

Borrowing Arrangements for SMSF Property

Effective October 2007, legislation was passed to allow SMSFs to borrow on a limited recourse basis. As a result and due to further legislative changes SMSFs can now borrow funds to purchase direct property, however there are conditions that need to be met. These changes in legislation have resulted in a boom in the number of SMSFs holding real property as a means to secure their retirement futures.

SMSFs must satisfy the following conditions for arrangements entered into on or after 7 July 2010 to purchase direct property using borrowing:

- The borrowed money must be used to acquire a 'Single Acquirable Asset' ('the asset');
- The money used to purchase the asset must be borrowed under a 'Limited Recourse Borrowing Arrangement' (LRBA);
- The asset must be held in a specially designed trust commonly called a 'Bare Trust' or a 'Property Trust';
- The SMSF must have the right to acquire legal ownership of the asset, from the property trust, upon repayment of the outstanding loan;
- The borrowed money can be used to carry out 'Repairs' and 'Maintenance'; however it must not be used make 'Improvements' to the asset;
- An SMSF must not purchase a property from a 'Related Party' unless it is 'Real Business Property' acquired at market value.

All SMSFs purchasing property using borrowed money need to be aware of these rules. Contravention may have civil and criminal consequences, and also place at risk the status of the SMSF as a complying superannuation fund.

What is a Single Acquirable Asset?

Put simply, a single acquirable asset can be defined as a single object of property; for example an apartment, residential property, or a block of vacant land.

Further, the single acquirable asset can comprise two separate assets at law and be treated as the one asset for the purpose of borrowing in an SMSF. This often happens when two assets are inseparable, such as an apartment with a car park on separate title that cannot be sold separately, or two assets that are acquired under a single contract, such as a house and land package. Under both scenarios the two assets will be treated as one single acquirable asset, and as such, borrowing can be used to acquire them.

Two common mistakes made by SMSFs using borrowed funds to buy property include:

- Building a house on an existing block of land owned by the SMSF. A house is not a single acquirable asset in its own right. Money borrowed to build the house effectively results in the acquisition of services and building materials, not a single acquirable asset.
- Serviced apartments. The apartment without the furniture is a single acquirable asset. However, the apartment and the furnishings package, even if purchased together under the one contract, is not a single acquirable asset. The furnishings package, even if purchased under a separate contract is not a single acquirable asset as it would include multiple items.

What is a Limited Recourse Borrowing Arrangement ('LBRA')?

An LBRA is an agreement between the lender and the SMSF that carries with it special conditions. Under an LBRA any recourse that the lender or any other person has against the SMSF is limited to the asset, and any rights to that asset (eg rent), that the SMSF borrowed funds to acquire.

What is a Bare Trust or a Property Trust?

A Bare Trust or a Property Trust is a unique trust structure used to split the beneficial and legal title of an asset. Under these specifically designed trusts, the beneficiary (ie the SMSF) has the beneficial rights to both income and capital of the asset. However, the SMSF does not hold legal title; The SMSF is only entitled to legal title on repayment of the money borrowed under the LRBA.

What constitutes Repairs and Maintenance to the asset?

The trustee of an SMSF can use money borrowed under an LBRA for carrying out repairs and maintenance on the asset, whether necessary at the time of the acquisition or at a later date.

What is a Repair?

A repair restores the function of the asset without changing its character and may include restoration to its former appearance, form, state or condition.

What is Maintenance?

The term 'maintaining' ordinarily means work done to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration, provided that the work merely ensures the continued functioning of the asset in its present state.

What constitutes an Improvement to the asset?

Borrowings under an LRBA cannot be used to fund improvements to the asset. However, money from other sources can be used to improve the asset. For example, accumulated funds held by the SMSF may be used to fund the improvements.

However, any improvements cannot result in the asset becoming a 'different asset,' as the asset identified when the LRBA is put in place must continue to be the asset that is held on trust under the LRBA.

General test: If an improvement will fundamentally change the character of the asset as a whole, then this will result in a different asset being held on trust under the LRBA. If this happens, you will be in contravention of the superannuation laws.

Below are some examples of a different asset being created:

Scenario	Result
Buying a vacant block of land under an LRBA and subdividing it into multiple titles	✗ The improvement has resulted in a different asset
Buying a vacant block of land under an LRBA and building a house on the vacant land	✗ The improvement has resulted in a different asset
Fire demolishes house under an LRBA and is replaced by three strata titled units	✗ The improvement has resulted in 3 different assets
A residential house under an LRBA is converted into a restaurant	✗ The improvement has resulted in a different asset
A room in a residential house under an LRBA is converted into a home office	✓ The improvement would NOT result in a different asset
The following improvements to residential house under an LRBA: A kitchen renovation, an extension to add two bedrooms, a swimming pool, a garage or an outdoor entertainment area	✓ The improvements would NOT result in a different asset
The addition of a fully functional 'Granny Flat'	✓ The improvement would NOT result in a different asset

What is a Related Party?

A related party is a member or trustee of the SMSF, a relative of the member or trustee, an entity which the trustee or member controls, or an employer who pays into the SMSF.

What is Business Real Property?

Business real property is real estate which is used wholly and exclusively for business purposes. The business can be run by a member of the fund, a related party or any other party. An SMSF can acquire business real property from a related party so long as it is acquired at market value.

Further reading

The Australian Taxation Office (ATO) website is a wonderful source of information for SMSF trustees and has a website dedicated to Limited Recourse Borrowing Arrangements for SMSF's. Please go to www.sequoia.com.au/ato for more information.

This information is intended to be of a general nature only and, as such, does not take into account any individual's personal financial situation, objectives or needs. It is intended as a guide only and is based on legislation current as at September 2012. We believe the information contained in this update has been obtained from reliable sources but we do not accept responsibility for any errors, omission or inaccuracies. It is important that you consider these matters or consult your financial adviser before you make any financial decisions.