

# ***SMSFR 2012/1 - Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts***

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## Self Managed Superannuation Funds Ruling

### Self Managed Superannuation Funds: limited recourse borrowing arrangements – application of key concepts

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#### **Preamble**

This publication represents the Commissioner's view about the way in which provisions of the *Superannuation Industry (Supervision) Act 1993*, or regulations under that Act, apply to superannuation funds that the Commissioner regulates: principally self managed superannuation funds.

Self Managed Superannuation Funds Rulings (whether draft or final) are not legally binding on the Commissioner. However, if the Commissioner later takes the view that the law applies less favourably to you than this ruling indicates, the fact that you acted in accordance with this ruling would be a relevant factor in your favour in the Commissioner's exercise of any discretion as to what action to take in response to a breach of that law. The Commissioner may, having regard to all the circumstances, decide that it is appropriate to take no action in response to the breach.

#### **What this Ruling is about**

1. This Ruling explains key concepts relevant to the application of the limited recourse borrowing arrangement (LRBA) provisions, as those provisions apply to a self managed superannuation fund (SMSF) that enters into an LRBA. The LRBA provisions are found in sections 67A and 67B of the *Superannuation Industry (Supervision) Act 1993* (SISA).<sup>1</sup>

2. The key concepts explained are:

- what is an 'acquirable asset' and a 'single acquirable asset';
- 'maintaining' or 'repairing' the acquirable asset as distinguished from 'improving' it; and
- when a single acquirable asset is changed to such an extent that it is a different (replacement) asset.

3. Although the analysis and examples developed in this Ruling focus primarily on real property, the principles discussed can also apply to other types of assets such as machinery or equipment.

<sup>1</sup> All legislative references in this Ruling are to the SISA unless otherwise indicated.

4. This Ruling does not consider:
- other issues arising from an LRBA, such as the application of the in-house asset rules<sup>2</sup> if an asset continues to be held under the LRBA trust (the holding trust) once the borrowing has been repaid; or
  - how other SISA and Superannuation Industry (Supervision) Regulations 1994 (SISR) provisions apply to any arrangement discussed, or examples given, in this Ruling.

## Ruling

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### The meaning of 'acquirable asset' and 'single acquirable asset'

5. An 'acquirable asset'<sup>3</sup> is any asset, other than money, that neither the SISA<sup>4</sup> nor any other law prohibits a trustee of an SMSF from acquiring.
6. An asset is defined in subsection 10(1) to mean any form of property. In the context of an LRBA, an acquirable asset is therefore any form of property, other than money, that a trustee of an SMSF is not otherwise prohibited from acquiring.
7. Money is Australian currency or currency of another country but does not extend to collectable banknotes or coins.<sup>5</sup>
8. The term 'property' is not defined in the SISA and therefore takes on its ordinary meaning. The phrase 'any form of property' has a very wide meaning.
9. The term 'property' can be used in different senses. It can describe:
- the proprietary rights, or
  - the often physical object of the proprietary rights (for example, land or machinery).

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<sup>2</sup> Part 8. The in-house asset rules are discussed in *Self Managed Superannuation Funds Ruling SMSFR 2009/4 Self Managed Superannuation Funds: the meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the Superannuation Industry (Supervision) Act 1993*.

<sup>3</sup> Subsection 67A(2).

<sup>4</sup> See for example section 66 which, subject to some limited exceptions, prohibits the acquisition of assets from a related party. This provision is discussed in *Self Managed Superannuation Funds Ruling SMSFR 2010/1 Self Managed Superannuation Funds: the application of subsection 66(1) of the Superannuation Industry (Supervision) Act 1993 to the acquisition of an asset by a self managed superannuation fund from a related party*.

<sup>5</sup> This is consistent with the view in SMSFR 2010/1 (paragraph 28).

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10. It is necessary to consider the meaning of property in both senses to determine whether money borrowed under an LRBA has been applied for the acquisition of a single acquirable asset. That is, it is necessary to consider both the legal form and substance of the asset acquired.

11. Having regard to both the proprietary rights and the object of those proprietary rights, it may be possible to conclude that a trustee of an SMSF is acquiring a single acquirable asset in the sense that the trustee is acquiring a single object of property notwithstanding that it is comprised of separate bundles of proprietary rights (for example, if there are two or more blocks of land). However, this will only be so if it is reasonable to conclude that, notwithstanding the separate bundles of proprietary rights, what is being acquired is distinctly identifiable as a single asset.<sup>6</sup>

12. Factors relevant in determining if it is reasonable to conclude that what is being acquired is a single object of property include:

- 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 that is significant in value relative to the value of the asset;<sup>7</sup> or
- whether under a law of a State or Territory the two assets must be dealt with together.<sup>8</sup>

13. Each of the following circumstances would not, without more, be sufficient to support a conclusion that what is being acquired is identifiable as a single object of property:

- there is a physical object situated across two or more titles and that physical object:
  - is not significant in value relative to the value of the land;<sup>9</sup> or
  - is temporary in nature or otherwise able to be relocated or removed relatively easily therefore not preventing the titles being dealt with separately.<sup>10</sup>

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<sup>6</sup> See also paragraphs 97 to 115 of this Ruling.

<sup>7</sup> See Example 2 (paragraphs 49 to 51) and Example 3 (paragraphs 52 to 57) of this Ruling.

<sup>8</sup> See Example 4 (paragraphs 58 and 59) of this Ruling.

<sup>9</sup> See Example 2 (paragraphs 49 to 51) and Example 3 (paragraphs 52 to 57) of this Ruling.

<sup>10</sup> See Example 3 (paragraphs 52 to 57) of this Ruling.

- a business is being conducted on two or more titles;<sup>11</sup>  
or
- the assets are being acquired under a single contract because, for example, the vendor wants to deal with the assets as a package or the lender will only lend over a group of assets.<sup>12</sup>

### **Borrowings applied in maintaining or repairing but not improving the acquirable asset**

14. Money borrowed under an LRBA may be applied not only in acquiring a single acquirable asset but also in carrying out repairs and maintenance to that asset whether necessary at the time of its acquisition or at a later time.

15. No amount that has been borrowed under an LRBA by a trustee of an SMSF may be applied to improve the single acquirable asset.<sup>13</sup> If a trustee of an SMSF expends borrowed money to improve a single acquirable asset, the exception under section 67A to the subsection 67(1) borrowing prohibition ceases to be satisfied. If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).

16. To determine if an asset has been repaired or maintained or whether it has been improved, reference is made to the qualities and characteristics of the asset at the time the asset is acquired under the LRBA.

### ***Distinguishing between maintaining, repairing and improving a single acquirable asset***

17. The terms 'maintaining', 'repairing' and 'improving' an asset are often practically concerned with the physical form of an asset rather than its legal form. However, to the extent relevant to proprietary rights, they similarly apply.

18. Maintaining, repairing and improving are given their ordinary meaning having regard to the context in which they appear in the LRBA provisions.<sup>14</sup>

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<sup>11</sup> See Example 3 (paragraphs 52 to 57) of this Ruling.

<sup>12</sup> See Example 1 (paragraphs 47 and 48) and Example 5 (paragraphs 60 and 61) of this Ruling.

<sup>13</sup> Subparagraph 67A(1)(a)(i).

<sup>14</sup> See also paragraphs 116 to 133 of this Ruling.

*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<sup>15</sup> 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.

*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.<sup>16</sup>

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<sup>15</sup> This would include considering the appearance, form, state and condition of the acquirable asset.

