Self Managed Superannuation Funds – A Guide to Borrowing

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1 / Introduction

Superannuation funds (including self managed funds) have been permitted to borrow since September 2007.

Doing so has proven to be a popular and effective way of increasing the investment capital available to a self managed fund for several reasons:

- gearing is a common wealth creation strategy. The super borrowing rules simply extend that opportunity to super funds;
- limits on the amount that can be contributed to super have made it hard to add money to superannuation. Naturally members and their advisers are exploring other ways of increasing superannuation balances;
- the tax concessions associated with superannuation make it an excellent vehicle in which to accumulate long term assets expected to yield capital gains;
- many self managed fund members have strong cash flow directed to their funds (regular contributions) making this the ideal vehicle from which to meet loan repayments;
- the increasing popularity of superannuation pensions means that most superannuants leave significant amounts in their funds well beyond retirement. This makes it possible to take a very long term view with investment opportunities – including borrowing strategies.

There are, however, inevitably a range of rules to be followed in structuring an effective borrowing arrangement within a self managed fund. These rules were substantially amended in July 2010 and this guide describes the rules which apply to:

- any borrowing arrangements put in place on or after 7 July 2010; and
- any pre-existing borrowing arrangements that have been substantially changed or refinanced on or after 7 July 2010.

This guide is no substitute for advice but for those who have already:

- chosen the asset in which they intend to invest; and
- resolved to achieve ownership within their self managed fund by borrowing,

We hope it will provide a useful reference point in understanding the rules and identifying the potential traps.

2 / Legal Framework

All superannuation funds are required to comply with various rules set out in the Superannuation Industry (Supervision) Act 1993 and its Regulations ('SIS').

Sections 67A and 67B of this Act deal specifically with borrowing to invest. They set out five key rules.

Rule 1: The borrowed money must be used to buy a new asset

A superannuation fund may only borrow under these sections if it is doing so to acquire an asset[1].

'Acquire' in this context means using the borrowed monies to pay the purchase price, but can also include using the borrowing to pay for borrowing and acquisition expenses. Where the asset is property, for example, the borrowing could be used to pay stamp duty, legal fees, loan establishment costs etc.

Borrowings can also be used to meet the costs of maintaining or repairing the asset.

Borrowings cannot, however, be used for other purposes - for example, to improve an existing asset or to free up capital by securing a loan against an existing asset.

As the borrowing must be used to acquire a new asset, it will need to be arranged at the time the asset is purchased, not at some later date.

Rule 2: The 'asset' must be a 'single acquirable asset'

A ***single acquirable asset*** cannot be money and must be either a single asset (eg an individual real property) or a collection of identical assets that have the same economic value.

For example, a fund may put in place a single borrowing arrangement to acquire 100 BHP ordinary shares (100 identical assets all with the same value both now and in the future). However, a single borrowing arrangement could not include the following variations:

- 50 BHP ordinary shares and 50 BHP preference shares; or
- 50 BHP shares and 50 NAB shares.

These latter investments would require separate borrowing arrangements for each holding.

Where a collection of assets is to be treated as a 'single acquirable asset' (eg 100 BHP ordinary shares identified above), they must be treated as a block once they have been purchased. For example, the fund could not sell just some of the shares to reduce its exposure to BHP – either all of the shares must be sold or none.

The equivalent requirement for property investments is that as a general rule, only one individual property (on a single title) can be held under one borrowing arrangement (although a fund could, of course, hold multiple properties under separate arrangements). There are some exceptions to this general principle.

Sometimes two or more land titles can be grouped together where there is a substantial physical feature that unifies them. For example, a factory built across 3 titles might connect or unify the 3 titles in a way which means those titles cannot, in practice, be dealt with separately.

Another common situation where assets on separate titles can be dealt with together as a single acquirable asset is where local, State or Federal law effectively requires that to be the case. For example, laws that require a strata unit and a related car park to be sold together would mean that both the unit and the car park could be included under the same borrowing arrangement as a single acquirable asset.

Rule 3: The asset must be one the superannuation fund is permitted to acquire

As well as dictating the way in which superannuation funds may borrow, SIS imposes more general restrictions on the types of investments superannuation funds may hold. In the case of assets such as property, these restrictions also extend to matters such as to whom the property may be leased.

