# Limited recourse borrowings

This flyer is designed to provide an overview of the superannuation borrowing rules and the steps involved in entering a borrowing arrangement to purchase a property.

## Overview of the rules

Superannuation funds are generally prohibited from borrowing money. There are, however, a small number of exemptions that apply, including an exemption for limited recourse borrowing arrangements. The rules that enable superannuation funds to borrow to invest are contained in section 67 of the Superannuation Industry (Supervision) Act 1993 (SIS Act). The rules can be complex and significant penalties apply if the rules are not followed precisely.

There are four conditions that must be met for limited recourse borrowing arrangements:

1. The borrowing must be applied to the acquisition of a single acquirable asset.
2. The acquirable asset must be held in trust so that the superannuation fund obtains a beneficial interest in the asset.
3. The superannuation fund has the right (but not the obligation) to acquire legal ownership of the asset.
4. The rights of the lender, or any other person, against the superannuation fund trustee in connection with default are limited to the asset (limited recourse loan).

## Singular nature of an asset

Borrowings can only be used to acquire a 'single acquirable asset' or a 'collection of identical assets'. However, determining that a particular property is a single asset can be more difficult than it may first appear.

In many instances, a property may be held under several legal titles. Often these are for historic reasons such as easements created across a property or the joining of several titles and may result in the property not meeting the definition of a single acquirable asset. A property which is built over two titles may qualify as a single acquirable asset if the property can only be dealt with as a whole. For example a factory which is built over three titles of land may qualify. Conversely, a farm which is run over three titles would generally not qualify. Even though the farm is managed as one, it could physically be managed as separate farms and would therefore not qualify.

Another common example is a residential apartment that has a car park included in the sale of the property. Where they are on separate titles they could meet the requirements if a State law prohibits the individual titles of the apartment and the car park to be disposed of separately. However, where the titles can legally be dealt with separately they will not constitute a single acquirable asset.

## Held in trust

The asset needs to be held in a holding trust, ie a trust that only holds the asset, for the duration of the loan. There are many names for these types of trusts but they are all bare trusts; they don't perform any function or transactions other than holding the asset.

Most lenders will require the trustee of the holding trust to be a corporate trustee. The trustee cannot be the same company as the SMSF corporate trustee company, however, it may have the same directors as the SMSF corporate trustee (ie the members).

## Ownership details

The registered ownership of the property should be in the name of the holding trust trustee.

## Ownership right

The SMSF must have the right to acquire ownership of the property. This requirement means that the SMSF cannot purchase a property jointly with any other party.

