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TOTAL SUPERANNUATION BALANCE AND LIMITED RECOURSE BORROWING ARRANGEMENTS

Joseph Cheung, Daniel Butler and Bryce Figot

If the *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018* (Bill) becomes law, an individual member's total superannuation balance (TSB) may be increased by their share of the outstanding balance of a limited recourse borrowing arrangement (LRBA) that commenced on or after 1 July 2018. However, the increase only applies to members:

- 1 Who have satisfied a relevant condition of release with a nil cashing restriction, or
- 2 Whose superannuation interests are supported by assets that are subject to an LRBA between the superannuation fund and its associate (often referred to as a 'related party' in everyday conversation).

This article examines the effect of the proposed law on members who have satisfied a relevant condition of release with a nil cashing restriction, and also how it applies to members whose superannuation interests are supported by assets that are subject to an LRBA

between the superannuation fund and its associate (often referred to as a 'related party' in everyday conversation).

For completeness, we note that the proposed law applies to both members of self-managed superannuation funds (SMSFs) and other funds with fewer than five members. For the purpose of this article series, we will focus on its application to SMSFs.

Members satisfying a condition of release with nil cashing restrictions

Under the proposed law, the relevant conditions of release with nil cashing restrictions are:

- Retirement,
- Terminal medical condition,
- Permanent incapacity, and
- Attaining age 65.

Only members who satisfy the relevant condition of release with nil cashing restrictions will have their TSB increased. We illustrate this with an example.



The quote

An increase in the member's TSB as a result of their share of the outstanding balance of an LRBA can create liquidity issues for the SMSF.

Example

Pierre and Samantha are the only members of their SMSF. The value of Pierre's superannuation interests in the SMSF is \$1 million. The value of Samantha's superannuation interests is \$500,000. The assets of the SMSF comprise of cash only.

Pierre is 61 years old and has retired. Samantha is 54 years old and employed on a full-time basis. For completeness, she wishes to continue working until she attains age 65 years. Therefore, Pierre is the only one who has satisfied a condition of release with a nil cashing restriction.

The SMSF acquires a \$2.7 million property. The SMSF purchases the property using all of its cash (i.e. \$1.5 million) and borrows an additional \$1.2 million from an unrelated third party lender using an LRBA.

The SMSF now holds an asset worth \$2.7 million (being the property). The SMSF also has a liability of \$1.2 million under the LRBA.

Of its own cash that it used, two-thirds (\$1 million) was supporting Pierre's superannuation interests and the other one-third (\$500,000) was supporting Samantha's interests. These proportions also reflect the extent to which the asset supports Pierre and Samantha's superannuation interests.

Pierre's TSB is \$1.8 million. This is comprised of the two-thirds share of the net value of the property (being \$1 million) and the two-thirds share of the outstanding balance of the LRBA (being \$800,000). Samantha's TSB is \$500,000. This is because she has not satisfied a condition of release with a nil cashing restriction. Accordingly, the one-third share of the outstanding balance of the LRBA (being \$400,000) does not increase her TSB.

The following are some key points to note from the above example.

- An increase in the member's TSB as a result of their share of the outstanding balance of an LRBA can create liquidity issues for the SMSF. Considering the above example, if Pierre's TSB just before 1 July 2019 is \$1.8 million (i.e. greater than \$1.6 million), this would prevent him from making any non-concessional contributions (NCCs) without an excess in the financial year ending 30 June 2020. This may affect the SMSF's ability to repay the LRBA.
- An increase in the member's TSB can also affect other superannuation rights and obligations (for more information about the various superannuation rights and obligations that depend on a member's TSB, please refer to our previous article "Total superannuation balance milestones").
- Where the loan has not been repaid by the time that a member satisfies a relevant condition of release with nil cashing restriction, the member's share of the outstanding balance of the LRBA will

increase their TSB. Considering the above example, although the one-third share of the outstanding balance of the LRBA does not increase Samantha's TSB, if she subsequently satisfies a relevant condition of release with nil cashing restriction (e.g. retirement or attaining age 65 years) before the LRBA is repaid, her share of the outstanding balance of the LRBA will increase her TSB.

