

## SMSF BORROWING - QUESTIONS AND ANSWERS

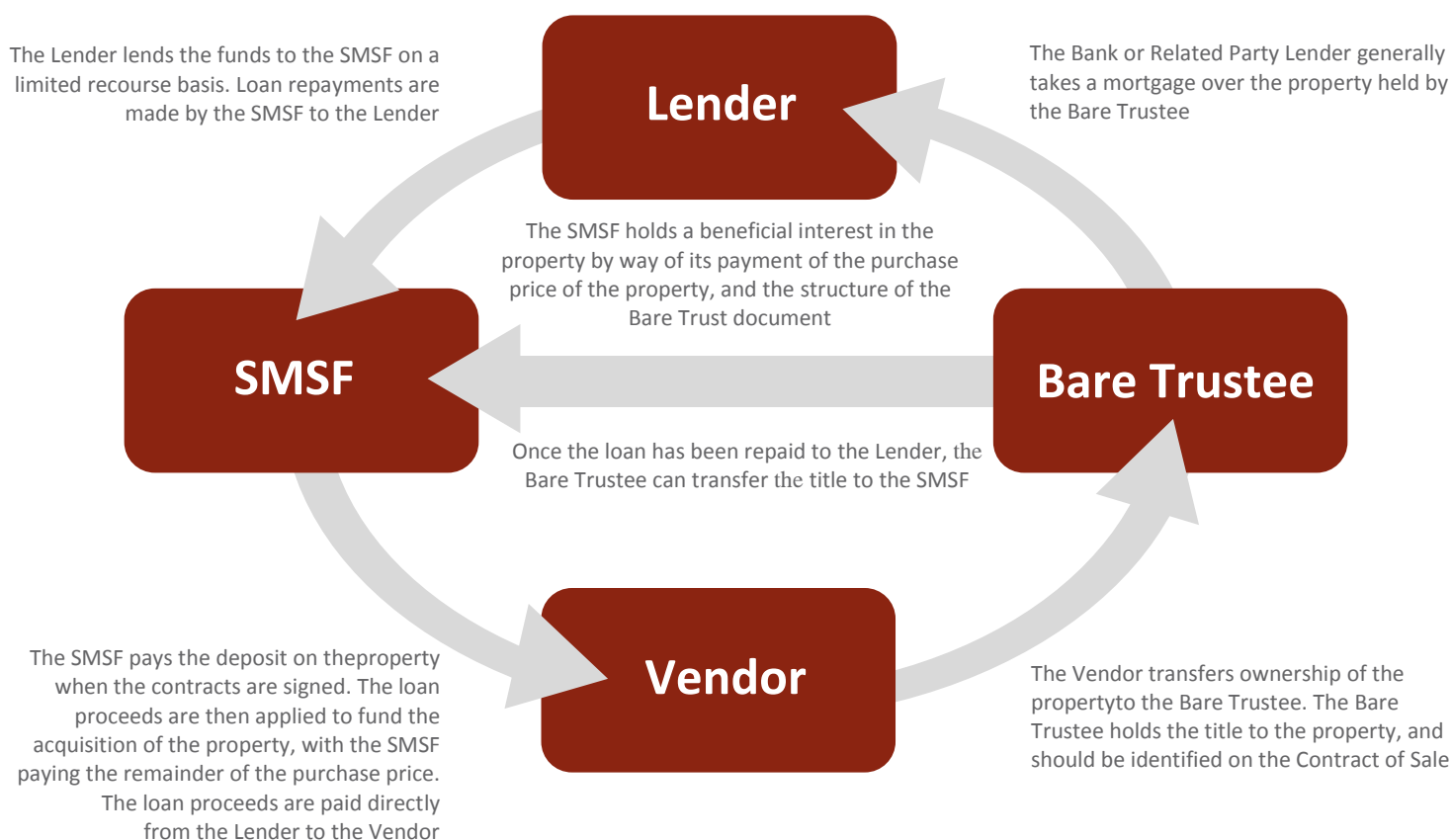
As a market leader in SMSF borrowing documentation, Topdocs has compiled a list of commonly asked questions regarding SMSF borrowing arrangements (formally known as 'limited recourse borrowing arrangements') to help SMSF trustees and their financial advisers.

