

04 May 2017

Manager
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The Treasury
Langton Crescent
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By email: superannuation@treasury.gov.au

Dear Sir/Madam

SUBMISSION ON CONSULTATION OF EXPOSURE DRAFT *TREASURY LAWS AMENDMENT (2017 MEASURES NO. 2) BILL 2017: LIMITED RECOURSE BORROWING ARRANGEMENTS (BILL)*

This submission has been prepared by the Superannuation Committee of the Law Council's Legal Practice Section (**the Committee**).¹ The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and clear. The Committee makes submissions and provides comments on the legal aspects of the majority of all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

The Committee is pleased to have the opportunity to comment on the Consultation of exposure draft Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: limited recourse borrowing arrangements (**Bill**). The Committee is guided by its objectives identified above and has only made comments below where the Committee has identified issues within its remit.

The Superannuation Committee makes the following points on the Bill and the accompanying explanatory memorandum (EM) concerning revised provisions affecting the transfer balance cap and total superannuation balance for members in self-managed superannuation funds (SMSFs) with respect to borrowings through a limited recourse borrowing arrangement (LRBA):

General

1. The Committee notes the very limited time provided for consultation on the Bill, being four business days. Whilst the Committee understands that Treasury is working to a

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tight time-frame, it is unrealistic to expect that genuine and productive industry consultation can occur within such short periods.

2. In addition, the Committee is concerned that the proposed changes will substantially diminish the appetite for banks and other credit providers to lend to SMSFs via LRBAs and will largely operate as an effective prohibition on LRBAs from 1 July 2017. The Committee queries whether any consultation has taken place with respect to how the proposed changes in the Bill are likely to affect the credit risk assessment process for banks and other credit providers lending to SMSFs via LRBAs.
3. In this regard, it is noted that the Financial System Inquiry (also known as the 'Murray Inquiry') recommended a prohibition on LRBAs. The Federal Government's response to this in October 2015 was as follows:

The Government does not agree with the Inquiry's recommendation to prohibit limited recourse borrowing arrangements by superannuation funds.

While the Government notes that there are anecdotal concerns about limited recourse borrowing arrangements, at this time the Government does not consider the data sufficient to justify significant policy intervention. The Government will however commission the Council of Financial Regulators and the Australian Taxation Office (ATO) to monitor leverage and risk in the superannuation system and report back to Government after three years.

This timing allows recent improvements in ATO data collection to wash through the system. The agencies' analysis will be used to inform any consideration of whether changes to the borrowing regulations might be appropriate'.

4. The Superannuation Committee is concerned that the proposed changes in the Bill will operate to pre-empt the review referred to in the Government's response to the Murray Inquiry and will render it unnecessary. It is unclear whether there has been any reporting back from the ATO or the Council of Financial Regulators to inform the proposed changes affecting LRBAs in the Bill and the Committee suggests that this process should be followed before any decision is made and law is passed that will effectively bring about a prohibition on LRBAs. If Treasury is concerned about LRBAs subverting the application of the contribution cap and transfer balance cap rules, such concerns could also be addressed by the review with due industry consultation.
5. The Committee also suggests that if these proposed amendments are to proceed, consideration should be given to the potential for adverse retrospective application to:
 - (a) re-financing of any existing borrowing - where banks and other credit providers may not be prepared to offer refinancing due to the introduction of these new measures affecting fund liquidity and serviceability of the loans;
 - (b) whether refinancing an existing borrowing after 30 June 2017 will be treated as a 'new' borrowing to which the new measures would then apply; and
 - (c) any contracts for the acquisition of an asset with a post 30 June 2017 settlement - in which case some level of grandfathering is warranted.

