

## Limited Recourse Borrowing & SMSFs

- ❖ s67A – exception to general borrowing prohibition
- ❖ Limited recourse borrowing arrangement (LRBA) needed for each “single acquirable asset”, eg
  - ❖ real estate
  - ❖ units/shares in an ungeared, property holding unit trust/company
  - ❖ listed securities in a single company or trust
- ❖ 3 separate “legal persons” needed for an LRBA, ie lender, SMSF trustee & custodian trustee

### **LRBAs Involving SMSFs – 2 Key Components**

There are 2 key components for a limited recourse borrowing arrangement (“LRBA”) that meets the requirements of sections 67A and 67B of the *Superannuation Industry (Supervision) Act 1993* (“the *SIS Act*”) being used to partly fund the trustee of a self managed superannuation fund (“SMSF”) purchasing real estate or other permitted assets for the fund, ie an:

●●**LRBA contract.** This contract sets out the obligations of the 3 parties to the contract, ie the lender, the trustee of the SMSF and the custodian trustee.

The lender may be a bank or other financial institution, a private company associated with the members of the SMSF or an individual such as a member of the SMSF. The loan can be at interest or interest free. The only asset that the lender can recover against is the acquirable asset being purchased under the particular LRBA contract, ie cross securing 2 or more LRBAs is not permitted.

The obligations under this contract are concluded either once all of the instalment payments required to be made under the contract have been made or if the asset subject to the LRBA is sold. Any sale proceeds are allocated first to the lender (to repay the outstanding debt), with the surplus being paid to the trustee of the SMSF.

●●**Custodian trust.** The terms of this trust (with its sole beneficiary being the trustee of the SMSF) provide for a custodian trustee to hold the acquirable asset on trust for as long as the asset is subject to the terms of the LRBA. for the duration of the LRBA. When the LRBA contract has come to an end, the custodian trustee transfer ownership of the acquirable asset to the SMSF trustee.

The custodian trustee must be a separate legal person from both the lender and the trustee of the SMSF, eg if the lender is the sole fund member and the SMSF trustee is a private company of which the lender is the sole director and shareholder, the custodian trustee is usually another private company.

## Security & LRBAs

- ❖ SMSF can only provide security to lender over the acquirable asset being purchased via LRBA
- ❖ Risk of deemed member contribution if recourse to other SMSF assets provided + *S/S Act* breach
- ❖ No cross security permitted via separate LRBAs
- ❖ Banks financing LRBAs can require member (or 3<sup>rd</sup> party) personal guarantees
- ❖ LRBA must be part of SMSF investment strategy

### ***Subsection 67A(1) – Limited Recourse Borrowing Exception***

“... (a) the money is or has been applied for the acquisition of a single acquirable asset, including:

(i) expenses incurred in connection with the borrowing or acquisition, or in maintaining or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset); and

(ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and

(b) the acquirable asset is held on trust so that the RSF trustee acquires a beneficial interest in the acquirable asset; and

