



CAVENDISH

Self Managed Superannuation Limited Recourse Borrowing Explanatory Notes

What are the general requirements for establishing a limited recourse borrowing arrangement under section 67A of the *Superannuation Industry (Supervision) Act 1993* ("SISA")?

1. The trustee of the self managed superannuation fund ("**SMSF**") borrows money.
2. The borrowed money is applied towards the acquisition of a 'single acquirable asset' ("**Asset**").
3. The Asset is one which the trustee of the SMSF is not prohibited from acquiring under SISA or any other law.
4. The Asset is held on trust ("**Security Trust**") for the benefit of the SMSF. That is, the trustee of the Security Trust ("**Security Trustee**") acquires the legal title to the Asset, while the trustee of the SMSF ("**SMSF Trustee**") acquires a beneficial interest in the Asset.
5. The SMSF Trustee has the right to acquire legal ownership of the Asset from the Security Trustee by making one or more payments after acquiring the beneficial interest in the Asset.
6. The rights of the lender or any other person against the SMSF Trustee for, or in connection with, default in respect of the repayment of the borrowed money (and related charges) are limited to the rights relating to the Asset only (leaving the other assets of the SMSF unencumbered).
7. The Asset is not subject to any charge, except as otherwise provided for above (at Item 6).

Step-by-step guide to establishing a limited recourse borrowing arrangement

- Step 1:** Identify the Asset that the SMSF Trustee would like to acquire pursuant to a limited recourse borrowing arrangement and confirm that the Asset is one that the SMSF Trustee is permitted to acquire under SISA or any other law.
- Step 2:** Confirm the (expected) purchase price of the Asset including stamp duty and GST if necessary, determine the amount of borrowings required and identify a lender (whether a financial institution or a related party of the SMSF).
- Step 3:** Ensure that the trust deed governing the SMSF permits the SMSF Trustee to enter into such an arrangement (e.g. the SMSF Trustee has the power to borrow, acquire assets, charge assets, appoint nominees or custodians, etc) and that the SMSF's investment strategy contemplates such an investment.
- Step 4:** Engage Cavendish whose lawyer will prepare/review/amend the following documentation:
- SMSF trust deed
 - Security Trust deed
 - Minutes of meeting of trustees
 - Loan/security documentation (if related party loan)
 - Letter of advice
- Step 5:** Proceed to acquire the Asset in the name of the Security Trustee (and not in the name of the SMSF Trustee).

Example – Bank Finance: Direct Loan Strategy

The SMSF Trustee wishes to acquire a residential investment property ("**Property**") from an unrelated party. The total purchase price of the Property (including stamp duty and transaction costs) is \$400,000.

The SMSF has \$200,000 in cash available to acquire the Property, and will borrow the remaining \$200,000 from a financial institution ("**Bank**").

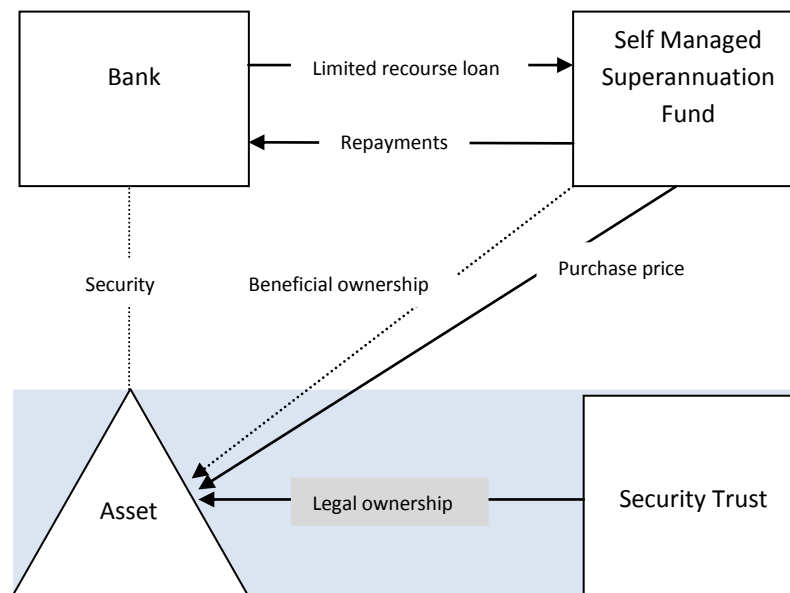
The SMSF's trust deed permits the SMSF Trustee to borrow to acquire the Property. In addition, the SMSF Trustee has reviewed and updated the SMSF's investment strategy.