Transfer balance cap credit for LRBA repayments

6. The Committee makes the following comments about the proposed changes to apply a transfer balance credit where a trustee of an SMSF makes a (re)payment in respect of an LRBA:
 - (a) sub-paragraph (3) of proposed subsection 294-55 provides for the credit to arise at the time the relevant (re)payment of the loan is made – inevitably requiring an assessment at the time of the loan repayment (for example, monthly) to determine whether there is a resulting increase in the ‘value of’ the superannuation interest supporting the relevant retirement phase income stream – the Committee is concerned about the work involved in the regular assessments this provision will inevitably require and how they might be accurately made, given that a fund may have numerous investments and superannuation interests and would not ordinarily be otherwise required to determine the ‘value’ of a superannuation interest other than at year end or on crystallisation of an entitlement;
 - (b) sub-paragraph (2) of proposed subsection 294-55 assumes that there is a direct and identifiable correlation between a repayment and an increase in the value of a member’s superannuation interest – the Superannuation Committee considers this is unlikely to be the case for most funds, where the increase in value of a member’s interest is only determined after taking into account all income (including asset re/devaluations), expenses and taxation of the fund for a particular period and then allocating on a fair and reasonable basis or by application of such methodology as is provided for by the trust deed (for example, determining a ‘final crediting rate’ is a process only undertaken following an annual review and set as at 30 June or 1 July, once audited accounts are available);
 - (c) it is not clear whether the reference to ‘value of a superannuation interest’ under sub-paragraph (1)(b) would take into account increases in the market value of the underlying assets quite apart from the repayment value (or ‘outstanding value’ as referred to in Subdivision 307-D) – for example, an increase in the notional underlying equity of an asset by virtue of the principal outstanding being increased by ten percent should not translate to a 10% increase in ‘value’ based on the market value of the property at the time of the repayment which may have been heavily impacted by inflation or other factors. The reference to ‘value’ should be replaced by a definition of ‘outstanding amount’ or like concept to avoid these members being treated less favourably than members whose transfer balance accounts are not affected by increases in the market value of their assets in the fund;
 - (d) the Committee is also concerned about the uncertainty in determining such increase in ‘value’ and the likelihood of disputes arising and having to be resolved by the Courts;
 - (e) the new requirements impose an additional significant burden on administration and accounting for these requirements because the information required under these new measures would not currently be tracked (and certainly not on a real time basis);

- (f) whilst the EM purports to provide guidance on these new measures, there are problems inherent in the guidance, such as:
- (i) the incorrect assumption that there will be identifiable assets at a given point in time that 'support' a superannuation interest – most trust deeds include express provisions to ensure that assets are not directly linked to a member or their superannuation interests in the fund and there is not any current requirement to make such a correlation;
 - (ii) further, all assets of a fund may be taken to 'support' all members' interests in a general sense and it may be difficult to associate particular assets with particular interests – see *CPT Custodian Pty Ltd v Commissioner of State Revenue* and related authorities;
 - (iii) the EM refers to a repayment being sourced from assets that support the same interest not impacting the transfer balance credit because there will be a corresponding reduction in 'cash', however this outcome is not made clear under section 294-55 and the EM should not be relied upon to produce the correct outcome under the relevant provisions;
 - (iv) the example set out at Example 1.1 is overly simplified and unlikely to be helpful to trustees and their service providers (or to auditors) because:
 - rental cash flow may not match loan repayments;
 - any reconciliation of these amounts may only take place at year end, thus leading to a different result on the facts of the example set out;
 - it may be difficult (and not possible) to work out appropriate proportioning of repayments (and resulting proportionate increases in 'value' of superannuation interests) between multiple superannuation interests of multiple members (some of whom may be making contributions for the relevant period of the repayment and some of whom may have expenses that differ to other members – e.g. insurance premiums, taxation, activity-based fees);
 - (v) variable interest and interest only loans are not addressed – where no principal or varying amounts of principal are repaid; and
 - (vi) under paragraph 1.30 of the EM, the Committee notes that internal commutations of excess may not be possible for death benefit pensions or for certain other pensions the terms of which limit commutations or partial commutations – thus making the credit more problematic than is suggested by the EM.

