DGL ACCOUNTANTS

What factors should a trustee consider before entering a limited resource borrowing arrangement?

Key considerations

The LRBA must comply with the relevant provisions under superannuation law to be exempt from the general prohibition on borrowing under superannuation law. Broadly, the relevant provisions (see especially s 67A of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA')) require that:

- the asset must be held on trust (ie, by the holding trustee for the fund trustee as recorded in the declaration of trust) so that the SMSF trustee acquires a beneficial interest in the asset;
- the SMSF trustee must have a right to acquire legal ownership by making one or more payments in respect of the borrowing used to acquire the asset;
- the lender's rights (and any other person's rights) against the SMSF trustee for, in connection with, or as a result of the borrowing or charges relating to the borrowing must be limited to the rights relating to the acquirable asset, such that the loan is a limited recourse loan;
- the asset acquired with the borrowing must be a single acquirable asset (there are certain other limited circumstances in which the borrowed amount can be applied, such as costs relating to the purchase of the asset, or repairs and maintenance);
- the borrowing can be refinanced;
- the asset cannot be replaced unless it is in accordance with superannuation law; and
- the asset cannot be improved, such that its essential function and nature is altered.

If a guarantee is provided and the fund trustee subsequently defaults on the loan, such that the lender calls on the guarantee, the amount paid pursuant to the guarantee could be treated as a contribution to the fund.

This is because the guarantor has a right of subrogation as against the fund trustee (which is broadly, the right to be reimbursed pursuant to a right of indemnity). This right to be reimbursed, however, is also limited to recourse against the asset acquired with the loan. As such any waiver of the guarantor's right to reimbursement, or the failure to call for reimbursement such that the statute of limitations prevents any action as against the trustee, could give rise to a deemed contribution to the fund.

There are also a number of practical matters that you may wish to consider, such as:

- ensuring the deposit for the asset is paid by the SMSF as this may impact on any available stamp duty exemption, depending on the State or Territory in which the asset is located; and
- the purchaser named in the contract of sale — whether a substituted purchaser or nomination will give rise to additional stamp duty.

Outlined in the table below is factual information that outlines some of the other issues that you may wish to consider before proceeding:

Fund deed	We recommend that you review the SMSF's governing rules to ensure that the trustee has express power to hold, invest in and lease real property. Further, the governing rules must also permit the SMSF trustee to borrow to acquire property and charge its assets.
Investment strategy	We recommend that you consider updating the SMSF's investment strategy to ensure it takes into account the impact of acquiring the asset via borrowings. In particular, you may wish to review the asset classes and relevant percentages to ensure they are consistent with the SMSF's assets and investment profile and account for the proportion of the SMSF's assets that are invested in each asset class. You may also wish to consider the impact on the SMSF's cash flow, risk and liabilities as well as the SMSF trustee's ability to pay benefits to members and/or members' dependants in accordance with s 52B of the SISA. The SMSF trustee should consider taking out appropriate insurance if the SMSF will be holding real property as part of its investment strategy in the event that a person is injured in connection with the property. Importantly, any compensation required to be paid by an SMSF trustee to an injured party is unlikely to be limited to the value of the property. This strategy should be prepared after obtaining advice from a licensed financial adviser and documented in the SMSF's investment strategy.
Lease agreement	A written lease agreement on arm's length terms must be in place between the SMSF trustee and the tenant, for example, the rent, review period and duration of the lease must be consistent with current market practices for comparable premises in light of similar lease arrangements.

Tax considerations

Generally, the tax provisions provide that a holding trust that complies with the borrowing provisions is a 'look through' vehicle for tax purposes under division 235 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997').

Before acquiring an asset, or transferring the asset from the trustee of the holding trust to the SMSF trustee, you should obtain advice on the following tax matters:

- stamp duty on the purchase, execution of the holding trust and transfer to the SMSF trustee on repayment of the borrowing;
- land tax;
- capital gains tax; and
- GST.

You should also consider the extent to which the interest on the borrowing is deductible and whether any income derived from the LRBA is assessable income of the SMSF.

You should also consider if division 7A of the *Income Tax Assessment Act 1936* (Cth) applies and ensure the parties to the transaction are dealing on arm's length terms. If the parties are not dealing on arm's length terms and the SMSF trustee derives more income than it otherwise would if the parties were dealing on arm's length terms, the SMSF trustee may derive non-arm's length income ('NALI'), which is taxed at 47% rather than the concessional tax rates that generally apply to the earnings of a complying superannuation fund in accordance with s 295-550 of the ITAA 1997.

The ATO has issued guidance in relation to what constitutes arm's length terms in the context of LRBAs where the lender is not a bank or financial institution in PCG 2016/5 and TD 2016/16. Broadly, LRBAs consistent with arm's length terms should not give rise to NALI.