Borrowing in the SMSF

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Borrowing in the SMSF

Background

Previously, superannuation legislation prohibited the trustee of a superannuation fund from maintaining a borrowing or giving a charge over fund assets, except in very specific circumstances.

A change to the legislation came about following a joint review conducted by the Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO). The review concluded, after many years of uncertainty, that investments in installment warrants (effectively a type of borrowing) did breach the borrowing provisions contained in the Superannuation Industry (Supervision) Act 1993 (SIS Act). Despite this and as a result of the widespread use of installment warrants through self managed superannuation funds (SMSFs) the Government chose to legislate to allow for the longstanding practice.

This resulted in amendments to the borrowing provisions effective from 24 September 2007, which allows the trustee of a superannuation fund to borrow in order to fund the acquisition of an asset where certain other conditions are met.

However, further changes occurred on 7 July 2010, where the Government legislated to reduce the risks and resolve some uncertainties for superannuation fund trustees when borrowing to acquire allowable assets. This resulted in more amendments to the borrowing provisions and led to the introduction of section 67A of the SIS Act. This section allows for an exemption from the general borrowing prohibition through the use of 'limited recourse borrowing arrangements' (LRBA).

The new borrowing provisions are seen as being 'tighter' than the old rules in some respects, especially in relation to acquirable assets, what can be included in the loan amount, replacement assets and guarantor indemnity. These issues will be discussed in further detail in this article.

What are the legislative requirements?

As mentioned above, LRBAs can be used to allow trustees to borrow to acquire allowable assets, however, section 67A of the SIS Act provides the conditions that borrowing arrangements must meet. These conditions include:

» Borrowed funds must be used to fund the acquisition of a single 'acquirable asset' (explained below):
» The acquirable asset is held in a separate trust and the fund acquires a beneficial interest in the acquirable asset;
» The fund has a right, but not an obligation, to acquire the legal ownership of the asset by making one or more payments after acquiring the beneficial interest;
» The borrowing must be of a limited recourse nature. i.e. the lenders rights or any other person's rights, (i.e. a guarantor) against the trustee for default on the borrowing is limited to the rights relating to the acquirable asset held in the separate trust so that no other fund assets can be recovered by the lender; and
» The asset being acquired under the borrowing arrangement is subject to any charge other than in respect of the borrowing by the trustee (i.e. the asset cannot be used as security for another borrowing).

What is an Acquirable Asset?

Under the old rules, it was possible for a borrowing to be used to acquire multiple non-identical assets, such as a parcel of shares in a range of different companies. However, this potentially allowed a lender to cherry pick assets in the event of a default, thereby leaving the fund with the poorest performing assets. To prevent this, the new rules explicitly require that a borrowing can only be used to acquire a single 'acquirable asset'.

An acquirable asset is generally a single asset, excluding money (i.e. Australian or foreign currency). However, a collection of assets that are identical and have the same market value will also be treated in the same way as a single asset.

Examples of a single acquirable asset include a collection of:

» Shares of the same type in a single company (eg. ordinary shares in X Ltd);
» Units in a unit trust that have the same fixed rights attached to them; and
» Economically equal and identical commodities (eg. gold bars, irrespective of whether they might, for example, have different serial numbers).

Examples of assets that would not be allowable include a collection of:

» Shares in a single company with different rights (eg. ordinary and preference shares);
» Shares in different entities;
» Units in a unit trust of different classes that have different rights attached to them or are potentially subject to differing trustee discretion; and
» Buildings where each is held under separate strata title, irrespective of whether they are substantially the same at acquisition time.

In the case of a real property purchase, a single title for land and the accompanying property would be considered a single acquirable asset. However, additional items such as furnishings would not be allowed to be purchased through the same LRBA.

Thus, trustees will need to establish separate loan arrangements for each asset they wish to invest in or each property they wish to acquire. Given the current costs involved to establish these types of arrangements, this may be impractical.

Finally, assets that may be acquired are limited to those which the superannuation fund itself is not prevented from acquiring by SIS Act or any other applicable laws.

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Refinancing and related expenses

The new law applies to new LRBAs. Pre-existing LRBAs that are refinanced will also fall under the new rules where:

- The refinance involves the rescission or replacement of the original loan contract; or
- A change is made to the terms and conditions of an arrangement that fundamentally alters the character of the arrangement.

The new laws will not apply if the refinancing involves a re-negotiation of the borrowing with the same lender, that is simply a variation of a loan contract that continues to exist.

The new laws also state that the borrowing amount can include expenses incurred in connection with the purchase of the acquirable asset; or expenses incurred in maintaining or repairing the acquirable asset to ensure its value is not diminished (eg. conveyancing fees, stamp duty, brokerage and loan establishment costs). However, expenses incurred in improving the acquirable asset are not included. In other words, a superannuation fund cannot borrow money to use the funds to improve an asset, as this would fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the fund. This could affect SMSF trustees who, for example, purchase a block of land or real property with the view to develop it in the future.

