

SMSF LIMITED RECOURSE BORROWING ARRANGEMENTS

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We can help you from
the onset and discuss
with you key compliance
considerations

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LIMITED RECOURSE BORROWING ARRANGEMENTS



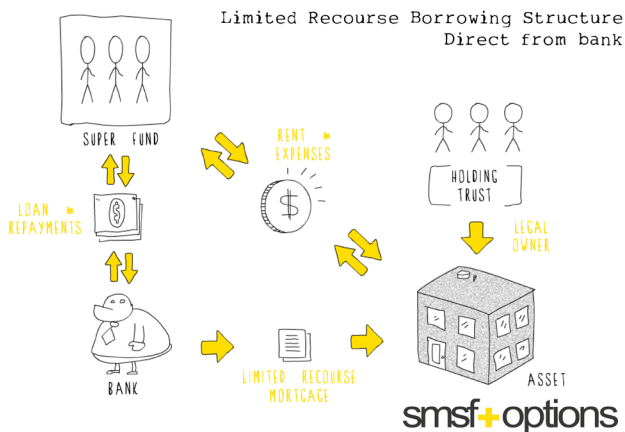
Used in the right circumstances this strategy can assist members grow their retirement savings



Self-Managed Superannuation Funds (SMSFs) are normally not allowed to borrow, there are however 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."

WHAT IS AN SMSF LIMITED RECOURSE BORROWING ARRANGEMENT?

An SMSF limited recourse borrowing arrangement (LRBA) 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 holding trust.



The SMSF trustee acquires a beneficial interest in the asset with the trustee of the separate holding 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.

IS A LRBA RIGHT FOR ME?

Used in the right circumstances this strategy can assist members to grow their retirement savings. However there are many risks and issues that should be considered carefully before embarking on this strategy.

Borrowing arrangements that do not comply with the law can cause considerable problems for SMSFs. 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 serious consequences if the rules are not followed, it is essential to seek specialist advice well before to signing a contract on a property.

HOW WE CAN HELP?

We can help you from the onset and discuss with you key compliance considerations such as:

- + Does your SMSF Trust deed allow LRBA's?
- + Can the asset be acquired?
- + What are the costs involved?
- + Are any property alterations required and are they allowed?
- + How will improvement costs be funded?
- + Can I loan the money from a related party?
- + Will the fund have sufficient liquidity?
- + What are the correct steps in setting up this structure?
- + When can I make sign a contract?
- + Are there any tax loss capital gains considerations?
- + Are there any alternative structures to purchase the asset?

We can also refer you to a financial planner specialising in this area if required.

FURTHER INFORMATION

To find out how smsf+options can assist you in setting up a LRBA, please contact your adviser below:

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LRBA FACT SHEET

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To comply with the rules, the asset must be in the name of the security Holding Trust

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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 beneficiary interest in an asset that your fund may not otherwise be able to afford (it could be a business premise 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.

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.

LRBA FACT SHEET



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.

COST

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.

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 is 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 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.

LRBA FACT SHEET



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.

OTHER ALTERNATIVES

While there are benefits and limitations of purchasing an asset via a SMSF LRBA, it is important to consider other alternatives that may be more appropriate for your needs. This may include purchasing a property via one of the following structures.

- + Tenants in Common with another party
- + Non-g geared Unity Trust & LRBA
- + A Pre 1999 Related Unit Trust
- + Unrelated Unit Trust
- + A Delayed Settlement Transaction