Please note the following Q and As reflect changes relating to SMSF borrowing arrangements that occurred as a result of the passing of the Superannuation Industry (Supervision) Amendment Act 2010 (2010 Legislation) on 6 July 2010. Subsequently, the ATO has issued a series of documents aimed at providing guidance in respect of the legislation; the 2 main ones being:

1. 'Limited recourse borrowing arrangements by self-managed super funds – questions and answers' (dated 29 June 2012) (Tax Office Q and As); and
2. Self Managed Superannuation Funds Ruling SMSFR 2012/1 - 'Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts' (SMSFR 2012/1).

### Q. Who are the parties to the Loan?

A. A SMSF Borrowing Arrangement has 4 parties - the Lender advancing the money to the SMSF, the SMSF itself (through its Trustee), the Vendor selling the property to the SMSF and the Bare Trustee (otherwise known as the Custodian Trustee) who will hold the Property on trust for the SMSF. The role of each of the parties is outlined below:



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## Q. Who can lend money to the SMSF?

A. Both related parties and unrelated parties can lend money to the SMSF to facilitate a SMSF Borrowing Arrangement. Topdocs can provide you with contact details for each of the major banks lending on SMSF Borrowing Arrangements, as well as finance broker contact details if required.

Note, if a related party is making the loan to the SMSF, the loan must be made on commercial terms. In particular, the SMSF Trustee must be able to demonstrate that the SMSF is not paying in excess of an arm's length rate of interest to the related party. Similarly, a rate of interest that was less than commercial being paid to the related lender may also contravene the Superannuation Industry (Supervision) Act 1993 (SIS Act) legislation.

The ATO, in Tax Office Q and As, states that the calculation of a rate that represents an arm's length rate of interest needs to be based on 'reasonably objective and supportive data' such as rates charged by arm's length financial institutions for a similar borrowing.

## Q. Who may provide advice about establishing a SMSF Borrowing Arrangement?

A. The Government has released for comment proposed Regulations under the Corporations law to provide SMSFs access to consumer protection mechanisms, product disclosure statements and statements of advice. The proposed change will require that those providing advice on, or 'issuing', SMSF Borrowing Arrangements must have an Australian Financial Services

Licence. An 'issuer' is defined as each party to the arrangement, including any person who enters into a legal relationship that sets up the arrangement.

The final Regulations, once passed, will come into force 3 months after they are registered, to allow a 'settling in' period.

## Q. What type of Assets can the SMSF purchase via a SMSF Borrowing Arrangement?

A. A SMSF can purchase any asset that it would ordinarily be able to purchase under the SIS legislation, if using SMSF money.

## Q. What are the limitations in acquiring Real Property via a SMSF Borrowing Arrangement?

A. The following general limitations apply when acquiring property via a SMSF Borrowing Arrangement:

### Business Real Property

If purchased from a related party vendor, the terms of the sale must be commercial, that is, the terms of the sale should be comparable to terms that would occur if the vendor was unrelated to the Fund and should not favour the vendor or the SMSF.

Generally, this would require the Fund Trustee to have an independent valuation of the Property prepared.

Also, if acquiring the Property from a related party, the Property must satisfy the definition of 'Business Real Property' as defined by the SIS Act.

### Commercial Property

Commercial property may be leased to a related party of the Fund, as

long as the terms of the lease are commercial.

## Residential Property including Off the Plan

Residential property cannot be purchased from a related party of the Fund in any circumstances and may not be leased to a related party of the Fund in any circumstances.

The following specific limitations also apply to acquiring Real Property via a SMSF Borrowing Arrangement:

### Single Titles

The Property being purchased via a single borrowing arrangement must be classified as a single acquirable asset. The Tax Office Q and As state that the acquisition of real property on separate titles is not a permissible acquisition under a single borrowing arrangement, except in limited circumstances.

