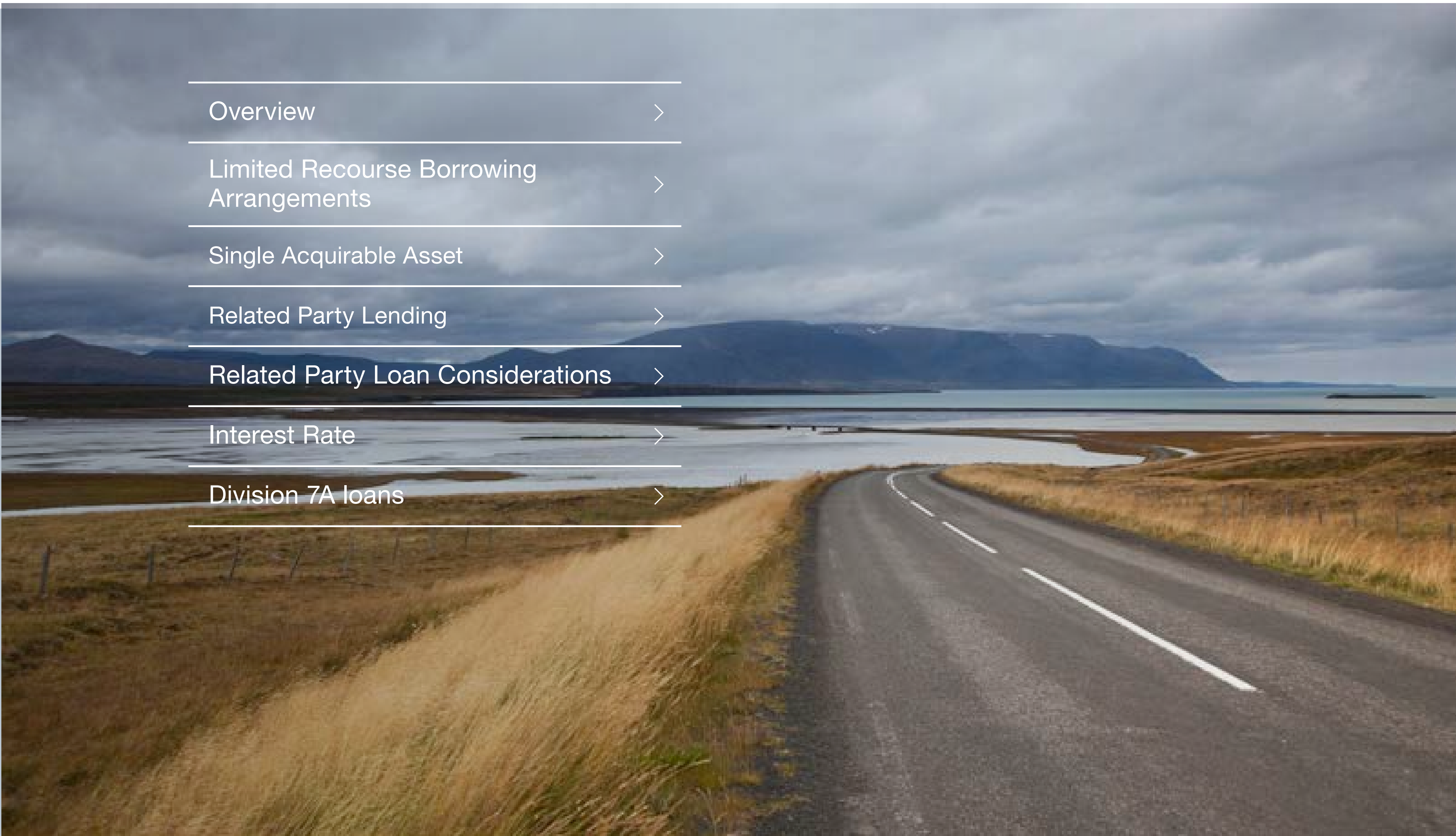
BT Panorama

TechKnowledge Adviser

SMSF Borrowing

SMSFs are generally prohibited from borrowing, with some very limited exceptions.



