SMSFs and Geared Property Investment

Self-managed superannuation funds (SMSFs) can borrow in order to acquire certain assets. These borrowing arrangements are strictly regulated.

When borrowing to acquire an asset, the fund takes out a loan on a ‘limited recourse’ basis, which is a term that indicates the security of the lender is only in respect of the encumbered asset that has been acquired. In other words, the lender cannot make claims (in the event of, for example, default) on other assets that the SMSF may own.

With a ‘limited recourse borrowing arrangement’ (LRBA), the SMSF has beneficial ownership of the asset (keeps the earnings the asset makes), but not ‘legal’ ownership. Upon discharge of the loan, legal title vests with the SMSF.

Some welcome clarification

The ruling issued by the Tax Office recently (SMSFR 2012/1) has come as a welcome clarification for many SMSF trustees, as the Commissioner has explained his interpretation of key concepts, including:

• what is a ‘single acquirable asset’

• ‘maintaining’ or ‘repairing’ the acquirable asset as distinguished from ‘improving it’

• when a single acquirable asset is changed to such an extent that it is a different (and therefore a replacement) asset.

The Tax Office’s pronouncements clarify situations where there may be two separate assets at law, but because they are inseparable for all practical purposes (such as a building and the land it stands on) they will be treated as a single asset when it comes to an SMSF borrowing. The Tax Office has also distinguished between repairs that are carried out to ‘reinstate the function of an asset’ compared with an improvement that enhances that asset.

The definition of a single acquirable asset also considers both proprietary rights (ownership) and the object of ownership — thus allowing for an asset to meet the definition of a single asset even though it may consist of separate items of proprietary rights (such as two or more blocks of land). In this instance, relevant factors have been added to the ‘single asset’ decision equation, such as ‘the existence of a unifying physical object, such as a permanent fixture attached to land, which is significant in value relative to the overall asset value’.

The definition also takes into account whether a state or territory law requires that two assets be dealt with as one. A relevant example here would be an apartment with a car park on a separate title. If according to state law the apartment and car park must be transferred together to meet state property title transfer rules, then these will be considered a single asset rather than requiring a separate LRBA for each title.

Maintenance, improvement, replacement?

An important distinction to remember is that in some situations repairs can be paid for from LRBA funds but, if permitted, improvements must be paid for from other sources, such as the fund members' own resources. What has also been clarified is that if, for example, a residential property is destroyed by fire and subsequently rebuilt as a residential property, even though the value of the property may increase (due to use of better materials etc), this is still viewed as simply restoring the asset. As long as its state or function remains unchanged, this will not be considered an improvement.

However even where improvements are made (using funds other than those sourced via an LRBA), many popular improvements are permitted that will still not create a different (replacement) asset. Examples include adding a driveway, granny flat or swimming pool, also extending to add a bedroom or entertainment area in residential premises.

Alterations that change the characteristic of the property however, such as from residential to a commercial use, will not be permissible.

Investment options open up

SMSF trustees may have better reason to look to investing in either their own business premises or other investment properties now the rules on SMSFs borrowing funds to invest are on a surer footing.

Until now, the definition of what constitutes a single acquirable asset, as well as what constitutes the maintenance or repair of these assets, as distinguished from 'improving' them, has caused confusion and anxiety among many SMSF trustees and their advisers.

The issues involved were thrown into sharp relief by the 2011 natural disaster events Cyclone Yasi and floods in Queensland as well as devastating bushfires in Western Australia. Many of the damaged properties were owned by SMSFs, the trustees of which found that the rules governing building reconstruction works severely lacked clarity — as evidenced, for example, in a huge jump in applications to the Tax Office for private rulings on what constituted a repair (allowed), and an improvement (disallowed).

As an avenue to use borrowed funds for investment purposes, LRBAs are very important to many SMSFs, but failing to meet the strict requirements risks contravening the general prohibition on borrowing funds, and places at risk an SMSF's status as a complying superannuation fund — so operating within the rules is imperative.