<sup>16</sup> It will be a different asset (as discussed at paragraphs 31 to 37 of this Ruling) if the alterations or additions are to such an extent that its character is fundamentally changed.

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24. Determining if an acquirable asset is merely restored, or whether its state or function is significantly altered for the better, is a question of fact and degree. In each case it is necessary to consider the qualities and characteristics of the acquirable asset that is subject to the LRBA at the time the LRBA was entered into. Whether the state or function of the acquirable asset has altered significantly for the better is determined objectively and without reference to the actual use to which the acquirable asset is put. 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.

25. The following table provides illustrations contrasting repairs or maintenance with improvements.

*Table 1: repair or maintenance or improvement*

	<b>Repair or maintenance example</b>	<b>Improvement example</b>
<i>Residential property</i>		
1.	<p>A fire damages part of the kitchen (cooktop, benches, walls and ceiling).</p> <p>Restoration (replacement) of the damaged part of the kitchen with modern equivalent materials or appliances would constitute repair or restoration of a part of the entire asset being the house and land.</p> <p>If superior materials or appliances are used it is a question of degree as to whether the changes significantly improve the state or function of the asset as a whole.</p> <p>For example, the addition of a dishwasher would not amount to an improvement, even if a dishwasher was not previously part of the kitchen, on the basis that this is a minor or trifling improvement to the state or function of the asset as a whole.</p>	<p>If the house was extended to increase the size of the kitchen this would be an improvement.</p> <p>If as well as restoring the damaged part of the internal kitchen (a repair) a new external kitchen was added to the entertainment area of the house the external kitchen would be an improvement.</p>

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	<b>Repair or maintenance example</b>	<b>Improvement example</b>
2.	<ul style="list-style-type: none"> <li>• The guttering on the house is replaced with the modern equivalent and the house is repainted. If in replacing the guttering a leaf guard is also fitted this would not amount to an improvement on the basis that this is a minor or trifling addition to the entire asset being the house and land.</li> <li>• A fence is replaced using modern equivalent materials. If part of replacing the fence also included the addition of a gate to provide another access point, this would not be regarded as an improvement on the basis that this is a minor or trifling addition to the entire asset being the house and land.</li> <li>• A fire alarm is installed to comply with new requirements of the local council. This would not be regarded as an improvement on the basis that this is a minor or trifling addition to the entire asset being the house and land.</li> </ul>	<ul style="list-style-type: none"> <li>• A pergola is built to create an outdoor entertaining area.</li> <li>• The addition of a swimming pool or a garage.</li> <li>• An integrated home automation system is installed including electronically controlled lighting, multi-room audiovisual distribution and security system.</li> <li>• A house extension to add a further bathroom.</li> </ul>
3.	<p>A cyclone damages the roof of the house. Replacement of the roof in its entirety with the modern equivalent is a repair as it is restoring the asset to what it was. If superior materials are used it is a question of degree as to whether the changes significantly improve the state or function of the asset as a whole.</p>	<p>The addition of a second storey to the house at the time of also replacing the roof would be an improvement.</p>



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	<b>Repair or maintenance example</b>	<b>Improvement example</b>
4.	<p>A fire destroys a three bedroom residential house. Rebuilding a broadly comparable house is not an improvement as it restores the asset to what it was before the fire.</p> <p>If superior materials, fittings or appliances are used it is a question of degree as to whether the changes significantly improve the state or function of the asset as a whole.</p>	<p>Rebuilding a residential house that is not broadly comparable to that destroyed is an improvement.</p> <p>However, if the funds to rebuild are from an insurance company and not from borrowings this does not affect the LRBA.<sup>17</sup></p>
5.	<p>A residential house is acquired under an LRBA and is rented out for a number of years. As the area is now a real estate hot spot a decision is taken to renew the kitchen which, although functional, is significantly out of date and showing wear and tear.</p> <p>The design of the kitchen is improved and modern equivalent, rather than superior, materials and appliances are used.</p> <p>The changes made do not significantly improve the state or function of the asset as a whole.</p>	<p>A residential house is acquired under an LRBA and is rented out for a number of years. As the area is now a real estate hot spot a decision is taken to demolish the house. Rebuilding a residential house that is not broadly comparable to that demolished is an improvement.</p> <p>However, if the funds to rebuild are not from borrowings this does not affect the LRBA.<sup>18</sup></p>
<p><i>Farm on a single title</i></p> <p><i>The farm is the single acquirable asset under an LRBA. At the time of entering into the LRBA the farm includes one set of cattle yards, four bores including windmills, tanks and troughs and three kilometres of fencing.</i></p>		
6.	<p>Replacing a section of the cattle yards or the existing fencing is a repair.</p> <p>Ensuring the bores, windmills, tanks and troughs continue working is repair or maintenance. This would include laying new pipes between the tank and trough to replace the old pipes.</p>	<p>Each of the following additions is an improvement:</p> <ul style="list-style-type: none"> <li>• a further set of cattle yards;</li> <li>• a further bore, tank; windmill and trough;</li> <li>• a further dam;</li> <li>• a further shed;</li> <li>• a further two kilometres of fencing.</li> </ul>

<sup>17</sup> See paragraph 30 of this Ruling.

<sup>18</sup> See paragraph 30 of this Ruling.

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	<b>Repair or maintenance example</b>	<b>Improvement example</b>
<i>Machinery or equipment</i>		
7.	An item of earth moving equipment is acquired under an LRBA. Immediately after its acquisition money borrowed under the LRBA is used to fund repairs to the hydraulic system of the asset to return it to its full functionality. This would be a repair.	A major overhaul of the asset is carried out with all significant parts of the asset being replaced. This is likely to be an improvement on the basis that the changes have significantly improved the state or function of the asset.

***Acquiring an asset in need of repair***

26. If deterioration of an asset occurred before the asset was acquired under an LRBA and that asset is subsequently repaired using borrowings under the LRBA, the use of borrowings for that purpose is nonetheless permitted under subparagraph 67A(1)(a)(i).

27. However, the greater the state of deterioration of the asset at the time of its acquisition, and the LRBA being entered into, the more likely it is that subsequent alterations or additions to that asset will be regarded as improvements.<sup>19</sup>

***Subsequent draw downs for repairs***

28. Subsequent draw downs under an LRBA give rise to additional borrowings.<sup>20</sup> However, an LRBA that satisfies the requirements of section 67A when entered into will continue to satisfy those requirements if:

- the additional borrowings are applied in maintaining or repairing the asset held under the LRBA; and
- the draw downs are provided for under the terms of that LRBA.

<sup>19</sup> See also paragraphs 132 and 133 of this Ruling.

<sup>20</sup> Each drawn down is a new borrowing: see paragraph 65 and 93 of *Self Managed Superannuation Funds Ruling 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*.

## ***Repairs to an asset already owned by an SMSF***

29. If an asset is already owned by an SMSF, and thus not subject to an LRBA, a borrowing to fund repairs or maintenance for that asset would not satisfy the requirements of the LRBA provisions. This is on the basis that:

- the money is not applied for the acquisition of a single acquirable asset<sup>21</sup> but is instead applied to repair an asset that the SMSF already owns;
- the asset that is the subject of the repair is not held on separate trust for the benefit of the SMSF.<sup>22</sup> Rather it is held directly by the SMSF; and
- anything used in carrying out the repair is not subject to an LRBA in its own right.