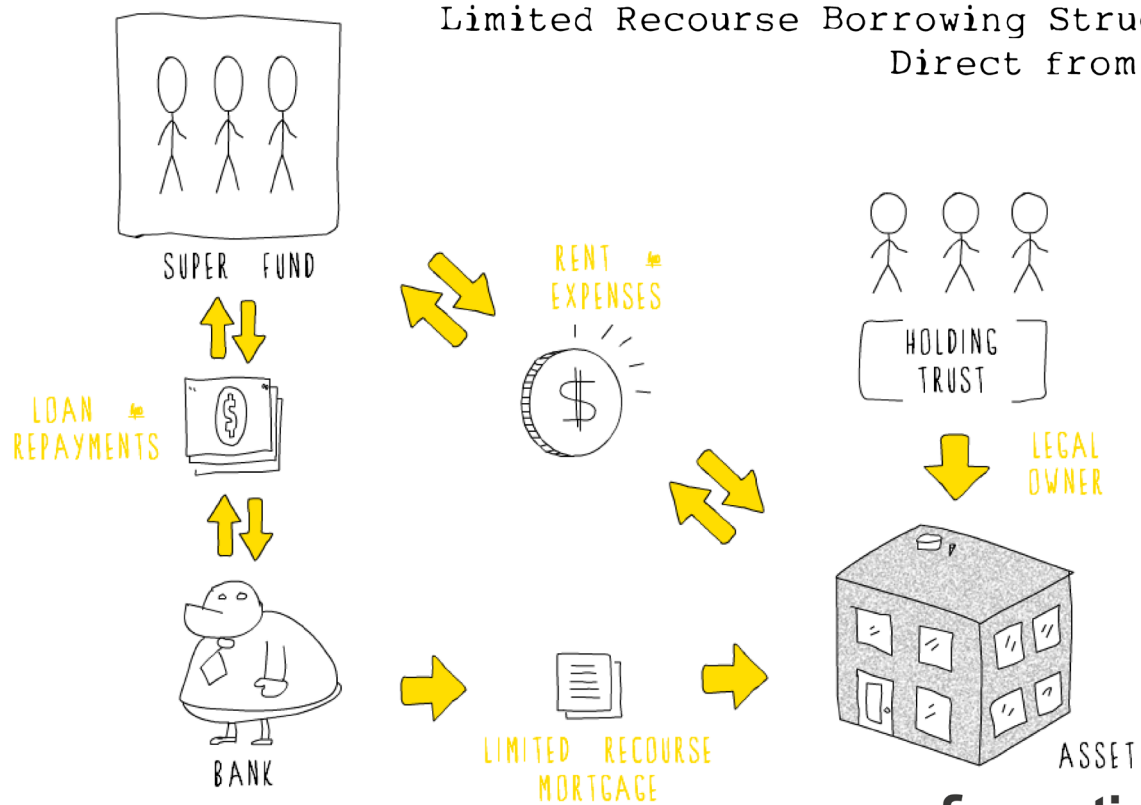
FURTHER INFORMATION

To find out how smsf+options can assist you in setting up a LRBA, please contact your adviser below:

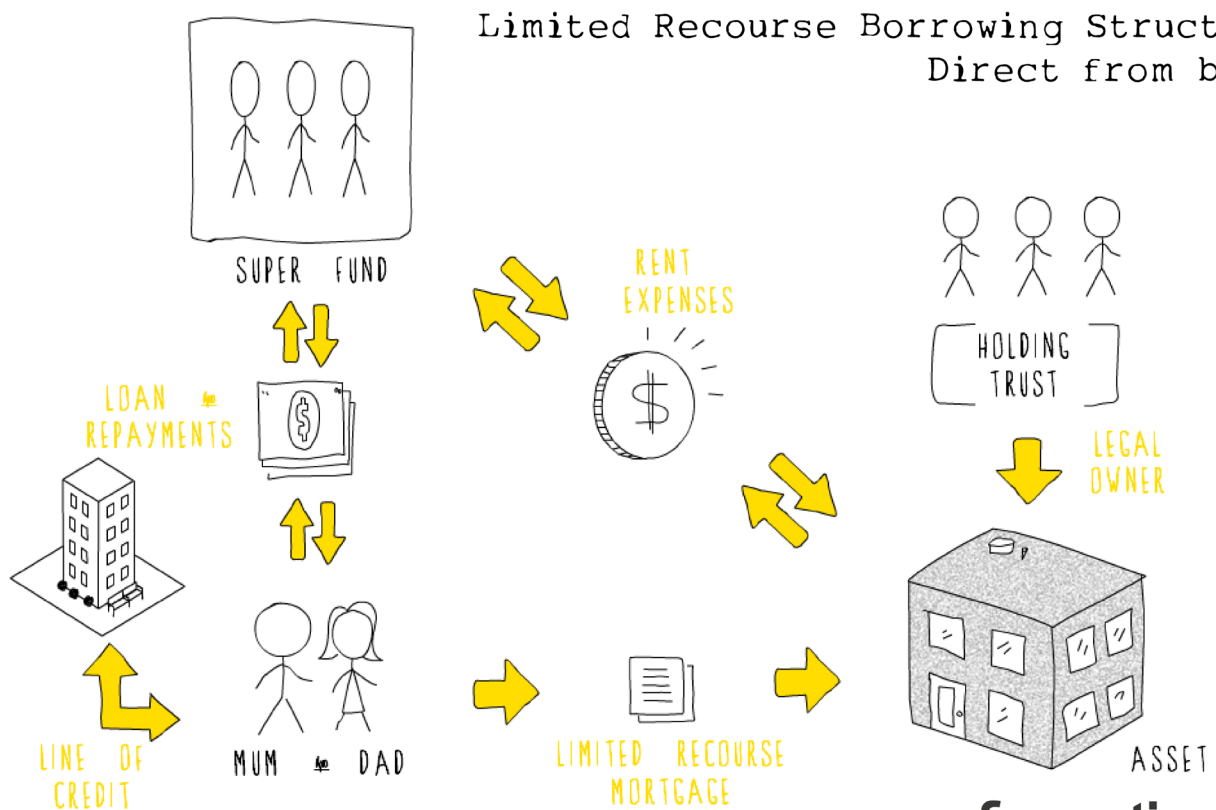
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SMSF LRBA CHECKLIST



