



4 May 2017

Manager
Melbourne Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear Ms Dowdell,

**SMSF ASSOCIATION SUBMISSION ON INTEGRITY OF LIMITED RECOURSE BORROWING
ARRANGEMENTS DRAFT LEGISLATION**

The SMSF Association (SMSFA) welcomes the opportunity to make a submission regarding the Government's draft legislation concerning limited recourse borrowing arrangements (LRBAs) and their interaction with the total superannuation balance and transfer balance cap legislation.

We are pleased that the Government has followed suggestions made by the SMSFA in our recent correspondence with the Minister for Revenue and Financial Services regarding making the amendments prospective and ensuring that interest repayments on an LRBA are not counted towards the transfer balance cap (TBC) as a credit. However, we have some significant concerns regarding the Government's proposed amendments.

LRBAs and the transfer balance cap

The SMSFA understands the Government's integrity concerns regarding using LRBAs to circumvent the transfer balance cap. However, we believe that the proposed amendments will give rise to complex compliance requirements that potentially outweigh the small number of SMSFs who are able to use LRBAs in an advantageous manner under the TBC.

Given that the legislation proposes a TBC credit arises where the relevant LRBA loan repayment results in an increase in value of the superannuation interest supporting an income stream, this may result in frequently recurring TBC credits arising. For example, an SMSF that is paying an LRBA down on a fortnightly basis may have a TBC credit arising every two weeks which will need to be reported to the Australian Taxation Office for Transfer Balance Account Reporting (TBAR) purposes. We do not believe that the original policy intent of the TBC intended for SMSF trustees to need to engage in TBAR on such a regular basis given that the credits and debits on existing legislation are linked to infrequently occurring events.



Accordingly, we would advise the Government not to proceed with the proposed TBC amendments given the small number of SMSF trustees that can use LRBA's to potentially circumvent the operation of the TBC and the compliance burden of reporting that the amendments will create.

If the Government is to proceed with the LRBA TBC amendments, we believe that the explanatory memorandum should be revised to clarify that the type of arrangement that gives rise to a TBC credit can only occur where a fund has segregated pension assets. That is, the assets supporting a pension are held separately from those in accumulation phase. Pensions that are supported by all assets of the fund will not be able to have "assets supporting a pension interest" increase in value, as the loan repayment will be taken proportionately to be made from accumulation and pension interests. This does not result in a transfer of value from assets that are taxable to those that are not.

LRBA's and the Total Superannuation Balance

The SMSFA does not support the Government's proposed amendments to include an SMSF member's share of the outstanding balance of an LRBA in their total superannuation balance (TSB). While not explicit in the explanatory memorandum, we understand from correspondence from the Minister for Revenue and Financial Services dated 28 March 2017 that the policy intent of the changes is stop people manipulating the \$1.6 million TSB restriction on non-concessional contributions (NCCs) by withdrawing funds from their SMSF and then lending back to the fund via an LRBA, potentially allowing further NCCs to be made.

We believe that the changes in their current form go beyond stopping this potential loophole in the TSB restriction on NCCs and instead effectively prevent SMSFs being able to undertake a LRBA after the amendments take effect. This is the effect because for the vast majority of LRBA's an SMSF will require NCCs to be able to service the loan and by including the outstanding LRBA loan value in a person's TSB, they are likely to be restricted from making further NCCs. We have provided an example of how the amendments will restrict the use of the LRBA in the Attachment.

It is also our understanding that sensible SMSF lending criteria and practices used by banks will prevent banks from lending to an SMSF unless they are able to make substantial and consistent NCCs to service a loan. The proposed amendment will prevent that occurring for many SMSFs with average to large balances, as including the outstanding value of the loan will cause them to be close to breach the \$1.6m TSB restriction on NCCs.

The amendments will have the consequence of preventing SMSF members from using LRBA's in a legitimate strategy to build their retirement savings to have a secure and dignified retirement. The changes will have significant effects on small business owners who often use a combination of NCCs and LRBA to transfer their small business premises – often their most significant asset – to superannuation to fund their retirement.

We do not believe it is the Government's intention to amend the superannuation laws so that LRBA's become impracticable for SMSFs to undertake. This is especially given recent statements from



Government Ministers opposing the Australian Labor Party's policy announcement that they will follow the Financial System Inquiry's recommendation to ban LRBA's, supporting borrowing by SMSFs.¹

The amendments will also make SMSF members with an LRBA be the only superannuation fund members who are required to use a value for their TSB that does not reflect their true value of retirement benefits at the time it is calculated. For instance, if an SMSF member has an outstanding LRBA loan of \$500,000, a \$1 million property and \$500,000 in cash, if they were to take their retirement benefits as a lump sum, they would be entitled to \$1 million after paying down the LRBA loan. However, under the proposed amendments their TSB would be \$1.5 million.

This outcome does not align with the policy intent of the TSB restriction on NCCs, which is intended to restrict people with sufficiently large superannuation benefits from making further large contributions to the tax-preferred superannuation retirement. Net assets, being what someone's retirement benefit is actually worth is the appropriate measurement for this policy.