## **Money other than borrowings used to improve an asset**

30. Subparagraph 67A(1)(a)(i) provides that borrowings under an LRBA cannot be used to fund improvements. However, money from other sources can be used to improve (or repair or maintain) a single acquirable asset. For example, accumulated funds held by the SMSF may be used to fund the improvements.<sup>23</sup> However, any improvements must not result in the acquirable asset becoming a different asset.<sup>24</sup>

## **Whether the same asset or a different asset is held on trust under the LRBA**

31. The single acquirable asset identified when the LRBA is put in place must continue to be the asset that is held on trust under that LRBA, unless its replacement is covered by section 67B.

32. If an asset is replaced in its entirety with a different asset (even if of the same type) and that replacement is not covered by section 67B, the exception under section 67A to the borrowing prohibition ceases to be satisfied from that time. If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).

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<sup>21</sup> As required under paragraph 67A(1)(a).

<sup>22</sup> As required under paragraph 67A(1)(b).

<sup>23</sup> If the money is sourced from the SMSF, the other provisions of the SISA must nonetheless be complied with by the trustee (or the investment manager) of the SMSF.

<sup>24</sup> See also paragraphs 31 to 37 of this Ruling.

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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 Ruling, 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).<sup>25</sup>

35. The following table illustrates whether a change to a single acquirable asset results in a different asset(s).<sup>26</sup>

*Table 2: whether it is a different asset*

	<b>Single acquirable asset</b>	<b>Whether it is a different asset(s)</b>
1.	Vacant block of land on single title	A vacant block of land is subsequently subdivided resulting in multiple titles. One asset has been replaced by several different assets as a result of the subdivision.
2.	Vacant block of land on single title	A residential house is built on vacant land which is on a single title. The character of the asset has fundamentally changed from vacant land to residential premises. This is a different asset.
3.	Residential house and land	A house is demolished following a fire and is replaced by three strata titled units. The character of the asset has fundamentally changed along with the underlying proprietary rights. This has created three different assets.
4.	Residential house and land	A residential house is converted into a restaurant by renovations which include fitting out a fully functioning commercial kitchen. As a result of the renovation the character of the asset has fundamentally changed from residential premises to restaurant premises. This is a different asset.

<sup>25</sup> See Examples 11 to 15 (paragraphs 73 to 84) of this Ruling.

<sup>26</sup> See also paragraphs 134 to 145 of this Ruling.

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	<b>Single acquirable asset</b>	<b>Whether it is a different asset(s)</b>
5.	Residential house and land	One bedroom of a residential house is converted to a home office. This would not ordinarily result in a change in the overall character of the asset as a residential house. The conversion of the bedroom into an office does not result in a different asset.
6.	Residential house and land	A fire destroys a four bedroom house and a new superior residential house is constructed on that land using both insurance proceeds and additional SMSF funds. Rebuilding another residential house (whether of the same size or larger) does not fundamentally change the character of the asset held under the LRBA. The addition of a garage, for example, would also not change the character of the asset.
7.	Residential house and land	While each of the following changes would be improvements each (or all) of the changes would not result in a different asset: <ul style="list-style-type: none"> <li>• an extension to add two bedrooms;</li> <li>• the addition of a swimming pool;</li> <li>• an extension consisting of an outdoor entertainment area;</li> <li>• the addition of a garage shed and driveway;</li> <li>• the addition of a garden shed.</li> </ul>
8.	Residential house and land	To allow a road to be widened, a local government authority undertakes the compulsory resumption of a minor portion of the frontage of a property which has a residence on it. While the resumption results in the existing property title being replaced, 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.

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	<b>Single acquirable asset</b>	<b>Whether it is a different asset(s)</b>
9.	Residential house and land	A 'granny flat' is to be constructed in the backyard of a 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. 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.
10.	The improvements listed in Column 3 of Table 1 at paragraph 25 of this Ruling.	These improvements do not result in a different asset as the changes do not fundamentally change the character of the asset held under the LRBA.

***Alterations or additions to the asset not made by the trustee of an SMSF***

36. Whether or not alterations or additions to a single acquirable asset result in a different asset being held on trust is not affected by the identity of whoever made the changes.

37. Alterations or additions made by a tenant to a rental property that is held under an LRBA do not, however, result in a different asset if:

- the alterations or additions do not fundamentally change the character of the asset (as discussed at paragraphs 31 to 35);<sup>27</sup> or
- in the case of the addition of fixtures that do fundamentally change the character of the asset, the fixtures remain the property of the tenant.<sup>28</sup>

**Property development**

38. If a house on a single title block of land (that is, the single acquirable asset) is acquired under a contract of purchase with a deposit paid upon entering into that contract and the balance payable at settlement, each payment is applied for the acquisition of that single acquirable asset and may be funded under a single LRBA.

<sup>27</sup> For example, a tenant's fit out of office space.

<sup>28</sup> This is further explained at paragraphs 143 to 145 of this Ruling.

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39. If a contract is entered into for an off-the-plan purchase of a strata titled unit (that is, the purchase of a unit that is yet to be built and strata titled) and under the contract a deposit is required upon entering into the contract with the balance payable at settlement after the unit is built and strata titled, each payment is applied for the acquisition of that strata titled unit. Providing that the strata titled unit is a single acquirable asset<sup>29</sup> the deposit and the balance payable at settlement may be funded under a single LRBA.

40. A similar outcome results if the contract entered into is for the purchase of a single title vacant block of land along with the construction of a house on that land before settlement occurs. In this situation the deposit paid upon entering into the contract and the balance payable upon settlement is applied for the acquisition, under that contract, of land with a completed house on it. The deposit and the balance payable at settlement may be funded under a single LRBA.<sup>30</sup>

41. 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. The money applied to acquire the option may be funded under an LRBA. However, the subsequent acquisition of the house and land or the strata titled unit upon exercise of that option would need to be funded under a separate LRBA, as the asset acquired upon exercise of the option is different to the option asset itself.

## Funds to which the Ruling applies

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42. This Ruling applies to SMSFs<sup>31</sup> and former SMSFs.<sup>32</sup> References in the Ruling to SMSFs include former SMSFs unless otherwise indicated.

## Date of effect

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43. This Ruling applies to arrangements entered into on or after 7 July 2010 (including an arrangement that is a refinancing of a borrowing of money under an arrangement entered into before, on or after 7 July 2010).

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<sup>29</sup> This outcome may differ if the acquisition is of the strata titled unit and another asset(s) such as a separately titled car park or a furniture package.

<sup>30</sup> See Example 10 (paragraphs 71 and 72) of this Ruling. This is in contrast to the outcome if construction of the house occurs after settlement, which is illustrated at Example 9 (paragraphs 68 to 70) of this Ruling.

<sup>31</sup> As defined in section 17A.

<sup>32</sup> A former SMSF is a fund that has ceased being an SMSF and has not appointed a registrable superannuation entity (RSE) licensee as trustee – see subsection 10(4).

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44. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling

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**Commissioner of Taxation**

23 May 2012

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## Appendix 1 – Examples

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**①** *This Appendix is provided as information to help you understand how the Commissioner’s view has been reached.*

45. The following examples further illustrate the application of the principles discussed in this Ruling.

46. Each example assumes that the SMSF is not prohibited from acquiring the asset (for example, the acquisition is not from a related party). Further, the application of other provisions of the SISA and SISR have not been considered and could, therefore, potentially apply depending on the particular circumstances.

