

Gear up for a lawsuit

More exceptions allowing super funds to borrow money for investments are a big opportunity for the members. Don't let them give someone a new chance to sue you, PETER BOBBIN writes.

THE FIRST negligence claim under the new rules that allow superannuation funds to borrow is already in the works, somewhere. Perhaps this is a sign of how consumer-conscious or litigation-friendly Australian society has become.

In the dying days of the Howard government, the Superannuation Industry (Supervision) Act (SIS) was amended with yet another exception to the rule that super funds may not borrow. New SIS subsection 67(4A) says, in effect, that the prohibition does not apply when a trustee is borrowing to acquire an asset through a special-purpose trust.

Many in financial services did not notice the introduction of 67(4A). Some were still recovering from the heady days of the 2007 million-dollar super contributions. A few say it is too good to be true and will not last. Some are coming to terms with it only now, as the media chatters of impending Australian Tax Office intervention.

And amid this confusion and noise, the first related professional negligence case has been born.

Most of the chatter relates to the self-managed super fund market. In terms of the number of funds, the excitement is justified. The 370,000-plus SMSFs control more than a quarter of Australia's \$1.2 trillion superannuation wealth. ATO statistics suggest the average SMSF has a balance of \$800,000. If just 20 per cent of SMSFs decided to gear their investments to 50 per cent, there would be borrowings of \$30 billion in the next year or so.

It is a great time to be in the superannuation financial services profession, even with the fearful chatter.

But is there anything to be concerned about in this chatter? Yes ... and no.

Within days of subsection 67(4A)'s introduction, I issued an alert paper to Argyle Forum members. This paper was re-emailed across the country many times. As a result, many people began discussing their thoughts and plans with me on the direction in which the new law would take their role in the industry.

Within weeks, I was discussing the law with a friend, who told me that, as a partner of one of the larger firms, he was advising and documenting a \$250 million superannuation fund borrowing for a large-fund client.

An investment fund manager, from one of the three-lettered companies, tells me that the new rules will allow

his institutional book of large super funds to achieve their own debt-funding objectives. Instead of having to create a wholesale fund with compromised internal debt levels, each fund can make its own arrangements.

There is less discussion on large-fund borrowing than there is on "SMSF debt. And yet there is more borrowing activity in the large-fund sector. The non-SMSF market represents \$900 billion. A conservative 20 per cent-g geared strategy in this sector would eclipse any potential SMSF borrowing. (I use 20 per cent as an example since that is the share-gearing level Labor Holdings, the Australian Labor Party's investment vehicle in Queensland, has adopted.)

Against this background, those who are fuelling the superannuation borrowing scare campaign need to consider how their prophecy – that the ATO will change the law – could ever come true. It cannot; the ATO does not have the power to do this. Besides, the ATO regulates only SMSFs which, by value, are only a quarter of the market, when the new borrowing rules apply to all super funds.

The law is relatively straightforward. If the ATO has any concerns, all it needs to do to quell the apparently over-enthusiastic is to announce that it will enforce the prudential standards and covenants of SIS and impose contributions tax on any private loan that is a disguised contribution. Put another way, there is no need to adjust the law, because enough power already exists for what is needed.

Mind you, the ATO should not be alone in saying this. It needs to co-ordinate its views, if it decides to give any, with the Australian Prudential Regulation Authority. This is the regulator for the various large super funds that make up three-quarters of the market. Some of these funds are exploring whether to borrow hundreds of millions of dollars and how to break down the "opportunity" to individual member accounts.

But remember the ATO may decide not to give any

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view. It has said it believes it does not have the power to give private and binding opinions on prudential matters that affect SMSFs. This is despite it being the police, prosecutor, jury, judge and executioner!

So what are the main issues and where do you need to take care?

The SMSF members, or associates of them, can be the lenders; there is no prohibition on this. SIS sections 65 and 66 expressly limit superannuation interactivity that involves lending to or acquiring assets from members, but section 67 does not.

In fact, some SMSFs are actively embracing member lending because they can secure cheaper debt. Most third-party super lending is commanding a risk premium between 70 and 250 basis points. This is strong encouragement for SMSF members to personally borrow under alternate security at standard interest rates and lend to their own super fund at the same rate. We have been told many times that just a 1 per cent annual difference can add significantly to the retirement pool.

Although member lending is OK, low- or no-interest member loans will be an ATO target. It is difficult for the Tax Office to argue that a low- or no-interest member loan is in breach of SIS section 109, but it can quite reasonably suggest that such an arrangement is a disguised contribution, not a loan.

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

Somebody is promoting the borrowing rules as a way to circumvent the contribution caps. They will document an arrangement as a loan only to find that the Tax Office will attack it as a contribution.

They will lose if, in truth, it is a contribution. And the tax liability will be significant. The promoter will be wholly liable (even if the member-client also promoted it) under SIS section 55. Take care with what you do and promote.

Another problem area that the ATO should co-ordinate is the inherent product-switch recommendation. The Tax Office and the Australian Securities and Investments Commission have worked together before in the

SMSF segment – on their agreement that \$200,000 is the minimum needed to consider establishing an SMSF. I wonder whether they can co-ordinate their comments on product-switching issues.

In virtually any proposal for a super fund to borrow, there will be a financial product-switch recommendation. The deposit for the asset that is later borrowed against must come from existing super assets. Under section 947D of the Corporations Act, the onus is on the adviser to justify the strategy and product redemption that will fund the deposit, even if it is the client who suggests the borrowing. Advisers should be comfortable that they can justify the debt recommendation. Fees, charges and other consequences will need to be explained in a statement of advice.

The one area that will be beyond all of the regulators is that of the property investment spruikers. There is little doubt that SMSFs will release their pent-up borrowing demand into property acquisitions. Strong diversification arguments support a flood of superannuation borrowings into property. ATO statistics show 56 per cent of SMSF assets are in shares, 22 per cent in cash and 11 per cent in other assets, leaving only 11 per cent in property. Some would say that this is unbalanced.

South-east Queensland should brace itself for the SMSF migration. But holidaying SMSF trustees should pack their cynicism, instead of their rose-coloured property glasses.

This discussion on the issues to watch reminds me of that first negligence claim that's soon to be filed under Australia's new exemptions allowing super funds to borrow. The events that will support that case are happening now. It may take three or five years before the suit begins its path through the court system, but it has certainly already begun somewhere.

The rules allowing super funds to borrow are a great opportunity. The chatter about the ATO stopping these new rules is silly and baseless. However, I do hope that the Tax Office acts early to discourage some who see a chance to make money from and off super funds.

Have you taken care? 🌟

■ Peter Bobbin is a senior partner at commercial law firm the Argyle Partnership. Email pbobbin@argylelawyers.com.au