

Excited about Superannuation Borrowing? Don't be! It is Just a Stupid Borrowing

Do the new superannuation-funds-can-borrow rules excite you? New Section 67(4A) of the Superannuation Industry Supervision Act (SIS Act) has heralded the most exciting opportunity in superannuation since 30 June 2007 (and before that, since 1 July 1988) - superannuation funds can now borrow. Fertile and inventive minds are already at work devising new investment packages and financial product suites. Are you excited?

Don't be, it is nothing to get excited about. In fact, the opposite emotion is what is needed, you need to worry.

The more that you worry about the new superannuation-funds-can-borrow rules, the greater the likelihood is that you will get it right. As simple as the rules appear to be, the nuance of issues that must be met when compared to the penalty outcomes that may apply demand conservatism.

Anyway, this is all about superannuation, this alone commands the need for conservatism.

So why and how should you be conservative?

In the following, I raise just a sample of the issues that appear central and relevant to any considered analysis to section 67(4A). Below I note my summary comments only, the research that backs-up the summary points would express volumes and likely bore the reader. I also add that the following is not exhaustive, but these are the most problematic to start with. I welcome your feedback.

It is still a stupid borrowing

In recent times many superannuation funds have invested in high risk debt – Westpoint and Fincorp are two that come to mind. They now get the opportunity of looking at debt from a different perspective. Will they remember that it is still just a stupid debt?

It is well known that debt is a marvellous investment multiplication tool. Provided your interest expense is less than the gain on the investment, you will get ahead faster. Conversely, the investor superannuation fund will go backwards quickly where the interest cost exceeds the investment return. For the first time, the trustees of superannuation funds need to consider the borrowing issues, the risk and return benefits need to be assessed and the investment strategy needs to be updated. Care is needed to ensure that trustees have a long term investment view with a retirement purpose, and that any debt is looked at in this context.

Anyone found to be promoting the superannuation-funds-can-borrow-rules must emphasise the credit investment risk in a practical and communicative way. New Section 67(4A) limits any superannuation borrowing to a limited-recourse loan arrangement. Will

the investor understand what this means? Doesn't limited-recourse mean that their moneys are protected? Failure to highlight the risks of debt will result in negligence claims.

The risks are limited?

The new law says that the rights of the lender against the superannuation fund for default on the borrowing and charges related to the borrowing are limited to rights relating to the original asset.

What the superannuation trustee/members need to have made clear to them is that the whole of the asset is at risk. Especially in the self managed superannuation fund area where single asset investments are not uncommon, is it prudent to put the whole of the fund assets at risk? Would this be the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide? If not then such an approach to these new rules is a breach of section 52(2)(b) of the SIS.

The loan-to-valuation ratios inherently mean that the equity portion of the asset, the part that the superannuation fund has financed with the first instalment, is at risk.

Loan-to-valuation ratios, although part of the investment management and documentation process, bring fresh challenges to superannuation. Don't ignore it, this invokes the prudent man test, it impacts somewhat in the arms length relation that is needed and may determine whether the borrowing is really a contribution.

And what does the reference to *charges related to the borrowing* mean? Already there is discussion about what kind of charges can be fitted into a borrowing. But this is not the right question. It is not any borrowing is available to a superannuation fund; the trustee can only securing a borrowing that is related to the asset purchase. And it is these charges that are available to a lender against the asset.

It is a relaxation of a prohibition, not permission.

New section 67(4A) does not permit a superannuation fund to borrow, it relaxes the prohibition in section 67(1), but only if the conditions within the new exceptions are met.

The proper starting point for an analysis of this new law is not with section 67(4A) but with the prohibition in section 67(1). A superannuation fund must not borrow or maintain an existing borrowing – this rule still applies.

The starting point is to ask the question: is the nature of the arrangement in truth a borrowing. No matter how the arrangement is described, if in truth it is a borrowing then the prohibition in section 67(1) has prima facie application. Once this is resolved, only then do you look to section 67(4A) to determine whether or not the nature of the arrangement is excluded from the prohibition. To be excluded the money borrowed must have been used to finance an acquisition of an asset. Any other borrowing arrangement fails the new exception to the rule and is in breach of the long standing SIS prohibition in 67(1).

So don't borrow to put money into a trust for a future intention to buy an asset when it is identified, this does not fit the nuances demanded by new section 67(4A).

Section 67(4A) is an exclusion section that saves a superannuation fund from being in breach of the borrowing prohibition. To enjoy the exclusion, the arrangement must comply precisely with the elements expressed in Section 67(4A). There is no room for error. It is not a borrowing; it is a debt funded asset acquisition.