### **Example 1 – two adjacent blocks of land**

47. *As part of the investment strategy of an SMSF, the trustees of the SMSF want to acquire two adjacent blocks of land under a single LRBA. While the vendor will only sell the two blocks together, there are no physical or legal impediments to the two blocks of land being sold separately.*

48. *The two blocks of land are not a single acquirable asset. As a result, the two blocks of land cannot be acquired under a single LRBA. However, the blocks of land could be acquired under separate LRBAs.*

### **Example 2 – a factory complex on more than one title**

49. *A trustee of an SMSF wants to enter into an LRBA to acquire a factory which is constructed across three titles. The existence of the factory adds considerably to the value of the land and thus is a significant part of the value of the asset. The factory is therefore relevant as a unifying physical object.*

50. *The factory and the land comprised of the three titles, is a single acquirable asset and can be acquired under a single LRBA.*

51. *However, if the factory was derelict and thus not of significant value relative to the land this asset could not be acquired under a LRBA as the factory is not relevant as a unifying physical object and thus the assets are the three titles.*

### **Example 3 – farmland with multiple titles**

52. *The trustee of an SMSF wants to enter into an LRBA to acquire a farm. While the farm has been conducted as a single primary production business it comprises two titles.*

53. *Although only one farming business is conducted on the land, there are no physical or legal impediments to the land, represented by the different titles, from being dealt with separately.*

54. *The existence of any (or all) of the following features spanning the two titles is not sufficient to alter this outcome:*

- *agricultural crops;*
- *fencing; or*
- *irrigation systems.*

55. *In this regard, agricultural crops do not prohibit titles being dealt with separately and fencing and irrigation systems are able to be moved or altered such that the titles either with or without those objects can be dealt with separately. Further, an inability to physically access land identified by one of the titles, other than through the land identified by the other title, is not of itself sufficient to prohibit the titles being dealt with separately.*

56. *As these features are not necessarily considered a barrier to part of the farm (one of the titles) being sold off, whether for farming or for other purposes, the farm consisting of both titles is not a single acquirable asset and cannot be acquired under a single LRBA.*

57. *However, if the farming business concerned a piggery and the piggery is conducted in a large shed with infrastructure that is constructed over both titles then, similar to the approach with the factory in Example 2, this would be a relevant consideration. Assuming that the piggery adds considerably to the value of the land and thus is a significant part of the value of the asset it would be a single acquirable asset.*

#### **Example 4 – apartment with separate car park**

58. *The trustee of an SMSF wants to enter into an LRBA to purchase an apartment with a separate car park on the same strata plan that contains a notice of restriction. The apartment and car park are each on a separate legal title. As the strata plan contains a notice of restriction, if the car park and apartment are not transferred together the transfer of title of the apartment cannot be registered according to the relevant law of the State.<sup>33</sup>*

59. *As the two titles must both be transferred if the transfer of title of the apartment is to be registered, this effectively means that the two assets must be dealt with together under a law of the State. In these circumstances the apartment and car park comprise a single acquirable asset that may be acquired under a single LRBA.*

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<sup>33</sup> For example, in the circumstances covered by section 6 of Schedule 2 to the *Subdivision Act 1988* (Vic). (See also section 8 of Schedule 2 of that Act).

## **Example 5 – serviced apartment and furnishings**

60. *The trustees of an SMSF want to enter into an LRBA to purchase a serviced apartment that will be leased to a provider of short-term residential accommodation. The purchaser of the apartment is required by the vendor<sup>34</sup> to also purchase a furnishings package.*

61. *The apartment without the furnishings package is a single acquirable asset and its acquisition could be funded under an LRBA. However, the apartment and the furnishings package, even if purchased together under the one contract, is not a single acquirable asset. The furnishings package, even if purchased under a separate contract, is still not a single acquirable asset as it would include multiple items.*

## **Example 6 – purchase of residential premises**

62. *The trustees of an SMSF want to acquire land that has an existing residential house on it. A deposit is paid to the vendor on signing the contract to acquire that land with the house. The balance of the purchase price is paid at settlement 60 days later. The relevant asset acquired is the land along with the existing house.*

63. *The land with the existing house is a single acquirable asset and the deposit and the payment at settlement is applied for the acquisition of that asset. The trustees of the SMSF can enter into a single LRBA to fund both payments.*

## **Example 7 – completed ‘off-the-plan’ apartment**

64. *The trustees of an SMSF enter into a contract to purchase a strata titled apartment ‘off-the-plan’. A deposit is required upon entering into the contract with the balance to be paid upon settlement for the completed strata titled apartment.*

65. *A single LRBA can be entered into to fund both the deposit and the balance to be paid under the contract upon settlement. Both the deposit and the settlement payment are applied for the acquisition of a single acquirable asset being the completed strata titled apartment.*

## **Example 8 – house built *in situ* on land already owned by the SMSF**

66. *An SMSF owns a vacant block of land. The trustees of the SMSF want to enter into an LRBA to construct a house *in situ* on the block of land.*

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<sup>34</sup> It would not alter the outcome if the furniture package was being acquired because the apartment is leased to an existing tenant as a furnished apartment.

67. *The house cannot be a single acquirable asset under section 67A. As the house is built in situ it does not exist as an asset separate from the land that can be held on separate trust. Money borrowed to build the house effectively results in the acquisition of services and building materials. These acquisitions would not satisfy the LRBA requirement that the arrangement involves the acquisition of a single acquirable asset.*

#### **Example 9 – purchase of land and construction of house using borrowings**

68. *The trustees of an SMSF want to enter into an LRBA where the single acquirable asset is a vacant block of land. The SMSF intends that the borrowing will provide sufficient funds for the construction of a house on that block. Assuming that title to the vacant land transfers to the holding trust prior to the house being built, it is the vacant land that is acquired and held on trust under the LRBA.*

69. *This arrangement will cease to satisfy the requirements of section 67A if money borrowed under the LRBA is subsequently used to construct the house and thus improve and fundamentally change the character of the asset held on trust (that is, from vacant land to residential premises).*

70. *This outcome is not altered even if the contracts entered into for the acquisition of the land and the construction of the house contain clauses linking the two contracts.*

#### **Example 10 – acquisition of a yet to be constructed house on land using borrowings**

71. *The trustees of an SMSF want to enter into a contract to acquire, as a 'package', land with a yet to be constructed house on it and to fund the acquisition using borrowings under an LRBA. As the contractual arrangement is for the acquisition of land with a completed house on it, and settlement occurs once construction of the house is finished, the deposit and the payment on settlement can be funded under a single LRBA.*

72. *In contrast to Example 9 (paragraphs 68 to 70), this arrangement is for the acquisition of a single acquirable asset, being the land with the house constructed on it.*

#### **Example 11 – house built over two titles**

73. *The trustee of an SMSF enters into an LRBA where the single acquirable asset is a house which is built across two titles. Subsequently the house is relocated so that it stands on only one of the titles.*

74. *The arrangement ceases to satisfy the requirements of the LRBA provisions. The relocation of the house results in the asset under the arrangement no longer being a single object of property. Following the relocation there are two separate assets, the block of land with the house and a vacant block of land, that could be dealt with separately. If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).*

## **Example 12 – replacement of equipment following an insurance claim**

75. *An SMSF enters into an LRBA where the single acquirable asset is an item of equipment. The item of equipment is subsequently destroyed and a new item of equipment is provided by the insurer as a replacement.*

76. *The arrangement ceases to meet the requirements of the LRBA provisions as the original item of equipment has been replaced in its entirety and that replacement is not covered by section 67B.<sup>35</sup> If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).*

77. *If a cash payment is instead made by the insurer to the holding trust, that cash cannot be held on trust under the LRBA as the replacement acquirable asset. If this were the case, the arrangement would also cease to meet the requirements of the LRBA provisions.*

## **Example 13 – purchase of cattle property and construction of a shed using SMSF funds**

78. *The trustees of an SMSF enter into an LRBA where the single acquirable asset is a 10,000 hectare cattle property. This single title property has fencing, water troughs, windmill pumps and a dam but no dwelling or other buildings or structures erected on it. A large shed is constructed, using SMSF money, to provide shelter to the cattle.*

79. *The shed is an improvement. However, 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.*

80. *Should a residence also be built on the property to allow the owner or a manager to live on site 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.*

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<sup>35</sup> In contrast to the example at item 6 of Table 2 (paragraph 35) of this Ruling, the equipment in Example 12 is completely replaced. However, in the example at item 6 the land on which the house stood continues to be held by the holding trust and a house is being rebuilt to restore the asset held on trust to a house and land asset.

