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Limited Recourse Borrowing Arrangements

Self-managed superannuation funds (SMSFs) are popular with people who like to have direct control over their savings. One of the benefits of an SMSF is that they allow you to invest in ways that are not always possible through other super funds.

An SMSF, like all types of superannuation funds, must operate within strict rules set by the government. One example of this is the Superannuation Industry (Supervision) Act that generally prohibits a trustee of a superannuation fund from borrowing money.

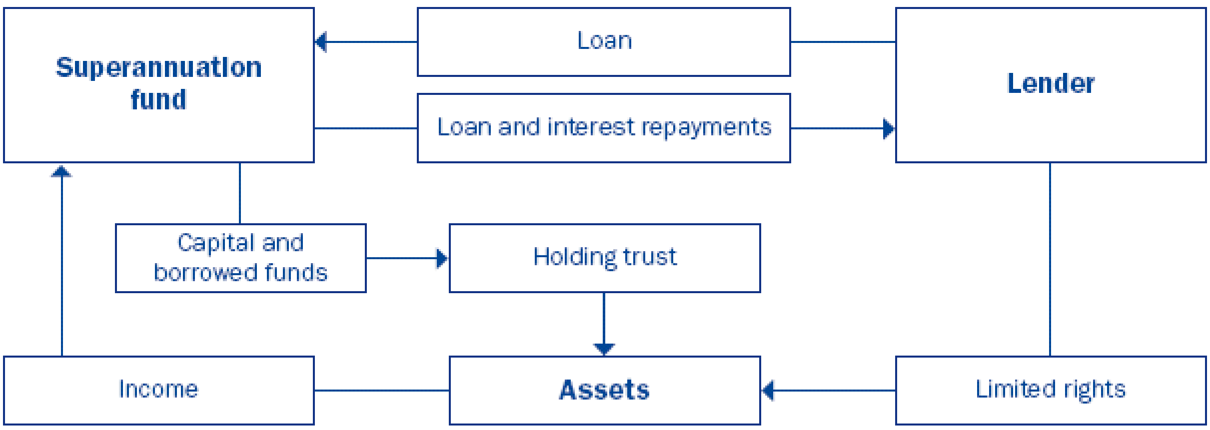
Amendments to the legislation have made it possible for a super fund trustee to borrow money to acquire a beneficial interest in an asset. This includes self-managed superannuation funds. This means that if you are a trustee of your own SMSF, you can enter in an agreement to borrow money to purchase an investment asset. This legislation refers to this as a ‘limited recourse borrowing’ arrangement.

What is a limited recourse borrowing arrangement?

The limited recourse borrowing arrangement permitted via an SMSF is a complicated matter. However, in simple terms, it involves the super fund trustee borrowing money to acquire an interest in an asset. This acquired asset must be held on trust for the SMSF trustee, who is the beneficial owner of the asset. The SMSF trustee will have a right, but not an obligation, to acquire legal ownership of the asset once the loan is repaid.

To meet the legislative requirements, the borrowing must be a ‘limited recourse’ arrangement. This means that in the event that the trustee defaults on the loan the lender’s right are limited to the particular asset only.

The diagram below outlines the limited recourse borrowing arrangement.



How do I set up a limited recourse borrowing arrangement?

To set up a limited recourse borrowing arrangement, you will need to seek the assistance of a qualified professional to help with the legal paperwork. The table below sets out the steps you will need to follow:

Setting up a limited recourse borrowing arrangement	
Ensure the trust deed of your SMSF allows for it	• The trust deed of an SMSF outlines the parameters within which the SMSF must operate. • If you want to set up a limited recourse borrowing arrangement, the SMSF's trust deed must allow it. • The investment made through the limited recourse borrowing arrangement must also be allowed by the SMSF investment strategy.
Identify the asset to be acquired	• You should look at the asset's expected capital growth, the anticipated net income, as well as how it fits with the other assets within your SMSF.
Establish the holding trust	• The trustee of the holding trust will be the legal owner of the asset. This will need to be someone other than the trustee of the SMSF. • The SMSF will have a beneficial interest in the asset, but does not hold the legal ownership of the asset until the loan is repaid. • You will need the help of a qualified legal professional to draw up the documentation to set up the trust.
Obtain a loan to purchase the asset	• The SMSF trustee must arrange a loan to buy the asset. • The loan must be a limited recourse loan to ensure that the super laws are met. • You will need to factor stamp duty and other costs into the purchase price. • You can borrow the funds from a financial institution who offers this type of arrangement. • Alternatively, you can obtain the funds through related party borrowing. There are certain conditions and rules regarding this type of borrowing.