(c) the RSF trustee has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and

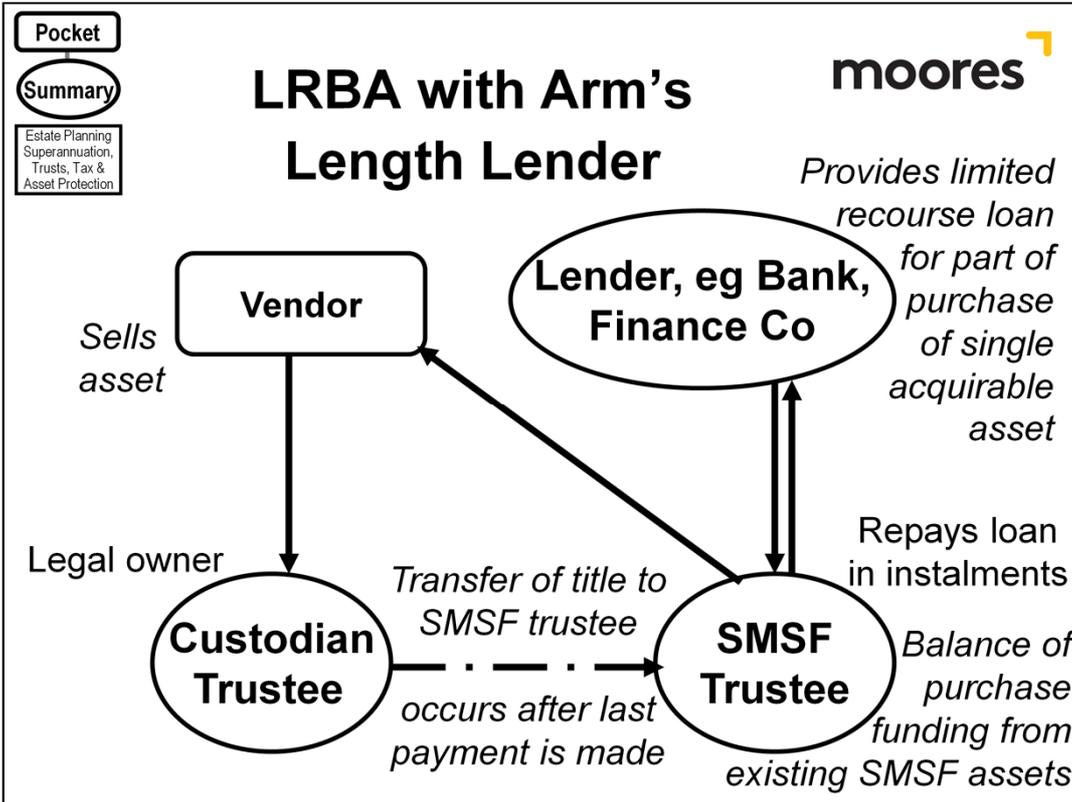
(d) the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) default on:

(i) the borrowing; or

(ii) the sum of the borrowing and charges related to the borrowing;  
are limited to rights relating to the acquirable asset; and

(e) if, under the arrangement, the RSF trustee has a right relating to the acquirable asset (other than a right described in paragraph (c)) - the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the acquirable asset; and

(f) the acquirable asset is not subject to any charge (including a mortgage, lien or other encumbrance) except as provided for in paragraph (d) or (e).”



**Single Acquirable Asset**

Just what is meant by a single acquirable asset is defined in s67A of the SIS Act:

“(2) An asset is an acquirable asset if:

- (a) the asset is not money (whether Australian currency or currency of another country); and
- (b) neither this Act nor any other law prohibits the RSF trustee from acquiring the asset.

(3) This section and section 67B apply to a collection of assets in the same way as they apply to a single asset, if:

- (a) the assets in the collection have the same market value as each other; and
- (b) the assets in the collection are identical to each other.

