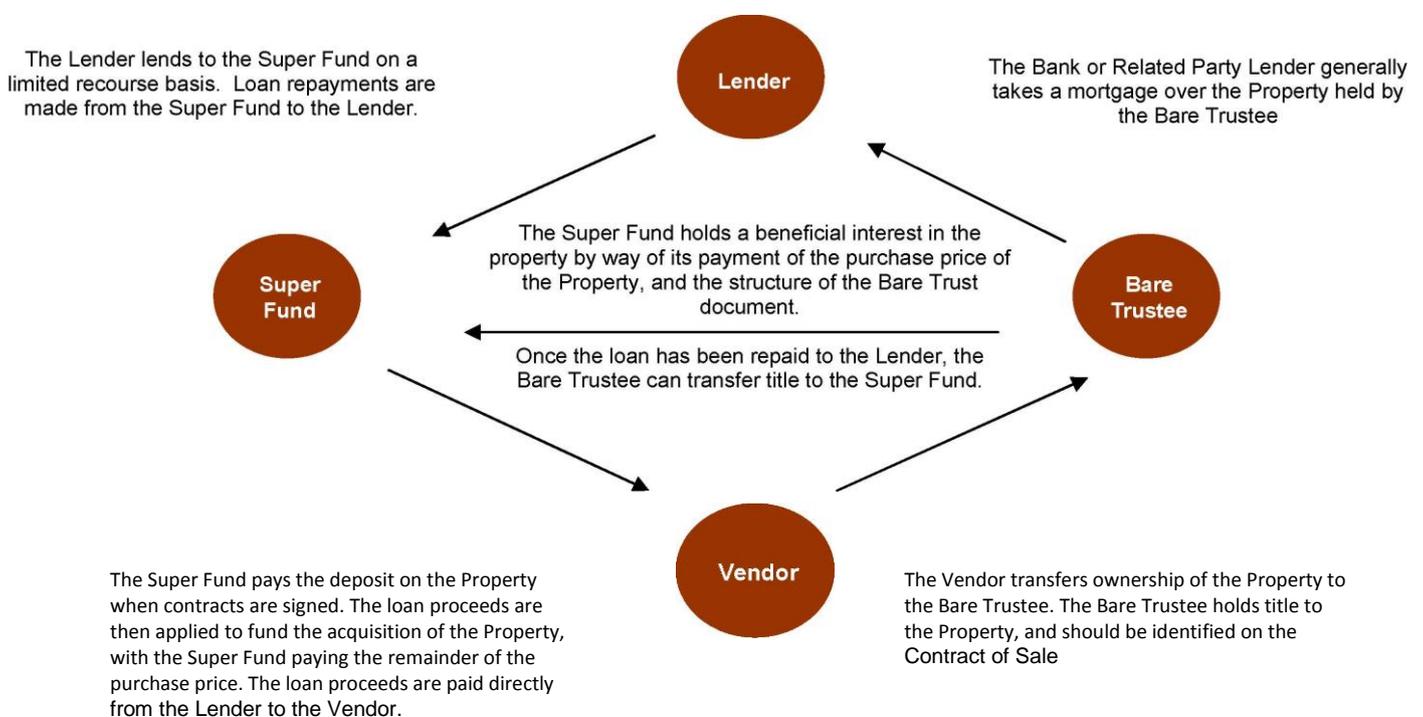


## SMSF Borrowing – Qs and As

Borrowing through your SMSF is not as difficult a process as you may think. As a market leader in SMSF borrowing documentation, We have compiled a list of commonly asked questions regarding Complying SMSF Loans (sometimes called 'instalment warrants') to help SMSF Trustees and their financial advisers to disseminate the vast amount of information in the marketplace regarding Super Fund borrowing.

Please note the following Qs and As have been updated to reflect changes relating to Super Fund borrowing that occurred as a result of the passing of the *Superannuation Industry (Supervision) Amendment Act 2010 (New Legislation)* on 6 July 2010.



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

**A.** A Complying SMSF Loan has 4 parties -the Lender loaning the money to the Super Fund, the Super Fund itself, the Vendor selling the property to the Super Fund and the Bare Trustee (otherwise known as the Custodian Trustee) who will hold the Property on trust for the Super Fund. The role of each of these parties is outlined below:

### Q. Who can lend money to the Super Fund?

**A.** Both related parties and unrelated parties can lend money to the Super Fund to facilitate a Complying SMSF Loan. ACFP can provide you with contact details for each of the major banks lending on Complying SMSF Loans, as well as finance broker contact details if required.

Note if a related party is making the loan to the Super Fund, 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 would also contravene the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* legislation.

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The ATO, in its document titled 'Limited recourse borrowing arrangements by self-managed super funds – questions and answers' (dated 29 July 2010) (**Tax Office Qs 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 similar a borrowing.

### **Q. What type of Assets can the Fund purchase via a Complying SMSF loan?**

**A.** A Super Fund can purchase any asset that it would otherwise be able to purchase under the SIS legislation and regulations.

### **Q. What are the limitations in acquiring Real Property via a Complying SMSF Loan?**

**A.** The following general limitations apply when acquiring property via a Complying SMSF Loan:

**Commercial 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 Super Fund. The Property must also satisfy the definition of 'Business Real Property' as defined by the SIS Act. Generally, this would require the Fund Trustee to have an independent valuation of the Property value prepared.

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)** – 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 Complying SMSF Loan:**

#### **Single Titles**

The Property being purchased via a single borrowing arrangement must be classified as a single acquirable asset. The Tax Office Qs and As state that the acquisition of real property on separate titles is not a permissible acquisition *under a single borrowing arrangement* even if the properties are substantially the same at the time of acquisition.