The SMSF Trustee approaches the Bank to obtain a limited recourse loan and engages the services of a lawyer to prepare the relevant legal documentation (including the Security Trust deed).

A company is incorporated to act as Security Trustee. The Security Trustee signs the sale and purchase contract and uses funds provided by the SMSF Trustee to pay the deposit of \$40,000 on the Property.

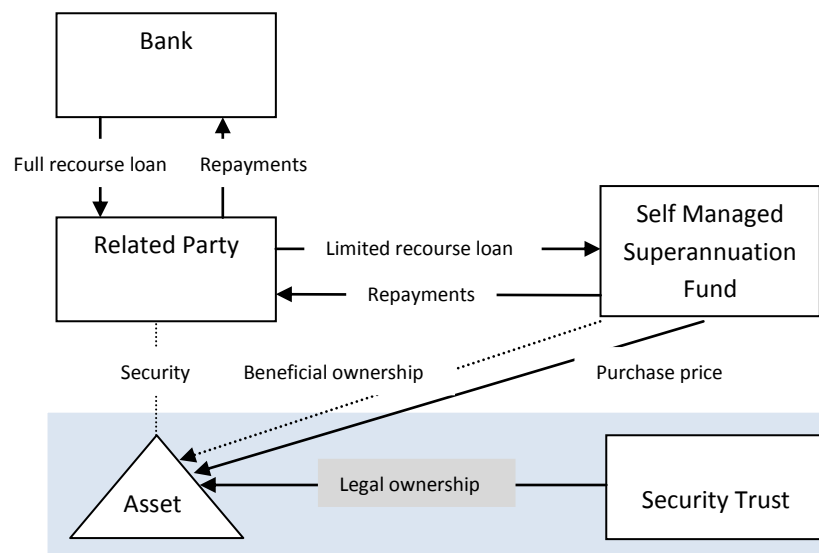
At settlement, the SMSF Trustee (using its own funds and the funds borrowed from the financial institution) provides \$360,000 to the Security Trustee. The Security Trustee uses the funds to settle on the Property and is consequently registered as the legal owner of the Property. Pursuant to the terms of the Security Trust deed, the SMSF Trustee acquires a beneficial interest in the Property.

Diagram – Direct Loan Strategy



Alternatively, the SMSF Trustee may borrow from a related party of the SMSF. The related party of the SMSF may already have the cash available to lend to the SMSF or the related party may be required to obtain a loan from a financial institution. Note, where the related party obtains a loan from a financial institution (to on-lend to the SMSF), the loan may be a full recourse loan. It is only the subsequent loan from the related party to the SMSF that must be a limited recourse loan.

Diagram – Indirect Loan Strategy



Frequently Asked Questions

1. *What assets can be acquired under a limited recourse borrowing arrangement and can assets be acquired from a 'related party' of the SMSF?*

An Asset must be a 'single acquirable asset' and one that the SMSF Trustee is not prohibited from acquiring under SISA or any other law. For example, the Asset may be (amongst others) listed securities, commercial property, shares in private companies and residential property.

An Asset can be acquired from a related party, provided that such an acquisition is permitted under section 66 of SISA.

2. *What is a 'single acquirable asset'?*

A SMSF Trustee is not permitted to borrow to acquire multiple assets in the one Security Trust. However, a 'single acquirable asset' includes a collection of assets where such assets are identical and have the same market value.

For example, a SMSF Trustee would not be prohibited from borrowing to acquire 100 ordinary shares in BHP Billiton Limited in the one Security Trust. However, a SMSF Trustee would generally be prohibited from

acquiring 100 ordinary shares in BHP Billiton Limited and 100 ordinary shares in Rio Tinto Limited in the same Security Trust.

