

DOING IT THE RIGHT WAY

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Since 24 September 2007, SMSF trustees have been able to borrow for direct property purchases under the limited recourse borrowing rules.

We have noticed a number of mistakes or poorly developed approaches commonly being made in the borrowing process by trustees and their accountants and advisers.

The SMSF loan under section 67A of the Superannuation Industry (Supervision) (SIS) Act is not an ordinary loan. It takes careful planning to get the loan correctly settled, not only in order to guarantee compliance with the superannuation legislation but also with a view to the stamp duty issues, particularly to ensure that any subsequent transfer of the property from the holding trustee to the SMSF trustee when the loan is repaid attracts only nominal stamp duty.

In working with accountants and advisers we have identified 10 common traps for unwary trustees; traps which can at best delay the process with accompanying additional cost and inconvenience but at worst could lead to non-compliance with the SIS Act or double

Trap 1: Failing to understand lenders' requirements

Because SMSF lending is functionally different from ordinary property lending, SMSF advisers and their trustee clients cannot make any assumptions about what lenders are looking for from them.

Carefully check with the lender as to what requirements they have for SMSF limited recourse loans. Remember that banks and brokers are learning just as fast as everyone else is in this

area. Trustees should expect closer scrutiny than ordinary property loans because the lender is offering limited recourse terms.

The lender will likely want proof that the fund deed provides the necessary power to borrow. An update of the trust deed may be needed if the trust deed has not been amended since the legislation was introduced in September 2007 or in revised in July 2010.

Will the lender require the member to agree to a particular contribution program to ensure sufficient money in the fund to meet any shortfall in income from the property? If so has the trustee considered whether that program will be possible and advisable?

Will the lender require sign off by the fund's accountant, financial planner and lawyer before proceeding? Will the lender require personal guarantees? Can the members provide guarantees and remain compliant?

Will the bank require that the SMSF trustee and or the holding trustee be companies? Where the fund is buying business real estate from a related party, will the bank expect to see a full contract (arguing section of the act) rather than simply a transfer document.

Be sure you have carefully considered all the lender's requirements before proceeding.

Trap 2: Failing to appoint an SMSF loan champion

SMSF borrowing and purchasing can be complex. We have identified 15 main stages in a typical transaction that have to be successfully negotiated. Each stage in the lending process needs to be handled in the correct sequence.

There are many players who may be involved in (if an arm-length purchase is being funded) the real estate agent, the vendor, the vendor's solicitor, the fund's conveyancing solicitor, the lender, the loan broker, the lender's solicitor, the fund's superannuation solicitor, the custodian, the fund's accountant, the fund's financial planner and the stamp duties office twice.

The process needs a champion someone who drives the process on behalf of the fund and understands all of the issues. An investment/compliance transaction of this kind will go seriously wrong unless someone takes complete control. The property experts will ignore the investment/compliance issues and the investment/compliance experts will ignore the property issues.

Appointing an SMSF loan champion to oversee the entire process is essential and will almost certainly save time and money. The failure to do so will likely result in confusion including problems.

The fundamental point is that limited recourse borrowing can be a complex transaction and such transactions require drivers.

Trap 3: Not paying the entire purchase price from the SMSF

Buying property sometimes requires quick responses and these can be fatal for SMSFs buying and using a loan. The stamp duties legislation in the various states can catch trustees if the good faith deposit is paid from their own pocket and not quickly reimbursed by the SMSF.

All the money must come from the fund or its lender. Further there must be a clear documentary trail showing this to be the case.

If you suddenly realise that the purchase has been completed without complying with this rule then seek advice immediately. A solution may be possible, such as treating the payment as a contribution, but time is of the essence.

Money provided by the lender pursuant to the loan agreement with the SMSF trustee are treated as being provided by the SMSF trustee.

Trap 4: Not arranging the stamping of the holding trust deed

The holding trust deed must be stamped to ensure that any ultimate transfer from the holding trustee to the SMSF trustee attracts only nominal stamp duty. Further it must be stamped within the period allowed for stamping (generally either two or three months after first execution).

And even though the amount of duty may be nominal, tempting the fund to delay paying that duty, it makes sound, practical sense to have all documents stamped when the people and the financial records relating to the documents are readily available.

The documentary evidence could be very difficult, if not impossible, to find in, say, 1(1 years' time when the loan is being repaid.

Note that the holding trust deed cannot be stamped until after settlement of the purchase.

The duties authorities need confirmation that the settlement money only came from the fund (and its lender) and this confirmation cannot be provided until after settlement.

