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SMSFs and limited recourse borrowing arrangements: what you need to know

Setting up a limited recourse borrowing arrangement within a self managed super fund (SMSF) can allow you to gear your super and invest in asset classes, such as direct property and shares. However, the rules are complex and require specific arrangements to be put in place. SMSF trustees should therefore seek specialist advice to help them navigate these rules and to understand the risks involved.

What is a limited recourse borrowing arrangement?

A limited recourse borrowing arrangement is a specific type of borrowing arrangement that allows an SMSF trustee to borrow for investment purposes. To qualify, the borrowing must be established under an arrangement that satisfies the following criteria:

- The borrowing must be used to acquire a single acquirable asset.
- The acquirable asset must be held on trust for the SMSF so that the trustee acquires a beneficial interest in the asset.
- The trustee must have the right to acquire the legal ownership of the asset after making one or more payments.
- The rights of the lender, or any other person, against the trustee in relation to a default on the borrowing must be limited to the asset acquired with the borrowing.
- The acquirable asset must not be subject to any charge other than that provided in relation to the borrowing.
- The acquirable asset must not be replaced with another asset other than in certain specific circumstances.

Under the rules a borrowing can also be used to pay for any transaction or borrowing costs, such as legal fees, loan application fees and stamp duty, and to fund repairs and maintenance to the asset but not to improve the asset.

What is a single acquirable asset?

A single acquirable asset is defined as any single asset, other than money, that the trustee is permitted to acquire under the superannuation investment rules. A single acquirable asset may also include a collection of identical assets that are bought and sold as a whole.

Examples of a single acquirable asset include:

- A property on a single title.
- A collection of shares of the same class in a single company that are bought and sold as a single unit.
- A collection of units that have the same fixed rights in a trust that are bought and sold as a single unit.
- A collection of economically identical commodities, such as gold bars, that are bought and sold as a single unit.

Assets that are made up of a number of different assets, such as a strata title apartment with a car space on a separate title, or farmland on several parcels of land on different titles, will generally not qualify as a single acquirable asset unless they are distinctly identifiable as a single asset. Factors that are relevant in determining whether multiple assets can be treated as a single asset include the existence of a building across two or more land titles or whether there is a state or territory law that requires the assets to be dealt with together. For more information on what qualifies as a single acquirable asset, please speak to your financial adviser.

The requirement for a separate trust

Under the limited recourse borrowing rules, the asset acquired with the borrowing must be held on trust so that the trustee of the SMSF acquires a beneficial interest in the asset. This means that the SMSF trustee will not be permitted to hold the legal title of the asset and that a separate trust will be required to be established to hold the asset until the borrowing arrangement comes to an end. However, as the beneficial owner of the asset, the SMSF trustee will be entitled to all the income, such as rent, generated by the asset.

Who sets up the trust?

Depending on the lender, a SMSF trustee will either need to establish their own trust arrangement to hold the asset on behalf of the fund or the lender may provide a custodial trust arrangement as part of the loan offering. Where an SMSF trustee needs to set up their own trust arrangement the lender will generally require the documents establishing the trust to be subject to independent legal review before it will approve the loan – which may involve additional costs. For more information, please speak to your financial adviser.

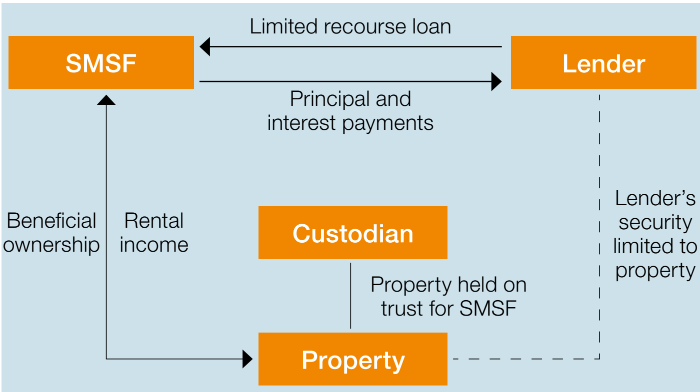
Limited recourse loan requirement

One of the main requirements of the limited recourse borrowing arrangement rules is that the rights of the lender, or any other person, against the SMSF trustee in relation to a default on the borrowing must be limited to the asset acquired with the borrowing. That is, the lender must not have any recourse to any of the fund's other assets in the event that the SMSF trustee defaults on the loan and the asset's sale proceeds are insufficient to repay the outstanding loan.