The interest is tax deductible, or is it?

I have discussed this issue before and it seems that I will be forever raising the fact that not all interest payments are tax deductible. In fact, there are very many situations when an interest expense incurred in acquiring an investment can only be capitalised and the total cost only used to offset a future taxable capital gains calculation.

The tax deductibility of interest is one of the most litigated issues that can be found in the annals of taxation court cases. Every decade there is at least one new landmark decision which advances our thinking in this most complex of areas. And now this complexity will become the burden of superannuation funds.

If you are responsible for preparing the spreadsheet that will prove the financial worth of the superannuation fund borrowing, take great care with explaining whether or not the interest will be income tax deductible. What you say and how you say it will have impact. The nature of the underlying investment will drive the outcome. Unless you have specialist abilities in taxation law you should avoid a commitment that the interest will be tax deductible.

There are very good reasons why the tax deductibility of interest remains one of the most tax litigated issues – it is not as straight forward as some think.

Having said that, any straightforward arrangement of buying a property with debt and renting it out should be ok.

It's a Financial Product - No it's Not, Yes it Is, No it's Not

How the superannuation-funds-can-borrow rules are presented and packaged with an underlying financial product recommendation will determine whether the whole arrangement is of a financial product invoking all of the disclosure and consumer protection provisions of the Corporations Act. Broadly, the answers are simple, but as always, it is on the edges where the lines will blur and the problems will arise.

If what is presented is a bundled offering (ie if you include the various structural entities along with a loan or an investment then you have a bundled offering), it will be a financial product. Where the offer is unbundled, it should not be a financial product. Where your marketing has bundled what would otherwise be an unbundled service offering, the grey lines will have been blurred. If you do not hold an Australian Financial Services License when offering a bundled arrangement of debt and investment and other administration management services, you are in breach of the law. Pursuant to 763A of the Corporations Act all that you need to be offering is a facility through which, or through the acquisition of which, the superannuation fund does one or more of the following:

- (a) makes a financial investment; or
- (b) manages financial risk.

The Australian Securities & Investments Commission will be very interested in your arrangement and may seek to impose a fine, seek a banning order or in the worst of cases press for gaol as the penalty. They will be keen to see you enjoy plenty of contemplation time.

Deriving Derivatives

It is interesting how some are approaching the creation of a trust and debt packaged arrangement. The more they look into the simplicity of the words in section 67(4A), the more they see and the more that they seek to package into their arrangement.

It is not, and it should not be that hard. The greater the complexity, the greater the potential that what is designed is a derivative. This will invoke the complexities of the superannuation derivatives principles, including those in SIS Regulation 13.15A. This is not needed.

Circumvent the Contribution Caps

Some excitement sits around the fact that the lender is not prescribed in section 67(4A). So why can't the lender be the member or an associate of the member? The answer is they can be, but only if it is a borrowing, not a loan. The superfund should clearly identify the assets which it is its intention to acquire and structure the borrowing accordingly.

Claims that the opportunity will circumvent the contribution caps are wrong. The strategy of having a member or associate 'lend spare cash' to the superannuation fund is doomed to fail. And the cost of failure will be significant. Let me make one point clear, the new superannuation-funds-can-borrow rules do not circumvent the contribution caps. Yes, it is exciting to note that new Section 67(4A) does not limit who may be the lender to the superannuation fund. But again, you are looking at the wrong starting point. It is the superannuation fund that is borrowing, not the member that is lending.

If this last point appears too subtle for you, stop worrying about the superannuation-funds-can-borrow rules, but please abandon any attempt to advise others.

A Contribution by any other name is still a Contribution

Documenting an arrangement as a loan does not make it true. There are very many court cases in bankruptcy, family law and commercial debt where the Courts have been called upon to identify the truths of the arrangement. Don't let this be you or a client of yours.

Somebody is currently promoting the superannuation-funds-can-borrow rules as a way to circumvent the contributions caps; they will document an arrangement as a loan only to find that the ATO will attack it as a contribution. Somebody will lose, because in truth it was a contribution. The tax liability will be significant.

The SIS does not assist us, it defines a contribution in Regulation 1.03 as "contributions", in relation to a fund, includes:

- (a) payments of shortfall components to the fund; and
- (b) payments to the fund from the Superannuation Holding Accounts Special Account ;

but does not include benefits that have been rolled over or transferred to the fund.

