Self Managed Super – Limited Recourse Loan

Many people are interested in the ability to purchase property within a Self-Managed Superannuation Fund (SMSF). An SMSF allows you to invest directly in residential or commercial property using the funds accumulated in superannuation. If you want to purchase an investment property within your SMSF, but don't have quite enough available capital, your fund may be able to borrow money for the purchase under a limited recourse borrowing arrangement (LRBA).

Although gearing can deliver benefits, the risks associated with gearing may mean it is unsuitable for you. It is essential to carefully consider these risks before proceeding with a gearing strategy.

In most situations, an LRBA is used to purchase real property. However, it may also be possible to purchase direct shares or even managed funds using an LRBA (subject to certain conditions being met).

An LRBA can only be used to purchase a 'single acquirable asset'. While an SMSF could purchase multiple assets using borrowed funds, multiple loans would need to be implemented so that the lender's recourse is 'limited' to the single property or asset to which it relates.

How it works

There is a general rule that an SMSF cannot borrow under superannuation law. However, there is a very specific exemption for arrangements that meet all of the requirements of an LRBA. It is important to meet all of these requirements otherwise the fund will be in breach of the superannuation rules and may face penalties.

An LRBA is a loan structure where the only SMSF asset that the lender (or any other party) has recourse to is the asset that was purchased using the loan, if the fund is unable to meet its loan obligations.

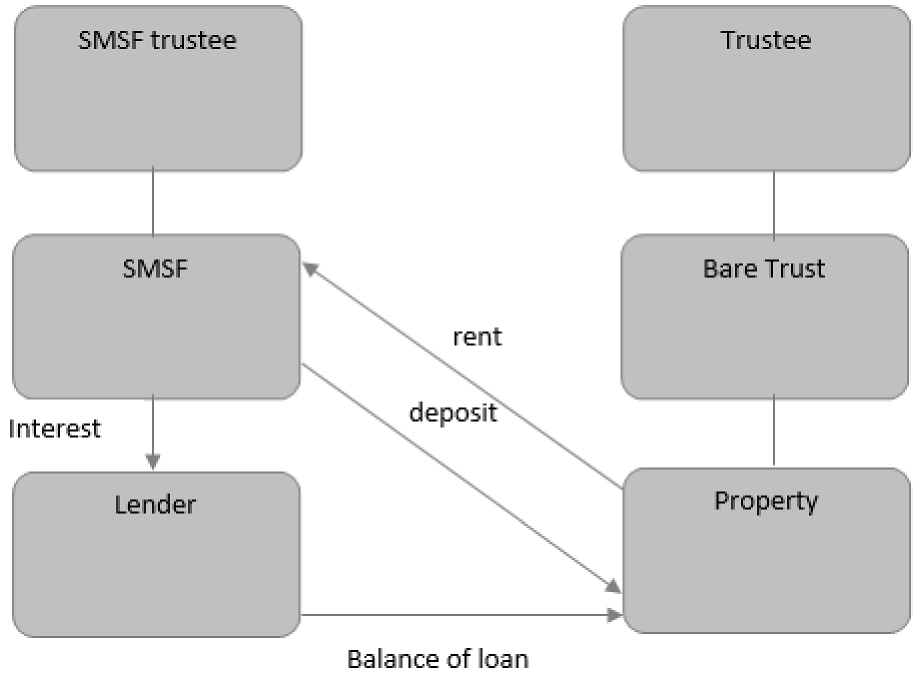
It involves establishing a security (or bare) trust to legally hold the asset on behalf of the SMSF, i.e. a trust that only holds the asset, for the duration of the loan. There are many names for these types of trusts but they are all bare trusts; they don't perform any function or transactions other than holding the asset. Most lenders will require the trustee of the holding trust to be a corporate trustee. The trustee cannot be the same company as the SMSF corporate trustee, however, it may have the same directors as the SMSF corporate trustee (i.e. the members). This 'bare trust' arrangement broadly recognises that the asset is to be held by the security trust until the debt is repaid, at which point legal ownership can pass to the SMSF.

