

Self-Managed Super Fund: limited recourse borrowing arrangements

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When dealing with limited recourse borrowing arrangements (LRBAs), it is important to understand the consequences that may arise where the LRBA is not implemented and maintained on a proper basis by a self-managed super fund (SMSF).

An SMSF can invest in a range of asset classes as prescribed in its investment strategy. It is the only retirement vehicle that allows its members to hold real property within their fund. In some instances, what draws people to have an SMSF is the attraction of being able to utilise their super balance and borrow money to purchase a real property. However, it is important to note that a SMSF can generally only borrow under an LRBA as prescribed by the superannuation law.

What is an LRBA?

An LRBA involves a SMSF trustee taking out a loan from a third-party lender. If the loan is from a related party, the loan term must not exceed 15 years. The ATO also places additional conditions on the loan arrangement, to ensure it remains an arm's length transaction. These restrictions do not apply to loans from commercial lenders.

The borrowed amount can only be used to purchase a 'single acquirable asset' (asset) which includes a property (residential or commercial) or a collection of identical assets that have the same market value to be held in a separate trust.

Generally, when a borrower defaults on loan repayments, the lender often has access to other assets owned by the borrower. With an LRBA, if the loan defaults, the lender's right is limited to the asset held in the separate trust. This means there is no recourse to the other assets held in the SMSF.

How do LRBAs work?

To facilitate an LRBA, a bare trust needs to be established. Essentially, a bare trust is an empty trust which is legally set up purely to own the asset being purchased on behalf of the SMSF. The SMSF has full beneficial interest in the asset held and receives all rental income or dividends generated.

The trustee of a bare trust must be different from the SMSF's trustee. Most lenders only provide loans to bare trusts if both the SMSF and the bare trust have corporate trustees. However, the same people can be directors of both companies.

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The SMSF makes loan repayments to the lender, covering interest and capital repayments. It also pays for maintenance, repairs, and property management fees of the asset if it is a property.

An SMSF can enter into an LRBA with a lending institution on commercial terms or, with a related party of the fund subject to satisfying safe harbour provisions outlined in ATO's "safe harbour"guidelines, which are stipulated in PCG 2016/5.

If an SMSF wishes to invest in additional assets, it will need to establish a separate bare trust with a separate LRBA for each borrowing.

One of the main attractions of borrowing to purchase shares or property within an SMSF is that capital gains are concessionally taxed. For example, a capital gain on a property held for longer than 12 months is taxed at only 10%, and in retirement pension phase any capital gains are tax free.

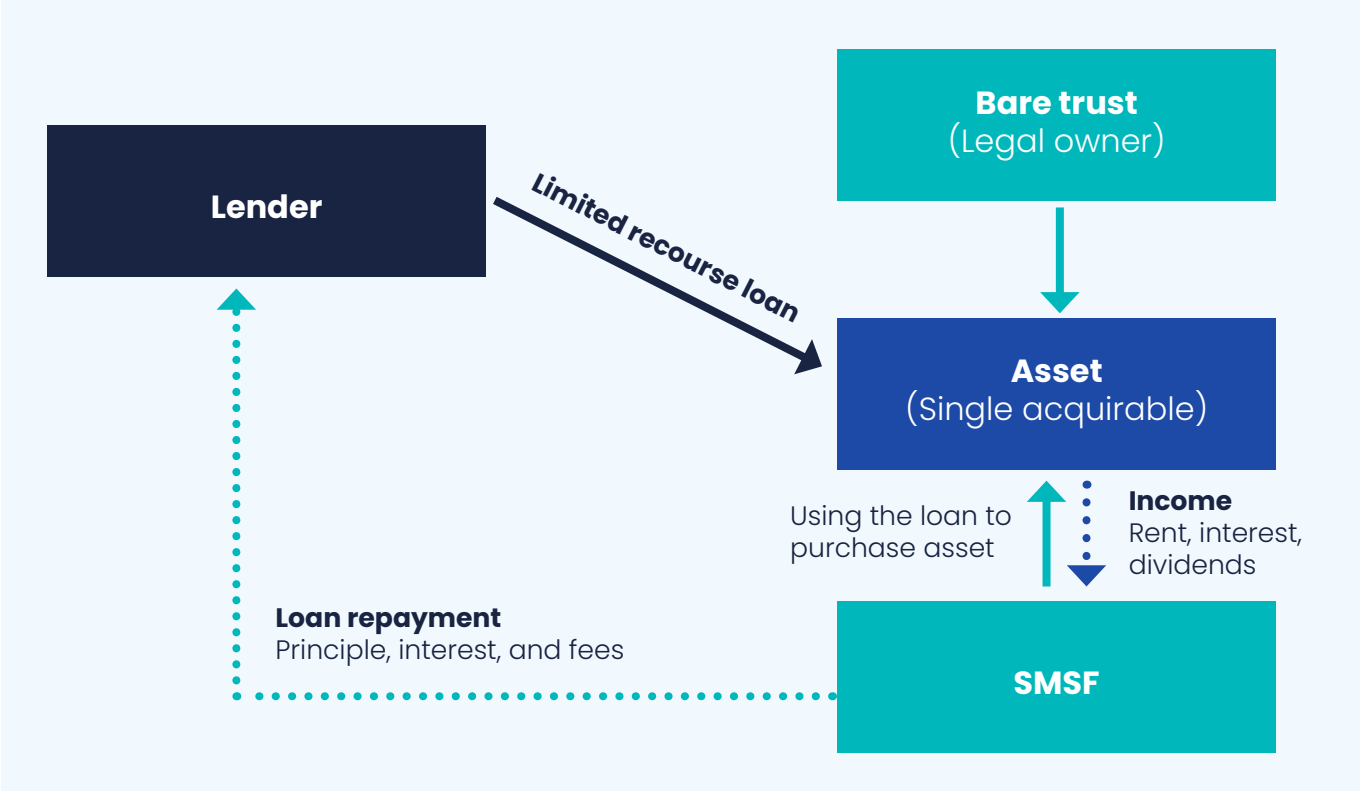
Commercial loan terms are typically from 1 to 20 years during which time the SMSF can choose to:

- Repay the loan and acquire full ownership of the asset, or
- Sell the asset and use the proceeds to repay the outstanding loan and other associated costs. Any amount leftover is retained by the SMSF.