Purchasing the asset	• The SMSF will need to provide the following amounts to allow it to buy the asset:
	  ◦ Loan proceeds
	  ◦ SMSF's contribution
	• The total of these two amounts will be equal to the purchase price of the asset, plus expenses.
	• The asset to be purchased must be a single acquirable asset (see below).

Income and tax deductions are received by the SMSF	• Once the asset has been acquired, your SMSF receives all of the income from the asset and be entitled to any associated tax deductions.
Acquiring the asset	• Once the loan is repaid, the SMSF trustee has the right, but not the obligation to acquire the asset. • You will need to seek legal advice to minimise stamp duty and capital gains tax.

What assets can be purchased using a limited recourse borrowing arrangement?

While the asset itself can generally be any asset that the fund would ordinarily be allowed to purchase, it will need to meet the definition of a single acquirable asset.

Further, when considering a property purchase, there is no restriction on the type of property that can be acquired under a limited recourse borrowing arrangement. That is, the property could be either a residential or commercial building. However, if the property is to be acquired from a related party, it is critical to remember that the property must satisfy the definition of business real property. If the property fails to meet this requirement the fund will not be permitted to acquire the property from a related party.

In the context of a share investment, it is possible for a collection of shares to be regarded as a single asset where all the assets in that collection are identical, have the same market value, and are treated as a single asset. That is, they are bought and sold together as a collection.

It is also important to note that the trustee must ensure the rules that apply to SMSF's are still met. These include:

- the in-house asset rules
- arm's length rules
- rules relating to the acquisition of assets from related parties, and
- the sole purpose test.

The fact sheet on Self Managed Superannuation Funds contains more information on these rules.

When entering into a limited recourse borrowing arrangement, the investment and the borrowing must be permitted under the fund's trust deed and in accordance with the fund's investment strategy.

What are the benefits of a limited recourse borrowing arrangement?

- Using a limited recourse borrowing arrangement (and borrowing money) may allow you to buy assets that are otherwise unaffordable for your SMSF.
- Your SMSF will receive all of the income and deductions, without having to fund the entire purchase price upfront.
- Purchasing an asset where only a deposit is initially paid out of the fund's assets, rather than one lump sum, can leave money in your fund to invest in other assets.

- Growth of the asset occurs in the concessionally taxed superannuation environment. Capital gains tax is limited to a maximum of 15%.
- There is no risk to your other fund assets if the value of the underlying asset fails.
- Building your savings in superannuation may protect them in the event that you go bankrupt.
- If you default on the loan, the rights of the lender (and any other person) are limited to the rights of the underlying asset, that is, no other assets within the SMSF are accessible to the lender.

What are the disadvantages of a limited recourse borrowing arrangement?

- Limited recourse borrowing arrangements are complex and require the assistance of suitably qualified professionals. As such, they will typically be more expensive than a typical non-SMSF property loan to put in place.
- If the strict requirements of the limited recourse borrowing arrangement rules are not met, this could result in severe penalties for your superannuation fund.
- If the asset does not perform as expected, the losses will be magnified. This is because you have borrowed money to purchase the asset and, even though the asset reduces in value you still have to continue making loan repayments. This means that the loan will represent a greater proportion of the asset's value.
- Circumstances may change. The fund may not be able to meet the loan repayments. If this happens, the holding trust may be forced to sell the investment at an inappropriate time.
- This type of arrangement is based on current laws and regulations. These may change in the future which could affect the success of your SMSF.
- If interest rates rise during the period in which you hold the loan, your cost of borrowing increases. This requires extra cashflow, but also means you require a greater return on your investment to cover the costs. If interest rates rise dramatically and you are unable to afford the payments, the fund may be forced to sell the investment at an inappropriate time, such as when it is valued at less than the amount outstanding on the loan.
- There are restrictions on the type of work that can be carried out on a property while the limited recourse loan is still in place. For example, a vacant block of land could not be built on, nor sub-divided, while the loan is still in place.
- There are restrictions with regards to the types of assets you can purchase. Borrowing arrangements put in place after 7 July 2010 requires that the borrowed funds be used to purchase a 'single acquirable asset'.