Generally, this means that in order for a single borrowing arrangement to be facilitated, the property must consist of a single title. However, in SMSFR 2012/1, the ATO relaxes the position to some degree by suggesting that, in certain instances, properties over multiple titles may be considered to be a single acquirable asset. Examples of those instances, provided in the Ruling, include:

- an apartment with a car park on a separate title, where the laws of the State do not permit them to be separately disposed of;
- a factory complex on more than one title; and
- a farm with a large shed constructed over multiple titles, where the shed is of significant

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value compared to the total asset.

**Multiple titled properties may still be acquired under a series of SMSF borrowing arrangements, if each title is held under a separate Bare Trust.**

Careful consideration must be made in these circumstances, as each separate Bare Trust must then have a separate loan, and a separate charge over the property being held in each Bare Trust.

## House and land packages

It is important to note that house and land packages must be acquired via a single contract, with settlement occurring once construction and, if necessary, strata titling, has been completed. This means that the SMSF cannot execute a contract of sale for the land, then execute a separate contract of sale for the construction of the house on that land. SMSFR 2012/1 indicates that both the deposit to secure the contract, and the payment at settlement, could be completed using borrowed funds under a SMSF Borrowing Arrangement.

## Building on existing vacant land owned by the SMSF

Both the Tax Office Q and As and SMSFR 2012/1 state that a SMSF cannot borrow to build a house on vacant land owned by the SMSF.

## Adding to an existing property being acquired under a SMSF Borrowing Arrangement

In SMSFR 2012/1, the ATO provides an example of the addition of a 'Granny Flat' to a property with an existing residence, subject to a SMSF Borrowing Arrangement. This may be done, on the basis that the

property will remain residential, but must not be done using borrowed money. In other words, SMSF funds may be used.

## Q. Can capital improvements and associated expenses be included in the SMSF Borrowing Arrangement?

**A.** The 2010 Legislation clarifies that money under a limited recourse borrowing arrangement applied for the acquisition of an asset can be used for expenses incurred in maintaining or repairing the asset, to ensure that its functional value is not diminished. However, that money cannot be used to improve the asset, as this would, according to the Explanatory Memorandum to the Bill which introduced the legislation (Explanatory Memorandum), fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the SMSF.

Hence, a borrowing cannot be used to construct a building or to renovate, other than to make repairs which do no more than ensure that the functional value of the property is not diminished.

In practice this means that the Loan can be drawn down to cover the cost of maintaining and repairing the asset as described above, but not improving it.

Associated expenses that are considered to be intrinsically linked to the purchase of the acquirable asset can, under the 2010 Legislation, also be included as part of the borrowing. The examples provided in the 2010 Legislation (i.e. conveyancing fees, stamp duty, brokerage or loan establishment costs) are specifically allowed as part of the borrowing arrangement.

SMSFR 2012/1 provides further guidance in an attempt to distinguish between what actions may constitute 'repairs and/or maintenance' and what is considered to be 'improvements', and refers to whether the work would fundamentally change the character of the asset. The Ruling provides a number of examples of amendments to an asset and the line between repairs or maintenance and improvement.

The Ruling also clarifies the position regarding the use of non-borrowed money to improve an asset under a borrowing arrangement. The indication is that SMSF money may be used to improve an asset. However, the range of improvements is limited to an extent, as they must not result in the state or function of the asset being significantly altered for the better. If so, the asset is likely to become a 'replacement asset'.

## Q. What are the limitations of acquiring listed securities, units and commodities via a SMSF Borrowing Arrangement?

**A.** The 2010 Legislation states that the asset being acquired via the borrowing must be a single acquirable asset, or collection of identical assets, that have the same market value (eg a collection of ordinary shares in a single company).

In practice, this means that shares may be acquired via a SMSF Borrowing Arrangement, but only if those shares are of the same market value, in the same company.

