

Property and SMSFs: loosening the rules

If your SMSF has borrowed money (or thinking of borrowing money) to acquire 'bricks and mortar' property then there are a few things you need to know.

A new ATO ruling released last month helps to clarify what you can and can't do with property that is under a limited recourse borrowing arrangement (LRBA).

The ruling addresses three key areas:

- Under the borrowing rules in the Superannuation Industry and Supervision (SIS) Act, the borrowing must be used to acquire a "single acquirable asset." The ruling seeks to define what constitutes a single asset.
- The borrowing rules allow an asset that is held under a borrowing arrangement to be improved, however, the trustees cannot use borrowed funds to make the improvements. There is a fine line between what is a repair or improvement and the ruling attempts to clarify how the ATO assess the difference between these terms.
- Also, if you do improve the property, any improvement must not result in the asset becoming a different asset. The ruling looks at the factors the ATO considers, and what your SMSF auditor needs to consider, when they assess whether a property has been changed to such an extent that it is no longer the same asset.

If a fund falls outside of these rules, the fund must sell the asset. Imagine having to sell a property your fund recently acquired, leaving your fund with the stamp duty, legal and agent's fees (or perhaps making a loss because the market conditions were not as good as they were when you purchased the property).

Is the property a single asset?

Assuming the fund is able to purchase the asset, the borrowing rules require that the money is used to acquire a single asset. For example, if the fund purchased a block of units, is the block considered to be one asset or are each of the units inside the block individual assets?

In the ruling the ATO concedes that *"it may be possible ... that the trustee is acquiring a single object of property notwithstanding that it is comprised of two or more proprietary rights. However, this will only be so where ... the separate proprietary rights is distinctly identifiable as a single asset."* The bottom line is that if the rights can be dealt with separately, then they are not a single asset regardless of how the trustee wants to treat them.

Common examples include:

- where the fund acquires a property and the car park is held on a separate title but laws do not allow separation of ownership then there is a single acquirable asset.
- where a warehouse is constructed on multiple titles, then there may be a single acquirable asset.

Maintenance, repair or improvement?

There has been confusion in this area as 'maintaining' 'repairing' and 'improving' are common terms and not defined in the legislation. In the ruling, the ATO states:

- Maintaining generally means work done (or in anticipation) to prevent defects, damage or deterioration of an asset provided that it merely ensures the functional efficiency of the asset is maintained in its present state.
- Repairing generally means remedying or making good defects in, damage to, or deterioration of, an asset and contemplates the continued existence of the asset. The ATO goes on to state that *"an asset may be acquired in a state in which a part of the asset is defective, damaged or suffering some deterioration of what would be considered to be its normal level of functional efficiency. Restoration of that part of the asset to its functional efficiency would be a repair for LRBA purposes."*

The ruling seems to suggest that the repair needs to bring the item back to its original condition but not go beyond that. The cost of the repair in the context of the overall asset is also likely to be a factor in the ATO's assessment of whether or not what has occurred is repair, maintenance or an improvement.

Defining improvement remains a grey area as it is a matter of interpretation whether something is merely repaired or maintained or has been improved.
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Quote of the month

*"A genuine leader is not a searcher for consensus but a moulder of consensus."
Martin Luther King, Jr.*

What's the difference between price and value?

You are looking to buy a small business. You see something you are interested in: right industry, right location but is it the right price? In today's market everyone is looking for a bargain. The difficulty in assessing the price of a small business is that there may not be a lot of ready comparisons available in the market. If you are looking to buy a business where there is a large and active market - like a newsagency, pharmacy or coffee lounge - then comparisons will be available. And, there are industry models that typically set the pricing for these types of business. However, if you are looking at a more unique business where there is not a lot of public information, the going can get tougher.

If you need an opinion on price, be careful and make sure you get the information you are really after.

When you value a small business it is not unusual for the valuation to come in under the asking price. A normal reaction to this is that the business must be overpriced. While this is sometimes true it is not automatically the case. In a perfect market, price and value are the same thing - but we don't operate in a perfect market. As a result, this causes price to trade at either a premium or a discount to value. Over the past decade in Australia, price has traded at a premium of up to 30% on value for good quality businesses. To test the price of a business, you need to understand both its value and also any information on the price that businesses of the type you are looking at have traded for in the market.

When you ask for a valuation of a prospective business, the real question you might be seeking an answer to is should I buy this business? This is a very different question to one about valuation. Should I buy this business is about a range of both financial and non-financial indicators. It is as much about whether the business suits your lifestyle expectations and core capabilities as it is about the financial performance. If the business is a growth business and needs lots of marketing push, then it will not suit you unless you like the marketing aspect and have the time to dedicate to it. To assess all of this you need to understand the business and the business model in operation. You then need to compare the model to your expectations and also your business strengths. None of us are good everything. You need a business that matches your strengths. You don't want to pay too much for the business but equally you don't want to miss out on the right business because the asking price is a bit more than you expected or what someone has told you it's worth. Whether or not you are prepared to pay a premium to value will depend on how much you want the business and what growth you can see in it. Good quality businesses with good growth prospects will almost always command a premium as there are always buyers for these types of businesses. Understanding the true value of a business, is understanding what it is worth now and also what value you can add to it. Once you know both these numbers you should be ready to negotiate on price.

Property and SMSFs: loosening the rules *continued...*

Can you improve a property?

Trustees can use money provisioned under a borrowing arrangement to maintain or repair the property but not improve it. If the trustees use money from other sources outside of the borrowing, they can improve the property as long as the improvements do not turn it into a different asset. For example, if the fund borrows money to acquire a vacant block of land and then builds a block of units on it, the asset would be fundamentally changed and considered to be a different asset.

If the fund does not have to borrow money to acquire the property, then the property can be improved as long as the investment decisions are in line with the funds investment strategy (don't forget to minute key decisions) and all other SIS requirements are met – note there are some traps when using related parties to carry out the improvements.

Property and natural disasters

Trustees can now take some comfort in knowing that they can rebuild an asset that has been destroyed by flood or fire and not breach the borrowing rule. Using an insurance pay-out in these cases to rebuild what is essentially the same asset that existed prior to the event seems to be allowed.

Get advice!

Despite the clarifications offered by the ruling, the borrowing rules remain complex and rely on subjective decision making. Trustees should ensure that they seek advice before purchasing, renovating or changing any property held by their fund.