  In the case of direct property, this means that you can only purchase a property on a single title. A collection of buildings under separate strata titles, or an apartment complex would not be permitted under these provisions. In the case of direct shares, this means that you can only purchase a collection of shares of the same type in a single company. Separate arrangements must be used for shares in different companies or different classes of shares in a company.

Loan terms

There are typically two methods of funding a limited recourse borrowing arrangement - through a financial institution or via a non-commercial (often related) party, such as a member of the fund.

Where a loan is provided by a non-commercial lender or related party, the loan terms must be consistent with a commercially available loan, otherwise penalty tax rates may apply.

In order to determine whether such a loan is on commercial terms, there are broadly two options available:

- **Benchmarking:** Obtain documentation from commercial lenders that detail commercial terms and align the terms of the borrowing arrangements accordingly. However, it should be noted that this method does not provide certainty that the ATO will assess the terms as being on an arm's length basis.
- **Safe Harbour:** Structuring the LRBA in line with the ATO's 'Safe Harbour' terms. This method does provide certainty that the ATO will assess the terms as being on an arm's length basis.

The details of these arrangements can be found via the ATO on:

https://www.ato.gov.au/law/view.htm?DocID=COG/PCG20165/NAT/ATO/00001

You should seek expert legal advice to ensure that the loan agreement is properly drafted and that the terms of the loan are properly documented.

Is this type of arrangement for me?

If you are considering a limited recourse borrowing arrangement using your SMSF, it is important that your fund has enough money available to cover the cost of borrowing, rather than having to rely solely on investment income to meet the interest costs of your loan. Investment income may be irregular and your interest payment may be due before the income is received.

Providing personal guarantees

There may be situations where your lender will ask you (in your personal capacity), or a related party of yours (such a family member, trust or company structure for instance), to provide a personal guarantee before they will allow you to borrow via the SMSF.

Providing a personal guarantee to the lender means that you consent to your personal asset(s) being used as collateral for the SMSF's borrowing. This means that the lender is able to recover the amount owed by selling the asset(s) used as collateral where the SMSF does not meet its repayment obligations and the terms and conditions of the personal guarantee.

To illustrate how a personal guarantee may be called upon in practice, let's look at the following SMSF example – Brown Family Super Fund.

- Investment property purchase price: $500,000
- Limited recourse loan (80% LVR) – interest only: $400,000

Unfortunately, two years after the Brown Family Super Fund bought the investment property the market suffered a downturn of 30%. This caused the value of the property to fall to $350,000.

At this time, the SMSF was unable to meet its loan repayments, and the bank called in the loan on the investment property. To pay out the loan, the SMSF was forced to sell the property, however the SMSF still owed the bank $50,000 (loan value less sale price) plus recovery costs.

In these circumstances, the bank is able to sell the personal asset which had been provided as a guarantee to recover the remaining $50,000 loan.

Seek advice

If you are considering a limited recourse borrowing arrangement using your SMSF, it is important that you have met with a qualified legal practitioner to ensure that:

a) your SMSF trust deed allows this type of arrangement; and

b) you fully understand how the arrangement works and what your legal, tax and administrative obligations will be.

A limited recourse borrowing arrangement through an SMSF is a complicated strategy and should not be entered into lightly. We are more than happy to discuss the advantages and disadvantages of this type of arrangement and how it may be appropriate for your own circumstances.

If this sounds like something you need to explore, or review what you already have, please feel free to fill in the form here: https://www.fasttrackwealth.com.au/contact-us/

Or contact Adam on 07 3263 4123.