In respect of real property, a SMSF Trustee would not be prohibited from borrowing to acquire real property situated on a single title of land in the one Security Trust. However, a SMSF Trustee may be prohibited from acquiring real property situated on more than one title of land in the one Security Trust, please refer below. In addition, a SMSF Trustee would be prohibited from acquiring real property and non-fixtures (such as furnishings) in the same Security Trust.

The ATO have released a ruling SMSR 2012/1. This ruling expands on their interpretation of what constitutes a 'single acquirable asset'. It states that it may be possible to conclude that a trustee is acquiring a single acquirable asset notwithstanding that it is comprised of two or more titles however this will only be so where the property is distinctly identifiable as a single asset. If the underlying assets can be dealt with separately then it will not be a 'single acquirable asset'. Acceptable situations may include a building situated across two land titles or where the laws of a State or Territory prevent the assets being dealt with separately.

3. *What is a 'limited recourse loan'?*

The security provided by the SMSF Trustee to the lender in respect of the loan is limited to the Asset to which the borrowings were applied – that is, all other assets of the SMSF must remain unencumbered.

Where the SMSF Trustee defaults on the loan, the lender may take possession of, and dispose of, the Asset and take amounts outstanding from the capital proceeds received from the sale of the Asset. The balance of the capital proceeds (if any) is then returned to the SMSF Trustee. If there is a shortfall in capital proceeds, the lender will not have recourse to any other assets of the SMSF.

4. *Can a SMSF Trustee apply the borrowings towards expenses incurred in connection with the borrowing and/or acquisition of the Asset?*

The SMSF Trustee may apply the borrowings towards expenses incurred in connection with the borrowing or acquisition of the Asset, or in maintaining or repairing the Asset. However, such borrowings cannot be applied towards improving the Asset in any way.

Such allowable expenses include conveyancing fees, stamp duty and loan establishment costs.

5. *Can a SMSF Trustee borrow to develop real property?*

A SMSF Trustee will be prohibited from borrowing to develop real property as such development would constitute a replacement asset or an improvement to an existing asset that changes the character of the asset.

SMSFR 2012/1 expands on the ATO's interpretation of what constitutes an improvement and what constitutes acceptable improvements. It states that although borrowings cannot be used to improve a single acquirable asset, money from other sources, such as from the other resources of the self managed superannuation fund or an insurance payout, could be used to improve (or repair or maintain) that asset. However, any improvements must not result in the acquirable asset becoming a different asset.

Consideration must be given to whether any improvements or other changes to an acquirable asset result in a different (replacement) asset being created. An extra bedroom added to a residential home, or the rebuilding of a home destroyed by fire, even if more extensive, would not create a new asset. The conversion of a residential property to commercial, strata titling or the sub-division of land would constitute a different asset.

If the acquirable asset is changed (including by way of improvements) to such an extent that it fundamentally changes the character of the asset such that it becomes a different asset, then a contravention will occur.

6. *Who can lend money to the SMSF under a limited recourse borrowing arrangement and is the SMSF Trustee allowed to borrow from a 'related party' of the SMSF?*

Under SISA, there is no restriction on who can lend money to the SMSF under a limited recourse borrowing arrangement. The lender may be an unrelated financial institution or a related party of the SMSF (including a member of the SMSF).

Where the lender is also a related party of the SMSF, the arm's length rules contained in SISA must be strictly adhered to and any arrangement involving related parties of the SMSF must be entered into and maintained on arm's length terms. Further, the ATO has issued specific guidelines for related party loans under a limited recourse borrowing arrangement. These are contained in Practical Compliance Guideline PCG 2016/5.

7. *Can a limited recourse loan be refinanced?*

A SMSF Trustee can refinance an existing limited recourse borrowing (including in respect of any accrued interest on such borrowing).

8. *Can an Asset held within a Security Trust be replaced?*

In limited circumstances, an Asset may be replaced with another asset ("**Replacement Asset**"). Section 67B of SISA exhaustively defines Replacement Asset and the concept of Replacement Asset is generally limited to circumstances where a share in a company/unit in a unit trust is exchanged for another share/unit with the same market value and in the same entity (e.g. under a corporate reorganisation or takeover).

9. *Is an arrangement that permits the capitalisation of interest permitted under SISA?*

An arrangement that permits the capitalisation of interest in respect of the limited recourse borrowing is permitted under SISA.