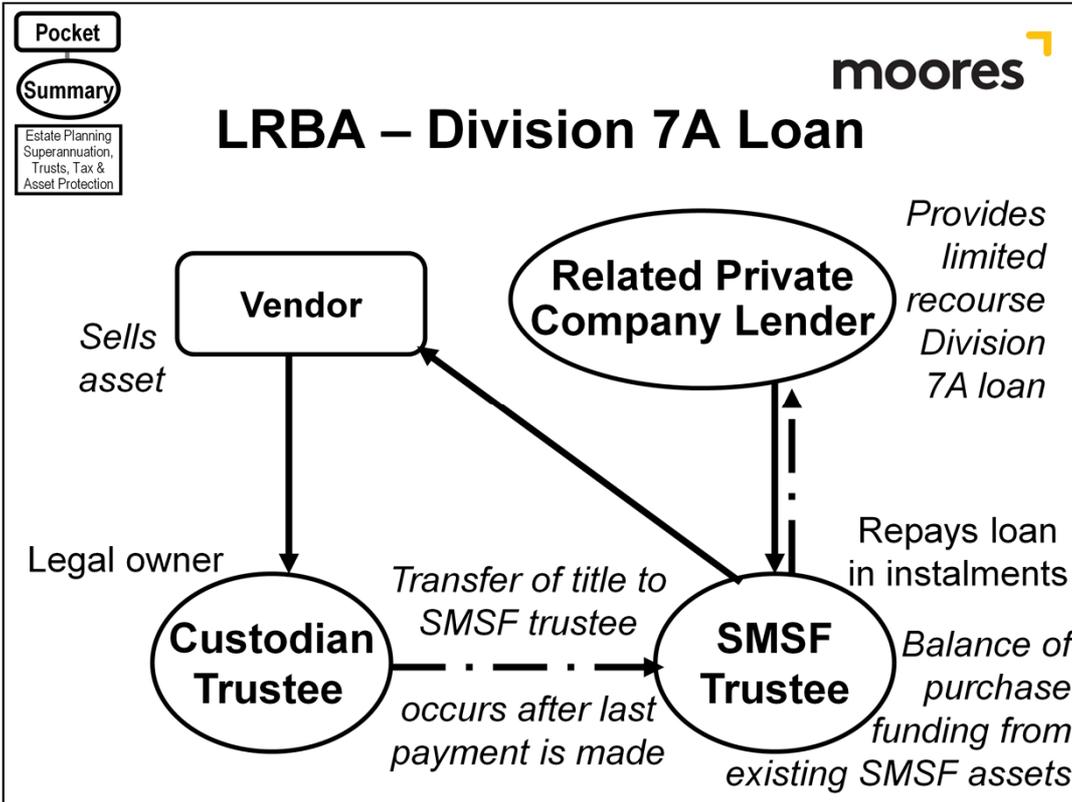
Example: A collection of shares of the same class in a single company.”

In Appendix 1 to *SMSF Ruling SMSFR 2012/1*, the ATO provides examples of when real estate that is spread across more than one land title can be viewed as a single acquirable asset, eg an apartment and on or more car parking units, none of which can be sold separately because of a restriction on their titles.

**Replacement Assets**

Under s 67B, an LRBA can also be used for a replacement asset, eg an asset or a collection of identical assets that have the same market value at the time of replacement or (in the case of shares or units) because the replacement has occurred as a result of a takeover, merger, demerger or restructure of a company or trust.

In paragraphs 17 to 29 of *SMSF Ruling SMSFR 2012/1*, the ATO distinguishes between maintaining and repairing a property, as against improving or replacing the property.



### **Choice of Lenders for LRBA's involving SMSFs**

1. A **bank or other financial institution**. An interest bearing limited recourse loan (ie the lender can only recover against the asset being purchased) is made by a bank for part of the funds needed to acquire the asset. The maximum percentage a bank will be prepared to lend will vary depending on the nature of the asset being acquired, eg residential property v commercial property, and the preparedness of fund members to provide personal guarantees. The interest rate charged by the bank will usually be higher than the rates for full recourse loans secured against a family home. The balance of the acquisition price will need to come from the trustee of the SMSF.

