BT Panorama

SMSF Borrowing

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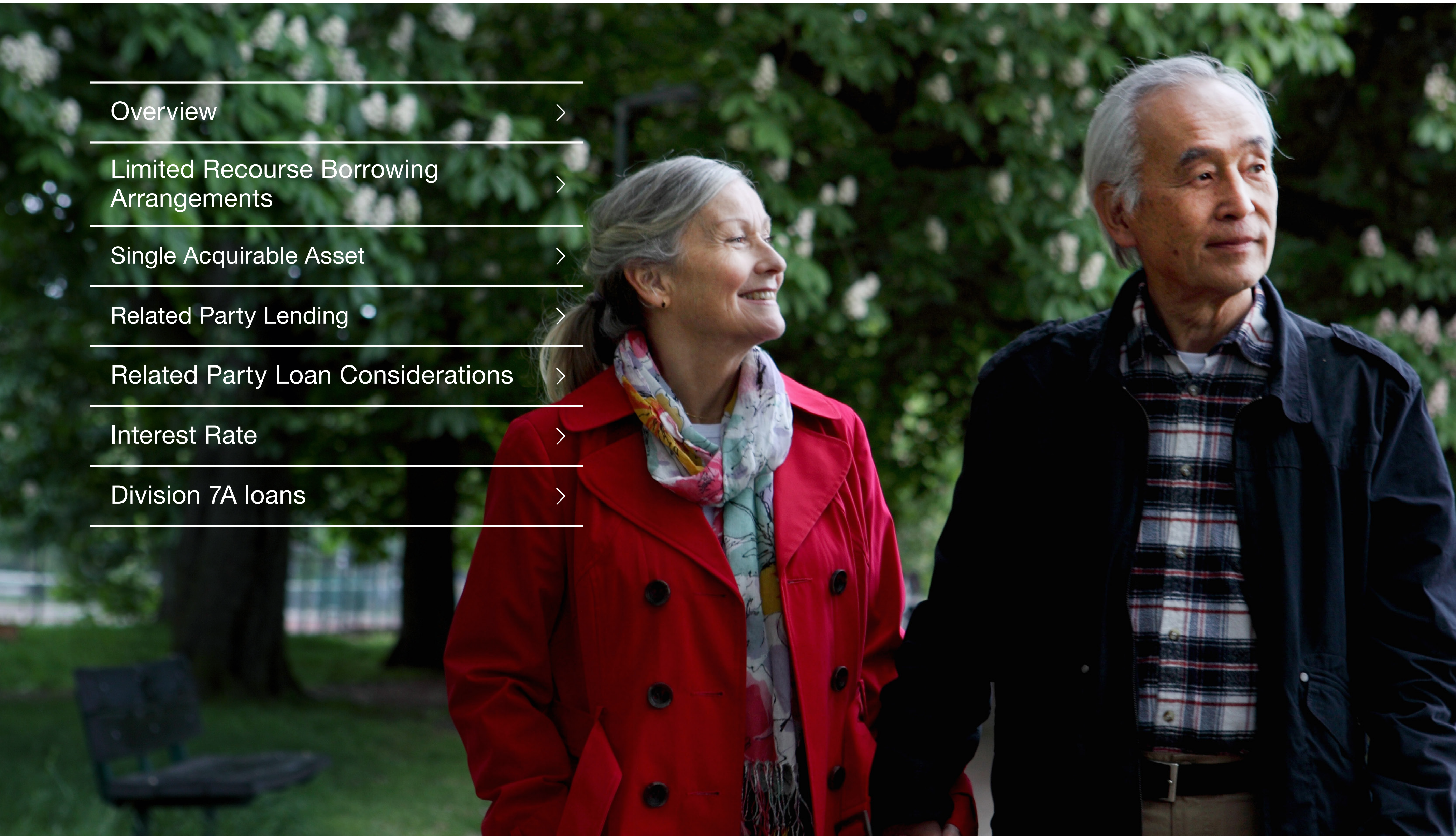

There are exceptional circumstances where an SMSF can borrow

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 previous set of rules, the new legislation is generally more restrictive. Those subject to the pre 2010 rules are able to purchase multiple assets with borrowed funds and also fundamentally change those assets whereas those subject to the post 2010 rules are unable to do so. As such, care should be taken 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 placing a charge over an 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 of the asset in question.

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 repayments 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 pursue any of the assets of the fund other than those acquired via 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 of LBRAs is that the borrowing must be used to purchase a single acquirable asset which itself 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 are acquired via an 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 of SMSFs from borrowing.

In addition, the SMSF can use borrowed funds for repairs and maintenance, but not improvements. This means the trustees need to be aware of the nature of the work being performed and how this will be funded. To assist trustees with these decisions, the ATO released the ruling SMSFR 2012/1 which discusses what is considered to be a repair/maintenance, improvement and replacement.

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

Some interesting examples from the ruling include:

- 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 way of 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 via a related party, this became a popular strategy to implement LRBAs. This can be done by the related party lending their excess cash or by the related party borrowing from a financial institution in their own name and on-lending these funds to the SMSF.

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 need to be a formal loan agreement between the lender (ie 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 classify it under the 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 has stated that there needs to be a transfer of funds. Therefore, the member would need to lend the funds to the SMSF by actually transferring the funds to the SMSF. The SMSF would then pass these funds back the member to pay for the acquisition of the property.

Interest Rate

A question that often arises when discussing related party lending is what interest rate should be charged. Firstly, the rate should not be excessive as that would be a breach of section 109 of the SIS Act 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 into an arrangement which is more favourable to the SMSF. However, while there is no reciprocal prohibition preventing the SMSF entering into an arrangement which is more favourable to the SMSF the income received by the SMSF from the asset held under the LRBA will be classified as non-arm's length income and subject to tax at the top marginal tax rate under section 295-550 of the Income Tax Assessment Act 1997.

The ATO have also released PCG 2016/5 which provide 'Safe Harbour' terms which it accepts will be consistent with arm's length dealings and the non arm's length income provisions will not apply where the guidelines are followed. However, related party loans for the purchase of units in Div 13.3A trusts are not covered.

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 (8.37% 2025/26). 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.

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