Practical application

LRBAs commenced pre-1 July 2018

The proposed law does not apply to:

- LRBAs that commenced before 1 July 2018, and
- The refinancing of the outstanding balance of an LRBA that commenced before 1 July 2018.

For these circumstances, a member's TSB is unaffected by the proposed law.

LRBAs commencing on or after 1 July 2018

An SMSF trustee that is considering acquiring an asset via an LRBA should consider the potential effect of the proposed law on each member's TSB where the members satisfy or are about to satisfy a relevant condition of release with a nil cashing restriction. For example, if a member is about to satisfy a condition of release with a nil cashing restriction because they have met preservation age and are about to enter into retirement for superannuation law purposes, the SMSF trustee may need to consider how the member's TSB will be calculated if the proposed law comes into operation and upon the member entering into retirement for superannuation law purposes. The SMSF trustee may also consider whether there are any flow-on consequences, such as the member's ability to make NCCs, which could affect the SMSF's ability to repay the LRBA. Careful planning and forecasting may be necessary before an SMSF trustee can make an informed decision about whether to enter into an LRBA.

Similarly, for any SMSF that has commenced an LRBA on or after 1 July 2018, the SMSF trustee should monitor and assess the effect that the proposed law has on each member's TSB. If the member's TSB is affected, the SMSF trustee may need to consider whether there are any strategies available to:

- 1 Manage the increase in the relevant member's TSB that results from their share of the outstanding balance of an LRBA, and
- 2 Ensure that the LRBA can be repaid. For example, the repayment of an LRBA might be assisted by admitting additional members into the SMSF who have the ability to make NCCs. Naturally, the SMSF trustee should consider thoroughly the advantages and disadvantages of admitting additional members into an SMSF before making a decision.

Before implementing any strategies, consideration should be given to determine whether the implementation of a certain strategy might trigger the application of

the general anti-avoidance provisions such as Part IVA of the *Income Tax Assessment Act 1936 (Cth)*.

In relation to this aspect, we note that paragraph 4.24 of the Explanatory Memorandum to the Bill states:

“...artificially manipulating the allocation of assets that are subject to [LRBAs] against particular superannuation interests at a particular time may be subject to the general anti-avoidance rules in Part IVA of the ITAA 1936 where such allocations formed part of a scheme that had the dominant purpose of obtaining a tax benefit.”

(For a discussion on some general strategies to manage a member's TSB, please refer to our previous three-part articles titled 'Strategies to reduce your total superannuation balance'.)

Lender is an associate of the superannuation fund

Many advisers and commentators have commented that the effect of the proposed law is that a member's TSB may be increased if their superannuation interests are supported by an LRBA that involves a 'related party' lender. In broad terms, a liability is treated as an asset for a member's TSB purposes. On a more technical level, the wording in the Bill refers to the term 'associate', which is a term defined in the *Income Tax Assessment Act 1936 (Cth)* (ITAA 1936). In contrast, the term 'related party' in the superannuation law context is a term defined in the *Superannuation Industry (Supervision) Act 1993 (Cth)*. The definitions are not identical, although there is significant overlap and similarity. Therefore, to thoroughly consider whether the proposed law has any effect on a member's TSB, SMSF trustees and advisers need to assess whether the lender or proposed lender is an associate of the SMSF.

We illustrate the effect of the proposed law with an example.

Example

Edward and Ellen are the only members of their SMSF. The value of Edward's superannuation interests in the SMSF is \$1.2 million. The value of Ellen's superannuation interests is \$800,000. The assets of the SMSF comprise of cash only.

Edward is 52 years old. Ellen is 43 years old.

The SMSF acquires a \$3 million property. The SMSF purchases the property using all of its cash (i.e. \$2 million) and borrows an additional \$1 million from E&E Pty Ltd, which is a company controlled by Edward and Ellen. Hence, E&E Pty Ltd is an associate of their SMSF.

The SMSF now holds an asset worth \$3 million (being the property). The SMSF also has a liability of \$1 million under the LRBA.