Even if the superannuation fund uses its own resources to materially alter or develop a property that was acquired with a borrowing, property development is not permitted in a LRBA, as a superannuation fund must not improve real property, regardless of how a property development activity is funded.

On 23 May 2012, the ATO released SMSF final ruling (SMSFR 2012/1) which provides their view on the SMSF borrowing provisions (i.e.. LRBAs). The ATO confirmed that the LRBA rules allow a fund to borrow to maintain or repair an asset to ensure its value is not diminished. However, they prohibit a fund borrowing to improve an asset.

Previously, the ATO's view was that whilst a fund could use their own cash resources to maintain or repair an asset it could not use cash resources to improve an asset. This final ruling now allows improvements to a property provided the improvements:

- Are not funded from borrowings (i.e.. money from other sources can be used); and
- Do not fundamentally change the nature of the asset.

Replacement assets

Following on from the above, 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, this would be considered a replacement asset.

It is important to note that a replacement asset is only permitted where the asset is a share or units in a unit trust, not property. Thus, the consequence of the acquirable asset becoming a different asset means a breach of the LRBA rules.

On another note, the new rules also ensure that the acquirable asset held in a separate trust under the borrowing arrangement can only be replaced by another asset in very limited circumstances. For example, a share (or a collection of shares) in a company or a unit (or collection of units) in a trust can only be replaced with identical assets of the same market value.

Generally, the replacement provisions for securities (i.e. shares and unit trusts) are predominately limited to corporate action type activities, for example, where the replacement asset occurs because of a takeover, merger, demerger or restructure.

Where the original asset was some other form of asset, such as real property, the trustee would be prohibited from replacing that asset with another asset, even where the replacement asset was of the same asset class.

What is the practical outcome of these changes?

The new borrowing exemption provides scope for a SMSF trustee to purchase an acquirable asset using borrowed funds. The trustee selecting an asset for purchase, engaging a legal specialist to establish a private trust in which to hold the asset and sourcing the borrowings from another party such as a bank or even a related party financier does this.

How does the structure work?

Where it is determined that such a strategy is suitable, practically the arrangement may work as follows:

- The SMSF trustee identifies the asset they wish to purchase;
- The private trust is established;
- The SMSF trustee obtains finance, on commercial terms, from either a related party or third party lender – the finance is to be applied for the purchase of the asset;
- The asset is purchased with the private trust identified as the owner of the asset;
- The SMSF is identified as the beneficial owner of the property, and has the right (but not the obligation) to obtain legal ownership from the trust upon payment of the final loan installment;
- The SMSF conducts all transactions in relation to the borrowing arrangement as beneficial owner of the asset. This includes making loan repayments and receiving income from the investment that is subject of the borrowing;
- The private trust does not conduct any transactions and effectively acts as a 'bare trust' for the purpose of holding the legal title to the asset in order to satisfy the legislation.

This structure provides flexibility for SMSF trustees to borrow to finance the acquisition of an asset in order to grow their superannuation balances and ultimately to fund their retirement.

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The opportunity for SMSF trustees who may be small business owners or keen property investors, to utilise borrowing through superannuation, to purchase a commercial business premises or expand their residential investment property portfolio, is undoubtedly one of the greatest advantages presented by these changes.

Prior to implementing such a strategy, careful consideration as to the suitability of the structure for the SMSF trustee should be given by both the adviser and the SMSF trustee. Not only is there an onerous set of legislative and regulatory requirements to comply with, there are also important decisions with regard to the investment, technical and borrowing aspects of the strategy that need to be reconciled.

The regulator's view

Whilst the requirements may not change the landscape significantly in respect of publically offered installment warrant products, legislation permits the use of a private trust in order to embark on the SMSF borrowing arrangement. It is these private arrangements that have attracted most interest from SMSF trustees, industry commentators and superannuation regulatory bodies.

As a result of the industry debate and the introduction of the new rules, the ATO has released their views regarding the application of the new superannuation law to LRBAs by SMSFs. In their guidance, the ATO confirmed the following relating to a private trust structure:

» The trust that holds the asset cannot be a discretionary trust or a unit trust;
» The law does not prohibit the financier of a SMSF borrowing arrangement from being a related party so long as all other legislative requirements are met; and
» The fund cannot put an existing fund asset into the borrowing arrangement.

Whilst it appears that the regulators are comfortable with SMSF trustees utilising private trust structures, the ATO issued a warning to trustees with regard to some of the features that may breach superannuation legislation, for example:

» Where existing borrowing arrangements are re-financed and do not meet the legislative requirements;
» The interest rate for the borrowing exceeds a commercial rate or conversely, is zero or less than the commercial rate for such arrangements, particularly where the lender is a related party;
» Where loan facilities provide for multiple draw down (s) and the draw down(s) is put to a purpose that does not meet the legislative requirements. Further, each draw down of funds from the loan facility will constitute a separate borrowing;
» Where capital improvements are made to real property in a LRBA;
» Where interest on the loan is capitalised, the amounts capitalised do not relate to the costs of the original borrowing;
» Where personal guarantees are provided for the borrowing by a member or related party of the fund and the guarantor's rights against the SMSF trustee are not limited to the rights relating to the asset being acquired under the arrangement;
» The asset acquired by the trustee is one that is prohibited by existing superannuation legislation investment restrictions.

