

Borrowing in your SMSF



Super funds have been restricted from borrowing money for many years. The reason is that the legislators thought that if super funds were allowed to borrow money, they could subject the fund's assets to an unacceptable level of risk.

In September 2007 there were changes to the SIS Act that now allow instalment warrant financing arrangements, now referred to as Limited Recourse Borrowing Arrangements (LRBA) subject to certain rules. This legislation was enhanced and reviewed in 2010, and further clarified in 2012 by the ATO.

Benefits of borrowing in your SMSF

The use of an LRBA allows SMSF Trustees to gear investments via super. Shares, property and any assets that can ordinarily be purchased by a super fund can form part of a gearing strategy.

This effectively enables Trustees to increase the value of the assets in super and access certain types of assets such as property that they may not be able to purchase in full. Any assets that are held until pension mode prior to disposal can enjoy the benefit of zero capital gains tax payable on the capital gain.

Key Rules

- The loan must be for a single acquirable asset
- The asset must be held on trust for the fund
- The SMSF must have beneficial ownership of the asset
- The fund has the right to acquire legal ownership of the asset after one or more loan repayments
- The rights of the lender against the trustee (either directly or indirectly) are limited to the rights relating to the acquirable asset and any personal (non-super) assets the trustee may offer as guarantee
- The acquisition of the asset must meet the criteria of the sole purpose test – that the investment has the ultimate goal of providing for retirement
- The acquisition must satisfy the acquisition rules.

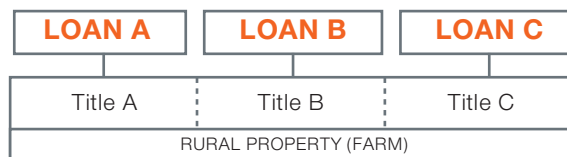
What is a 'single acquirable asset?'

- A collection of shares that are identical, have the same market value as each other, and are treated as a single asset (eg. a collection of the same class shares in a single company bought at one time)
- A collection of units in a unit trust that are identical
- A collection of economically equal and identical commodities (eg. a collection of gold bars)
- A property with one title
- Farming land over multiple titles may be considered as a single asset if there is a significant unifying object spread over both titles (ie. a shed).

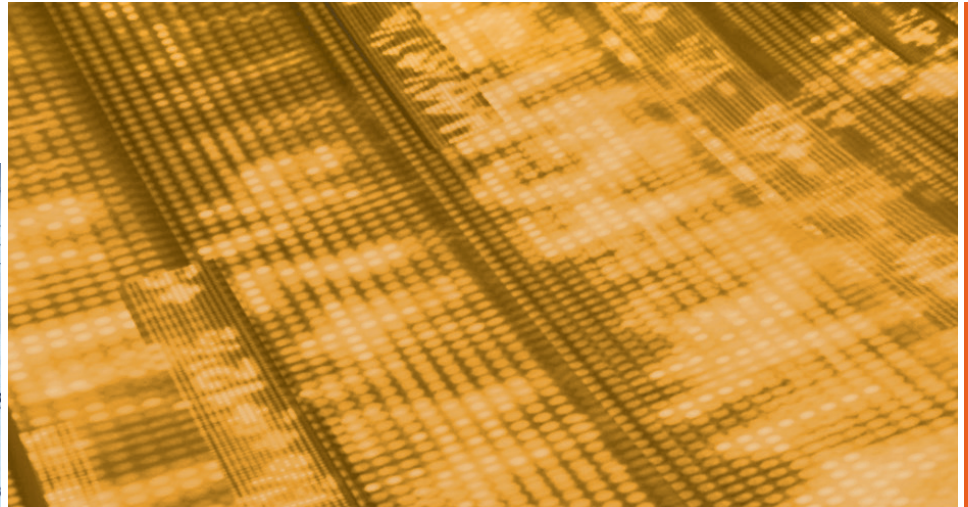
* Explanatory Memorandum: Superannuation Industry (Supervision) Amendment Bill 2010

What is not a 'single acquirable asset'

- A collection of shares in a single company that have different rights (eg. ordinary and preference shares)
- A collection of units in a unit trust or different classes that have different rights attached to them or are potentially subject to differing trustee discretion
- A collection of shares in different entities
- A collection of buildings each under separate strata title (irrespective of whether the buildings are substantially the same at the time of acquisition)
- Farming land over separate titles will not be considered a 'single acquirable asset': even if there is an inability to access one title, other than through the other title or the existence of crops, fencing or irrigation systems across multiple titles.



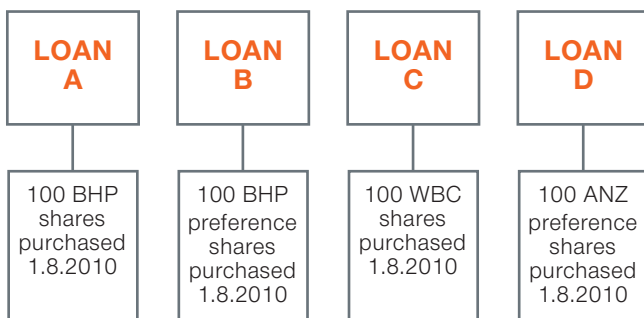
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Borrowing for Shares

- A collection of shares must be acquired and disposed of as a collection and cannot be sold down over time
- All of the shares attached to the loan must be sold as a block
- Dividend reinvestment plan – additional or bonus shares cannot be added to the single acquirable asset – would need to be transferred to the fund and invested in the name of the fund.