LRBAs come with a number of legislative requirements that not only need to be met upon establishment, but for the life of the borrowing. Failure to adhere to these additional requirements can result in a breach of the LRBA which can have significant consequences for trustees and the SMSF.

For more information, refer to the ATO website www.ato.gov.au and search 'Limited recourse borrowing arrangements'.

How LRBAs work - simplified example



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Considerations

Borrowing inside an SMSF is not a simple process and professional advice is recommended.

Some points to consider:

- A SMSF can only invest in assets that meet Superannuation Industry Supervision (SIS) regulations, i.e., an asset cannot be acquired from a related party unless it is listed shares or business real property.
- A SMSF can only borrow to acquire assets if the trust deed allows it, which may require a review of the SMSF trust deed and investment strategy.
- A bare trust must be established for each borrowing/loan contract.
- Borrowed funds do not count towards contribution caps.
- The loan used to purchase the asset can only be an LRBA – which means the lender generally has no claim on any other assets in the SMSF other than the asset purchased with loaned funds. The lender may require security over assets outside of your SMSF using personal guarantees.
- You are not allowed to make significant changes to the asset acquired under an LRBA to the extent that its nature changes, e.g., sub-divide vacant land or developing vacant land into residential properties.

As part of the ongoing day to day management of an SMSF, trustees are required by law to prepare and implement an investment strategy which they must then give effect to and review regularly.

When formulating and reviewing the investment strategy, where an SMSF primarily invests in a single asset class such as property, trustees should articulate how and why this investment gives effect to the SMSF's overall investment strategy with consideration of the risks that arise due to a lack of diversification in the fund.

For more information on the value of diversification, refer to MoneySmart website www.moneysmart.gov.au and search 'Diversification'.

For more information on SMSF investment strategies, refer to the ATO website www.ato.gov.au and search 'Your investment strategy'.

When can I remove the LRBA?

An SMSF can only remove the LRBA once the loan is completely paid out. At that stage, trustees can decide if they want to keep the property in the bare trust or collapse the bare trust and transfer the property to the SMSF.

Is an LRBA right for my fund?

It is important to seek professional advice to help you decide whether a LRBA strategy is right for your SMSF. Below are some key considerations:

- Who will be the lender and what will happen to the SMSF if borrowing interest rate rise?
- What will be the set-up costs and ongoing interest and management cost of the strategy? Fees can wipe out potential profits.
- LRBAs are generally long-term investments, will your SMSF be able to maintain the loan repayments and fees over that term? Will your SMSF have enough money left over to pay the other expenses of the fund such as insurance premiums, accountant and auditor fees, and taxes?
- Consider what would happen if one of the members of the SMSF dies, wants to leave the fund or retire and take their money out? Will the SMSF have to sell the asset purchased with the loan to pay out death benefits?
- Consider what would happen if one of members of the SMSF wants to retire and start a pension? Your SMSF can still hold an asset under an LRBA while it is paying a pension to one or more of its members. However, if fewer or no contributions are made, will the SMSF have enough money available to continue repaying the loan and meets its pension payment requirements?

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- Does the asset to be acquired need to be repaired, insured, and maintained? If so, will the SMSF have the money available to pay all these costs each year?
- If the asset is a property to be leased, will the SMSF have enough money to pay ongoing maintenance and loan repayments if the property is unoccupied and no rental money is received?

What are the pros of borrowing to invest inside a SMSF?

- Your SMSF has more money invested than if it hadn't borrowed and therefore could potentially benefit from higher investment income and capital growth.
- Investment income is taxed at maximum tax rate of 15%.
- The maximum capital gains tax rate is 15% with a one-third discount if held 12 months or more.
- The asset is fully protected from future litigation and bankruptcy you or your business may face (as long as it was not placed in your SMSF for protection against a specific litigation or bankruptcy you were aware of).

What are the cons of borrowing to invest inside a SMSF?

- An SMSF which invests primarily in one asset class, e.g., property, may not actually put you in a better position for retirement, factoring the rental income and capital growth versus the loan interest and cost of the property maintenance and repairs.
- Market risk could see the value of SMSF assets decline over time.
- There is illiquidity risk if property makes up a large portion of an SMSF's total assets. If the property cannot be sold quickly in the event of a default, it may impact an SMSF's ability to meet its obligations to members, e.g., make pension payments to members.
- Borrowing itself could affect an SMSF's ability to meet member benefit obligations due to ongoing loan repayments.
- SMSF and superannuation legislation changes on a regular basis and with each successive government. It can be hard to follow these rule changes and breaches can cost trustees or directors of a corporate trustee thousands of dollars in fines depending on the size of an SMSF.
- LRBA rules prohibit any property development lending under an SMSF or within an SMSF trust structure.
- You can't use borrowed funds to improve or alter the property, as this would create a 'new asset.' However, borrowed funds can be used for repairs or maintenance on an LRBA property. For more details, check the ATO website here.

  Once the loan is repaid and the property is transferred from the bare trust to the SMSF, you can use the SMSF's cash to improve the property.

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