Superannuation technical minutes, June 2011

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6.1 Property owned by SMSF and another party as tenants in common: using a share of the property as security for debt

Issue raised

Can another party's share of a property that is held as tenants in common with a self-managed super fund (SMSF) be used as security for the other party's borrowing without breaching SISR 13.14?

Background information

A SMSF and another party (not a superannuation fund) are about to acquire a property from an unrelated party at market value. Title to the property is to be held by the two parties as tenants in common (the precise share owned by each party is irrelevant for this question).

The SMSF will not be entering into a limited recourse borrowing arrangement in relation to its share of the acquisition.

The other party is, however, considering borrowing to acquire its share. The lender is seeking to secure the debt over the other party's share of the property.

SISR 13.14 provides that the trustee of a fund must not give a charge over, or in relation to, an asset of the fund.

Industry view / suggested treatment

It is our view that the underlying property itself is the asset, and hence, no 'share' of the property can be used as security. There are conflicting views in the industry, however, as some practitioners believe the 'share' of the property is a separate asset in its own right and that 'share' can therefore be used as security for borrowing by the non-superannuation fund entity.

Technical reference

SISR 13.14

Impact on clients

If the 'share' of the property is not an asset, some clients may have inadvertently given a charge over fund assets (and therefore be in breach of SISR 13.15).

Priority of issue where ATO view is required

Medium

Clarity is required on this issue for both practitioners and clients.

ATO initial response

Under regulation 13.14 of the SISR the trustee of an SMSF must not give a charge over, or in relation to, an asset of the fund (otherwise than to the extent permitted under regulations 13.15 and 13.15A of the SISR).

'Charge', for the purposes of Division 13.2 of the SISR (which includes regulation 13.14 of the SISR), 'includes a mortgage, lien or other encumbrance' (see regulation 13.11 of the SISR). Using an asset to secure a debt as described in the above question will constitute a 'charge' as defined, for the purposes of regulation 13.14 of the SISR.

If two or more parties hold a property as tenants in common, each holder has a proportionate interest in that property; that is, an undivided share of the property. Each tenant in common is entitled to deal with their proportionate interest (undivided share) as they wish. (Butt P, Land Law 6th Edn [14 02]; [14 48]) It therefore follows that any tenant in common can give a charge over its own proportionate interest in the property.

If a trustee of an SMSF gave a charge over its proportionate interest this would clearly contravene regulation 13.14 of the SISR.

If, however, a charge is given by another tenant in common over its proportionate interest the giving of that charge can still have significant consequences for the SMSF as a tenant in common.

Section 66G of the *Conveyancing Act 1919 (NSW)* is an example. A co-owner can apply to have a court appoint a trustee and vest the [entire] co-owned property in that trustee on a 'statutory trust for sale' (or on 'statutory trust for partition'). For these purposes, Butt (Land Law at [14 96]; [14 103]) explains that a co-owner is defined to also include an incumbrancee, such as a mortgagee or a chargee, of a co-owner's interest. Therefore, if a tenant in common has charged their interest in property to a mortgagee but does not satisfy their obligations in relation to the arrangement giving rise to the charge (eg, defaults on their loan repayments), the mortgagee can apply to have a court appoint a trustee and vest the co-owned property in that trustee on a 'statutory trust for sale' (or on 'statutory trust for partition'). Further, upon application, the court can require a mortgagee to discharge the mortgage so that the property vests in the trustee free from the mortgage. This would effectively leave the debt that was the subject of the mortgage to be satisfied from the mortgagor's share of the net sale proceeds or by the mortgagor personally if there is any deficiency.

This example shows that as the property that is the object of the asset of the SMSF may vest in a court appointed trustee the SMSF's asset is in effect converted to another asset (an interest in personalty). The SMSF's share of the sale proceeds (ie proportionate to its interest) would also be reduced by its share of costs and expenses borne by the trustee in selling the asset, so the value of the interest in personalty is likely to be less than its original interest in the jointly owned property.

The ATO also notes that there may be further or different consequences under other laws of the

relevant State or Territory upon default of a tenant in common who has given a charge over their interest in jointly owned property.

The ATO does not have a concluded view as to the potential application of regulation 13.14 of the SISR in these circumstances. However, as a preliminary view, it would be difficult to conclude that regulation 13.14 of the SISR has been contravened by the trustee of an SMSF if the SMSF's proportionate interest in the property does not in some way secure the payment of money owed, whether by the trustee of the SMSF or the other tenant in common, to another party (the chargee).

Leaving aside regulation 13.14 of the SISR, the consequences that can arise for an SMSF trustee upon default by another tenant in common in relation to a mortgage, raise other considerations. These include whether the SMSF entering into a tenancy in common arrangement:

- is consistent with the SMSF's investment strategy and the requirements in section 52 of the SISA and regulation 4.09 of the SISR;
- provides current day benefits to a member or a related party contrary to the sole purpose test in section 62 of the SISA (see SMSFR 2008/2);
- assists a member or relative of a member using SMSF resources and therefore provides financial assistance in contravention of section 65 of the SISA (see SMSFR 2008/1) (eg if the member would not have been able to acquire its interest in the property without the SMSF having acquired an interest);
- leaves open the possibility that the SMSF's share of any sale proceeds (eg under a statutory trust for sale) could be used to meet the liability of a mortgagee or chargee in relation to another co-owner's interest, resulting in financial assistance given by the SMSF to a member or relative of a member in contravention of section 65 of the SISA.

The ATO notes APRA's view as expressed in paragraphs 61 and 62 of *Superannuation Circular No. II.D.6*:

> **Joint investments with related parties**
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> 61. The SLAA4 [Superannuation Legislation Amendment Act (No 4) 1999] amendments clarified that a fund could invest in property with a related party on a tenants in common basis without the investment being classed as an in-house asset (section 71(1)(i)). While the borrowing restrictions prevent a fund from charging assets, the prohibition does not extend to the other titleholder. In APRA's view, it would be more prudent for a trustee to refrain from investing as a tenant in common where the related party intends to use its investment in the property as security against borrowings.
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> 62. In considering a joint investment when formulating the investment strategy of the fund, a trustee should weigh any risk that the strategy would be subordinated to the circumstances of the other party, for example, in respect of a forced sale of the property where the other titleholder is required to liquidate its assets. While effectively a forced sale would only be in respect of the other tenant's share, it is commercially more realistic to expect that the whole property would have to be sold in such circumstances. In APRA's view, an appropriate protection would be to obtain in writing the agreement of the lender that the fund's share of the proceeds of any forced sale would receive priority and are therefore not, indirectly, subject to any charge.

Meeting discussion

No comments were received on the answer's content. The member who raised the question explained that different approaches were being taken within the self managed superannuation fund sector of the industry so the purpose in asking was to have a statement from the regulator of self managed superannuation funds.

Sections within 6. Technical questions raised by members

Last Modified: Thursday, 4 August 2011