Those rules are quite detailed but the key point for the purposes of this guide is that a fund may only borrow to purchase an asset that SIS would allow it to invest in. This means some care is needed in choosing both *what the asset is* and *from whom it is purchased*.

Remember, though, that superannuation funds ***can***:

- acquire some assets from related parties (such as listed shares, managed funds, business real property);
- lease certain assets to related parties (eg business real property or in fact any asset within the in-house asset limits of 5%[2]);
- own assets through other entities (such as companies or unit trusts) which meet certain conditions; and
- own assets as tenants in common with other parties[3]

A borrowing arrangement could be used to assist a superannuation fund to make any of these investments.

[1] The legislation also contemplates a 'replacement' asset but this is quite restrictive – we have discussed it further below.

[2] 'In-house' assets are specifically defined in superannuation law. They generally include investments in, or assets leased to, related parties (albeit there are a range of exceptions). Superannuation funds are allowed to hold up to 5% of their balance in in-house assets.

[3] Although both the fund and the other party could theoretically borrow against "their" share of the asset as long as neither lender had the entire asset as security for either loan, it is often impracticable for either to do so, particularly when third party lenders are involved

Rule 4: The asset must initially be held on trust

One particular feature of the borrowing rules is that the fund is not allowed to acquire the asset outright in the first instance – it must be held on trust for the fund until the debt has been extinguished.

At that time, the fund can assume full legal ownership.

Don't confuse the term 'trust' with, say:

- a unit trust (where the asset is owned by a unit trust and the superannuation fund owns units);
- a discretionary trust (where someone is entitled to distributions from the trust at the discretion of the trustee).

Under a superannuation borrowing arrangement, the 'trust' is effectively a holding trust where a 'custodian' is holding legal title on behalf of the superannuation fund. The superannuation fund has rights to income, to dispose of the asset, or, on payment of the loan balance, to legal ownership. Other than that, the trust does not need to have any practical function. The 'trust' does not, for example:

- apply for a TFN, prepare financial statements, lodge a tax return etc;
- hold its own bank account – in fact, transactions relating to the asset and the loan would generally flow through the fund's normal bank account just as if the asset was owned directly by the superannuation fund;
- register for GST (if this is necessary, it is the superannuation fund not the custodian that would register for GST);
- carry out any duties (such as managing assets like property) – see our comments on capital gains tax ('*What happens when the asset is transferred from the custodian to the superannuation fund in its own right*' below); or
- meet any expenditure associated with the asset (such as maintenance of a property, renovations, agents' fees etc). Again, these would all be met by the superannuation fund. Even non cash costs such as depreciation would appear in the superannuation fund's financial statements and tax returns rather than being dealt with separately within a trust.

Land tax is slightly unusual in that there would be two land tax assessments – one on the custodian (as the legal owner of the land) and one on the superannuation fund. The superannuation fund effectively receives a credit for the assessment levied on the custodian to ensure that tax is not paid twice.

The custodian (the entity holding the asset on trust for the superannuation fund) would, however, take steps to clearly distinguish this asset from other assets it owns. For example, it might:

- have a unique HIN (or investor number) for shares (or managed fund units) owned on trust for the superannuation fund;

- keep records (such as a copy of the borrowing agreement and bank statements showing the flow of funds) to evidence the fact that the asset is held on trust for the fund where this is not obvious from the legal title. This is often an issue for assets such as property where the title deeds simply record the legal owner (the custodian in this case) rather than the beneficial owner (the superannuation fund).

The custodian (rather than the superannuation fund trustee) would be named as the landlord (lessor) if the asset was a property that was rented out to another party.

Rule 5: Security must be limited to the asset being acquired

Superannuation fund borrowings are often referred to as "limited recourse" loans.

This is because if the superannuation fund fails to meet its obligations under the loan, the agreement must be structured so that the most a lender can do is seize the asset acquired with borrowed funds. The loan agreement must not give the lender or any other person recourse (access) to any other assets of the superannuation fund.