Examples of collections of identical assets that are allowed under the 2010 Legislation (as specified by the Explanatory Memorandum) include:

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- shares of the same type (eg ordinary shares) in a single company;
- 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 collections that are now not allowed under the 2010 Legislation (as specified by the Explanatory Memorandum) include:

- shares in a single company that have different rights, eg ordinary and preference shares;
- units in a unit trust of different classes that have different rights attached to them or are potentially subject to differing trustee discretion; and
- shares in different entities.

Further, to ensure that an acquirable asset is always interpreted in the singular, the words 'collection' and 'identical' should be interpreted as ensuring that an acquirable asset is one or more things that within the arrangement are seen and treated as a whole, eg a collection of shares must be acquired and disposed of as a collection and cannot, for example, be added to or sold down over time.

The definition of 'acquirable asset' excludes SMSF Borrowing Arrangements that involve money as an asset (ie Australian currency or currency from any other country). This addresses concerns with SMSF Borrowing Arrangements over multiple assets that are traded for money and managed in a similar fashion to margin accounts.

## **Q. Can an Asset in a SMSF Borrowing Arrangement be replaced with another asset?**

**A.** The 2010 Legislation only allows you to replace the original asset in certain circumstances.

The asset held on trust under the borrowing arrangement can only be replaced by another asset in very limited circumstances listed in the amended SIS Act or its Regulations, including:

- where instalment receipts are replaced with shares in a company; or
- shares in a company or units in a unit trust are replaced as a result of a takeover, merger, demerger, restructure or trustee action or under a scheme of arrangement.

Significantly, real estate is not mentioned, which means that a SMSF Trustee cannot replace one property with another.

The Explanatory Memorandum makes it clear that certain circumstances, which might have been thought to bring about the replacement of assets within the meaning of the pre-7 July 2010 law, are excluded, such as:

- the buying and selling of shares only as a consequence of implementing an investment strategy;
- the replacement of an asset arising from an insurance claim covering loss of original asset;
- the replacement of a title over real property upon subdivision; and
- the replacement of a title over real property as a result of Government action such as the

resumption of all or part of the property or re-zoning.

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## **Q. What is the procedure to commence a SMSF borrowing arrangement?**

**A.** In order to ensure your Fund complies with the SIS legislation and the ATO's interpretation of it, it is important to set up your SMSF Borrowing Arrangement correctly. Topdocs suggests the following steps when commencing a SMSF Borrowing Arrangement:

### **Step 1 - Find the Property the SMSF wishes to purchase**

### **Step 2- Obtain pre-approval of the Loan**

Some clients may enter into contracts before pre-approval of the Loan is made. Clients should consider Step 5 at this point if they are signing the contract before pre-approval of the loan.

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## Step 3 - Determine who will act as Trustee of the Bare Trust

The vehicle that holds the property on trust for the SMSF is called a 'Bare Trust' (sometimes known also as a 'Custodian Trust' or 'Security Trust'). The Bare Trust must have a Trustee, and it is the Bare Trustee that holds title to the property.

The Trustee of the Bare Trust should be a separate legal entity from the Trustee of the SMSF. Topdocs recommends that clients use a Company to act as Trustee of the Bare Trust.

## Step 4 - Have the required documentation completed for the SMSF to commence the borrowing

This documentation is required for the Fund to comply with the SIS Legislation and the ATO requirements, and includes:

1. The Bare Trust
2. Establishing a company to act as Trustee of the Bare Trust, if required
3. Updating the SMSF Trust Deed, if required
4. Updating the Fund's Investment Strategy, if required

## Step 5 - Sign the contract in the same of the Bare Trustee or as required by the Revenue Office in the relevant jurisdiction

NOTE: the contract of sale can be signed before pre-approval of the Loan, however it is preferable for the contract to be signed after the Bare Trustee has been determined (or, if a Company, established) so the Bare Trustee can be noted on the contract. Serious stamp duty implications can arise if the contract of sale is not properly completed -

see 'Who signs the contract of sale' below for further details.