Trap 5: The lender as holding trustee

The idea that you can save money by having the lender act as the holding trustee in a related-party loan to an SMSF is a fallacy. It will result in a fundamental conflict of interest.

SMSF trustees and their advisers don't need the extra grief of having the Australian Taxation Office (ATO) questioning if this arrangement is suitable and compliant.

The presence of that conflict (where the holding trustee is both the bare trustee for the fund and the lender to the fund) will undermine the 'absolute entitlement' of the SMSF. This in turn could have at least land tax and capital gains tax (CGT) repercussions for the fund, not to mention undermining SIS Act compliance. The arrangement should be avoided.

Trap 6: The holding trustee as the borrower

The SMSF trustee must be the borrower. The parties to the loan contract must be the lender and the SMSF trustee. The holding trustee on the other hand is the buyer. The sale contract is between the seller and the holding trustee.

If the holding trustee is the borrower, although the provisions of section 67A are avoided (there being no loan to the SMSF), full stamp duty will be payable on any transfer of title from the holding trustee to the SMSF trustee rather than nominal duty. The very existence of the holding trust may itself be non-compliant in that case.

Trap 7: The holding trustee having active duties

The only function of the holding trustee is to hold legal title to the property while the loan is outstanding, grant the mortgage to the lender and enter into leases of the property.

If the holding trustee has active duties to perform and does not act at the direction of the SMSF trustee then the holding trust may be a GST entity, be required to prepare and lodge tax returns and the 'look through' approach from the holding trust to the super fund may not apply for income tax and CGT purposes.

Some of the banks require holding trust deeds to contain active additional requirements on the holding trustee. We do not recommend these and believe in any case that they are unnecessary.

Trap 8: SMSF trustee as purchaser mixing structures

Often we are confronted with an exchanged contract where the SMSF trustee is the buyer.

This is a breach of section 67A and must be rectified for the transaction to proceed. Clients should seek advice before they take any step in a limited recourse borrowing.

Most limited recourse borrowing arrangements are structured to take advantage of the 'apparent purchaser' or 'agency purchaser' duty concessions. If so, the purchaser must be the holding trustee.

One prominent lender requires the holding trustee to be a company it controls.

Consequently this lender will require the SMSF trustee to be the purchaser and special conditions are included in the contract of sale to the effect that the vendor will, on settlement, transfer title to the bank nominated holding trustee rather than to the SMSF trustee. This arrangement confers additional control to the lender, but does not cause its company to be party to and possibly entangled complications arising from, the contract of sale.

Generally this structure of a limited recourse borrowing arrangement involves different steps, parties and transactions and, in New South Wales at least, more stamp duty.

Trap 9: Out-of-date SMSF trust deeds

Limited recourse borrowing for super funds is relatively new and dates from September 2011. There was a significant alteration in the law in July 2011). Trust deeds of SMSFs drafted before September 2007 are unlikely to permit trustees to enter into such arrangements and are unlikely to confer on trustees the relevant powers for such arrangements.

Lenders' solicitors will review the trust deed of SMSFs that are making borrowing applications. If the trust deed has not been recently updated, lenders may require appropriate amendments. While amending a super trust deed is not necessarily an onerous task, typically the SMSF trustee will be told of the need to amend shortly before the intended settlement date. Usually, settlement cannot occur unless and until the amendments are made.

Knowing and understanding the lender's requirements (such as updating the super trust deed) at the outset of the transaction will permit any necessary amendments to be made without delaying crucial steps of the transaction.

Trap 10: Related-party loans that breach section 109

Section 67A does not prohibit the trustee of the SMSF from borrowing from a related party. However, it is important the lending arrangement does not breach other provisions of the SLS

For example, section 109 of the act provides that the fund and its related parties have to deal with each other so that the terms of the transaction are no more favourable to the other party than those which it is reasonable to expect as if the parties were dealing at arms-length.

The phrase 'no more favourable to the other party' has been considered by the ATO in 11) 2010/162 where it says this means "the terms cannot be more favourable to the related party than would have been the case had the parties been dealing at arm's length, but there is no contravention of s109 if the terms are more favourable to the SMSF-. There may still, however, be a contravention of other provisions such as the sole purpose test.

The calculation of the amount of the interest rate, the term of the loan, the frequency of interest payments, the obligation and timing of principal repayments and the security offered for the loan must all therefore meet the test in section 109. Our advice usually is for the client to ensure that the terms can be obtained elsewhere in the market. Keeping a record of that could prove useful if a suggestion of a breach is made.

In summary SMSF borrowing requires careful planning and good advice from people with experience. That way the traps can be avoided.