There are exceptional circumstances where an SMSF can borrow

Overview

SMSFs are generally prohibited from borrowing with some very limited exceptions. Apart from limited recourse borrowing arrangements (LRBA), those exceptions are as follows:

- to make a payment to a beneficiary which the trustee is obligated to make and it would not take the total amount borrowed to over 10% of the assets of the fund and the borrowing does not exceed 90 days.
- to pay a contributions surcharge and it would not take the total amount borrowed to over 10% of the assets of the fund and the borrowing does not exceed 90 days.
- to cover the settlement of a securities transaction where when the transaction was entered into, it was likely borrowing would not be required and the borrowing would not take the total amount borrowed to over 10% of the assets of the fund and the borrowing does not exceed 7 days.

Limited Recourse Borrowing Arrangements

In 2007, the Government passed legislation allowing SMSFs to undertake what was known then as instalment warrant borrowing. Within a short period of time, it became evident that trustees were using the exemption for arrangements that were never envisaged by the framers of the legislation.

As such, the 2007 legislation was replaced in 2010 by legislation which no longer referred to instalment warrants but referred to limited recourse borrowing arrangements (LRBAs) instead.

Borrowing arrangements which were put in place before 7 July 2010 will still be subject to the older legislation for as long as they are in existence and not refinanced. While there are a number of differences between the new legislation and the old, the new legislation is generally more restrictive. Those subject to the pre 2010 rules are able to purchase multiple assets with borrowed funds and are able to fundamentally change those assets which those subject to the post 2010 rules are unable to do. As such, care should be given when refinancing older arrangements to ensure that it will be compliant under the new rules.

The remainder of this document discusses the rules as they apply to arrangements put in place after 7 July 2010.

Structure

To avoid an SMSF putting a charge over its asset, an LRBA must be structured using a holding trust, also called custodian and bare trusts. The holding trust trustee acquires the asset on behalf of the SMSF and therefore, the holding trust trustee has legal ownership and the SMSF has the beneficial ownership.

The SMSF trustee has the right to acquire the asset from the holding trust by repaying the loan, though the option is entirely that of the SMSF trustee. If the SMSF trustee opts to not make any more payments on the loan, the lender's recourse is limited solely to the asset acquired with the borrowed funds. This would include any penalties and penalty interest the lender may have levied.

The lender may ask for a personal guarantee from a member and this is allowed by the legislation as long as the member provides the SMSF with a common law waiver to not go after assets of the fund other than that acquired in the borrowing arrangement. This means that in the event that the lender calls in the member's guarantee, the SMSF's other assets are not at risk.

Single Acquirable Asset

One of the central concepts for LBRAs is that the borrowing must be used to purchase a single acquirable asset which must be an asset that the fund would otherwise have been able to acquire.

In addition, it must be a single indivisible asset such as a single property, however there is a concession to this rule where the asset to be acquired is a collection of assets which are all identical to each other such as shares of a single class in a single company. It is important to note that the shares acquired must be dealt with as a parcel. Where 1,000 BHP shares were acquired in a LRBA and the SMSF trustee wanted to sell some of the shares, they would be obligated to either sell all the shares or fully repay the loan and then sell the portion of the shares required.

The single acquirable asset definition means that if the asset acquired is replaced, the arrangement no longer meets the requirements to be exempted from the general prohibition from SMSFs borrowing.

In addition, the SMSF can use borrowed funds for repairs and maintenance but not improvements which results in the trustees needing to be aware exactly what the nature of the work being done to the asset and where it is being funded from. To assist trustees with these decisions, the ATO produced ruling SMSFR 2012/1 which discusses what is a repair/ maintenance, improvement and replacement.

While there are a number of examples provided, many in the industry do not think that real world situations would be as clear cut as the ruling appears to imply and therefore, where there is a doubt, the trustee may benefit from seeking SMSF specific advice.

