SMSF Limited Recourse Borrowing Arrangements

Introduction

Although Self Managed Superannuation Funds (SMSFs) are normally not permitted to borrow, there are some important exceptions to this rule. One such exception, which has received plenty of attention in recent times, is an “SMSF limited recourse borrowing arrangement”, which gets its name because the rights of the lender against the SMSF trustee are limited if the SMSF defaults on the loan.

While it is true, used in the right circumstances, this strategy can assist members to grow their retirement savings, there are many risks and issues that should be considered before embarking on this strategy.

For example, careful planning is needed to ensure superannuation contributions and the fund’s investment income are sufficient to meet the loan repayments and other existing and prospective liabilities of the SMSF as they fall due. There may also be additional costs associated with acquiring an asset under a limited recourse borrowing arrangement that otherwise do not apply.

SMSF limited recourse borrowing arrangements that do not comply with the law can cause considerable problems for SMSFs. Some trustees may not be aware of the serious consequences. Some of these arrangements, if structured incorrectly, cannot simply be restructured or rectified and can result in the SMSF needing to sell the property at a substantial loss.

Given the growing focus on these strategies at seminars and in the media, and the serious consequences if the rules are not followed, we have prepared the following “SMSF limited recourse borrowing arrangements fact sheet” to help you understand the benefits and risks associated with this strategy.

Tony Oakley and Dianne Hodge, are members of the SMSF Association. This body is the pre-eminent professional association in Australia for SMSF advisers.

If you would like to learn more about SMSF limited recourse borrowing arrangements, and the benefits and risks specific to your circumstance, please contact our law firm in Melbourne or Mount Waverley.

Tony Oakley - Consultant
Accredited Specialist - Business Law

HICKS
OAKLEY
CHESSELL
WILLIAMS
Lawyers & Notary

Contact us at:

Melbourne Office
Phone: 03 9629 7411
Google Map Link

Level 14
114 William Street
Melbourne 3000

Fax: 03 9629 7422
DX: 31331 Mid-town
PO Box 16067
Collins Street West 8007

Mt Waverley Office
Phone: 03 9550 4600
Google Map Link

Central 1, Level 2, Suite 17
1 Ricketts Road
Mt Waverley 3149

Fax: 03 9544 8711
DX: 32002 Mt Waverley
PO Box 2165
Mt Waverley 3149

enquiries@hocw.com.au
www.hocw.com.au

Legal services include:
- Commercial Law;
- Commercial Litigation;
- Commercial Tenancy Law;
- Family Law;
- Wills & Estates;
- Property & Conveyancing

06/2019

What is an SMSF limited recourse borrowing arrangement?

A Self Managed Super Fund (SMSF) limited recourse borrowing arrangement typically involves an SMSF taking out a loan from a third party lender or from a related party, such as a member of the fund. The SMSF then uses the loan, together with its own available funds, to purchase a single asset (normally a residential or commercial property) that is held in a separate trust.

The SMSF trustee acquires a beneficial interest in the asset with the trustee of the separate trust being the legal owner of the asset. The SMSF trustee has a right to acquire legal ownership of the asset by making one or more payments. Any investment income received from the asset goes to the SMSF and if the SMSF defaults on the loan, the lender's rights are limited to the asset held in the separate trust. This means there is no recourse to the other assets held in the SMSF.

What are the key benefits?

- **Leverage your superannuation savings**
  An SMSF limited recourse borrowing arrangement allows your SMSF to borrow for investment purposes. Borrowing to invest or "gearing" your superannuation savings in this manner enables your fund to acquire a beneficial interest in an asset that your fund may not otherwise be able to afford (it could be business premises you own or operate your business from).

  Although your SMSF is not the legal owner of the asset, your SMSF acquires a beneficial interest in the purchased asset, meaning your fund is entitled to receive all of the income (such as rental income) derived from the asset. Your SMSF is also entitled to receive any capital gains when the asset is sold.

- **Tax concessions**
  Investment income received by your SMSF, including any income received because your fund holds a beneficial interest in an asset acquired under a limited recourse borrowing arrangement, is taxed at the concessional superannuation rates.

  If your fund is in the accumulation phase, this means the income received from the asset will be subject to no more than 15% tax. This could result in your fund paying considerable lower rates of tax on the income received compared with owning the asset in your own name or under a company or trust structure.

  Furthermore, if the income received from the acquired asset is being used to support the payment of one or more superannuation income streams from your fund, the income, including realised capital gains, is exempt from tax in your fund.

- **Asset protection**
  Generally superannuation assets are protected against creditors in the event of bankruptcy. This protection extends to assets that the superannuation fund has acquired a beneficial interest in. Therefore, structuring the acquisition of an asset under a limited recourse borrowing arrangement may provide greater asset protection benefits than may otherwise be the case.

What are the key risks?

- **Only certain assets can be acquired**
  Only assets that the SMSF trustee is not otherwise prohibited from acquiring can be purchased under a limited recourse borrowing arrangement. Generally, this means assets that you or a related party currently own cannot be acquired under a limited recourse borrowing arrangement. However, some exceptions do apply to business premises and listed securities that you or a related party own.

- **Single Asset**
  It is also a requirement that the asset acquired under a limited recourse borrowing arrangement is a single asset. This generally means shares in a single company that have identical legal rights or a property that has been constructed on a single legal title. In some situations properties constructed across one or more legal titles can still be considered a single asset under a limited recourse borrowing arrangement but only if there is a physical object (such as a building), or there is a State or Territory Law that prevents the separate legal tiles from being sold separately.