This is quite different to (say) a typical home or business loan. Under those more traditional loans, the lender would generally secure the loan on a particular asset (say a home worth $500,000) but if the borrower defaulted at a time when the loan was (say) $600,000, the lender would be free to pursue the borrower's other assets for the extra $100,000.

That option is not available in a superannuation fund borrowing arrangement.

A related point – the superannuation fund would generally use some of its own cash to finance the purchase (eg it could purchase a $500,000 property using $200,000 of its own cash plus $300,000 borrowed funds). However, it could not offer existing assets (rather than cash) as security for the loan.

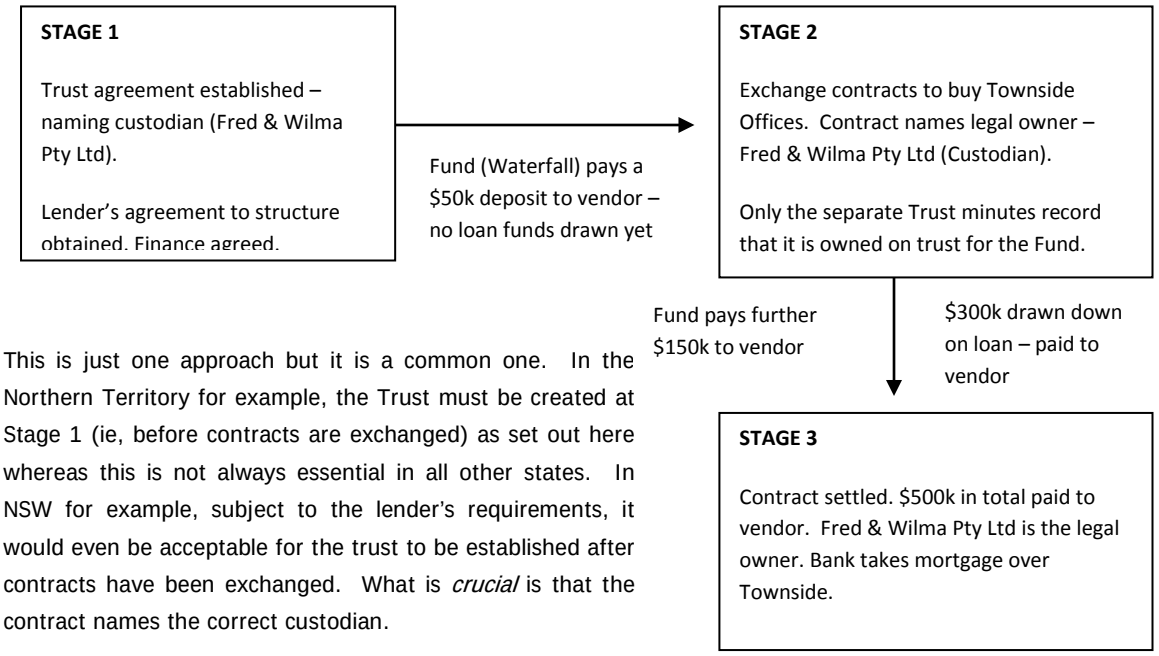
A note about guarantees.

The legislation does not prevent a lender asking for external guarantees (eg personal guarantees by the fund's members). In fact, this is quite common as it ensures that the lender effectively ends up in broadly the same position as if they had lent on more traditional terms. However, if another party such as a member provides a personal guarantee, they must specifically waive their rights to pursue the fund in the event of a default. In other words, it is fine for the *lender* to have additional protection as long as that genuinely doesn't create any further exposure for the *superannuation fund*.

3 / How does it actually work? An example:

Our clients Fred & Wilma are the sole members of a self managed superannuation fund – Waterfall Superannuation Fund. The Trustee of the fund is a company (Downstream Pty Ltd) of which they are the only directors. The fund intends to purchase a property (Townside Offices) for $500,000. It does so with a combination of $200,000 of its own cash and $300,000.

They set up a new company, Fred & Wilma Pty Ltd to be the custodian.