In practice this means that in order for a single borrowing arrangement to be facilitated, the property must consist of a single title. **Note however, that multiple titled properties may still be acquired under the legislation if each title is held by a separate Bare Trust.** However, 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. This means that the Super Fund cannot execute a contract of sale for the land, then a execute a separate contract of sale for the construction of the house on that land.

#### **Building on exiting vacant land owned by the Super Fund**

The Tax Office Qs and As state that a Super Fund cannot borrow to build a house on vacant land owned by the Super Fund.

### **Q. Can capital improvements and associated expenses be included in the borrowing arrangement?**

**A.** The New 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 *Superannuation Industry (Supervision) Amendment Bill 2010 (Explanatory Memorandum)*, fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the fund. Hence, a borrowing cannot, under the amended law, be used to construct a building on land 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 asst 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 New Legislation, also be included as part of the borrowing. The examples provided in the New Legislation (ie conveyancing fees, stamp duty, brokerage or loan establishment costs) are specifically allowed as part of the borrowing arrangement.

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## **Q. What are the limitations of acquiring listed securities, Units and commodities via a borrowing arrangement?**

**A.** The New 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 Super Fund borrowing, 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 New Legislation (as specified by the Explanatory Memorandum) include:

- 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; and

Examples of collections that are now **not** allowed under the New 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 sold down over time.

The definition of 'acquirable asset' excludes limited recourse borrowing arrangements that involve money as an asset (ie Australian currency or currency from any other country). This addresses concerns with limited recourse 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 borrowing arrangement be replaced with another asset?**

**A.** The New 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 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 fund 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 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 Loan?**

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

### **Step 1 -Find the Property the Super Fund wishes to purchase**

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

Some clients may however 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.

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

The vehicle that holds the property on trust for the Super Fund is called a 'Bare Trust' (sometimes known also as a 'Custodian Trust' or 'Instalment Warrant Trust'). The Bare Trust must have a Trustee, and it is the Bare Trustee that holds title to the property. Our opinion is that the Trustee of the Bare Trust should be a separate legal entity from the Trustee of the Super Fund. ACFP recommends you use a Company to act as Trustee of the Bare Trust.

#### **Step 4 -Have the required documentation completed for the Fund to commence the borrowing.**

This documentation is required for the Fund to comply with the SIS Legislation and the Australian Tax Office requirements.

This documentation includes:

1. The Bare Trust (also sometimes called a 'Custodian Trust' or 'Instalment Warrant Trust').
2. Establishing a company to act as Trustee of the Bare Trust (if required).
3. Updating the Super Fund Trust Deed (if required).
4. Updating the Fund's Investment Strategy (if required).

#### **Step 5 -Sign the contract in the name of the Bare Trustee (or as required by your state revenue office)**

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 Super Fund. Therefore, it is the Bare Trustee that should be noted as the purchaser of the property on the contract of sale, NOT the Super Fund OR the Super Fund Trustee. Each state has different requirements regarding the manner in which the Bare Trustee is noted on the contract. In some states, the name of the Bare Trustee alone is sufficient, whereas other states require a greater amount of detail (for example, the name of the Bare Trust and the Super Fund). As a 'belts and braces' approach to the contract, we recommend the purchaser on the contract be noted in the following manner:

[Bare Trustee Name] ATF [Super Fund Trustee Name] ATF [Super Fund Name]

Whilst the above may seem long winded, it shows that the Bare Trustee is holding the property on trust for the Super Fund.

We do however recommend you speak with your respective State Revenue Office or a property law expert to confirm how the purchaser name 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 Super Fund. You should speak to your respective State Revenue Office to confirm how best to sign the contract of sale as discussed above.

## **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 Super Fund at the time of the transfer of property from the Bare Trust. There has been talk that the legislators are looking to address this concern, and it should be noted that a property drafted Bare Trust Deeds can minimise the risk of Capital Gains Tax being payable at the time of transfer of the Property from the Bare Trust to the Super Fund. ACFP 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 Super Fund Trustee in relation to the loan. The Tax Office Qs and As state that it is acceptable for guarantees to be signed in relation to a Super Fund borrowings as long as the rights to recourse of the lender and the guarantors against the Super Fund are limited to the asset that is being acquired.

## **Q. Can a limited recourse borrowing arrangement be refinanced?**

**A.** Yes. The New Legislation clarifies that a fund trustee can, indeed, refinance an existing limited recourse borrowing. According to the Explanatory Memorandum, refinancing may allow the fund trustee to minimise the risk of default on a borrowing resulting from a temporary inability to make a repayment, eg a fund facing solvency issues due to benefit payment obligations.

An arrangement entered into on or after 7 July 2010, that is a refinancing of a borrowing arrangement entered into before, on or after that date will be subject to the New Legislation.

A re-negotiation 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 re-negotiation amounts to a rescission or replacement of the original contract this is to be regarded as a refinancing and the application provision and, therefore, the New Legislation will apply to the arrangement.

Refinancing is not the only way that a new arrangement may arise to which the amended law will apply, eg a change to the terms and conditions of an arrangement that fundamentally alters the character of the arrangement may result in a new arrangement to which the amended law applies.

## **Q. Which entity registers for GST?**

**A.** As the Super Fund 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 Super Fund, 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's and A's 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 Super Fund 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's Qs and As, it would not be acceptable for this cash account to operate as a trading account for investment purposes.

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