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YourGuardian

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 Loan Arrangements) subject to certain rules. This legislation was enhanced and reviewed in 2010.

Benefits of Borrowing in your SMSF

The use of Limited Recourse Loans 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

- 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.

* 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).



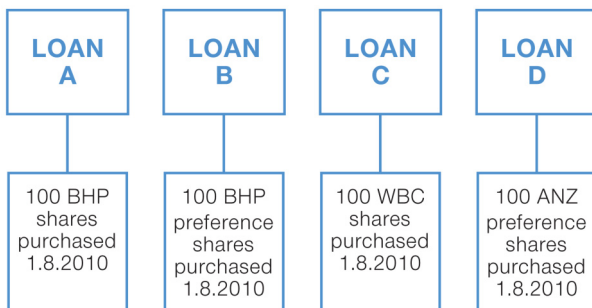
Borrowing in Shares

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:

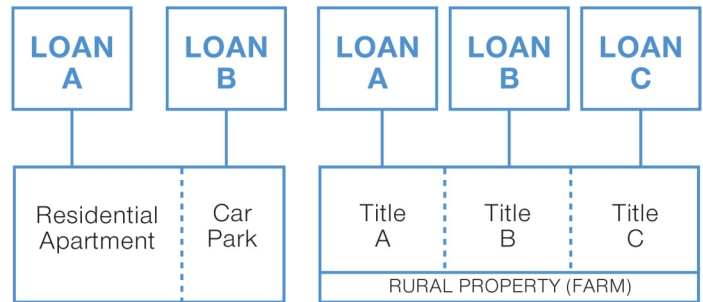


Borrowing in Property

- There are key rules relating to borrowing to invest in property:
- Multiple titles under one borrowing arrangement is 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
- 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 are generally only allowed if the property development has been completed. There are very detailed rules around OTP acquisitions and Trustees would need to seek SMSF specific advice prior to purchase.
- The underlying property cannot be improved or enhanced in anyway during the life of the loan even with personal cash or funds held outside super
- You cannot purchase a property in your SMSF from a member or related party (acquisition rules)



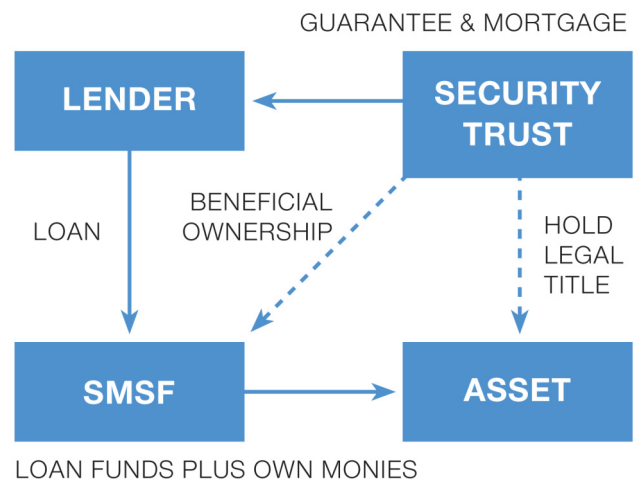
An asset purchased using a limited recourse borrowing arrangement cannot be improved in any way as this is seen as a change in the asset originally acquired by the loan, potentially increasing the risk to the fund – regardless of who provides the finance to make improvements.



Investing in Managed Funds/Trusts

- Units in a specific trust (eg a managed fund) would be permitted as long as they all had the same rights attached
- It is not possible to acquire units in a range of managed funds
- It is not possible to acquire assets via a conventional wrap structure – embedded CMT would fail the definition of a single acquirable asset

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 purchasing property, trustee of security trust 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.

What 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.



TRUSTEE TIP: Where the lender is a SMSF Fund Member – be mindful the interest earned by the fund member is subject to Income tax and may be as high as 46.5%

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.

Practical Steps to Setting up a Limited Recourse Loan Arrangement

- Step 1** Establish the SMSF or if you have an existing SMSF, ensure your trust deed allows borrowing and that the asset you wish to purchase is in line with your investment strategy
- Step 2** Identify the asset for purchase
- Step 3** Establish the Custodian Trust – usually with the aid of a specialist Lawyer
- Step 4** Choose a Lender
- Step 5** Arrange the loan agreement and mortgage upon settlement

Important things to consider

- Limited Recourse loan arrangements are highly complex, particularly when involving a SMSF and the needs 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 rule (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.

Costs Involved with borrowing in SMSF

SMSF Establishment

\$695 Fund Establishment

\$895 Corporate Trustee

SMSF Annual Fees

SuperGuardian's annual fee for a fund with one asset and limited recourse loan and a bank account start at \$1890 per annum including the independent audit.

For further information relating to our fees and charges visit www.superguardian.com.au.

SMSF Borrowing Documentation

The fees charged by many Lawyers to create the trust documentation vary greatly, however average fees are in the vicinity of:

\$1600 Related Party Finance Agreement

\$1200 Commercial Lending Agreement

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 SuperGuardian can assist you with borrowing in your SMSF please call us on 1300 787 576.

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