This is just one approach but it is a common one. In the Northern Territory for example, the Trust must be created at Stage 1 (ie, before contracts are exchanged) as set out here whereas this is not always essential in all other states. In NSW for example, subject to the lender's requirements, it would even be acceptable for the trust to be established after contracts have been exchanged. What is *crucial* is that the contract names the correct custodian.

4 / What documentation is required?

There are two important elements to documenting a superannuation fund borrowing arrangement:

- the trust (to record the fact that a custodian holds the asset on trust for the superannuation fund); and
- the actual loan agreement (this document will set out the terms of the loan including the interest rate to apply, any rules surrounding the rate at which repayments are to be made etc.).

They don't have to be in the same document although they often are when the lender is a related party (see our section 'Source of funds' below). Where the lender is a third party such as a bank, the bank will prepare the loan documentation while the superannuation fund trustee might be responsible for the agreement creating the trust.

5 / Some points to note and traps to avoid

Source of funds

The legislation is silent on who can lend to the superannuation fund. Consequently, the fund could borrow from any entity, including:

- an unrelated third party – such as a bank; or
- a related party – say a fund member, a family member, a business etc.

The fund could even borrow from a related party (say a member) who has in turn obtained the finance from a bank or other financial institution. There are some additional points to think about when the fund is borrowing from a related party – these are discussed below in "Terms of the loan".

Flow of funds

The diagram earlier illustrated a situation where the lender (the bank) paid its share directly to the vendor.

In fact, the loan funds could have passed through the superannuation fund's bank account. While this is unlikely to happen when the lender is a bank, it would perhaps be common if the lender was a related party who was simply drawing on a line of credit to finance their loan to the fund.

To ensure there is no risk the fund could be considered to have either received these funds as a contribution or borrowed money without purchasing an asset, we would suggest that this does not happen until shortly before settlement.

Vendor finance

There is nothing to prevent the vendor financing the superannuation fund's loan. The same rules apply regardless of where the finance comes from.

One quirk, however, is that superannuation law specifically requires a temporary advance of money to meet the loan requirements. Hence it will be necessary to ensure that the vendor actually advances money, this is used to acquire the asset and the resulting loan is paid back in the usual way. Simply creating the appropriate book entries will not meet the requirements.

Borrowing externally

Where an external financial institution such as a bank is lending directly to a superannuation fund, there are some particular issues to check ***before*** any assets are purchased, for example:

- discussing the proposed loan structure with the bank and identifying the documentation they require. Some banks, for example, prefer to prepare both the loan and trust documentation as a single package rather than allowing an external supplier to provide the trust documents;

- having the bank review the superannuation fund's trust deed. Many financial institutions insist on specific amendments to existing deeds even if they already allow borrowing;

- identifying any special requirements in relation to key roles such as the custodian and/or trustee of the superannuation fund. Some banks, for example, require that the trustee of the fund is a company even though this is not required by law and most insist that the custodian is a company.

- identifying any other requirements the bank may have before extending the loan. Many, for example, require a degree of certification from a financial planner and / or an accountant. The nature of that certification varies between institutions and changes from time to time. For example, some banks may require a licenced financial adviser to formally endorse the strategy while others simply require confirmation that the arrangement complies with superannuation law or that the client has sought financial advice.

Borrowing from a related party – who lends the money?

How should we decide (say) which member of a couple or which entity within the 'family' group should be the lender to the superannuation fund?

If the related party is in turn borrowing externally (say from a bank), it is common to choose the lower earning spouse.
This is because the related party lender will effectively make a profit on the arrangement if there is an interest rate differential to reflect the fact that he or she is accepting a lower rate of security than the external lender.

It generally makes sense to ensure that this 'profit' is taxed in the hands of the lowest earning taxpayer.

Another factor, however, might be whether that individual can provide the requisite security for the external lender – ie, does he or she own other assets which can be provided to the bank as security for the loan?

Custodian – who?

This is the entity which holds the asset on trust for the superannuation fund. It must have legal ownership of the asset until the fund has fully repaid the loan (at which point outright ownership can be transferred to the fund).

Since the custodian is holding an asset for the superannuation fund, it is important that it is not also the trustee of the superannuation fund. This is because no entity can hold an asset on trust for itself – if it does so, legally there is no trust.