Due to the limited recourse nature of these loans many lenders will limit the amount they will agree to lend without a third party agreeing to guarantee the loan or to indemnify the lender for any losses suffered in the case of a default. For example, a lender may only lend up to 50% of the value of a residential property under a standard limited recourse loan arrangement but may agree to increase this to 80% where a third party guarantee or indemnity is provided.

Limited recourse borrowing arrangement structure

The following diagram illustrates the structure of a typical borrowing arrangement used to acquire property.



Once the loan has been repaid the arrangement can then be unwound and the legal title of the property transferred to the SMSF.

Replacement asset restrictions

Once an asset has been acquired under a limited recourse borrowing arrangement the trustees will not generally be permitted to replace that asset with another asset other than in certain limited circumstances.

For example, if an SMSF trustee acquired 100 shares in a company under a limited recourse borrowing arrangement it would not be permitted to sell those shares and then use the proceeds to acquire shares in a different company under the same borrowing arrangement. In this case, the trustee would need to use the proceeds to extinguish the loan and then establish a new limited recourse borrowing arrangement to acquire the shares in the different company.

Situations where an asset is permitted to be replaced include:

- Where a share in a company or a unit in a trust is replaced with shares or units in the same company or trust of the same market value (for example due to a share split).
- Shares or units in a different company or trust acquired due to a takeover, merger, demerger or restructure.
- Shares acquired through an instalment receipt arrangement.
- Certain arrangements relating to stapled securities or the replacement of units in a trust.

Can a borrowing be used to fund improvements to a property?

Under the limited recourse borrowing rules a borrowing can be used to maintain and repair an asset acquired with a borrowing, but not to improve an asset.

The Australian Taxation Office defines repairs as work done to make good any defects, damage or deterioration to an asset so as to restore the function of the asset without changing its character, while maintenance involves work done to prevent damage to, or deterioration of, the asset so as to maintain the asset in its present state.

In contrast, an improvement involves significantly altering the state or function of the asset for the better through substantial alterations or the addition of further substantial features.

For example, while a trustee would be permitted to draw down on a loan to pay for repairs to the structure of a building damaged by pests, fire or a storm, or to repaint a building to prevent deterioration, a trustee would not be permitted to use borrowed funds to add any new or significant features to the building, such as an additional bedroom or bathroom, as this would generally involve an improvement.

Can other monies be used to pay for improvements?

Although borrowed monies cannot be used to improve an asset the Australian Taxation Office has confirmed that money from other sources (ie non-borrowed monies) can be used to improve the asset[1]. However, this will only be possible where the scale and nature of the improvements do not fundamentally change the character of the asset and therefore effectively create a non-allowable replacement asset.

For example, an SMSF trustee may be able to use the fund's own cash reserves to renovate a residential property so long as those renovations do not involve changing the property's use from residential to commercial, or do not involve converting a single residential property to multiple properties via subdivision. For more information on what improvements can be made to a property held under a limited recourse borrowing arrangement please speak to your financial adviser.

How much does it cost to establish a limited recourse borrowing arrangement?

The costs to establish a limited recourse borrowing arrangement can be substantial and can significantly exceed the costs associated with borrowing outside super.

Some of the costs that may be incurred to establish a limited recourse borrowing arrangement include:

- The cost to obtain the required legal documentation to establish the trust structure and to set up the associated borrowing arrangements.
- The cost of getting the fund's trust deed amended to allow the fund to borrow and for an asset of the fund to be held on trust.
- The cost of changing the fund's trustee structure from individual trustees to a corporate trustee (required by some lenders).
- The cost of any loan application fees and the cost of a lender arranging to have the loan arrangement subjected to independent legal review.

1 Self Managed Super Fund Ruling SMSFR 2012/1 SMSFs: limited recourse borrowing arrangements – application of key concepts.

- The cost of any financial advice sought in relation to the arrangement (some lenders require SMSF trustees to have received independent financial advice as a condition of the loan).

Trustees may also need to consider the cost of establishing an SMSF where they do not already have one and should also factor in any additional insurance and estate planning advice that may be required where a fund has borrowed to acquire a significant asset.

