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Limited Recourse Loan

Many people are interested in the ability to purchase property within a Self-Managed Super Fund (SMSF). An SMSF allows you to invest directly in residential or commercial property using the funds accumulated in super. If you want to purchase an investment property within your SMSF, but haven't quite saved enough, your fund may be able to borrow money for the purchase under a limited recourse borrowing arrangement (LRBA). In most situations, an LRBA is used to purchase an investment property, but it can also be used to purchase direct shares or even managed funds. However, an LRBA can only be used to purchase a 'single acquirable asset'.

Benefits

- The SMSF will be able to purchase an asset (i.e. property) when it does not have enough available capital to purchase the asset outright. This investment may potentially provide greater investment returns than other assets.
- The SMSF assets may have greater diversification by providing funds to acquire other 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.
- 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.

How it works

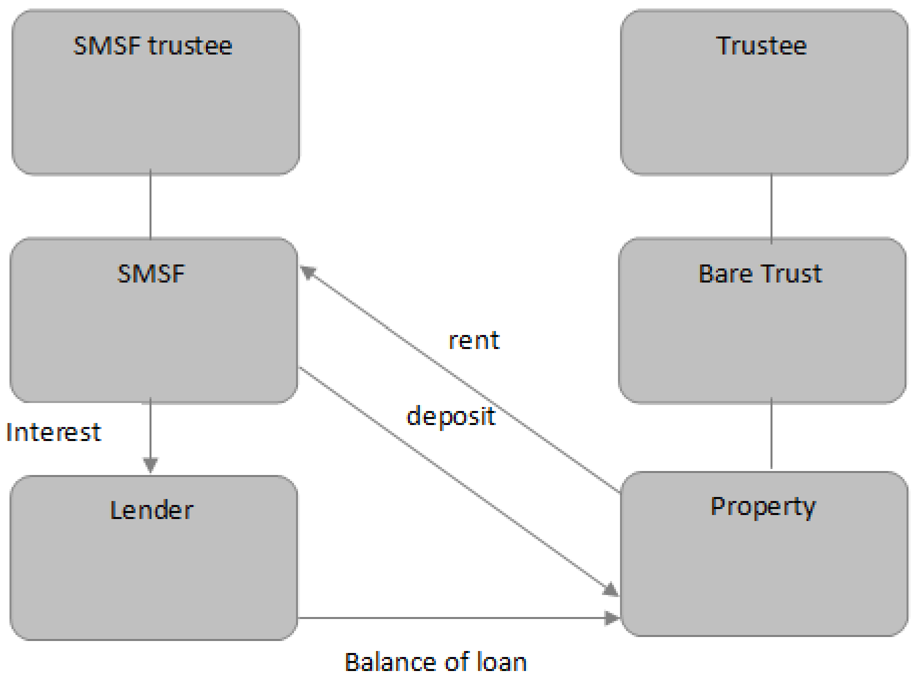
There is a general rule that an SMSF cannot borrow under superannuation law. However, there is a very specific exemption for arrangements that meet all of the requirements of an LRBA. It is important to meet all of these requirements otherwise the fund will be in breach of the superannuation rules and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

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

It involves establishing a security trustee 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 company, 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 as it should 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
- 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.

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 and buy property and possibly update the SMSF's investment strategy to confirm that borrowing to purchase a property is consistent with the SMSF's investment objectives. Then you need to set up a holding 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:



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Consequences

- The profitability of this strategy depends on the income and capital growth of the proposed investment being greater than the borrowing costs. Potentially greater losses could be made due to the larger investment made by the SMSF.
- Potential stamp duty implications arising from the LRBA structure. Fees and charges can add up and will reduce your super balance.
- Interest expenses should be tax deductible (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, as this may impact the SMSF's ability to meets its obligations to members. The potential that your property will need to be sold 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.
- The possibility that the SMSF investment return is below the inflation rate which impacts the spending power of money.
- The potential risk that tenants are unable to pay rent, or the property is not rented.
- SMSF needs separate bare trusts for each property or title if they can be sold independently.
- SMSF cannot significantly change the property e.g. major renovations etc.
- SMSF cannot use borrowings to refinance an existing super fund property.
- The possibility that the SMSF investment and cash flow will be adversely impacted by a fall or rise in interest rates.

Date: 1 April 2018