In our example, the custodian could be:

- members (Fred and/or Wilma either jointly or individually);
- other related parties of the fund (say their children or another company of which one or both of them are directors);
- the same people as the directors of the corporate trustee; or even
- someone completely different (say a company of which Fred is a director along with other people or even a company of which neither Fred nor Wilma are directors).

However, it could not be Downstream Pty Ltd (the Trustee of the fund).

There is no major driver to choose one member or entity over another except that most commercial lenders will require that the custodian is a company.

What *is* important is that the custodian's record keeping clearly differentiates the assets held on trust for the superannuation fund from assets it owns outright (see our earlier comments on this). This is vital for:

- protection of the superannuation fund's asset in the event that the custodian is sued; and
- the general superannuation requirement (set out in SIS) that fund assets are kept separate from other assets.

Terms of the loan

The legislation does not stipulate any particular terms and conditions for superannuation loans.

However, superannuation and tax laws generally force funds and their related parties to deal with each other on an arm's length basis. Striking appropriate terms is therefore particularly important when the lender is a related party. (In theory the same applies to loans from banks but given that the arrangement is with a third party there is generally no difficulty in demonstrating that it is commercial!)

In particular, the ATO takes the view that if a superannuation loan is not on commercial terms, special tax treatment will apply to all the income earned on the asset bought with the borrowed money. Specifically, the income will be classified as "non arm's length income" which is taxed at the highest marginal tax rate rather than the concessional rates normally applicable to superannuation (15% / 0%).

The ATO has previously released a list of terms and conditions for superannuation loans that are called "safe harbour" terms (these were set out in *Practical Compliance Guideline 2016/5*). Funds that adopt these terms can assume that the loan is commercial without having to do any extra work to prove it.

What if the superannuation trustee and lender want to arrange *different* loan terms? This is perfectly acceptable. The safe harbour terms are not a benchmark or minimum standard – in fact at the time the ATO's Practical Compliance Guide was released, more favourable terms were often available from bank lenders in the superannuation borrowing market. However, the onus will be on the trustee to support the fact that the terms they have chosen are commercial. They might do this by documenting comparable terms available at the time or identifying their reasons and justification for any deviation.

Let's say, for example, that an individual borrows from a bank and then "on lends" to the superannuation fund as outlined earlier. The individual's loan from the bank might be fully secured on his home and the bank is able to pursue his other assets for the full amount in the event of a default. Given that the superannuation fund's borrowings must be obtained on a limited recourse basis, the individual's loan to the superannuation fund will effectively carry a lower level of security.

A common approach under these circumstances would be to:

- charge the superannuation fund slightly more interest than the individual is paying personally (a differential. of 0.2 5% - 0.5% pa is not uncommon); and/or

- ensure that the superannuation fund's loan to valuation ratio is lower than other lending arrangements (say the superannuation fund might only borrow 50% of the purchase price of a property rather than 70%).

Providing the terms are commercial, the lender and superannuation fund could agree on:

- multiple drawdowns – note, however, each drawdown must be reviewed to ensure that it meets the rules. For instance, a drawdown to pay for interest capitalisation or to repair the acquired asset would be fine, but a drawdown to make capital improvements to the acquired asset would not (see our discussion on *"What if the asset is improved or changed in some way?"* below);

- any payment term – including the ability to extend a pre-agreed term on the agreement of both parties ***or*** to have a payment term that is not even fixed at the outset (ie, the loan is repayable on demand by the lender);

- any payment frequency – including some flexibility (such as 'no less frequently than annually');

- whether or not the loan is interest only, a combination of principal and interest or even whether interest is capitalised;

- whether the loan can be terminated early by either party (ie can the superannuation fund simply repay all outstanding debts in full at any time?).

Security

The legislation permits the lender to take a mortgage over the acquired asset. While the does not require it, the lender will almost always do so in a standard commercial arrangement. This is essential in that it gives the lender the right to force the custodian to *sell* the property. Given that this would be the norm in 3rd party arrangements, it will generally also be advisable where the lender is a related party simply to ensure that the arrangement overall is commercially justifiable.