The Australian Taxation Office view of a contribution is broad enough to encompass a loan by a member - *A superannuation contribution is a payment made to a superannuation fund ... to provide benefits for individuals on their retirement, or for their dependants on their death.*

None of this is satisfactory. But then again, none of this is really too hard. When is a borrowing a contribution? Firstly ask whether it was a loan and not a borrowing. Again the nuance may be lost on some but it is central to a section 67(4A) compliant arrangement. Now ask what is the purpose of the loan? If it is to boost a member's superannuation, this may satisfy the sole purpose test but it does not satisfy the 67(4A) requirements. In the words of section 67(4A); *the borrowing prohibition does not prohibit a superannuation trustee from borrowing money under an arrangement under which the money is or has been applied for the acquisition of an asset.* These are the words around which the arrangement that is a borrowing must be constructed.

Another way of looking at the is-the-borrowing-really-a-contribution argument is to ask the lender the question: *is the borrowing really a contribution?* If privately they say yes, tell them not to do it.

Trust the Trust

We can only guess at why the Parliamentary draftsmen required the incorporation of trust concept. However, it is an essential part of the arrangement. Did you also know that a declaration of trust over dutiable property (shares, real estate and units in a unit trust) is liable for ad valorem stamp duty? In New South Wales, the stamp duty on acquisition of land worth \$1 million is \$40,490.00. A declaration of trust that is compliant with Section 67(4A) is also liable to stamp duty of \$40,490.00. There is a real double stamp duty risk in how the trust arrangement is structured.

You should also be aware that a document that requires stamp duty and which has not been stamped, at law, is nothing. It will not have achieved its intended effect. So those who feel that to contract the arrangement it is necessary to craft a trust, think carefully about how you do so, the stamp duty consequences are financially rewarding to the Office of State Revenue.

Extraction of Cash

I came across this subset of an arrangement recently. It was raised to my attention without letting me know who was suggesting it. I was intrigued. A borrowing can enable an 'extraction' of cash that is linked to an underlying increase in the value of the assets. I revisited section 67(4A) and could not see how the words could be contorted to achieve this.

In my view this does not work. Once again it suggests that the person has started at the wrong end, they have looked at the borrowing, but it is really a credit supported purchase.

There is a Product Switch

Does this really need to be commented upon? In virtually any superannuation-fund-can-borrow recommendation there will be financial product switch recommendation. Look to the requirements of section 947D of the Corporations Act, if this applies to you.

The onus is on the advisor. How will you justify the debt recommendation? There will be fees, charges and other consequences that need to be explained in a statement of advice.

Investment Strategy

Superannuation must be the subject of an investment strategy for the investments and this must put this into action – refer section 52(2)(f) of the SIS Act. The strategy must have regard to the whole of the circumstances of the fund, some suggestions of which include:

- The risk involved in an investment;
- The existence or lack of diversification;
- The liquidity of the fund having regard to the demands on its cash resources; and
- the ability of the superannuation fund to discharge its existing and prospective liabilities.

Trustees must make sure all investment decisions are made in accordance with the documented investment strategy of the fund and should seek investment advice or appoint an investment manager in writing if in any doubt.

How do you consider that debt should fit into this arrangement? Do give this some thought.

Covert the Covenants

There are many more SIS Act Covenants that are relevant. The trustee of a superannuation fund must:

1. exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary *prudent* person would exercise in dealing with property of another for whom the person felt morally bound to provide;

[I wonder whether and to what extent a prudent person with a moral duty to another would recommend and put into place a gearing strategy inside a superannuation fund]

2. ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries;

[I know that it may sound radical but there are times when it is not in the best interests of the members of a superannuation fund to borrow]

3. not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers;

[the terms of the arrangement that appears to be section 67(4A) compliant will fail this if it has the result that the trustee may not properly perform or exercise their functions and powers]

It should also be noted that under section 52 of the SIS Act *a covenant by each of the directors of the trustee to exercise a reasonable degree of care and diligence for the purposes of ensuring that the trustee carries out the first-mentioned covenant, and so operates as if the directors were parties to the governing rules.*

New Section 67(4A) has introduced the most exciting innovation in superannuation since 30 June 2007 (not that the \$1 million contribution was an innovation, in truth it was a new prohibition). We have to go back 19 years to 1988 and the introduction of taxation of the superannuation fund, as the next most interesting innovation. On behalf of superannuation professionals, SMSF trustees and the industry generally, I extend a heartfelt thanks for the kind act from the Howard government.

Yes, it is exciting, but don't get too excited, the new superannuation-funds-can-borrow rules just allow a borrowing to buy something via a very specific manner.

That is it!

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