Income and capital gains tax

The Federal Government has confirmed that a superannuation trustee who enters into a limited recourse borrowing arrangement for the purpose of purchasing an asset is to be treated as the owner of the asset for income tax purposes. This generally means that any income generated by the asset must be included in the fund's assessable income and that there will be no capital gains tax event when the asset is transferred back to the SMSF after the loan has been repaid. For more information on the tax treatment of a limited recourse borrowing arrangement and the tax deductibility of any associated interest costs, please speak to your taxation adviser.

Stamp duty

The SMSF trustee will generally be liable for stamp duty on any asset acquired via a limited recourse borrowing arrangement. However, concessions are available to avoid stamp duty applying a second time when the asset is transferred back to the SMSF after the loan is repaid. Unfortunately, these rules are complex and vary depending on which state the property is located. Specialist legal advice should therefore be sought to ensure the borrowing arrangement is structured to comply with the requirements of the relevant state concession.

Understanding the risks involved

Before setting up a limited recourse borrowing arrangement an SMSF trustee should review and understand the risks involved. Some of the risks associated with limited recourse borrowing arrangements include:

Compliance risk – this is the risk that the borrowing arrangement does not comply with the legislative requirements or that the trustee undertakes activities within the arrangement that would breach the superannuation borrowing rules. To manage this risk and to avoid any potential penalties, SMSF trustees should seek specialist financial advice to help them establish and maintain a complying borrowing arrangement.

Investment risk – Borrowing for investment purposes increases investment risk as it increases potential losses. Trustees should therefore ensure that they understand the risks involved and that an investment strategy that involves borrowing is appropriate given the fund's overall risk profile and the needs and circumstances of the members.

Where a fund's investment strategy also involves borrowing to invest a significant proportion of the fund's assets into a single asset, such as a residential or commercial property, the fund will be exposed to increased investment risk due to a lack of diversification. Trustees should ensure they understand the risks involved of exposing the fund to inadequate diversification and that the strategy is appropriate given the fund's overall risk profile and the needs and circumstances of the members.

Mortality risk – Where a fund has taken out a borrowing the trustees should assess what impact the death or disablement of a member would have on the fund's ability to meet its ongoing mortgage repayments. For example, if a fund relied on member contributions to service its loan the death of a member could result in the fund defaulting and being forced to sell the asset. To manage this risk the trustees should consider taking out additional insurances to allow the loan to be repaid without having to sell the asset. Please speak to your financial adviser for more information on how this strategy may be implemented.

Is a borrowing suitable?

To determine whether a borrowing strategy would be suitable for a fund the trustees will need to consider a range of issues. These include:

- whether a borrowing would be appropriate given the risk profiles of the members and the fund's overall investment objectives
- whether the fund will have sufficient cash flow to make the required loan repayments taking into account any changes in interest rates and any periods during which the members may be unable to contribute or where the fund's assets generate less income than expected
- the investment risk associated with the particular asset and the time frame of investment
- the resulting level of diversification of the fund's assets and the risks associated with inadequate diversification
- the liquidity of the asset acquired with the borrowing and whether the trustee would be able to sell the asset at short notice where required. For example to repay debt or fund benefit payments.
- the costs associated with implementing a limited recourse borrowing arrangement compared to alternatives.

What alternatives are available?

Before establishing a borrowing arrangement, trustees should consider whether there are any lower cost alternatives. For example, SMSF trustees could consider acquiring assets such as property via a tenant in common arrangement with a related party or they could invest in internally geared investment products, such as a geared share fund or instalment warrant. Speak to your financial adviser for more information on the alternatives to a limited recourse borrowing arrangement.

Other insurance considerations

In addition to considering the need to hold life and disability insurance to allow the fund to repay debt, the members should also consider the following insurances:

- general insurance, such as building and public liability insurance in respect of property
- income protection insurance to ensure a member is still able to contribute during any period they would otherwise not be able to work due to a temporary invalidity.

The importance of advice

Borrowing to invest via a limited recourse borrowing arrangement is complex and significant penalties can apply for any breaches of the requirements. It is therefore extremely important that SMSF trustees seek specialist financial advice to help them navigate the rules and to understand the risks involved.

Speak to us for more information

Count Financial is Australia's largest network of professional accountant-based advisers. If you would like to know more about self managed super funds and their borrowing arrangements, talk to a Count Financial Adviser. They can tailor an appropriate strategy to suit your individual circumstances.

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