

SMSF BORROWING - CASE STUDIES

In this article, we summarise a number of SMSF borrowing scenarios that have been brought to our attention – including ones that work and ones that require a little more thought.

Scenarios that work

Buying Residential Property off the Plan

Jack and Jill are trustees of the JackJill Super Fund. They wish to purchase a unit in a new housing development. The units have not been built yet, and construction is scheduled to finish in February 2010. The builder requires the Fund to place a deposit on the unit at contract which will be in October 2009. If the Fund were to purchase the unit, would the transaction comply with the Superannuation Industry (Supervision) Act 1993 (SIS Act) and Superannuation Industry (Supervision) Regulations 1994 (SIS Regs)?

This strategy would comply with the SIS Act and SIS Regs as long as the following conditions were met:

1. The Super Fund pays the initial deposit on the unit at contract.
2. The Super Fund **does not** make any ongoing construction payments;
3. Upon completion of the construction of the unit, the Super Fund makes a one off payment to the vendor

(consisting of the loan proceeds and the balance of the purchase price funded by the Super Fund) to complete the transaction.

4. The vendor of the property is a non-related party of the Super Fund.

Buying commercial property

Peter and Sally are trustees of the P & S Smith Superannuation Fund. Both Peter and Sally are dentists and are partners in the same dental practice. They are tired of paying rent for the premises they occupy and are looking to purchase a commercial dental surgery through their SMSF. They have found premises which have a non-related vendor, and they wish to purchase this premises and lease the space to their dental practice. If they proceeded on this basis, would the transaction comply with the SIS Act and SIS Regs?

The acquisition of business real property via a Super Borrowing is more flexible than the purchasing of residential property. In this example, as long as the lease terms were on a commercial basis, and the Fund paid the initial deposit on the premises and made a one off payment to

the vendor (consisting of the loan proceeds and the balance of the purchase price funded by the Super Fund) at settlement, this transaction would comply with the SIS Act and SIS Regs.

In other circumstances, the Fund could also purchase business real property from a related party, so long as the purchase price was on commercial terms (based on an independent valuation of the market sale value of the property).

Scenarios that require a little more thought

Two Super Funds purchasing one property as tenants in common

Bill and Laura are Trustees of the Bill & Laura Jones Super Fund. John and Jane are also Trustees of a Super Fund, the John and Jane Jones Super Fund. John and Bill are brothers.

Bill and John are property investors outside of super, and have been given the opportunity to purchase a commercial building for a purchase price of \$5 million dollars. Neither family has sufficient personal wealth outside super to purchase the building; however, if the two families were to pool their

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superannuation resources, they believe they could afford the property. The two families decide to purchase the commercial property via a Super Borrowing as tenants in common, each having a 50% share in the acquisition.

What is the possible issue that could arise from this transaction?

1. According to the legislation, each Fund would have to take a separate loan to fund their respective 50% share in the building. Due to the requirement that the loan has to be limited recourse in nature, each Fund may find it difficult to find a commercial lender that will lend to the Fund on this basis given the recourse of the loan is a 50% entitlement to an asset that cannot be separated for sale. Consequently, should one of the Super Funds default on the Loan, it would be difficult for the commercial lender to act upon the mortgage on a 50% share of the property.

This issue could potentially be resolved in two ways:

1. The two funds, if the members had sufficient personal wealth, could take a loan each from a related party, rather than a commercial lender. In this instance, the Funds would have to satisfy the

requirement that the loans were on commercial terms in order for the transactions to comply with the SIS Act and SIS Regs. Some complications could still arise, for example if one party defaulted on their repayments, the lender would still only have recourse to a half share in the property. A properly drafted management agreement, outlining the procedures to be taken should one of the Funds default on their respective loan, may solve this issue.

2. The four members of the two Funds could start a third Fund and pool their superannuation assets in that way. This in turn would mean that only one loan would be required to fund the purchase of a 100% equity in the property. This would make it easier for the third Fund to find a commercial lender to lend against the property purchase as the commercial lender would have recourse on a whole asset.

This solution also would reduce the costs involved in documenting the purchase of the property, as only one Custodian Trust (the vehicle that holds the property on trust for the Super Fund) would be required, and only one set of lender costs would be involved. It would,

however, mean documenting the establishment of a new Fund, and require the ongoing administration of the third Fund on a yearly basis.

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One Fund purchasing one property over two titles

William and Connor are Trustees of a SMSF. They wish to purchase a commercial premises that is currently being leased by ABC Cars Pty Ltd and used as a new car dealership.. The premises over which the car dealership spreads is quite large, and encompasses two property titles. The dealership consists of a car yard, and a maintenance garage. Upon acquiring the property, the Super Fund would continue to lease the property to ABC Cars Pty Ltd.

The Fund wishes to purchase the premises via a Super Borrowing. What issues are pertinent in this transaction?

The major issue here is the fact that the property is over two titles. A key aspect of Section 67A of the SIS Act is that the loan proceeds have to be applied to fund the acquisition of **an asset**. Consequently, if the Super Fund were to purchase the property, the ATO **may** have issues with the transaction given that it comprises two titles should they strictly interpret the legislation.

This issue is a common one, given that there are a number of circumstances in which a property may straddle two or more titles, for example:

1. a building straddling two titles;
2. rural land;

3. a residential apartment that has a car space on a separate title;

4. and packages of shares.

In the end, it is up to yourself, and your client, to make a judgment call on whether or not the transaction would create a red flag with the ATO, and you may even apply for a private ruling. There are some steps that can be taken to mitigate this risk, should the asset your client wishes to purchase comprise multiple titles:

1. If the titles in question can be sold independently, for example, if the car yard was sitting on one title and the maintenance garage was sitting on the second title, we would recommend the Fund take out two separate loans, one for each property title, as they can be sold as independent titles should a default occur. In this situation, the Super Fund would require two Custodian Trusts, as a Custodian Trust itself can only hold one asset.
2. If the maintenance garage straddled both titles, therefore precluding the reasonable sale of the two titles independently as above, the client could consider consolidating the two titles. In doing this, the Super Fund would only have to apply for a single loan, and prepare a single Custodian

Trust, as the property would then comprise a single title.

Other issues to be wary of:

1. A SMSF cannot purchase residential property from a related party vendor via a Super Borrowing, even if the purchase is on commercial terms as this is a breach of the related party rules of the SIS Act.
2. The Super Fund cannot develop related party land via a Super Borrowing. For example if a Super Fund owned a parcel of land, even if it was debt free, the Super Fund could not borrow to build on that land.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

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