

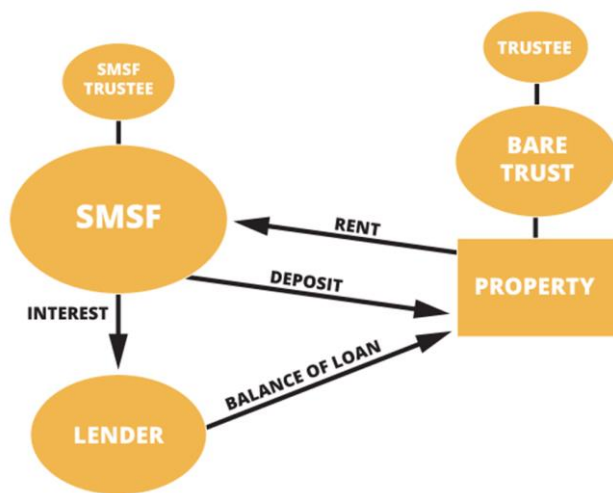
SMSF limited recourse borrowing

From July 2007, amendments to the superannuation legislation provide trustees of self-managed superannuation funds with the opportunity to borrow or gear their investments.

Despite a subsequent modification to the borrowing rules in July 2010, which introduced the concept of a 'single acquirable asset', trustees still need to be prudent in their approach to investments acquired by the fund. The investment itself must be made for the benefit of the members and must take into account other legislative requirements under the SIS Act such as the sole purpose test and the in-house asset rules and the investment must form part of the fund's valid investment strategy.

SMSF LRBA structure

Typically, a limited recourse borrowing arrangement can be illustrated in the following diagram:



Characteristics of a limited recourse borrowing arrangement

- SMSF borrows money from either an unrelated third party such as a bank or a related party;
- borrowings are applied to the purchase of a single acquirable asset;
- asset being purchased is of a type allowed under SISA;
- asset is held in a separate custodian or bare trust which is the legal owner of the asset;
- SMSF only has a beneficial interest in the asset until the loan is extinguished, at which time the SMSF has a right to acquire legal ownership of the asset;
- loan is limited recourse in nature, meaning the lender has no right to any other asset of the fund other than the asset that is subject to the borrowing arrangement;
- Generally, there would be a charge or registered mortgage over the asset in instances where there is a commercial lender.

Considerations

Prior to entering into any contractual agreement trustees should satisfy the following:

- review the trust deed and confirm that the trustees are able to maintain a borrowing arrangement;
- make the necessary amendments to the fund's investment strategy incorporating the use of limited recourse borrowing arrangements;
- determine who will be the trustee of the bare trust - this may require the incorporation of a new company as the trustee cannot be identical to the trustee of the superannuation fund;
- if the borrowing is from a related party, the loan should be on an arm's length basis and its terms should be comparable to those in loans from banking or other lending institutions (see 'Safe Harbour' provisions);
- self-managed superannuation fund trustees need to complete their due diligence in relation to the lenders requirements regarding the provision of any loan - failure to do so may see the trustee purchase an asset and be unable to arrange a suitable borrowing arrangement; and
- do the trustees have the assets for the fund to meet its share of the purchase? The lender's contribution will be subject to the value of the property and their acceptable loan to valuation ratio (LVR) (see 'Safe Harbour' provisions).

Single acquirable asset

SMSF Ruling SMSFR 2012/1 has at its core the application of key concepts in relation to limited recourse borrowing arrangements. Under the ruling a single acquirable asset can include:

SMSF limited recourse borrowing

- any form of property, other than money, that the trustee is not otherwise prohibited from acquiring; or
- a collection of identical assets, each with the same market value – such as shares of the same class in a single company or units in a unit trust that have the same fixed entitlement.
- an interest rate of 5.75% (2015/16) now 5.65% (2016/17) where the LRBA is in relation to property (7.75% (2015/16) now 7.65 (2016/17) where the borrowing arrangement is in relation to shares or units) and must be updated every financial year (using May RBA lending rate)- it is possible to fix the interest rate for five years;
- the term of loan can be no more than 15 years (seven years for borrowings involving shares and units) and this cannot be reduced through refinancing;
- the maximum loan to value ratio (LVR) cannot exceed 70 per cent (an LVR no greater than 50 per cent for borrowings involving shares or units);
- there must be a registered charge or mortgage over the property or parcel of shares or units;
- repayments must be done at least monthly and must include both an interest and principal component;
- all loan documentation must be done in writing and properly executed; or
- alternatively, the loan could either be brought to an end or refinanced with a commercial lender.

Restrictions on changing the nature of the asset

Properties with multiple titles may require a separate custodian or bare trust for each title unless the contract stipulates they cannot be sold independently, for example, a city apartment with two car parks and storage facility.

The SMSF cannot borrow to develop a property (i.e. change the asset by converting it from single to multiple titles) or demolish a property and build a bigger property or two smaller properties on the one title.

'Safe Harbour' provisions – related party lender

In April 2016 the ATO released Practical Compliance Guidelines PCG 2016/5, the subject of which is ensuring the establishment of arm's length terms where the borrowing arrangement involves a related party lender. This was in response to concerns around the increase in non-commercial loans being used in respect of borrowing arrangements.

PCG 2016/5 outlines the characteristics required of a related party loan for the regulator to view such loans as being commercial and as such not create non-arm's length income (NALI) issues for the fund. With respect to related party loans, the following is required to be in place:

Documentation

SMSF Works can assist in the preparation of documentation allowing trustees to acquire property under a limited recourse borrowing arrangement inclusive of:

- checklist and guidelines for trustees
- declaration of trust (bare trust deed)
- loan agreement (if related party loan)
- minutes and trustee resolutions
- technical support
- company formation if required for trustee of bare trust

Note - The ATO has extended the 30 June 2016 deadline for SMSF trustees that have a related party loan under an LRBA to ensure that the related party loan is on commercial terms or complies with the safe harbour guidelines. This deadline has been extended to 31 January 2017, meaning the ATO will not select an SMSF for review purely as a result of it having an LRBA in place for 2014/15 or earlier years. However, the related party loan would need to be on commercial terms and loan repayments of principal and interest for the year ended 30 June 2016 would also need to be made by 31 January 2017.

The above information is of a factual nature only and should not be used or seen as specific advice.

From 1 July 2016, anyone providing personal advice must be licensed to do so with the advice being presented in a written Statement of Advice (SoA). For further information please contact your adviser or info@smsfworks.com.au

Other Factsheets on various SMSF topics are available on our website at www.smsfworks.com.au

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