Of its own cash that it used, 60% (\$1.2 million) was supporting Edward's superannuation interests and the other 40% (\$800,000) was supporting Ellen's interests. These percentages also reflect the extent to which the asset supports Edward and Ellen's superannuation interests.

Edward's TSB is \$1.8 million. This is comprised of the 60% share of the net value of the property (being \$1.2 million) and the 60% share of the outstanding balance of the LRBA (being \$600,000).

Ellen's TSB is \$1.2 million. This is comprised of the 40% share of the net value of the property (being \$800,000) and the 40% share of the outstanding balance of the LRBA (being \$400,000).

The following are some key points to note from the above example.

- An increase in the member's TSB as a result of their share of the outstanding balance of an LRBA can create liquidity issues for the SMSF. Considering the above example, if Edward's TSB just before 1 July 2019 is \$1.8 million (i.e. greater than \$1.6 million), this would prevent him from making any non-concessional contributions (NCCs) without an excess in the financial year ending 30 June 2020. This may affect the SMSF's ability to repay the LRBA and fund pension payments and ongoing expenses.
- An increase in the member's TSB can also affect other superannuation rights and obligations (please refer to our previous article 'Total superannuation balance milestones' for more information).

Practical application

LRBAs commenced pre-1 July 2018

The proposed law does not apply to:

- LRBAs that commenced before 1 July 2018, and
- The refinancing of the outstanding balance of an LRBA that commenced before 1 July 2018.

For these circumstances, a member's TSB is unaffected by the proposed law.

LRBAs commencing on or after 1 July 2018

An SMSF trustee that is considering acquiring an asset via an LRBA should consider the following questions:

- 1 Is the proposed lender an associate of the SMSF?
- 2 If so, what is the potential effect of the proposed law on each member's TSB?
- 3 Are there any flow-on consequences, such as the member's ability to make NCCs, which could affect the SMSF's ability to repay the LRBA?

Careful planning, analysis and cash flow projections may be necessary before an SMSF trustee can make an informed decision about whether to enter into an LRBA.

The above questions also apply for any SMSF that has commenced an LRBA on or after 1 July 2018. If the lender is an associate of the SMSF and the member's TSB is affected, the SMSF trustee may need to consider whether there are any strategies available to manage the increase in the relevant member's TSB that results from their share of the outstanding balance of an LRBA.

Some possible strategies relating directly to the LRBA include but are not limited to:

- Refinancing the outstanding balance of an LRBA to borrow from a lender that is not an associate of the SMSF, or
- Restructuring the lender (where the lender is not a natural person, e.g. a company) so that it is no longer an associate of the SMSF — this is a complex strategy and the SMSF trustee should seek expert advice before making a decision to restructure.

As discussed earlier, prior to implementing any strategies, consideration should be given to determine whether the implementation of a certain strategy might trigger the application of the general anti-avoidance provisions such as Part IVA of the ITAA 1936, as per paragraph 4.24 of the Explanatory Memorandum to the Bill.

Additional tip

It is important to note that even if an LRBA can be refinanced with a lender that is not an associate of the SMSF, the proposed law can still operate to increase a member's TSB where the LRBA has not been repaid by the time that a member satisfies a relevant condition of release with a nil cashing restriction. Under these circumstances, the member's share of the outstanding balance of the LRBA will increase their TSB. Accordingly, careful planning and monitoring is required even after an LRBA is refinanced with a lender that is not an associate of the SMSF.

Conclusion

As can be seen from the above, an SMSF trustee that is considering acquiring an asset via an LRBA should carefully plan and consider the potential effect of the proposed law on each member's TSB where the members satisfy or are about to satisfy a relevant condition of release with a nil cashing restriction.

Furthermore, an SMSF trustee that is considering acquiring an asset via an LRBA should also consider carefully whether the lender is an associate of the SMSF, and if so, the potential effect of the proposed law on each member's TSB.

The existing and proposed law in relation to TSB is a complex area of law and where in doubt, expert advice should be obtained. Naturally, for advisers, the Australian financial services licence under the *Corporations Act 2001* (Cth) and tax advice obligations under the *Tax Agent Services Act 2009* (Cth) need to be appropriately managed to ensure advice is appropriately and legally provided. **FS**