**Example 14 – purchase of a small farm and construction of a residence using SMSF funds**

81. *The trustees of an SMSF enter into an LRBA where the single acquirable asset is a one hectare blueberry hobby farm on a single title. The property has 25 mature blueberry bushes on it as well as a bore and irrigation.*

82. *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. 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.*

**Example 15 – commercial building extensions using SMSF funds**

83. *The trustees of an SMSF enter into an LRBA where the single acquirable asset is a property which has a car washing facility on it. The property is leased to a tenant who operates a car washing business. The trustees decide to expand the facility by extending the back of the building to double the number of wash bays. The extension, which involves concreting, roofing and plumbing work, will be funded from accumulated funds held by the SMSF and will result in higher rent being received from the tenant.*

84. *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.*

## Appendix 2 – Explanation

**ⓘ** *This Appendix is provided as information to help you understand how the Commissioner's view has been reached.*

### Background

85. A number of provisions of the SISA place restrictions on the investment activities of an SMSF. One of these provisions is subsection 67(1) which, subject to specified exceptions, prohibits a trustee of an SMSF from borrowing money or maintaining an existing borrowing of money. The borrowing prohibition is designed to limit the risk of superannuation fund investment as can be seen from the statement in the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999:

Superannuation funds are generally not permitted to borrow in their own right. This is designed to reduce the risk to retirement income from gearing their assets.<sup>36</sup>

86. One specific exception to the prohibition on borrowing is provided by sections 67A and 67B.

87. Section 67A permits a borrowing arrangement (an LRBA) if the money borrowed is, or has been, applied for the acquisition of a single acquirable asset and that asset is held in a holding trust. Under such an arrangement the trustee of the SMSF acquires a beneficial interest in the asset and the right of recourse of the lender in the event of default is limited to the acquirable asset held in the holding trust. By making one or more payments after acquiring beneficial ownership the trustee of the SMSF has the right to acquire legal ownership. Additional rules apply to treat a collection<sup>37</sup> of identical assets having the same market value in the same way as a single acquirable asset.

88. Section 67B contains the specific circumstances where the borrowing arrangement may be maintained in relation to a replacement asset rather than the asset originally acquired.

89. Sections 67A and 67B replace former subsection 67(4A). Former subsection 67(4A) was replaced as certain practices had developed that led to prudential concerns with the borrowing arrangements created to comply with its requirements.<sup>38</sup>

<sup>36</sup> See page 4 under the heading 'Problem Identification'.

<sup>37</sup> Subsection 67A(3).

<sup>38</sup> See paragraph 1.4 of the Explanatory Memorandum to the Superannuation Industry (Supervision) Amendment Bill 2010. See also the Second Reading Speech for that Bill (Australia, House of Representatives 2010, *Debates*, vol 7, pages 4126 to 4128).

90. By comparison with former subsection 67(4A), which applies to arrangements entered into before 7 July 2010, sections 67A and 67B have been enacted to ensure that the term 'asset' is read in the singular and is not interpreted as permitting one borrowing arrangement over multiple assets. The exception to this is if the assets comprise a collection of identical assets that have the same market value. This change removes the ability, available under former subsection 67(4A), to pool different assets in one arrangement and thus prevents a lender from choosing which assets are sold in the event of a default on the borrowing.<sup>39</sup>

91. A further concern under former subsection 67(4A) was that of assets that were the subject of the borrowing being replaced at the discretion of the trustee of the SMSF or the lender.<sup>40</sup> Section 67B addresses this concern.

92. The borrowing prohibition in subsection 67(1) is also complemented by other investment rules in the SISA and the SISR.<sup>41</sup>

### **Contraventions**

93. Section 67A provides a limited exception to the prohibition under subsection 67(1) of a trustee of an SMSF borrowing money.

94. Section 67 is a civil penalty provision and therefore contravening, or being involved in a contravention, of section 67 may have civil and criminal consequences.<sup>42</sup> Contravention places at risk the status of the SMSF as a complying superannuation fund under the SISA.<sup>43</sup>

### **Legislative context**

95. The most relevant elements of sections 67A and 67B are set out below:

#### **67A Limited recourse borrowing arrangements**

##### *Exception*

- (1) Subsection 67(1) does not prohibit a trustee of a regulated superannuation fund (the **RSF trustee**) from borrowing money, or maintaining a borrowing of money, under an arrangement under which:

<sup>39</sup> Paragraphs 1.10 and 1.11 of the Explanatory Memorandum to the Superannuation Industry (Supervision) Amendment Bill 2010.

<sup>40</sup> Paragraph 1.4 of the Explanatory Memorandum to Superannuation Industry (Supervision) Amendment Bill 2010.

<sup>41</sup> For example, the restriction on acquiring assets from a related party in section 66. See a list of other restrictions at paragraph 80 of SMSFR 2010/1.

<sup>42</sup> Subsection 67(7).

<sup>43</sup> See subsection 42A(5) in relation to an SMSF. The status of an SMSF as complying or non-complying for SISA purposes will also have consequences for the SMSF under the income tax law and other parts of the superannuation law. Also see Law Administration Practice Statements: PS LA 2006/17, PS LA 2006/18 and PS LA 2006/19.



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- (a) the money is or has been applied for the acquisition of a single acquirable asset, including:
  - (i) expenses incurred in connection with the borrowing or acquisition, or in maintaining or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset); and  
Example: Conveyancing fees, stamp duty, brokerage or loan establishment costs.
  - (ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and
- (b) the acquirable asset is held on trust so that the RSF trustee acquires a beneficial interest in the acquirable asset; and
- (c) the RSF trustee has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and
- (d) the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) default on:
  - (i) the borrowing; or
  - (ii) the sum of the borrowing and charges related to the borrowing;are limited to rights relating to the acquirable asset; and  
Example: Any right of a person to be indemnified by the RSF trustee because of a personal guarantee given by that person in favour of the lender is limited to rights relating to the acquirable asset.
- (e) if, under the arrangement, the RSF trustee has a right relating to the acquirable asset (other than a right described in paragraph (c)) – the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) the RSF trustee’s exercise of the RSF trustee’s right are limited to rights relating to the acquirable asset; and
- (f) the acquirable asset is not subject to any charge (including a mortgage, lien or other encumbrance) except as provided for in paragraph (d) or (e).

*Meaning of **acquirable asset***

- (2) An asset is an **acquirable asset** if:
  - (a) the asset is not money (whether Australian currency or currency of another country); and

- (b) neither this Act nor any other law prohibits the RSF trustee from acquiring the asset.
- (3) This section and section 67B apply to a collection of assets in the same way as they apply to a single asset, if:
  - (a) the assets in the collection have the same market value as each other; and
  - (b) the assets in the collection are identical to each other.