Often, the lender will even seek further security such as a guarantee from another party (such as a member of the fund) or a mortgage over assets outside the superannuation fund.

If a guarantee is used to provide additional security to the lender, the guarantor must waive their usual rights against the fund trustee in the event of a call on the guarantee as mentioned earlier in Rule 5 above. This is achieved by limiting (by the express terms of the guarantee contained in the loan document) the guarantor's rights to rights of recourse to the asset being acquired.

Note that in certain circumstances, a guarantee that is actually called upon (because the superannuation fund has defaulted on the loan but the guarantor pays out the remainder to avoid the fund losing the asset) may be treated as a contribution to the fund. This can give rise to significant detrimental tax consequences and should therefore be handled with care.

What if the asset is to be sold?

Sometimes the various parties will want to sell the asset while the loan arrangement is still in place.

In the absence of any unusual restrictions in the trust arrangement or prohibitions on repaying the loan early, the process would simply be:

- as the custodian is holding the asset on trust for the superannuation fund, it is the superannuation fund trustee that will decide whether or not to sell (and instruct the custodian to do so);
- when the sale proceeds are available they will be used to discharge the loan and then the remainder is paid to the superannuation fund.

Note that the loan must be repaid if the asset is sold – it cannot be retained and used to acquire another asset.

What if the asset is to be improved or changed in some way?

Where a borrowing arrangement is used to acquire real property, it is not uncommon to do so with a view to making changes to that property at a later date.

The rules governing superannuation borrowing allow some improvements to be made while the loan is in place but not if they fundamentally alter the character of the asset. If they do result in a very substantial change, they are deemed to have effectively resulted in one asset (the original property) being replaced by another asset (the improved property). "Replacements" like this are not permitted while the loan is in place (although they are completely fine once the loan has been repaid and the borrowing arrangement unwound).

For example, a fund could not use borrowed funds to acquire a property and then do any of the following during the course of the loan:

- subdivide – as this would replace a single asset (the original property) with multiple assets and would not meet the "single acquirable asset" rules ***or*** the "replacement" rules;
- build a house on it (assuming that the asset acquired with the borrowing was simply vacant land);
- knock down (say) the house already standing on the property and replace it with several units or a commercial premises.

However, the asset could be improved in other ways (without creating a "replacement" asset) as long as its essential character remained the same. For example, the following would be acceptable improvements to a house purchased as part of a superannuation borrowing arrangement:

- extending a house to add new bedrooms;
- adding a pool, entertainment area, new storey etc;
- knock down an old house and rebuilding a new one which is materially larger or constructed with superior materials.

In each case the essential character of the asset remains the same – it is a house.

However, even these improvements cannot be financed with borrowed money – the fund must use its own resources or money from external sources such as insurance pay outs etc.

This is quite different to the situation that applies for "repairs & maintenance" (see Rule 1 above). Repairs and maintenance can be financed via additional draw downs on the loan, provided that at the outset, the terms of the loan provide for further drawdowns for these purposes.

Differentiating between the three groups (repairs / maintenance, improvements which don't result in a replacement asset and improvements which do result in a replacement asset) is often a matter of degree. The ATO has published a detailed ruling on this (known as SMSF Ruling 2012/1) which is a useful reference document.

What about shares – can they be traded?

It is not possible to (say) sell one group of shares and replace them with a holding in another company under a single borrowing arrangement.

Rather, a fund wishing to trade shares would need to:

- sell its original holding;
- repay the loan; and then
- undertake a new borrowing to invest in a different company.

There are very few circumstances under which a particular asset under a borrowing arrangement can be replaced with another. As a general rule, these are limited to (say) mergers and acquisitions where a fund's shareholding in (say) Company A is replaced with shares in Company B as a result of a merger.

The rules would even preclude a "replacement" along these lines where the new asset was a combination of shares in Company B and cash.

Could a fund that borrows to buy shares reinvest the dividends?

Yes – but the dividends would need to be passed to the superannuation fund and invested directly in the name of the fund (rather than under the holding trust / custodial arrangement). In a practical sense, then, this will probably require dividends (or distributions in the case of trusts) to be banked in the superannuation fund's normal bank account and invested.