You also need to remember that not every property can be purchased in an SMSF; it must meet the following criteria:

- must meet the 'sole purpose test' of solely providing retirement benefits to fund members
- must not be acquired from a related party of a member (unless exemption applies under the legislation)
- must not be lived in by a fund member or any fund members' related parties
- must not be rented by a fund member or any fund members' related parties (unless exemption applies under the legislation- which generally relates to a property that meets the definition of 'business real property').

Once you decide that purchasing a property using an LRBA is the right strategy for your SMSF, you need to ensure your SMSF's trust deed allows the fund to borrow. If it doesn't, you will need to update the trust deed to allow the fund to borrow before entering in to the arrangement. The purchase of the property

should also be consistent with the SMSF's investment. Again, if the investment strategy needs to be updated, this must be completed before the purchase takes place. Then you need to set up the security trust, select the property (ensuring you buy it in the name of the holding trust) and engage with a lender to obtain finances, and settle on the property by using the loaned funds (and any SMSF money) to complete payment. Your fund can then begin receiving rent payments in the SMSF bank account and making loan repayments to the lender.
It is summarised in the diagram below:



Benefits

- The SMSF may be able to purchase an asset (i.e. property) when it does not have enough available capital to purchase the asset outright.
- The SMSF may achieve greater asset diversification by using borrowed funds to acquire additional assets.
- SMSFs pay tax at a maximum rate of 15%. The rate of tax on capital gains where a property is held for more than 12 months effectively reduces to 10% on the ultimate disposal of the asset. If the asset is a segregated pension asset, and therefore fully supports a retirement phase pension interest at the time of disposal, capital gains tax may not be payable.
- The use of concessional superannuation contributions (tax deductible) can assist in paying down the SMSF debt. The rate of pay down may be faster in a superannuation environment than in a non-superannuation environment.

Risks, consequences and other important things to consider

These include:

- As with all gearing, the profitability of this strategy depends on the income and capital growth of the proposed investment being greater than the borrowing and ongoing costs. Gearing can magnify gains when the capital value of the investment increases, but will magnify losses if the capital value of the investment falls. The more the SMSF borrows, the greater the risk.
- Potential stamp duty implications arising from the LRBA structure. Fees and charges can add up and will reduce your superannuation balance.

- Interest expenses should be tax deductible to the fund (subject to the property being income producing) however tax legislation can be subject to change.
- Potential illiquidity risk - if the asset acquired is a major portion of the SMSF's total assets and the asset cannot be sold quickly, it may impact on the SMSF's ability to meets its obligations to members. To meet its obligations, the SMSF may need to sell the asset at a time when the sale price is at a low-point or it may be purchased when the sale price is at a high-point.
- If the asset is property, there is a potential risk that tenants are unable to pay rent, or the property is not rented.
- SMSFs need separate bare trusts for each property or investment if they can be sold independently.
- SMSFs cannot significantly change the character of the property while it is subject to borrowing. Before undertaking any changes to the property, it is recommended that specific legal advice be obtained.
- SMSFs cannot use borrowings to refinance an existing superannuation fund property.
- The possibility that the SMSF investment and cash flow will be adversely impacted by a fall or rise in interest rates.
- The outstanding balance of the LRBA entered into from 1 July 2018 is included in your total super balance if:
    - you satisfy a condition of release that allows you full access to your superannuation, or
    - if the loan is provided by an associate.

  Conditions of release for this purpose are retirement, terminal illness, permanent incapacity and reaching age 65. Associate includes members of the SMSFs, relatives and related entities (such as companies and trusts).
- The amount included in your total super balance is on a proportional basis to recognise the amount supporting your interest in the fund. If applicable, this is tested at the time of SMSF entering into a loan arrangement and on an ongoing basis. The inclusion of this amount in your total super balance may impact your ability to make certain contributions to superannuation. LRBA arrangements entered into before 1 July 2018 are not assessed under this rule. This exemption also extends to pre-1 July 2018 loan arrangements that are refinanced after that date.

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