SMSF Limited Recourse Borrowing Arrangements

- **Penalties**
  If an SMSF acquires an asset that does not meet the above rules, the SMSF trustees may be required to sell the asset at a substantial loss to the SMSF. The SMSF trustees may also be subject to monetary penalties and other sanctions for breaching the superannuation borrowing rules.

- **Property alterations and funding improvement costs**
  Assets acquired under a limited recourse borrowing arrangement cannot generally be replaced with a different asset. In a practical sense this means, during the life of the loan, alterations to a property acquired under a limited recourse borrowing arrangement cannot be made if it fundamentally changes the character of the asset. For example, property alterations that have the effect of changing the character of a property from a residential to a commercial property during the life of the loan are not permitted. However, alterations or improvements to the property that have the effect of improving the functional efficiency of the asset, but do not change the character of the asset, are permitted provided they are not funded by borrowed funds.

  Maintenance and repair costs associated with the acquired asset can be funded from borrowed funds, including a drawdown from the loan used to acquire the asset.

  SMSF trustees may be subject to monetary penalties and other sanctions if the replacement asset rules are breached.

- **Costs**
  There may be additional costs associated with acquiring an asset under a limited recourse borrowing arrangement that otherwise do not apply. For example, an SMSF limited recourse borrowing arrangement requires a separate trust to be established and the drafting of separate legal instruments such as trust deeds and company constitutions (if the trustee of the separate trust is a corporate trustee). Financial institutions may also charge for vetting your fund's trust deed, and the limited recourse nature of the loan can mean a higher rate of interest.

- **Sole Purpose**
  Investments in collectables such as artwork, jewellery and vehicles must be for genuine retirement purposes and not for present day benefits. The fund must be maintained for the sole purpose of providing retirement benefits to the members or dependants. A beach house for family use fails the 'sole purpose test'.

- **Liquidity**
  Loan repayments are required to be deducted from your fund. That means your fund must always have sufficient liquidity to meet the loan repayments. Careful planning is needed to ensure contributions and the fund's investment income are sufficient to meet the loan repayments and other existing and prospective liabilities as they fall due. This is particularly important if the property is not able to be leased for any period of time, or one or more members are in the pension phase (due to the requirement for the fund to also meet minimum pension payment requirements).

  Even for members in the accumulation phase, the contribution caps impose limits on the contributions that can be made on a tax concessional basis. This may limit the tax effectiveness of the limited recourse borrowing arrangement if non-concessional contributions are required to fund the loan repayments because the member's concessional contribution cap has been utilised already.

  It is also important for SMSF trustees to consider the need for life insurance should one or more contributing members of the fund die. Careful drafting of the fund's trust deed is required to ensure the proceeds of a life insurance policy, in this scenario, can be used by the SMSF trustee to repay the loan.

  If the SMSF trustee defaults on the loan, the lender may take possession of the asset and sell the asset with the SMSF trustees receiving the sale proceeds less the outstanding loan amount. If there is a shortfall between the outstanding loan amount and the sale proceeds received, the lender will not have recourse to any other assets of the SMSF. However, a guarantor (if there is one) may be called on to make up the shortfall.

HICKS
OAKLEY
CHESSELL
WILLIAMS
Lawyers & Notary

Contact us at:

Melbourne Office
Phone: 03 9629 7411
Google Map Link

Level 14
114 William Street
Melbourne 3000

Fax: 03 9629 7422
DX: 31331 Mid-town
PO Box 16067
Collins Street West 8007

Mt Waverley Office
Phone: 03 9550 4600
Google Map Link

Central 1, Level 2, Suite 17
1 Ricketts Road
Mt Waverley 3149

Fax: 03 9544 8711
DX: 32002 Mt Waverley
PO Box 2165
Mt Waverley 3149

enquiries@hocw.com.au
www.hocw.com.au

Legal services include:
- Commercial Law;
- Commercial Litigation;
- Commercial Tenancy Law;
- Family Law;
- Wills & Estates;
- Property & Conveyancing

LAW INSTITUTE OF VICTORIA SPECIALIST ACCREDITATION

06/2019

- **Loan documentation and purchase contract**
  The Australian Taxation Office has become aware that certain limited recourse borrowing arrangements entered into by SMSF trustees have not been structured correctly. Some of these arrangements cannot simply be restructured or rectified and unwinding the arrangement could require that the property be sold, causing a substantial loss to the fund.

  To comply with the rules, the asset purchased under the limited recourse borrowing arrangement must be acquired in the name of the Security Trust with the SMSF trustee acquiring a beneficial interest in the asset pursuant to the terms of the Security Trust Deed. The terms of the loan must be on a limited recourse basis with the lender having no access to assets of the fund if the SMSF trustee defaults on the loan.

- **Tax losses and capital gains**
  Any tax losses which may arise because the after-tax cost of the property exceeds the income derived from the property are quarantined in the fund. This means the tax losses cannot be used to offset your taxable income derived outside the fund. Similarly, the value of a property acquired under a limited recourse borrowing arrangement cannot be used as security for other loans, meaning the value of the property, including the equity built up over time, cannot be used to purchase further properties outside the fund.

- **Governing rules and other matters**
  Trustees should always consider the quality of the investment they are making and whether entering into a limited recourse borrowing arrangement is consistent with the investment strategy of the fund. The governing rules of an SMSF must allow the trustee of the fund to borrow before any limited recourse borrowing arrangement can be entered into. Investments that are not consistent with the fund’s investment strategy, or are not permitted by the fund’s governing rules, could result in an action for recovery of loss or damage suffered by a person with a beneficial interest in the fund.