



12 February 2018

Robb Preston  
Manager  
Retirement Income Policy Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [superannuation@treasury.gov.au](mailto:superannuation@treasury.gov.au)

Dear Mr Preston,

### **SMSF ASSOCIATION SUBMISSION ON SUPERANNUATION TAXATION INTEGRITY MEASURES**

The Self Managed Super Fund Association (SMSFA) welcomes the opportunity to make a submission on Government's superannuation taxation integrity measures. We understand the need for integrity measures to ensure that 'loopholes' in the legislation are not used by individuals to circumvent the new caps effective on 1 July 2017.

We have responded to the consultation paper on the two measures below separately.

#### **Limited Recourse Borrowing Arrangements and Total Superannuation Balance**

The first measure includes amendments to include a member's share of the outstanding balance of a Limited Recourse Borrowing Arrangement (LRBA) in their total superannuation balance (TSB).

##### *1. Does the exposure draft legislation achieve the policy intent of these measures?*

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 TSB.

The policy intent to 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 will be achieved.

The policy intent to not limit or effectively ban LRBAs will not be achieved in our view.

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 LRBAs, 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. The changes make the acquisition of a traditional LRBA arrangement extremely difficult and complex. 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 adequate 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 may cause them to breach the \$1.6m TSB restriction on NCCs.

The amendments will have the consequence of preventing SMSF members from using LRBA 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 an 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 become impracticable for SMSFs to undertake.

The amendments will also make SMSF members with an LRBA the only superannuation fund members who are required to use a value for their TSB that does not reflect the true value of their 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 is an inequitable outcome of the proposed amendments.

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 would 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 would have 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.

The proposed approach is likely to penalise many legitimate LRBA that are being used for genuine investment purposes.



## *2. Is there some other way in which that policy intent could be achieved?*

### 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. 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 inability 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 2018 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 in the attachment. 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.

## *3. Is there a risk of unintended consequences?*

As stated above the proposed amendments strongly amplify the risk of LRBA’s becoming increasingly difficult and complex. It is likely that the unintended consequence of these proposed amendments is that LRBA’s become an unviable option for SMSF’s and will no longer be utilised as a strategy to grow retirement savings. At the very least their attractiveness would be diminished.

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 SMSF’s 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 LRBAs.



## **Non-arm's length income (NALI) expenditure**

The second measure ensures that non-arm's length expenditure is taken into account when determining whether the non-arm's length income (NALI) taxation rules apply to a transaction.

### *1. Does the exposure draft legislation achieve the policy intent of these measures?*

The exposure draft legislation does achieve the policy intent of the NALI measures. The inclusion of non-arm's length expenditure closes any form of ambiguity regarding s 295-550 of the *Income Tax Assessment Act 1997* and the meaning of non-arm's length income. We believe it will be effective across NALI LRBA's and all other 'schemes' which are NALI.

The SMSFA believes that in situations where an SMSF acquires an asset through an LRBA on terms that are favourable to the SMSF, that even if rental income is at market rates, that the income should be assessable as NALI. This is due to the fact that the SMSF is in a position to receive income that it may not have been able to if the LRBA was on commercial terms.

The amendments ensure that SMSFs cannot circumvent the provisions by entering into schemes with non-arm's length expenditure. The amendments should have the effect of removing the possibility to circumvent certain contribution caps resulting in a transfer of wealth into superannuation or utilising the concessional rate for income via a scheme.

### *2. Is there some other way in which that policy intent could be achieved?*

We believe the policy intent is achieved with these amendments.

### *3. Is there a risk of unintended consequences?*

We are not aware of any unintended consequences with these amendments. The amendments should not affect LRBA's that are entered into with unrelated third parties or LRBA's with commercial rates of interest and expenses. The amendments should also not affect any dealings which are not considered 'schemes' such as arm's length private company dividends and trust distributions.

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 written in a cursive style with a large initial 'J'.

John Maroney  
CEO  
SMSF Association



### **ABOUT THE SMSF ASSOCIATION**

The SMSF Association is the peak professional body representing SMSF sector which is comprised of over 1.1 million SMSF members who have \$701 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.



**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.

<b>LRBA cash flow example</b>		
<b>SMSF: Single member fund in accumulation phase</b>		
<b><u>Fund Asset Profile</u></b>		
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>
<b>Member's Balance</b>		<b><u>800,000</u></b>
<b><u>Fund Property - earnings and expenses</u></b>		
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
<b><u>Other assets - earnings and expenses</u></b>		
Cash @ 2%	2,000	
Shares - yield @ 4.5%	<u>13,500</u>	
		39,800
Contributions & Income Tax		<u>-5,970</u>
<b>Net Cashflow</b>		<b><u>33,830</u></b>
<b>Required annual LRBA repayment (15 year loan)</b>		<b>83,047</b>
<b>SHORTFALL</b>		<b>-49,217</b>
	<b>Existing Rules</b>	
	TSB	\$800,000
	<b>Proposed</b>	
	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 under the proposed amendments due to the issues servicing the debt limiting NCCs causes.