## Step 6 - Settle the property with the Bare Trustee as the title holder

### Q. Who signs the contract of sale?

A. The Trustee of the Bare Trust is the entity that holds the legal title to the property on trust for the SMSF. Therefore, it is the Bare Trustee that should be noted as the purchaser of the property on the contract of sale, neither the SMSF nor the SMSF Trustee.

Each State or Territory has different requirements regarding the manner in which the Bare Trustee is noted on the contract. In some jurisdictions, the name of the Bare Trustee alone is sufficient, whereas others require a greater amount of detail (for example, the name of the Bare Trust or the name of the SMSF).

We recommend that you speak with the relevant Revenue Office or a property law expert to confirm how the purchaser should be noted the contract, as this may affect the stamp duty implications of the transaction.

### Q. What about double stamp duty?

A. As long as the name of the purchaser on the contract of sale is correctly noted (see point above), the Bare Trust Deed you are using is correctly prepared, and the timing of the sequence of events is correct, there should not be stamp duty applicable when the Bare Trustee subsequently transfers title to the SMSF. You should speak to your relevant Revenue Office to confirm how best to sign the contract of sale, as discussed above.

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## Q. What about CGT?

**A.** Both the Tax Office and the legislators have expressed concern that the current state of the law may impose Capital Gains Tax obligations on the SMSF at the time of the transfer of property from the Bare Trust.

There have been suggestions by the legislators that they are looking to address this concern, and it should be noted that a properly drafted Bare Trust Deed can minimise the risk of Capital Gains Tax being payable at the time of transfer of the property from the Bare Trust to the SMSF. Topdocs has taken great care to ensure that our Bare Trust documentation takes into account the potential CGT implications of this transfer.

## Q. What about personal guarantees?

**A.** Most banks will require guarantees to be signed by parties other than the SMSF Trustee in relation to the loan. The Tax Office Q and As state that it is acceptable for guarantees to be signed in relation to a SMSF Borrowing Arrangement as long as the rights to recourse of the lender and the guarantors against the SMSF are limited to the asset that is being acquired.

## Q. Can a SMSF Borrowing Arrangement be refinanced?

**A.** Yes. The 2010 Legislation clarifies that a SMSF Trustee can, indeed, refinance an existing limited recourse borrowing. According to the Explanatory Memorandum, refinancing may allow the Trustee to minimise the risk of default on a borrowing resulting from a temporary inability to make a

repayment, eg a SMSF facing solvency issues due to benefit payment obligations.

Are financing of a SMSF Borrowing Arrangement on or after 7 July 2010, even if the arrangement was entered into before that date, will be subject to the 2010 Legislation.

A renegotiation of a borrowing with the same lender that is simply a variation of a loan contract that continues to exist will not be subject to the amended law. However, where the renegotiation amounts to a rescission or replacement of the original contract, this is to be regarded as a refinancing and, therefore, the 2010 Legislation will apply to the arrangement.

Apart from refinancing, a change to the terms and conditions of an arrangement that fundamentally alters the character of the arrangement may also result in a new arrangement to which the 2010 Legislation applies.

## Q. Which entity registers for GST?

**A.** As the SMSF holds the beneficial interest in the property at all times, receives the income generated from the asset and is liable for expenses relating to the asset, it is the SMSF, and not the Bare Trust, that is required to register for GST (where applicable).

## Q. Can the Bare Trust have a bank account?

**A.** The Tax Office Q and As provide that the Bare Trust may have a cash account that does not form part of the asset being acquired.

The function of this account would be to deal with income and expenses generated from the Bare Trustee's holding of the asset. It should be

noted however that the SMSF is always liable for the expenses resulting from the holding of the asset, and always eligible for the income generated from the asset.

According to the Tax Office Q and As, it would not be acceptable for this cash account to operate as a trading account for investment purposes.

## 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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