Ticking all
the boxes



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Important note: There are a number of complex rules and regulations surrounding Superannuation, planning for retirement and SMSF Limited Recourse Borrowing Arrangements. The information provided in this checklist is a guide only, and should not be substitute for professional financial, legal or tax advice specific personalised to you situation. smsf+options will not be liable for any losses arising from reliance on this information.

Limited Recourse Borrowing Arrangement (LRBA) - Setup Steps

- Step 1 Find the Property or asset that you would like to purchase in your Self-Managed Super Fund**
The property must be a property that the Super Fund could otherwise invest in if bought outright, and must comply with the in-house asset rules and sole purpose tests. It is also a requirement that the asset acquired under a limited recourse borrowing arrangement is a single asset.
- Step 2 Meet with your specialist SMSF advisers**
Given the serious consequences if the rules are not followed, it is essential to discuss your plans with us well before to signing a contract on a property to ensure the the borrowing structure and your plans for the property are compliant with the rules.
- Furthermore, as there are a number of complex rules and regulations surrounding superannuation and planning for retirement, smsf+options recommended you seek professional financial and legal advice specific and personalised to you situation.
- Step 3 Obtain pre approval of the Loan**
This may be from a related party, bank or non bank lender as an example. The loan will be in the name of the SMSF.
- Step 4 Update the Super Fund's Trust deed & Investment Strategy if required**
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.
- Step 5 Setup the required borrowing structure**
This may include:
+ Establishing a company to act as Trustee of the Bare Trust
+ Establish the Bare Trust
+ For SMSFs with individual trustees, change the trustee of the fund to a corporate trustee. This is required by most financial institutions.
- Step 6 Sign the contract in the name of the Bare Trustee (or as required by you state revenue office).**
- Step 7 The SMSF's own lawyer/conveyancer acts on the purchase in the ordinary way.**
- Step 8 The SMSF pays the deposit, the balance purchase money (less the amount borrowed), the legal costs, and stamp duty in the ordinary way.**
- Step 9 Settle the property with the Bare Trustee as title holder**
- Step 10 The SMSF then manages the asset**
All rent, expenses and loan repayments paid to and by the SMSF.

Compliance Checklist

Is the property a single acquirable asset ?	Yes
	No >>> Compliance Breach

Is the property to be acquired from a related party?	Yes
	No

If Yes

Is the property considered business real property at the time of acquisition?	Yes
	No >>> Compliance Breach
	n/a

Will it be acquired at market value?	Yes
	No >>> Compliance Breach
	n/a

Will borrowed monies used only to: + purchase the asset + pay for expenses associated with the asset + pay for repairs?	Yes
	No >>> Compliance Breach

Do you intend to make any improvements to the property?	Yes
	No

If Yes

Will these be made with borrowed monies?	Yes >>> Compliance Breach
	No
	n/a

Will the improvements fundamentally change the charter of the asset as a whole?	Yes >>> Compliance Breach
	No
	N/a

If the loan is from a related party, are the terms of the loan commercial ?	Yes
	No >>> Compliance Breach

Will the loan be in the name of the fund and on a limited recourse basis?	Yes
	No >>> Compliance Breach

If a guarantee was provided, is the guarantors right of recourse limited to the acquired property ?

Yes

No >>> Compliance Breach

n/a

Will the contract been signed in the name of the holding trust?

Yes

No >>> Compliance Breach

Does your funds investment strategy need updating?

Yes

No

FURTHER INFORMATION

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