Example:



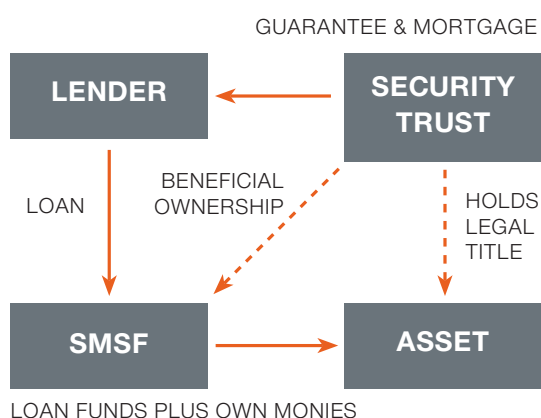
Borrowing for Property

There are key rules relating to borrowing to invest in property:

- Multiple titles under one borrowing arrangement is generally prohibited even if managed as a block, eg a single loan cannot be utilised to purchase property and a carpark attached to it if the carpark is on a separate title, unless the property and carpark are required to be dealt with together under a State or Territory law (eg. Notice of Restriction)
- Real Estate on a single title that has been purchased under an SMSF borrowing cannot subsequently be subdivided while the loan is still in place
- Off the plan (OTP) purchases using borrowings is permitted providing the construction of the building and the title registration happens prior to settlement. The balance of payment under the contract must also be due at settlement
- Repairs and maintenance can be carried out on the property, and money borrowed via the LRBA can be used to fund this. Improvements can be made to the property but they cannot be funded by the borrowings, nor can the improvement fundamentally change the nature of the asset as a whole. Therefore improvements must be funded by contributions or other super fund monies. Improvements include (but are not limited to) a second storey, extensions, addition of a swimming pool and installing a home security system. However, you must be careful not to improve the asset so much as to change the fundamental nature of it as a whole, as this is not permitted. For example, a vacant block subdivided into 2 separate blocks is a fundamental change, as is the conversion of a residential home into a restaurant and installing a commercial kitchen.
- You cannot purchase a residential property in your SMSF from a member or related party (acquisition rules).



How to Structure a Borrowing Arrangement



- The acquirable asset must be held on trust for the SMSF until the debt has been extinguished – the SMSF may then assume full legal ownership
- Acquirable asset must be the only property of the holding trust
- Complex trusts, including discretionary trusts and unit trusts, cannot be used – unlikely to satisfy the requirement that the SMSF trustee has the necessary interest in a particular asset of the holding trust, nor can the SMSF trustee be one of a number of unit holders in a unit trust
- Should not be the same trustee as the SMSF – arguably no trust (legally) if entity is holding an asset on trust for itself
- If renting property, the trustee of the security trust is to be named as the landlord
- Fund's balance sheet shows the acquirable asset and a liability (the loan)
- Any depreciation costs should appear in the fund's financial statements
- Keep records to evidence the fact that the asset is held on trust for the fund.

Which Lenders can you use?

The Lender can be a related party or a commercial bank.

A related party includes:

- Members of the SMSF who either loan the funds to the SMSF directly, or borrow from a bank to onlend to the fund
- One or more members' family trust or companies.

Related party loans need to maintain either a floating interest rate or fixed interest rate as specified and agreed by the parties, which should also be on a commercial arm's length basis.

The ATO have provided Practical Compliance Guidelines (PCG 2016/5) which clarify when a loan is considered to be maintained on arm's length terms.



Where the Lender is an SMSF Member – be mindful the interest earned by the fund member is subject to Income tax and taxed at their marginal rate of tax.

A Commercial Lender includes:

- Banks
- Financial Institutions
- Any other Individuals, trusts or companies not related to the fund.

Commercial lenders are likely to have lower lending ratios and charge commercial interest rates.

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Lending

The legal costs associated with Limited Recourse Loans vary greatly between each Financial Institution. We strongly recommend you discuss your options with a qualified Financial Planner who can assist you.

Summary

For further information relating to limited recourse loan arrangements, or to discuss how we can assist you with borrowing in your SMSF, please call us on 1300 032 020.

Important things to consider

LRBA's are highly complex, particularly when involving an SMSF and the need to satisfy all the other rules of the SIS Act including:

- the sole purpose test (s62);
- being consistent with the investment strategy of the fund (s62(2)(f));
- related party acquisition rules (s66);
- the in-house asset rules (s71);
- the arms length dealing requirement (s109);
- special income rules (if investment is in a related entity).

We recommend anybody contemplating these arrangements seek advice from a qualified Financial Planner and that trustees understand the risks and issues of introducing gearing into their funds.

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