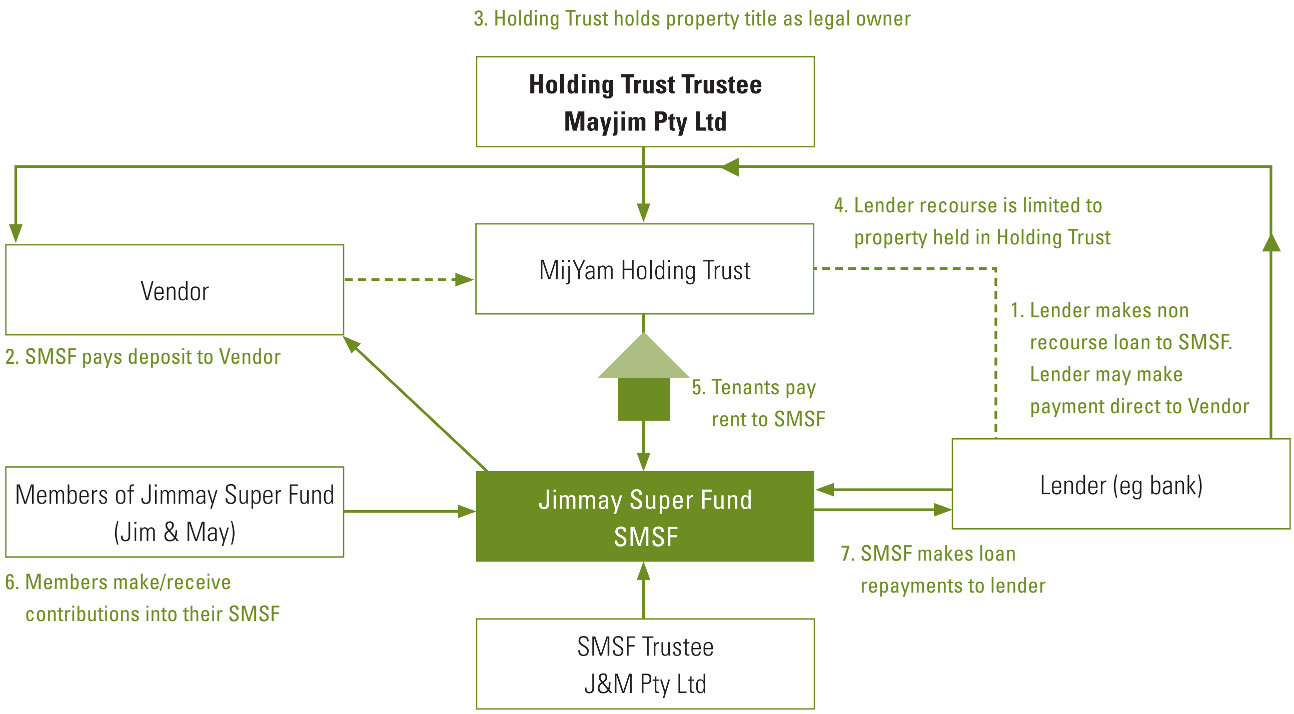
## Limited recourse

The requirement regarding the limited recourse nature of the loan means that only the asset purchased can be used as security for the loan. The limited recourse nature of the loan provides an additional layer of risk for the lender which is likely to be reflected in a higher interest rate. It is extremely important to ensure that the loan arrangement complies with this provision of the legislation. Just because the front page of a loan document is titled 'Limited Recourse Loan' doesn't necessarily mean that it is in fact a limited recourse loan.

The diagram outlines the following process:

1. The lender lends money to the SMSF
2. The SMSF uses the loan money plus a portion of the SMSF balance to purchase a property
3. The vendor transfers legal ownership of the property to the holding trust trustee
   – The beneficial owner of the property will be the SMSF
4. The SMSF charges its beneficial interest in the property to the lender
5. Tenants pay rental income to the SMSF
6. Members make contributions to the SMSF
7. The SMSF makes loan repayments to the lender

At the end of the loan term, the SMSF has the option to either sell the property and repay any remaining debt or repay the remaining debt and take direct ownership of the property.




- Jim and May are members of Jimmay Super Fund
- Jim and May are the directors of J&M Pty Ltd – the trustee of the Jimmay Super Fund
- Jim and May are directors of Mayjim Pty Ltd – the trustee of the MijYam Holding Trust

*NB: Individual steps may vary depending on lender's requirements

## Guarantees

Personal guarantees can be provided, however, they are limited to rights relating to the acquirable asset. The value of the acquirable asset is the maximum amount available from the fund upon default of the loan from the lender.

Any rights of a guarantor (or any other person) against the trustee of the fund are strictly limited to the acquirable asset. These measures ensure that no claim against the superannuation fund trustee could result in a claim on other assets of the fund.

## Understanding the basic structure

There are generally five parties involved in the limited recourse borrowing arrangement:

- The SMSF trustee (most lenders require the SMSF trustee to be a corporate trustee)
- The lender
- The holding trust trustee
- The vendor
- The members

## Replacement assets

The legislation clearly prescribes the circumstances in which an asset can be replaced. Generally, where an asset that is subject to a borrowing is sold, the loan will need to be repaid. A new loan arrangement will need to be established for any future borrowings. For example, a client purchased an apartment in their SMSF using a borrowing arrangement. The client is then presented with the opportunity to purchase a better apartment and, therefore, wishes to replace their existing apartment with the better apartment. In this instance, the client will need to sell the original apartment and extinguish the loan. A new borrowing can then be undertaken to purchase the new apartment.

Replacement assets do not include replacement:

- as a result of insurance claim proceeds for loss of original asset
- of title upon subdivision or rezoning
- by way of significant property improvement.