Further, we also contend that the rationale explained in paragraph 1.2 of the EM, "[t]he changes also ensure that where a fund has limited recourse borrowing arrangements in place, the total value of its assets is properly accounted for in working out individual members' total superannuation balances", is incorrect on the basis that net assets are the appropriate measurement of a person's retirement savings.

In addition to the issues raised above, the amendments discriminate against superannuation funds that use direct leverage through an LRBA, as opposed to those that use indirect leverage, such as through a geared unit trust. SMSF members that use an LRBA have their ability to make NCCs constrained by the level of outstanding debt the LRBA has while members who invest in geared products (e.g. a managed investment scheme that is internally geared) are not affected. The member with an LRBA has the gross value of their asset counted while the indirectly geared member has the net value of their asset included in the TSB. This is an inequitable outcome, as both investments are using gearing but through a different product.

Alternative solutions

As mentioned above, we understand that the "mischief" the Government is seeking to prevent is created by SMSF members withdrawing funds from their SMSF tax-free and using an LRBA to return it to the fund, and in the meantime, making additional NCCs.

This requires the SMSF member to be able to receive benefit payments from the fund and use a related party LRBA to ensure that they are in the same economic position but effectively reduce their TSB.

¹ The Hon. Scott Morrison MP, *Address to the Australian Business Economists, The Westin, Sydney, 27 April 2017*, <http://sim.ministers.treasury.gov.au/speech/006-2017/> and

The Hon Michael Sukkar MP, *Media Release Labor's Rushed Housing Proposal Grab Bag Has Zero Credibility*, 21 April 2017



The LRBA amendments could be better targeted by focussing on these elements that are required to defeat the policy intent of the TSB restriction on NCCs.

We understand that it would be unlikely for an SMSF to execute the Government's targeted strategy through a retail lender. Retail lenders' credit policies generally preclude older SMSF members (i.e. those who have satisfied an appropriate condition of release) from accessing funding for LRBA's due to their ability to make necessary contributions for repayment and also because the fund's earnings are often required to pay pensions in retirement phase. Again, this lends support to better targeting the proposed amendments.

Better targeting could occur through either:

- a) Restricting the proposed amendments to related party LRBA's, or
- b) Ban related party LRBA's from 1 July 2017 onwards so they cannot be used to exploit the TSB rules, or
- c) Restricting the proposed amendments to people who met a nil cashing restriction condition of release (i.e. they can withdraw tax-free lump sums from their SMSF), or
- d) A combination of the above recommendations.

By restricting the application of the proposed amendments to SMSF members who are able to actually use an LRBA to exploit the TSB NCC rules, this would avoid unfair outcomes for SMSF trustee who are using LRBA's in a legitimate fashion to build their retirement savings, as illustrated in the example above. We strongly encourage the Government to consider these alternative approaches so that people legitimately saving for their retirement through the use of an LRBA are not unfairly disadvantaged.

In conclusion, we urge the Government to reconsider the proposed LRBA amendments due to the complexity of the TBC amendments and the harsh effect of the TSB amendments on SMSFs intending to use an LRBA. We believe alternative, better targeted amendments can achieve the policy intent of the TSB amendments without severely impacting the ability for SMSFs to undertake LRBA's.

If you have any questions about our submission please do not hesitate in contacting us.

Yours sincerely,

A handwritten signature in black ink that reads 'John L. Maroney'. The signature is fluid and cursive, with a large initial 'J' and 'M'.

John Maroney
CEO
SMSF Association



ATTACHMENT

The following cash flow example illustrates how NCCs are required for SMSFs to service an LRBA. In this example, after considering the earnings, expenses and tax liability of the fund, to service a 66% loan-to-value ratio 15 year term LRBA, a \$49,217 NCC is needed to fund the LRBA repayment.

LRBA cash flow example		
SMSF: Single member fund in accumulation phase		
<u>Fund Asset Profile</u>		
Cash		100,000
Listed Shares		300,000
Property	1,200,000	
Limited Recourse Borrowing facility	<u>-800,000</u>	
Net property asset		<u>400,000</u>
Member's Balance		<u>800,000</u>
<u>Fund Property - earnings and expenses</u>		
Gross annual rent received @ 5%	60,000	
Concessional contributions made by member	<u>25,000</u>	85,000
Yearly interest on loan @ 6.4%		<u>-51,200</u>
		33,800
Rates	-2,500	
Insurance	-1,000	
Repairs	-1,500	
Water	-500	
Administration	<u>-4,000</u>	<u>-9,500</u>
		24,300
<u>Other assets - earnings and expenses</u>		
Cash @ 2%	2,000	
Shares - yield @ 4.5%	<u>13,500</u>	
		39,800
Contributions & Income Tax		<u>-5,970</u>
Net Cashflow		<u>33,830</u>
Required annual LRBA repayment (15 year loan)		83,047
SHORTFALL		-49,217
	Existing Rules	
	TSB	\$800,000
	Proposed	
	TSB	\$1,600,000

On the basis of this cash flow analysis, this type of LRBA would not be issued by a bank lending on commercial terms due to the issues servicing the debt limiting NCCs causes.