1 May 2017

The Manager – Melbourne Unit

Retirement Income policy division

The Treasury

Langton Crescent

Parkes ACT 2600

**Submission**

**Superannuation - integrity of limited recourse borrowing arrangements**

**Submissions due by Wednesday 3 May 2017**

This submission has been prepared by a SPAA SMSF Superannuation Specialist who operates an accounting practice (Chelle Corporation Pty Ltd) that acts as Tax Agent and administers approximately 80 self managed superannuation funds, of varying net asset values. A related company, My SM Super Pty Ltd has a limited AFSL and is licensed to advise in the SMSF sector.

What is the overall goal of the superannuation system – my perception is that it is to enable as many people as possible to accrue sufficient income producing assets over time to enable them to fund their own retirement, without the need, or with a reduced need, to draw on the government aged pension entitlements.

How does this proposal support the government’s retirement income objective?

Will the implementation and administration of this proposal, where it needs to be applied to all SMSF’s with LRBA’s who operate retirement and accumulation interests each year, generate more income for the government that the costs applied to the whole of the SMSF sector?

Some practical comments:

1. LRBA’s are not taken out lightly. Specifically, where borrowing is from a bank or other institution, the additional costs of acquisition include significantly increased bank establishments fees and legal fees to review the bare trust deed, in addition to the SMSF advisor, cost of the bare trust and corporate trustee. Where borrowing is from a related party, the bare trust structure needs to be put in place and legal fees are incurred to ensure that the agreement is documented and correct in accordance with the legislation. In addition, annual accounting and audit fees may be increased (specifically in the first year) so that the acquisition can be correctly accounted for in the financial statements of the superannuation fund;
2. In my view, except in an extremely small proportion of the SMSF LRBA population (which is only about 5% of the SMSF sector), LRBA’s would not be a transfer balance cap minimization tool – they are a strategy to utilise and leverage superannuation savings to build income producing assets for retirement in a protected environment. In my experience, the most successful use of this strategy has been the purchase of business premises where the business associated with the SMSF members/trustees rents the property on an arms-length basis. Often, due to the reduced level of gearing, the rent repays the loan of over a reasonable time frame and then surplus rental income can be accumulated to pay member benefits in the future. LRBA’s have only been available for 10 years – very few of our clients have used this strategy to purchase residential property, as the returns are insufficient to make the loan repayments and meet the outgoings required of the owner in a residential letting arrangement;
3. The member’s balance is still the market value of the net assets of the fund – the addition of a LRBA will not changes the net asset value of the fund, unless there is an increase in the underlying value of the asset subject to the LRBA. The acquisition of an asset under a LRBA will initially lead to an overall decrease in the assets of the fund, due to the LRBA establishment costs and asset acquisition costs – could these be recouped from the earnings of the accumulation interest prior to making any adjustment to the retirement interest?;
4. The proposal correctly identifies that, where a fund is 100% in retirement income stream, there is no accumulation interest from which to make the principal loan repayments, so no additional benefit can arise;
5. The practical application of the suggestion in the EM – to record a transfer balance cap credit where there is an increase in the value of the retirement phase asset subject to a LRBA – is difficult to practically apply, based on current software. Many funds are unsegregated between retirement and accumulation interests – often there is only one bank account that receives investment income and contributions, as well as paying fund expenses and pension payments;
6. How much of the fund’s earnings supporting the retirement and accumulation interests would be applied to the principal repayment of the LRBA, which I am assuming is the basis of the increase in value? Is there a deemed priority of the application of earnings to the LRBA to determine the increase in value of the retirement interest? Should all of the retirement earnings be applied first, or only the earnings relating to the asset, which is the subject of the LRBA? What if the asset earns no income for a period (for example, if the property is untenanted) – can the ‘increase in value’ be offset by the application of other retirement earnings first, or should the accumulation earnings be applied in priority?
7. All of this is assuming the value of the fund actually increases over time, as a result of principal repayments of the LRBA, funded from accumulation balance income/asset reductions. Currently, there is no transfer balance debit or credit applied where there is a change in the market value of the assets underlying the retirement phase interest. If this proposal is to be applied on the basis that there is an increase in the retirement interest due to the principal repayments, should there be an offsetting debit to the transfer balance cap where the asset, which is the subject of the LRBA, decreases in value (as there is no actual increase in the overall value of the fund)? At what point of time would this be measured?
8. The timing of the payment is the time of the credit – this may require 12 adjustments to the members transfer balance cap in a year. If weekly payments are made, this could require 52 adjustments;
9. The ATO has the ability to investigate every LRBA that is undertaken in the 2017 financial year and use Part IVA where it feels that this is a scheme that has been used to avoid taxation. Would this be a more appropriate tool to use rather than disrupt every fund with an LRBA, where members hold both a retirement and accumulation interest?

Overall, this proposal appears as a sledge hammer to crack a peanut. The trustees who are planning to, or have implemented a LRBA during the current year, will be easily identified on the lodgement of the SMSF returns for 2016/17. Where SMSF’s have had LRBA’s commencing in previous years, it is unreasonable to think that these were implemented to gain a benefit, as the government proposals were not available for consultation prior to 1 July 2016.

If you require any further information or have questions about the prectical application of this or future superannuation proposals, please don’t hesitate to contact me.

Thanks and regards

Michelle Wilson