Example: A collection of shares of the same class in a single company.

- (4) For the purposes of this section and section 67B, the regulations may provide that, in prescribed circumstances, an acquirable asset ceases to be that particular acquirable asset.

.....

#### **67B Limited recourse borrowing arrangements – replacement assets**

- (1) Subsection (2) applies to:
  - (a) a reference in paragraph 67A(1)(b), (c), (d), (e) or (f) to an acquirable asset (the **original asset**); or
  - (b) a reference in subsection 71(8) to an acquirable asset (the **original asset**) mentioned in paragraph 67A(1)(b);

(including a reference resulting from a previous application of subsection (2) of this section).
- (2) Treat the reference as being a reference to another single acquirable asset (the **replacement asset**) if:
  - (a) the replacement asset replaces the original asset; and
  - (b) subsection (3), (4), (5), (6), (7) or (8) applies.

.....

96. The categories of replacement assets set out in subsections 67B(3) to (7)<sup>44</sup> deal exclusively with shares in companies, units in unit trusts and instalment receipts (as defined in subsection 10(1)).

#### **The meaning of ‘acquirable asset’ and ‘single acquirable asset’**

97. Subsection 67A(1) sets out the requirements of an exception to the borrowing prohibition in subsection 67(1).

<sup>44</sup> Subsection 67B(8) provides for regulations to prescribe other circumstances.

98. Under the requirements of subsection 67A(1), a borrowing of money may be made or maintained if, under an arrangement, the money is or has been applied for the acquisition of a 'single acquirable asset'. That single acquirable asset must be held on trust so that the trustee of the SMSF acquires a beneficial interest in that asset.<sup>45</sup>

### ***The meaning of 'acquirable asset'***

99. The term 'acquirable asset' is a key concept as the exception under section 67A can only apply to a borrowing of money if, under an arrangement, the money is or has been applied to acquire a single acquirable asset.

100. The definition of acquirable asset in subsection 67A(2) makes it clear that an asset is an acquirable asset if:

- it is an asset that is not money, whether Australian currency or currency of another country;<sup>46</sup> and
- neither the SISA nor any other law prohibits the trustee of the SMSF from acquiring the asset.<sup>47</sup>

### ***Exclusion of money from acquirable asset***

101. While money is specifically included in the definition of asset,<sup>48</sup> it is specifically excluded from the definition of acquirable asset.

102. Both definitions refer to money in the form of currency, whether Australian currency or otherwise. However, the exclusion of money from the meaning of acquirable asset does not extend to collectable bank notes and coins.

### ***An asset the trustee of an SMSF is not prohibited from acquiring***

103. Paragraph 67A(2)(b) requires that the asset is one that the trustee of an SMSF is not prohibited from acquiring either by the SISA or by any other law.

104. The SISA does not prescribe the types of assets that an SMSF may acquire as part of its investment strategy. However, it does, for example, contain a prohibition on acquiring assets from related parties of the SMSF.

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<sup>45</sup> Paragraph 67A(1)(b).

<sup>46</sup> Paragraph 67A(2)(a).

<sup>47</sup> Paragraph 67A(2)(b).

<sup>48</sup> Subsection 10(1).

105. Subject to certain specific exceptions, subsection 66(1) prohibits a trustee or investment manager of an SMSF from intentionally acquiring an asset from a related party of the SMSF.<sup>49</sup> If the acquisition of the asset from the related party is prohibited by subsection 66(1), an arrangement under which borrowings are applied to acquire that asset will not meet the requirements of section 67A.<sup>50</sup> A related party<sup>51</sup> is a member of the SMSF, a standard employer-sponsor of the SMSF, or a Part 8 associate of either of those entities.

106. Section 83 is a further example of a provision that is relevant in determining if the acquisition of an asset is prohibited. Under section 83 an SMSF must not acquire an in-house asset<sup>52</sup> if:

- the market value ratio<sup>53</sup> of the in-house assets of the SMSF exceeds 5%;<sup>54</sup> or
- the acquisition of the in-house asset would result in the market value ratio of the in-house assets of the SMSF exceeding 5%.<sup>55</sup>

107. More broadly, the laws of the Commonwealth and the State or Territory in question must also be complied with. This includes compliance with the trust laws of the various States or Territories applicable to the SMSF.<sup>56</sup> Whether an acquisition is prohibited by a provision of the SISA, the SISR or any other law requires an examination of the facts of the particular case.

### ***Meaning of asset – any form of property***

108. The meaning of acquirable asset is clearly dependent upon the meaning of asset which, subject to any contrary intention, is defined in subsection 10(1) as follows:

asset means any form of property and, to avoid doubt, includes money<sup>57</sup> (whether Australian currency or currency of another country).

<sup>49</sup> Subsections 66(2), 66(2A) and 66(2B). Subsections 66(2) and 66(2A) are further explained in SMSFR 2010/1.

<sup>50</sup> For example, residential property owned by a related party could not be acquired under an LRBA as the SMSF trustee is prohibited from making such an acquisition under subsection 66(1).

<sup>51</sup> See definition of 'related party' in subsection 10(1).

<sup>52</sup> As defined in section 71. This is further explained in SMSFR 2009/4.

<sup>53</sup> Section 75.

<sup>54</sup> Subsection 83(2).

<sup>55</sup> Subsection 83(3).

<sup>56</sup> Paragraph 67A(2)(b); paragraph 1.20 of the Explanatory Memorandum to the Superannuation Industry (Supervision) Amendment Bill 2010.

<sup>57</sup> As discussed at paragraphs 101 and 102 of this Ruling, money is specifically excluded from being an acquirable asset.

109. The term 'property' is not defined in the SISA and as discussed in SMSFR 2010/1<sup>58</sup> and SMSFR 2009/4<sup>59</sup>, the phrase 'any form of property' has a very wide meaning. To summarise from those Rulings, property can include any type of right (that is, a claim recognised by law), interest or thing of value which is legally capable of ownership.

*Property can refer to the proprietary rights or the object of those proprietary rights*

110. In the High Court case of *White v. Director of Public Prosecutions (WA)*<sup>60</sup> French CJ, Crennan and Bell JJ (at [12]) noted in their joint judgement:

The term 'property' used in a statute may take its ordinary meaning, its legal meaning, or both meanings. The interpretation of the term depends upon the context and purpose of the provision in which it is found.

111. Similarly, in *McCaughey v. Commr of Stamp Duties*<sup>61</sup> Jordan CJ discussed the meaning of property in the following terms:

The word 'property' is used in different senses. It may denote either objects of proprietary rights, such as pieces of land, domesticated animals, and machines; or the proprietary rights themselves ... In common parlance it is usually employed in the former sense, but in the language of jurisprudence in the latter ... Property, in the sense of proprietary rights, may exist in relation to physical objects, or to intangible things such as debts or patent rights. Each separate piece of property consists of a bundle of proprietary rights relating to a particular object, including rights of administration and rights of enjoyment, the totality of which may be vested in a single person, or may be divided amongst a number of persons, as for example when they are shared by several who together own them all, jointly or in common.

112. In an LRBA context it is relevant to consider the meaning of property in both senses to determine whether borrowed money has been applied for the acquisition of a single acquirable asset. That is, it is necessary to consider both the proprietary rights and the object of those proprietary rights.