Refinancing

Refinancing a loan taken out to purchase a fund asset is specifically allowed for in the legislation.

Importantly, however, if the original loan was in place before 7 July 2010 (and consequently operates under different rules to those set out here), then the act of refinancing on or after 7 July 2010 will trigger a move to the new rules described here. As the old rules were far less restrictive, this could be detrimental.

This raises the question of what constitutes a refinancing. Not every variation to the terms of a borrowing will be regarded as a refinancing – rather it will depend the nature and extent of the variation and the intentions of the parties.

For example, consider the case where the original loan terms provide for the parties to agree to extend the loan period. If the period is ultimately increased by a relatively small period, and no other terms are changed, the extension is not likely to be deemed a refinancing.

Default

Default is particularly risky in a superannuation fund environment. This is – at least in part – because self managed fund trustees can sometimes find that cash flows disappear and it is difficult to replace them. This is particularly relevant when repayments are funded via contributions. Consider, for example, the following situations:

- members are made redundant;
- members die;
- members retire and/or start a pension.

Where possible t would be ideal to ensure that the loan agreement provided sufficient flexibility for the fund to deal with these changes in circumstances without forcing it to default on the loan.

This might mean that a related party loan agreement provides for (say):

- flexible repayment terms;
- amendment to the agreement with the consent of both parties; or
- some flexibility on what actually happens in the event that the fund defaults (in the first instance, for example, the lender might just be entitled to a higher interest rate rather than able to seize the asset).

The superannuation fund may also take particular action to protect against these changes. It could, for example, obtain insurance so that if one of the key members died (say the member to whom most of the contributions relate) the proceeds were available (*within the fund*) to repay the loan in full.

This does not mean that the insurance proceeds would not be added to the member's balance. Rather, it would mean that the ***cash*** from the insurance would be used to pay one of the fund's liabilities (the loan).

Consider an example where the deceased member has a balance of $400,000 and his spouse's balance is $300,000 (she is also a member of the self managed fund). Before any insurance is received, the fund's net assets ($700,000) consist of a property worth $1m together with a loan of $300,000. The deceased was insured for $300,000.

When the insurance proceeds are received, the fund uses the $300,000 to repay the loan. The value of the fund therefore increases to $1m (ie, it simply owns the property and no longer has any debt). The member account available for the deceased's beneficiaries, therefore, is now $700,000 (and the spouse's account remains at $300,000).

Of course, the fund would still be faced with the challenge of paying a death benefit when its only asset is a (now unencumbered) property!

Ultimately, whatever arrangements are put in place, the superannuation fund may well walk away and decline to make any further payments on the loan (where this was from a third party).

Looking back at our example for the Waterfall Superannuation Fund – the original loan was $300,000 and Townside Offices was worth $500,000 at the time of acquisition.

Let's say that three years later, the loan principal has been reduced to $250,000 but unfortunately the asset has declined significantly in value. It is now worth only $200,000.

If the superannuation fund simply declined to make any further payments, Townside Offices would be sold and the entire amount ($200,000) would be repaid to the lender. The superannuation fund would receive nothing even though it originally contributed $200,000 towards the purchase and has paid back $50,000 of the loan.

However, the lender would also not be able to pursue the superannuation fund for the $50,000 shortfall between the sale price and loan outstanding. (This is the sort of situation where a lender might call upon a personal guarantee from the members.)

This example illustrates why a mortgage is such an important security measure for third party lenders – it would have given the lender to Waterfall Superannuation Fund the right to force the custodian to sell the property before its value dropped below $250,000 (the amount outstanding on the loan).

Other superannuation & taxation rules

In their excitement to explore gearing opportunities within their self managed superannuation fund, many people make the mistake of forgetting about all the other rules governing such funds. It is important to ensure that any superannuation borrowing is considered in the context of:

- the sole purpose test. The sole purpose of any superannuation fund must be to provide for benefits on retirement or death (and certain other ancillary purposes). Any investment or borrowing must be consistent with this overarching requirement;

- the requirement to invest on an arms length basis.

