

SUPERANNUATION BORROWING RULES

Can a self managed superfund take out a loan to acquire an asset?

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Generally, the Superannuation Industry (Supervision Act) prohibits a SMSF from taking out a loan. However, in September 2007 the Act was changed to allow a SMSF to take out a loan under certain circumstances. Essentially, a SMSF will be permitted to take out a loan to enable acquisition of an asset provided the following 5 rules are satisfied:

- The loan must be applied solely to acquire an identified asset. However, the asset must not be an asset which the fund would otherwise be prohibited from acquiring.
- The asset must be held by a trust (called a "bare trust") so that the trustee of the SMSF only has a beneficial interest in the asset, with the legal interest being held by a custodian (called the "Security Custodian").
- The trustee of the SMSF must have the right to acquire legal ownership of the asset by making one or more payments after acquiring the beneficial interest in the asset.
- The Security Custodian can grant a mortgage over the asset in favour of the lender. However, the rights of the lender against the trustee of the SMSF for default on the loan must be limited to rights relating to the asset, i.e. the lender must have a limited recourse against the interest held by the trustee of the SMSF so that the existing assets of the SMSF may not be used as security for the loan.
- The asset held in the bare trust must be the only asset held by that trust.

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Can a self managed superannuation fund (SMSF) take out a loan to enable it to acquire an asset? Generally, the Superannuation Industry (Supervision Act) prohibits a SMSF from taking out a loan. However, in September 2007 the Act was changed to allow a SMSF to take out a loan under certain circumstances. Essentially, a SMSF will be permitted to take out a loan to enable acquisition of an asset provided certain rules are satisfied.

THE SECURITY CUSTODIAN

The Security Custodian must not be the trustee of the Fund. The Security Custodian may be an individual or individuals, however, it is preferable that the Security Custodian be a special purpose company formed specifically to be the trustee of the bare trust.

REQUIREMENTS OF THE ACT

The following important requirements of the Act apply:

- A SMSF is not permitted to acquire an asset that the Act would otherwise preclude it from acquiring. For example, an asset may not be acquired from a member of the SMSF (or an entity related to a member of the SMSF) unless the asset is commercial real estate, or listed securities, and the asset is acquired for its current market value.
- Acquiring the asset must not breach the sole purpose test. The sole purpose test requires that a SMSF be conducted for the sole purpose of providing retirement benefits to its members. For example, acquiring a holiday home to be used by a member of the SMSF would breach the sole purpose test.
- All terms upon which transactions relating to acquisition of the asset take place, must be comparable to the prevailing commercial terms for transactions of that nature.
- Investment in an asset must fit within the investment strategy of the SMSF.

THE LENDER

The party that is to provide the loan can be either an external lender (such as a bank) or a related party (such as a member of the SMSF or a member's family trust). The loan must be documented by a limited recourse loan agreement between the lender and the Security Custodian.

MANAGEMENT OF THE ASSET

The SMSF must be responsible for making decisions concerning management of the asset. For example, the SMSF must be entitled to all of the income earned by the asset and also be responsible for paying the expenses relating to the asset.

REVENUE ASPECTS

- The SMSF must pay tax on the net income derived by the asset
- Capital gains tax is payable by the SMSF if the trustee of the SMSF directs the Security Custodian to sell the asset
- Normal stamp duty is payable by the SMSF upon acquisition of the asset.

Usually, provided the transaction is documented correctly, neither capital gains tax nor stamp duty should be payable upon transfer of the asset from the Security Custodian to the trustee of the SMSF after the loan has been repaid.

NEGATIVE GEARING

If the net income derived from the asset (such as the net rent received if the asset is commercial real estate) is insufficient to meet expenses (such as interest payments on the loan), then the shortfall can be met from members' contributions to the SMSF. The investment strategy of the SMSF should address the possibility of the SMSF having to meet any such shortfall.

PRACTICAL EXAMPLES

Example 1

- A SMSF wishes to purchase a strata titled commercial office
- The purchase price is \$1,000,000
- The SMSF is able to contribute \$355,000 towards the price, and borrows approximately \$700,000, being the balance of the price plus costs.

Example 2

- A SMSF wishes to purchase a portfolio of listed securities
- The purchase price is \$500,000
- The SMSF is able to contribute \$250,000 towards the price, and borrows approximately \$260,000, being the balance of the price plus costs.

Example 3

- A SMSF wishes to purchase a factory building owned by one of its members
- The purchase price and current market value of the factory building is \$900,000
- The SMSF is able to contribute \$350,000 towards the price, and borrows approximately \$575,000, being the balance of the price plus costs.

Many banks and other lenders are now comfortable with the Superannuation Borrowing Rules and are able to provide loans that comply with the rules. However, it is crucial that all aspects of the transaction be documented correctly, otherwise serious consequences can follow for a SMSF and its members. One of our experienced lawyers can ensure that your SMSF complies with all.