113. In taking this approach it may be possible to conclude that a trustee of an SMSF has acquired a single acquirable asset in the sense that the trustee has acquired a single object of property that is comprised of separate bundles of proprietary rights. However, this will only be so if it is reasonable to conclude that notwithstanding the separate bundles of proprietary rights, what is being acquired is distinctly identifiable as a single asset.

<sup>58</sup> Paragraphs 9 to 12 and 90 to 99.

<sup>59</sup> Paragraphs 7 to 9 and 38 to 45.

<sup>60</sup> [2011] HCA 20; (2011) 243 CLR 478.

<sup>61</sup> (1945) 46 SR (NSW) 192 at 201.

114. Factors relevant in determining if it is reasonable to conclude that what is being acquired is a single object of property are set out at paragraphs 12 and 13 of this Ruling.

115. If there is more than one acquirable asset, the exception under section 67A can only apply if separate LRBAs are entered into with respect to each single acquirable asset.

### **Borrowings applied in maintaining or repairing but not improving the acquirable asset**

116. A borrowing of money under an LRBA can be applied to expenses incurred in maintaining or repairing the acquirable asset that is held under the LRBA.

117. However, a borrowing of money under an LRBA cannot be applied to expenses incurred in improving the acquirable asset.<sup>62</sup>

### ***The acquirable asset is identified at the time the LRBA commences***

118. Determining whether an acquirable asset has been repaired or maintained or whether it has been improved necessarily requires reference to the qualities and characteristics of the acquirable asset at a particular point in time.

119. The acquirable asset must be identified at the time the asset is acquired and the LRBA is put in place, as it is this asset that is required to be held on trust under paragraph 67A(1)(b). Thus, to determine if an acquirable asset has been repaired or maintained or if it has been improved, it is necessary to refer to the qualities and characteristics of the asset at that time.

120. Further, in determining whether the acquirable asset has been maintained or repaired or if an improvement has been made, it is the entire acquirable asset held on trust under paragraph 67A(1)(b) that is relevant. It is this acquirable asset that must continue to be held on trust under paragraph 67A(1)(b). For example, if the asset held under the LRBA is a three bedroom house and land, then it is the house and land asset that is relevant and not just the proprietary rights.

121. This approach is consistent with that taken to determine if what is acquired under an LRBA is a single acquirable asset. That is, both the proprietary rights and the object of those proprietary rights must be considered (see discussion at paragraphs 110 to 115 of this Ruling).

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<sup>62</sup> Subparagraph 67A(1)(a)(i).

## ***Distinguishing between maintaining, repairing and improving an acquirable asset***

122. As the terms maintaining, repairing and improving are not defined in the SISA they take their ordinary meaning having regard to the context in which they appear in the LRBA provisions.

### *Maintaining or repairing the acquirable asset*

123. It is immaterial whether expenditure is incurred in maintaining the acquirable asset held under an LRBA, or in repairing that asset, as money borrowed under an LRBA may be applied for either purpose. Therefore, while the ordinary meaning of both repair and maintenance is discussed below, it is not necessary to determine which specific category the expenditure belongs to as long as it is either one or the other.

124. Maintain, when used as a transitive verb is defined to mean (among other things) 'to keep in existence or continuance; preserve'; 'to keep in due condition, operation, or force; keep unimpaired'; and 'to keep in a specified state, position'.<sup>63</sup> Thus, maintaining an asset typically involves work done to prevent or anticipate defects, damage or deterioration (in a mechanical or physical sense). For example, repainting a timber house to prevent deterioration is typically maintenance.

125. A repair ordinarily means the remedying or making good of defects in, damage to, or deterioration of, property to be repaired (being defects, damage or deterioration in a mechanical and physical sense) and contemplates the continued existence of the property.<sup>64</sup>

126. A repair replaces a part of something or corrects something that is already there and that is damaged, has become worn out or dilapidated or has deteriorated. Repair may be necessitated through ordinary wear and tear, accidental or deliberate damage or by the operation of natural causes (whether expected or unexpected) during the passage of time.<sup>65</sup>

### *Improving the acquirable asset*

127. Improve, when used as a transitive verb, is defined to mean (among other things), 'to bring into a more desirable or excellent condition'; and 'to make (land) more profitable or valuable by enclosure, cultivation, etc.; increase the value of (property) by betterments, as buildings'.<sup>66</sup>

<sup>63</sup> *The Macquarie Dictionary*, 2005, 4<sup>th</sup> edn, The Macquarie Library Pty Ltd, Sydney.

<sup>64</sup> This is consistent with paragraph 13 of *Taxation Ruling TR 97/23 Income tax: deductions for repairs*.

<sup>65</sup> This is consistent with paragraph 15 of TR 97/23.

<sup>66</sup> *The Macquarie Dictionary*, 2005, 4<sup>th</sup> edn, The Macquarie Library Pty Ltd, Sydney.

128. To determine if an acquirable asset has been improved it is relevant to consider if the state or function of the acquirable asset as a whole has been significantly altered for the better compared to when it was acquired under the LRBA. Substantial alterations or the addition of further substantial features or rights to the acquirable asset for the better will result in an improvement to the acquirable asset.<sup>67</sup> However, alterations or additions that are relatively minor or trifling when compared to the acquirable asset as a whole will not result in an improvement to the acquirable asset.<sup>68</sup>

*Question of fact and degree*

129. It is a question of fact and degree as to whether something is merely maintenance or repair of the acquirable asset or whether it is an improvement to the acquirable asset.

130. It is necessary to:

- identify the alterations or additions made to the asset using borrowings; and
- determine if those alterations or additions to the asset significantly alter for the better the state or function of the asset as a whole.

131. While an increase in the value of the asset may provide an indication that the state or function of the asset has been improved, it is not of itself determinative. For example, rebuilding a comparable house following a house being destroyed by fire may result in an increase in value as it is now a new house on the land. However, this is nonetheless restoring the asset to what it was rather than improving it.

***Acquiring an asset in need of repair***

132. An asset may be acquired in a state in which a part of the asset is defective, damaged or suffering some deterioration of what would be considered to be its normal level of function. Restoration of that part of the asset is a repair for LRBA purposes if similar, or modern equivalent, materials are used. For example, replacing some broken windows in a house immediately following the acquisition of the house and land under an LRBA, is a repair for which borrowings can be used.

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<sup>67</sup> For example, an extension to a house to add another bedroom or bathroom; or the addition of a shed, a concrete driveway, or a pool.

<sup>68</sup> For example, a new leaf guard added when replacing the guttering.



133. However, the more run down an asset is at the time it is acquired under the LRBA the more likely that changes to that asset will significantly alter its state or function for the better such that the changes are improvements and not repairs. For example, if a run down building is acquired under an LRBA and the building is substantially renovated following its acquisition to enable it to be tenanted this would be an improvement for which borrowings under the LRBA could not be used.

### **Whether the same asset or a different asset is held on trust under the LRBA**

134. Paragraph 67A(1)(a) requires that a borrowing under an LRBA is applied for the acquisition of a single acquirable asset.

135. Paragraph 67A(1)(b) requires that the acquirable asset is held on separate trust so that the trustee of the SMSF acquires a beneficial interest in the asset. This means that the acquirable asset that the borrowings are applied to acquire must continue to be held on trust for the duration of the LRBA if section 67A is to continue to apply to that borrowing.

136. The requirement for the acquirable asset under the LRBA to continue to be held on trust is subject to the replacement asset exception in section 67B.

