to, among other things, instruments (other than regulations) relating to superannuation (Item 42 of the table in that subsection). As a result, Part 6 of the LIA does not apply to this instrument.

## **Statement of compatibility with Human Rights**

43. Since, as noted above, section 42 of the LIA does not apply to this instrument, a Statement of compatibility with Human Rights in respect of this instrument is not required under section 9 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

*Legislative references:*

*Legislative Instruments Act 2003*

12(2)

17

42

44(2)

Part 6

54(2)

*Superannuation Industry (Supervision) Act 1993*

10(1)

67

67(4A) (repealed)

67(4A)(b) (repealed)

67A

67A(1)

67A(1)(b)

Part 8

71(1)

71(1)(f)

71(8)

71(8)(a)

71(8)(b)

71(8)(c)

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83

84

*Human Rights (Parliamentary Scrutiny) Act 2011*

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