SMSF trustees should be mindful that the SMSF sector is under increased regulatory scrutiny.

Other important considerations

In addition to adhering to superannuation legislation and the guidance given by superannuation regulators, trustees of SMSFs should ensure that the following issues are addressed when implementing a borrowing strategy.

Trust deed

Where the SMSF trust deed has not been updated since the inception of the borrowing provisions, it is likely the deed will prohibit the fund from borrowing. Accordingly, the deed should be reviewed and where necessary, amended in order for a borrowing strategy to be undertaken.

Investment strategy

Trustees should ensure that the fund's investment strategy adequately considers risk, return, diversification and liquidity characteristics of its investments, as required by superannuation legislation. The investment strategy should be reviewed and updated where a borrowing strategy results in high exposure to one particular asset or asset class, especially where these assets may be illiquid, for example property.

Financial viability

From a practical perspective, where trustees do not provide personal guarantees in respect of the borrowing, obtaining finance from a financial institution may be difficult and/or expensive to obtain.

Under the old rules, some limited borrowing arrangements were structured to provide the lender with additional security (in addition to the asset held in the separate trust) from another party. This guarantor has often been a related party to the fund, where upon repayment default by the superannuation fund, the lender had recourse to receive from the guarantor, who then also had recourse to the superannuation fund trustee which meant that fund assets were able to satisfy the claim. The new rules now limit the recourse by any party solely to the asset held in the separate trust. This ensures that no guarantee or right of indemnity can be enforced against the trustee directly or indirectly.

Financing costs weighed against expected investment returns will therefore be a key consideration in respect of the financial viability of the strategy.

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Loan vs contribution

Where the party providing the loan to the SMSF is a related party such as a member or family company, care must be taken to ensure that the nature of the transaction is in fact a loan, as opposed to a contribution. In order to ensure that the transaction is properly classified as a loan, trustees should ensure that appropriate loan terms and conditions are in place and documented. The existence of a loan agreement setting out the term, interest rate, repayment frequency etc is essential elements to be included in any documentation.

Further, trustees should ensure that the terms and conditions as specified in the loan agreement are adhered to. In the event that such a transaction is classified as a contribution, the member's applicable contributions caps will apply which may expose the SMSF to excess contributions tax in the event that these deemed contributions breach these limits.

Obtain appropriate advice

Whilst obtaining sound financial planning advice is a critical step in evaluating whether borrowing through superannuation is a viable strategy, in order to implement the strategy, the SMSF trustee will need to engage a lawyer to draft the private trust deed. Where the deed is drafted correctly, taxes such as capital gains tax (CGT) and stamp duty may be avoided upon the ultimate transfer of the legal ownership of the asset from the private trust to the SMSF.

Tax anti-avoidance provisions and the sole purpose test; many promoters of superannuation borrowing strategies have contended that implementing such a strategy is a legitimate way of circumventing the contributions caps, which apply to superannuation contributions.

Trustees should be aware that any arrangements which result in deliberate avoidance of taxation or investment arrangements that confer immediate benefits upon superannuation fund members may fall foul of either part IVA of the Income Tax Assessment Act 1936 (ITAA 1936) or section 62 of the SIS Act (sole purpose test). Whilst utilising a borrowing strategy to grow an asset base in the tax effective superannuation environment can be a legitimate strategy, care should be taken to ensure that the dominant purpose of the strategy is not to avoid or reduce taxation liability.

Conclusion

It is evident from existing regulatory guidance that borrowing through SMSFs is an acceptable strategy where all the relevant legislative requirements are met. Notwithstanding this, SMSF trustees should have regard to the myriad of tax and investment issues that arise prior to embarking on such a strategy. These factors along with increased regulatory activity relating to SMSFs compel trustees to obtain comprehensive, expert advice on all the relevant issues prior to implementing this strategy.

Vault Financial Group

Who we are

Vault Financial Group ("Vault") established in 2009 by Brad A. Gunn and Sharath Sama with one objective: to provide personalised financial advice, specialising in Self-Managed Superannuation Fund (SMSF) administration and supporting advisory services.

With over 30 years' combined experience in the financial services sector, and having worked together in a boutique chartered accounting practice for 5 years, Brad and Sharath are fully aware of what clients want – honest, professional advice and service.

Our Services

Vault can assist you with all your financial and lifestyle goals. Some of our services include:

- Financial Planning
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- Retirement Planning
- Wealth Creation
- Wealth Protection
- Tax (Individual, Company, Trust, Partnership & SMSF)
- Insurance / Risk
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- Gearing Strategies

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