Property development is prohibited as the development results in the replacement of the asset with a substantially different asset. If a block of land is purchased using a borrowing, a dwelling cannot then be built on the land as this will alter the nature of the originally acquired asset – the land. This applies regardless of whether the dwelling construction is financed by a borrowing or not.

The legislation allows for an asset subject to a borrowing to be maintained or repaired using borrowed funds, but not improved. However, it may be possible to use existing fund assets to improve the asset, provided that the improvement does not change the asset such that it becomes a replacement asset.

## Insurance of assets

An issue which trustees need to consider in relation to property investments is public liability insurance. Whilst we are likely to consider this in the context of commercial properties where the public regularly visit, it is generally also needed in a residential context but is more likely to be overlooked.

A recent case regarding the death of a tradesman at a residential investment property highlights the need for trustees to ensure that adequate insurance arrangements are in place. The owner of the investment property was found to be liable for the death of a tradesman who was electrocuted when repairing a leaky roof.

## Steps involved

The steps involved in implementing a limited recourse borrowing arrangement are summarised below:

1. SMSF trustee determines that borrowing is an appropriate strategy
2. SMSF trustee ensures that the SMSF's trust deed permits borrowing arrangements (amend if necessary)
3. SMSF trustee ensures that the SMSF's investment strategy permits the acquisition of the property asset and that borrowing arrangements are permitted (amend if necessary)
4. SMSF trustee identifies the asset to be purchased
5. SMSF trustee obtains loan pre-approval
6. Change SMSF trustee to a corporate trustee if required by lender
7. Determine the holding trust trustee (establish company if necessary)
8. Holding trust trustee establishes the holding trust (pay stamp duty if required)
9. Holding trust trustee signs the purchase contract
10. SMSF trustee pays deposit
11. SMSF trustee and the lender complete loan documents
12. SMSF trustee pays legal costs and stamp duty on purchase
13. A property manager is appointed and insurance is arranged if required
14. SMSF trustee commences loan repayments
15. SMSF trustee receives rental income
16. At the end of the loan term, the SMSF has the option to either sell the property and repay any remaining debt or repay the remaining debt
17. Once the loan is repaid, ownership of the asset may be transferred from the holding trust trustee to the SMSF trustee

## Summary

If you are considering purchasing a property using the limited recourse borrowing arrangement, you need to check the fine print very carefully to make sure that things are as they seem and that the asset being acquired does in fact meet all of the strict requirements of the borrowing provisions.

## Planning considerations – tips and traps

The following points provide a reminder of planning issues that must be considered:

- Ability to finance the loan repayments
  - Particularly given the low contribution caps
- Suitability of property as an asset of the fund
  - What happens on death/divorce/incapacity?
  - Are there any additional consequences if there is a forced sale?
  - How long until clients are in pension phase and what will be the expected gearing position by then?
- Contingency plans on death
  - What happens to the ability to finance the loan and retain the property upon death?
  - Do clients have appropriate personal life insurance in place?
- Alternative purchasing strategies
  - Non geared unit trusts with a complimentary personal member gearing strategy (line of credit on the family home)
  - Traditional instalment warrants for share purchases/ property trusts

## Selecting a property – tips and traps

The following points provide a reminder of issues that must be considered when choosing the property:

- Does the property meet the definition of 'single acquirable asset'?
  - The property cannot already be owned, it must be acquired/purchased
  - Are there multiple titles?
- Does the SMSF trustee have the right to acquire legal ownership of the property?
  - The property cannot be jointly purchased
- Who is the property being purchased from?
  - Residential property may not be purchased from a member or a related party
  - Business real property may be able to be purchased from a related party at market value
- Not all commercial property is business real property
  - The property must be used wholly and exclusively for business purposes
- Who is the property being rented to?
  - Residential property may not be rented to a member or a related party
  - Business real property may be able to be rented to a related party at market value
- Property improvements
  - The property may not be improved using borrowed money
  - Improvements may be permitted using existing fund money, provided that the improvements do not change the property such that it becomes a replacement asset
  - Repairs and maintenance are permitted
- Insurance
  - Is appropriate insurance in place?
- Purchasing at auction
  - Ensure finance is pre-approved

For more information please contact your financial adviser or our client services team on **1800 254 180** or email **aetclientservices@aetlimited.com.au**



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