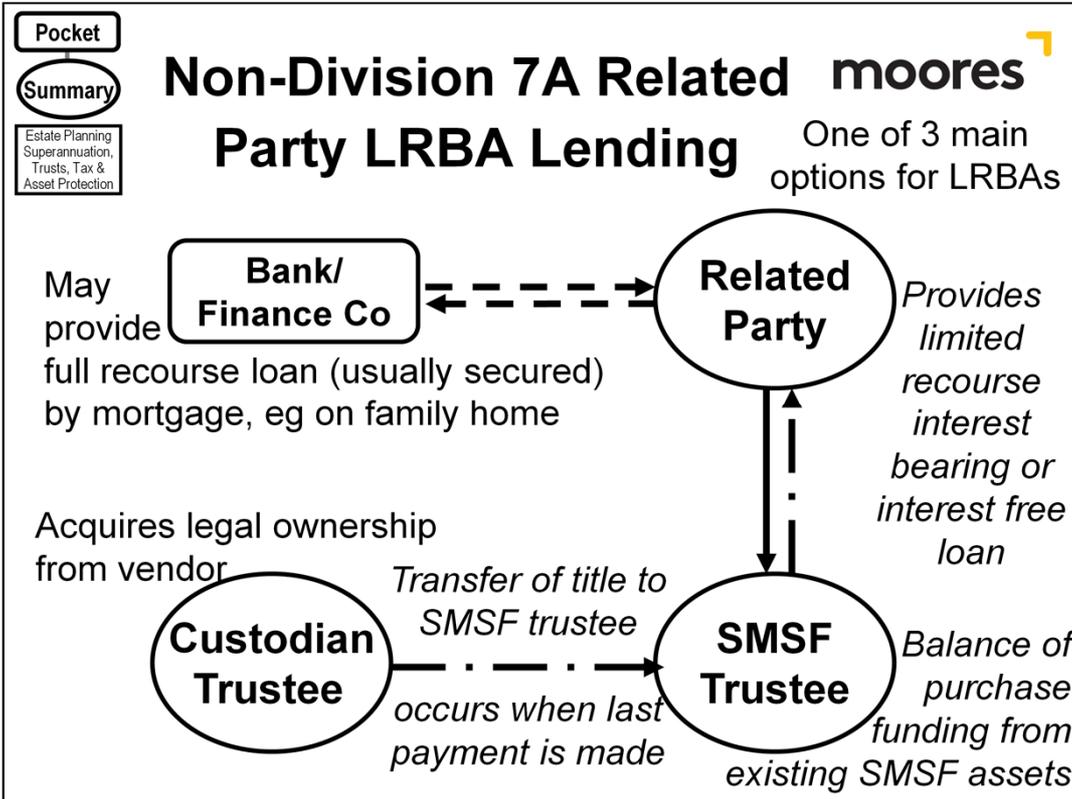
2. An **individual or private entity associated with the SMSF** and able to provide all or part of the funding. In the case of a loan funded by retained profits in a private company, the loan will need to meet the requirements of Division 7A of Part III of *ITAA 1936*, eg there must be a written loan agreement, with statutory rates of interest payable and a maximum term of either 25 years (if secured by Australian real estate) or 7 years if unsecured.

3. A **fund member** providing a limited recourse loan for all or part of the purchase monies who in turn borrows from a bank and other financial institution. This arrangement often means less borrowing costs as the bank is able to make a full recourse loan and obtain security over non-SMSF assets, eg a family home.

### **Consequences of Breach of s 67A or s 67B**

If the s 67A and s 67B requirements are not met, the general borrowing prohibition in s 67 of the *SIS Act* would apply instead. In that case, the:

- trustee of the SMSF would be in breach of the *SIS Act*
- SMSF would be in danger of losing its eligibility for the SMSF income tax concessions
- loan is likely to be seen as a contribution by the fund member (or members).



### LRBA's and SMSFs – Associated Documentation

Apart from the LRBA contract and the custodian trust, the other documents that may need to be prepared for an LRBA involving the trustee of an SMSF include:

1. If the lender is in turn borrowing to fund all or part of the limited recourse loan, eg via a full recourse loan secured against the lender's family home, the lender will need to provide the bank with appropriate security, eg via a mortgage and/or a personal guarantee.
2. A new company may need to be established to act as the custodian trustee, eg if a related party and/or member is the lender and the company trustee is the borrower, the new company will meet the requirement for the custodian trustee not to be either the lender or the borrower.
3. The SMSF itself may need to be established (a new company may also be required to act as trustee of the SMSF).
4. The governing trust Deed for an existing SMSF may need to be updated, eg to amend the borrowing restrictions to permit the use of an LRBA.
5. If the lender is the trustee of a trust, the trust deed powers may need updating.
6. Conveyancing documents for the purchase of real estate (and possibly the related party sale as well) or transfer documents for other assets such as units and shares.
7. If the asset purchased is real estate, the lease agreement between the tenant and the SMSF trustee for the lease of the property (if the parties to the lease are related, the terms of the lease should be commercially realistic).

As the SMSF is subject to annual audits, the firm preparing the LRBA contract and trust will usually also provide a letter regarding compliance of the s 67A and s 67B requirements.