MISTAKES HAVE DISASTROUS CONSEQUENCES

It's vital DIY fund loans are right

Monica Rule 

Handle with care: If you get it wrong at any point in the transaction, it may be impossible to fix and extremely expensive. Picture: Getty Images

Self-managed superannuation funds (SMSFs) can now borrow money to make investments. The new super law about Limited Recourse Borrowing Arrangements (LRBA) came into effect on July 7, 2010.

Since the law was introduced, the amount of SMSF investment in property assets has grown rapidly.

The new law has allowed SMSFs to purchase property that may otherwise have been out of reach.

However, there are many SMSF trustees entering into borrowing arrangements without meeting the strict superannuation law requirements of a LRBA.

The LRBA is not an ordinary loan arrangement, so SMSF trustees need to ensure they fully understand what the arrangement requires.

A LRBA is an arrangement where a SMSF borrows money from a lender to purchase an asset, such as property.

Limited recourse means the lender is offering limited recourse terms — that is, if for some reason the SMSF is unable to pay the outstanding loan, the lender can only take the asset over which the borrowing took place and cannot take any of the other assets of the SMSF for the outstanding loan. The asset is held in a "holding trust" while any part of the loan remains outstanding. Then, once the loan is fully repaid by the SMSF, the asset is then transferred from the holding trust to the SMSF.

You see, prior to this new law, SMSFs were only allowed to borrow to pay a benefit, a surcharge liability, or to settle securities transactions.

There were also dollar limits, for example 10 per cent of the total value of the assets in the SMSF, and time period restrictions. The borrowing rules were so strict to ensure that the accumulated super savings in SMSFs are not directly exposed to the risks associated with geared investments and to stop lenders from acquiring claims over SMSF assets ahead of members.

However, under the new LRBA other SMSF assets are protected. In the event the SMSF is unable to pay the outstanding loan, the lender's recourse to the SMSF is limited to the asset used as security for the loan and any guarantees provided by third parties.

If you are thinking of entering into a LRBA for your SMSF, it is important that you set up the structure correctly.

Otherwise, your SMSF may end up as a non-complying superannuation fund, losing its concessional tax rate and being forced to pay extra stamp duty and capital gains tax.

To enter a LRBA, you must consider the following things:

- Make sure your SMSF trust deed allows for borrowing as well as grant security and make sure the assets are held by a holding trust. Lenders' solicitors would want to see your SMSF Trust Deed to make sure it allows for such transactions.
- Make sure you have included LRBA type of investments in your SMSF's investment strategy.
- Determine who is to be the holding trustee and establish a holding trust. Some other names the holding trustee is commonly known as are "bare trust" or "custodian trust".

While you can use either an individual trustee or a corporate trustee for the trustee of the holding trust, it cannot be the same trustee as the SMSF. It must be a different trustee to the SMSF. Next, speak to a lawyer to draft the "Property Trust Deed" or a "Declaration of Custody Trust".

This is the document that states who the holding trustee is and the role of the holding trustee to act as the custodian of the asset for the SMSF trustee.

Then, once you have found an asset for your SMSF to acquire, negotiate the price with the vendor and reach an agreement.

The holding trustee will act as the legal owner of the property. Therefore, it is the holding trustee's name that must appear on the purchase document.

The purchase contract is between the seller and the holding trustee. Then find a lender to borrow money to purchase the asset and complete the loan arrangement with the lender. The loan must be between the lender and the SMSF trustee.

It is the SMSF trustee's name that must appear on the loan documents. The SMSF trustee is the borrower. You will need to make sure that all of the money used to purchase the property asset comes from your SMSF's bank account.

> If it is not set up properly, your SMSF may lose its 15 per cent tax rate and could be forced to pay extra stamp duty and capital gains tax.

This includes any deposit paid on the property. While the loan is outstanding, the holding trustee holds legal title to the property while the SMSF trustee has the beneficial interest in the property. The only function of the holding trustee is to hold the legal title to the property, grant the mortgage to the lender and enter into leases of the property.

The SMSF has beneficial interest in the property, so all rental income is paid directly to the SMSF's bank account. Expenses for the property such as rates and insurance are paid out of the SMSF's bank account.

The SMSF then makes loan repayments over the agreed period and, after paying off the loan, the legal ownership of the property is transferred from the holding trust to the SMSF.

This may all sound quite simple and straightforward, but borrowing strategies are quite complex and I have come across many SMSF trustees who make costly mistakes because they believe it is simply a matter of applying for a loan and buying a suitable property.

It is crucial that you establish the LRBA structure correctly.

One of the most common mistakes is SMSF trustees paying the deposit on the property from their personal finances and then attempting to recover the money from the SMSF at a later date.

This can have stamp duty consequences when the property is eventually transferred from the holding trustee to the SMSF.

The holding trustee is incorrectly recorded as the borrower to the loan on the loan documents which again will have stamp duty consequences when the property is transferred from the holding trustee to the SMSF trustee.

Trustees should also make sure that the holding trust deed is stamped to ensure that any ultimate transfer of the property from the holding trustee to the SMSF trustee attracts only nominal stamp duty. I believe the holding trust deed cannot be stamped until after settlement of the purchase.

In WA, the holding trust deed can be signed before and after the exchange.

Please check with your lawyer on this transaction because correct timing is critical otherwise double stamp duty may be payable.

Also make sure that the holding trustee has no other active duties to perform and only acts at the direction of the SMSF trustee. Otherwise the holding trust may become a Goods and Service Tax (GST) entity and be required to prepare and lodge tax returns.

The tax office has issued ruling SMSFR 2012/1 that details all the key concepts of a LRBA.

I strongly suggest trustees of SMSFs read this ruling prior to entering into any LRBA.

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Advisers warn of property pitfalls

Neale Prior

The peak body advising self-managed superannuation funds will issue a detailed warning to members this week about the potential pitfalls of borrowing money to buy assets.

Amid heavy promotion of investment properties to DIY super funds, the SMSF Professionals Association will provide members detailed information about what its technical expert describes as the "unique risks" of leveraged forays into property investment. Technical director Peter Burgess said it was crucial the ownership trust structure and documentation were meticulous from the beginning because mistakes were extremely hard to fix.

Mr Burgess said only one asset could be acquired under a leveraged purchasing arrangement, such as one property or shares in a particular company.

"Investors need to be aware of these rules because there are quite significant penalties if they get it wrong," he said. The risk was that the tax office could treat the loan proceeds as a contribution if the arrangement was not properly structured, potentially triggering a massive contribution tax bill. There were also rules prohibiting the asset being replaced and restrictions on improvements.

Mr Burgess said it was important that investors sought independent expert advice before borrowing to buy property for their superannuation fund.

NEXT WEEK
Your Money publishes Monica Rule's discussion of ongoing complications with LRBAs.