- The requirement to handle ongoing transactions on an arm's length basis to avoid "non arm's length income". As mentioned earlier, this will, for example, influence the choice of interest rate where the money is borrowed from a related party – what would be a reasonable rate if the party was acting at arms length from the fund and its members?

- the fund's investment policy. All superannuation funds are required to have an investment policy and hence a trustee who wishes to borrow for the first time will need to ensure that doing so is consistent with that policy (both in terms of the borrowing itself and the asset purchased with the borrowed funds). If it is not, the trustee will need to be comfortable that there are good reasons to change the policy before undertaking any borrowing;

- the fund's trust deed. Many older deeds prohibit borrowing because they were written at a time when the law did not allow it. It is vital that the trust deed is reviewed (and possibly amended) before the borrowing takes place. Particular provisions to think about are:

    - does it allow borrowing at all?
    - does it allow assets to be held by a custodian?
    - can the trustee allow a charge over an asset in line with the borrowing requirements?
    - if the lender is a third party such as a bank, are there any particular provisions that organisation requires within the deed? (In our experience, many if not most banks have at least some requirements.)

- the in-house asset rules. Certain investments in entities controlled by 'related parties' are considered in-house assets and hence the fund's ability to invest in them is limited. It is important to note that these rules still apply when the fund invests in them indirectly – ie, via a holding trust as part of a borrowing arrangement.

Interest & tax deductions

Generally, interest on the loan will be tax deductible to the superannuation fund – just like it would be tax deductible to any other entity.

There are some caveats, however, where the loan is extended by a related party and the "single acquirable asset" purchased by the superannuation fund is shares, units in a unit trust etc. In these circumstances, Division 247 of the Income Tax Assessment Act 1997 applies special tax treatment to any interest payments in relation to "capital protected loans" (which would include limited recourse superannuation borrowings).

Essentially, any interest paid over a particular RBA benchmark is not tax deductible to the borrower.

Bear in mind also that when a superannuation fund is paying pensions it only pays tax on some of its income. Under these circumstances, it is not able to claim a tax deduction for all of its expenses – including interest.

A fund in which (say) 60% of members' balances are in pension phase might find that it only pays tax on 40% of its income but is also only eligible for a tax deduction of 40% of its interest & other expenses.

What happens when the asset is transferred from the custodian to the superannuation fund in its own right?

This can only happen once the loan has been repaid. At that time, the self managed fund can assume legal ownership of the asset.

When legal ownership is transferred to the superannuation fund:

- at the time of writing, only nominal stamp duty is paid in all states and territories, as long as the superannuation fund can prove that it has paid the purchase price in full from its own funds (this proof is critical in securing the exemption). Because this area of law can change and different states have different specific requirements, it is *crucial* that anyone wishing to establish a borrowing arrangement within in a self managed fund confirms the precise details with the Office of State Revenue for their particular state before any contracts are exchanged;

- where the superannuation fund always has absolute entitlement to the asset, no capital gains tax will be paid as long as the custodian's role has simply been to hold the asset on trust for the fund. If the custodian had other duties (such as management of a property – where this was the asset purchased with the borrowed funds) there is a risk that capital gains tax would apply.

Sometimes the time and effort in proving to a Stamp Duty authority that the transfer of legal ownership to the superannuation fund should be eligible for concessional treatment can be daunting, particularly when the asset was purchased a long time ago and records of the original transactions may no longer be available. In such circumstances, it may be more practicable to simply leave the asset in the holding trust after the loan has been extinguished, rather than attempting to transferring legal ownership.

Doing so will not create any tax or compliance issues but it does mean that the limited recourse borrowing arrangement is still in place. Consequently all the restrictions around (say) subdividing a property or dealing with a group of shares as a single "block" continue to apply. These only disappear when all aspects of the arrangement are complete.

6 / Conclusion

The superannuation borrowing rules certainly contain some traps for the unwary.

In its simplest form, however, superannuation borrowing is relatively straightforward and can certainly be an invaluable way of increasing investment capital in an extremely efficient tax vehicle.

The key – as with most superannuation matters – is documentation. Getting this right at the outset is a crucial element to a successful gearing strategy.

We can assist with this process – contact us to discuss how we can help.

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