137. Section 67B allows for the replacement of a single acquirable asset (the original asset) that is a share, a unit in a unit trust or an instalment receipt (or a collection<sup>69</sup> thereof) in the circumstances set out in subsections 67B(3) to (8). If an acquirable asset has been replaced in circumstances covered by section 67B, references to the (original) acquirable asset in section 67A are treated as references to the replacement asset.<sup>70</sup> Consequently, the LRBA may be maintained over a different (replacement) acquirable asset if the asset, and the circumstances of its replacement, satisfy the requirements of section 67B.

### ***Whether a different asset is held on trust***

138. Consistent with the view (at paragraphs 110 to 115 of this Ruling) that the single acquirable asset is identified by both the proprietary rights and the object of those rights, consideration must be given to both the proprietary rights and the object of those rights when determining if the original acquirable asset continues to be held on trust under the LRBA.

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<sup>69</sup> Subsection 67A(3) provides that sections 67A and 67B can apply to a collection of assets in the same way as they apply to a single acquirable asset if the assets in the collection meet the requirements as set out in subsection 67A(3).

<sup>70</sup> Subsection 67B(2).

139. 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 the asset, this results in a different asset being held on trust under the LRBA. 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).

140. Whether an alteration or addition to a single acquirable asset results in a conclusion that a different asset is now being held on trust under the LRBA is a question of fact and degree. While it must be determined on the facts of each case, by reference to the legal and physical characteristics of the single acquirable asset as it was when the LRBA was entered into, relevant factors include:

- whether the acquirable asset has been entirely replaced by another asset – the other asset would be a replacement of the original acquirable asset;<sup>71</sup>
- whether the function of the acquirable asset has significantly changed through alterations or additions to the asset – this would indicate that a different asset is held on trust under the LRBA;<sup>72</sup> and
- whether the asset has been altered so that it is no longer a single acquirable asset by virtue of a unifying physical object and part of the asset could be sold off separately – this would indicate that different assets are held on trust under the LRBA.<sup>73</sup>

### ***Replacement of part of the acquirable asset***

141. A portion or part of a single acquirable asset might be destroyed or become worn out. That portion or part of the asset can be rebuilt or replaced provided that the legal and physical characteristics of the asset are not altered to such an extent that the asset has a different character. For example, if the acquirable asset consists of a house on land and the house is destroyed by fire, flood, cyclone or other disasters, building a new house on that land would not result in the creation of a different asset, regardless of whether the new house was superior to the house that was destroyed.<sup>74</sup>

<sup>71</sup> See Example 12 (paragraphs 75 to 77) of this Ruling.

<sup>72</sup> See Example 14 (paragraphs 81 and 82) as compared with Example 13 (paragraphs 78 to 80) of this Ruling. See also item 4 as compared with item 9 of Table 2 (paragraph 35) of this Ruling.

<sup>73</sup> See Example 11 (paragraphs 73 and 74) of this Ruling.

<sup>74</sup> See also item 6 of Table 2 (paragraph 35) of this Ruling.

142. Alternatively, if the acquirable asset was, for example, land with a hayshed and the hayshed was destroyed, building a house in its place would result in a different asset being held on trust under the LRBA. The asset subsequently held on trust under the LRBA is residential premises.<sup>75</sup>

### ***Alterations or additions to the asset not made by the trustee of an SMSF***

143. Whether or not alterations or additions to a single acquirable asset result in a different asset being held on trust under the LRBA is not affected by the identity of whoever made the changes. For example, an alteration or addition made and funded by a member of an SMSF could result in a different asset being held on trust under the LRBA. Government action could also result in a change to the asset that results in a different asset being held on trust under the LRBA. If a different asset is held on trust (and the circumstances are not covered by section 67B), the exception under section 67A to the borrowing prohibition ceases to be satisfied. If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).

144. If property is leased by the holding trust, the tenant may be permitted to make changes to that property, for example by adding a fixture<sup>76</sup>. If the changes made by the tenant are of such significance that they result in a different asset being held on trust under the LRBA and the fixture is the property of the holding trust, the exception under section 67A to the borrowing prohibition ceases to be satisfied from the time the change to the asset is made. If the borrowing is maintained the trustee of the SMSF will contravene subsection 67(1).

145. However, particular laws of a State or Territory may mean that property in a fixture remains with the tenant. If this is the case the changes made by the tenant would not result in a different asset being held on trust under the LRBA.<sup>77</sup>

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<sup>75</sup> See also item 3 of Table 2 (paragraph 35) of this Ruling.

<sup>76</sup> Whether or not something is a fixture is further explained at paragraphs 74 to 78 in *Self Managed Superannuation Funds Ruling SMSFR 2009/1 Self Managed Superannuation Funds: business real property for the purposes of the Superannuation Industry (Supervision) Act 1993*.

<sup>77</sup> See, for example, section 155 of the *Property Law Act 1974* (Qld). Under that provision property in agricultural fixtures can remain with the tenant. See also section 154A of the *Property Law Act 1958* (Vic).

## **Appendix 3 – Alternative views**

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**❶** *This Appendix sets out alternative views and explains why they are not supported by the Commissioner.*

146. An alternative view is that the reference to an ‘asset’ in sections 67A and 67B is concerned not with the physical properties of the object but only with the legal proprietary rights which are acquired.

147. Taking a legal proprietary rights approach, if borrowed funds are applied to acquire an estate in land under an LRBA and a substantial improvement (for example, the erection of a building) is subsequently made to that land, it might be argued that this would not result in either an improvement to the asset or a different asset as the relevant asset is the proprietary rights which have not changed.

148. However, to apply this view consistently would mean determining what a ‘single acquirable asset’ is solely by reference to the legal proprietary rights recognised at law, and regardless of any limitations that might exist in dealing separately with those rights. That is, if an SMSF wished to acquire real property comprising several land titles (for example, a factory built over three titles) each title would need to be held on a separate trust under a separate LRBA. Thus while the alternative view has merit it is not the view that is preferred.

149. Other approaches put forward were to determine what a ‘single acquirable asset’ is according to accounting or usage concepts or according to the investment decision rationale.

150. These approaches to determining what a single acquirable asset is are also not preferred as it is considered that they do not give adequate weight to either the meaning of a ‘single’ acquirable asset or the mischief that sections 67A and 67B were introduced to address.

151. The view in the Ruling is that it is necessary to have regard to both the legal form and substance of what has been acquired in order to determine whether it is a single acquirable asset. This view is open on the words of the law. In determining that it is the preferred view, consideration has been given to the following:

- as compared with focussing only on legal title, the view in the Ruling takes account of the character of the asset in determining if the asset is a single acquirable asset and if it remains the original asset that is held on separate trust under the LRBA;
- maintaining, repairing or improving an asset are typically more relevant to the object of the proprietary rights rather than the proprietary rights; and

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- while the view in the Ruling may mean that an asset (taking account of both the object of the proprietary rights as well as the proprietary rights) has fundamentally changed even though it may not have changed if only the proprietary rights were considered, consideration of both the object and the proprietary rights is applied consistently for both purposes. That is, in determining first if there is a single acquirable asset and secondly if it remains the same asset.

## **Appendix 4 – Detailed contents list**

152. The following is a detailed contents list for this Ruling:

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*Related Rulings/Determinations:*

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- borrowings & loans
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- improvement to land
- improvements to plant
- limited recourse loans
- real estate
- repair equipment
- self managed superannuation funds
- SMSF related parties
- strata titles
- superannuation

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