10. *Upon repayment of the borrowed money, is the legal title to the Asset automatically transferred to the SMSF Trustee?*

Section 67A requires that the SMSF Trustee has the right to acquire legal ownership of the Asset by making one or more payments after acquiring the beneficial interest in the Asset.

There is no legal requirement for the Asset to be transferred to the SMSF Trustee upon full repayment of any borrowings (and related charges).

11. Will the granting to the lender of a charge/mortgage over the Asset lead to a breach of the prohibition against charging fund assets in the SIS Regulations?

The charging of the Asset is a necessary feature of a limited recourse borrowing arrangement and the granting of a charge over the Asset to the lender to secure the borrowings will not result in a breach of the prohibition on charging fund assets. However, the Asset must not be subject to any other charges (including mortgages, encumbrances and liens).

12. Does interest on the borrowing need to be at commercial rates?

Interest charged on the borrowing should be charged at arm's length rates, if a Fund wishes to consider any alternative interest arrangement we suggest that seek independent advice. Again, for a related party loan, please refer to the ATO's PCG 2016/5.

13. What is a Security Trust and can any type of trust be used to acquire legal title to the Asset?

A Security Trust is essentially a bare trust arrangement established specifically for the purposes of one entity holding an Asset on trust for another entity. Under such an arrangement, legal title to the Asset is acquired by the Security Trustee, while the SMSF Trustee generally obtains an absolute beneficial interest in the Asset.

Discretionary trusts and unit trusts are not appropriate for use as Security Trusts in respect of limited recourse borrowing arrangements.

14. Who can act as Security Trustee of the Security Trust?

There is no restriction in section 67A as to who can act as Security Trustee of the Security Trust. The Security Trustee may be a company or one or more individuals. However, the Security Trustee and the SMSF Trustee should not be the same entity or persons.

Where a loan is provided by a financial institution to the SMSF Trustee, the financial institution may require the Security Trustee to be a company. In addition, some financial institutions will also require that the SMSF Trustee also be a company (and not individuals). It is important to determine the requirements of the lender in all circumstances.

15. Will the Security Trust be a 'related trust' of the SMSF?

Where the Security Trust has been established as part of a complying limited recourse borrowing arrangement, and the only property of the Security Trust is the original Asset (or a Replacement Asset), the Security Trust will not be a related trust of the SMSF.

16. Does an arrangement where a borrowing is guaranteed by a third party satisfy section 67A, particularly where the personal guarantee is provided by a member or related party?

SISA does not prohibit a member or other related party of a SMSF from providing personal guarantees in respect of a limited recourse borrowing arrangement.

However, where a payment is made by a guarantor to a lender to extinguish a SMSF Trustee's liability to the lender, the SMSF's capital will be deemed to be increased to the extent that the guarantor has satisfied the SMSF Trustee's liability. Such amounts will also be deemed to be a contribution to the SMSF and this may give rise to excess contributions issues.

17. What superannuation law issues should be considered prior to establishing a limited recourse borrowing arrangement?

A limited recourse borrowing arrangement is a sophisticated investment and should not be entered into lightly by a SMSF Trustee. Prior to entering into such an arrangement, the SMSF Trustee should first seek professional advice as to the following superannuation law issues:

- Exception to the prohibition on borrowing
- Sole purpose test
- Related party acquisition restrictions
- In-house asset restrictions
- Arm's length dealing requirements
- Prohibition on charging fund assets
- Prohibition on providing financial assistance to members
- Investment strategy requirements
- Trustee covenants (section 52 of SISA)

18. What taxation issues should be considered prior to establishing a limited recourse borrowing arrangement?

There are numerous taxation issues that should be considered by the SMSF Trustee prior to establishing a limited recourse borrowing arrangement, including:

- Will the SMSF Trustee or the Security Trustee be entitled to the income from the Asset?
- Will the SMSF Trustee or the Security Trustee be entitled to deductions in respect of maintaining the Asset?
- Will the interest paid by the SMSF Trustee in respect of the borrowing be tax deductible?
- Will there be any CGT, GST or stamp duty consequences in respect of the initial acquisition of the Asset or in respect of the transfer of the Asset from the Security Trustee to the SMSF Trustee?

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