LRBAs count towards total superannuation balance

7. The Committee recommends that Treasury give consideration to not proceeding with the proposed amendments to Subdivision 307-D. The Superannuation Committee queries the behaviour that these measures are designed to address as it is not clear on the face of the Bill or the EM.
8. The Committee's concerns raised above for the proposed amendments to the transfer balance credit provisions in connection with:
 - (a) having to artificially make a correlation between particular assets with associated borrowings and those amounts being treated as 'supporting' a member's superannuation interest(s); and
 - (b) determining a relevant proportion of (re)payments to apply to a member's superannuation interests - particularly where there are multiple interests, multiple members and/or multiple assets/investments,also apply to the amendments proposed to Subdivision 307-D.
9. The Committee notes the reference at paragraph 1.38 of the EM to a new 'test' that requires the trustee to determine which LRBA assets support which member's interests, as well as to the extent those interests are supported. However, the Committee rejects the assertion in that paragraph that the test only 'builds' on framework that already exists for funds in tracking the way in which income from its assets is allocated between the interests of its members. In the Committee's view for most funds this will be a significant new test and assessment requiring substantial further complex analysis.
10. The Superannuation Committee notes that whilst only one calculation as at 30 June of each income year is required, there are concerns about the operation of the proposed new measures because:
 - (a) the relevant proportion to be determined pursuant to subsection 307-231(2) might be skewed by other factors, including:
 - (i) contributions made by the member (i.e. the higher the member's contributions during the year the greater the proportion of the 'outstanding balance' will be credited to their total superannuation balance) - which may or may not correlate to their end benefit derived from the LRBA asset;
 - (ii) the performance of particular other investments not impacted by the borrowings that are allocated to a member's superannuation interest(s) (for example, particularly high investment performance on a share portfolio selected by a member will skew a greater share of the 'outstanding balance' to their interest);
 - (iii) insurance proceeds allocated to a member's interest(s) - for example, a member who is allocated insurance proceeds shortly prior to 30 June for a July benefit payment would have a significant disproportionate increase in their share of the 'outstanding balance' which is unlikely to result in any direct benefit being derived from the LRBA asset for the member;

- (iv) how expenses and taxes payable by the fund are allocated between members – including on an activity basis; and
 - (v) whether there are reserves or other unallocated amounts in the fund (for example, where a member has died and there is a question about whether the death benefit pending payment should be treated as a ‘supported super interest’.
- (b) contributions made by or in respect of a member (of a multi-member fund) which are used to fund loan repayments (not necessarily proportionately to the member’s interest) are double-counted in the member’s total superannuation balance because they will be:
- (i) typically credited to the member’s account balance (and superannuation interest) and will therefore form part of their total superannuation balance; and
 - (ii) also counted through the application of subsection 307-230 (albeit on a reduced ‘outstanding balance’ because of the contributions having funded repayments during the year),

and accordingly, the member’s total superannuation balance is artificially inflated because the contributions are counted as part of the member’s interest, but they will not add any real underlying ‘value’ to the member’s interest other than to the extent they are applied to reduce the debt owed by the fund.

11. The Committee also considers that Example 1.2 of the EM is not particularly helpful because it does not describe how the percentages for the allocation between the two members of the cash used to fund the LRBA property were derived. Ordinarily, it is unlikely that they would have been proportioned on any basis other than the total value of each of the interests – being 1/3rd and 2/3rds – so the 40% and 60% proportions are unclear. This analysis is important because the example then applies the 40%/60% proportions to allocate the relevant proportionate support of the LRBA asset to each of the member’s interests.

Application

12. The Committee suggests that in addition to item 7 of the Bill setting out the application of the new measures such that they will only apply in respect of borrowings entered into on or after the commencement of the Schedule (presumably proposed for 1 July 2017), the reference to borrowings or LRBAs under each of section 294-55 and 307 231 be described as borrowings first entered into on or after the commencement of the Schedule. Without this further reference it will be difficult to trace the temporal application of the provisions in the consolidated version of the Income Tax Assessment Act 1997 (**Cth**) – other than by going back to the amending legislation by which the changes were introduced.

Contact

The Committee would welcome the opportunity to discuss its submission further and to provide additional information in respect of the comments made above. In the first instance, please contact:

- Mr Luke Barrett, Chair, Superannuation Committee on (T) 03 9910 6145 or at (E) luke.barrett@unisuper.com.au; or
- Ms Michelle Levy, Tax Sub-Committee Chair, Superannuation Committee on (T) 02 9230 5170 or at (E) michelle.levy@allens.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Jonathan Smithers', with a long horizontal line extending to the right.

Jonathan Smithers
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