Some interesting examples from the ruling are:

- Adding a second storey to a house is not a replacement of the asset
- A subdivision of a block would be a replacement of the asset
- A house built on vacant land is a replacement of the asset
- A residential house converted into a restaurant by renovations would result in a different asset

A ‘granny flat’ constructed with two bedrooms, a family room, a kitchen and a bathroom and connected to utilities such as electricity, water and sewage in the backyard of an existing residence established on it would not result in the creation of a different asset.

Related Party Lending

As an SMSF is not prohibited from borrowing from a related party, this became a popular strategy to implement a limited recourse borrowing arrangement. This can be done by the related party lending their excess cash or by the related party borrowing from a bank in their own name and on lending these funds to the SMSF.

Related party borrowing may be undertaken for a number of reasons such as a related party being able to access finance at a cheaper rate or allowing the SMSF to access a higher LVR than they would otherwise be able to access. However, there are also some advanced strategies such as those dealing with 13.3A trusts which can realistically only be done with related party borrowings.

Related Party loan considerations

The most important point to consider when entering into a related party loan is that it must be properly documented to ensure that the LRBA is valid and satisfies the exemption from the general prohibition on SMSFs borrowing. While one of the reasons the trustees may wish to have a related party loan is to reduce the documentary burden, the level of documentation required will be similar to that needed for a loan from a financial institution, though obviously the trustees will have greater control of the process.

Specifically, there will have to be a formal loan agreement between the lender (eg the member) and the trustees of the fund and the trustees must have a genuine intention of treating the advance as a loan and to repay it in the future. Without these requirements being satisfied, there is a risk the ATO could treat the advance from the related party as a contribution or under non arm's length income provisions.

> There must be an advance of cash for a loan to come into existence.

Another requirement is that there must be an advance of cash for a loan to come into existence. This can cause an issue with related party lending where the member owns the asset to be acquired and is also providing the lending. While at first it may appear that it would be sufficient to transfer the property to the SMSF in return for the SMSF signing a loan agreement, the ATO have stated that there needs to be a transfer of funds. Therefore, the member would have to loan the funds to the SMSF by actually transferring the funds to the SMSF. The SMSF would then give these funds back the member to pay for the acquisition of the property.

Interest Rate

A question that often arises when discussing related party borrowing is what interest rate should be charged. Firstly, the rate should not be excessive as that would be a breach of section 109 of SIS which prohibits an SMSF entering into an arrangement with a related party where the arrangement is more favourable to the related party than is reasonable.

However, there is no reciprocal prohibition preventing the SMSF entering an arrangement which is more favourable to the SMSF. This has led some in the industry to believe that for a related party loan, the interest rate could be less than market rate or even nil and this was given further support when the ATO stated in the NTLG Superannuation Technical Working Group minutes (June 2012 – agenda item 7.4) that in such situations, it wouldn't deem the shortfall between the interest charged and 'arm's length' interest as a contribution.

It is up to the trustees to determine the appropriate interest rate and to consider what interest rate would be charged if they sought funding from a third party. However, it is recognised that this may be particularly difficult where the related party is lending at a higher LVR than what could be financed from a 3rd party. Importantly trustees need to be mindful of two recent ATO Interpretative Decisions that demonstrate that if related party loans are not made on commercial terms the income received by the SMSF from the LRBA may be classified as non arm's length income and subject to tax at the top marginal rate.

In addition, there may be other restrictions on setting the interest rate, particularly where Division 7A of the Income Tax Assessment Act 1936 applies.

Division 7A loans

In a related party lending arrangement, the lender can be the members or can also be entities controlled by the members. Where a private company makes a loan to a shareholder or their associate, including an SMSF of which they are a member, Division 7A applies which will deem the loan to be a dividend unless a specific exemption applies. Division 7A can also apply where the loan is from a private trust.

For the loan to be exempted from the deemed dividend provisions, the interest rate must be equal to or greater than the benchmark interest rate as published by the ATO (5.45% for 2015/2016). Furthermore, if the loan is fully secured over a registered mortgage and the value of the property less the value of any other liabilities secured over the property is at least 110% of the value of the loan, the maximum term is 25 years. For other Division 7A loans the maximum term is 7 years.

BT Panorama

BT16524i-1215lc