MSA
MORTGAGE SETTLEMENTS AUSTRALIA
A NATIONAL LAW COMPANY

SMSF LAWDOCS

SUPPORTING SMSF LENDING

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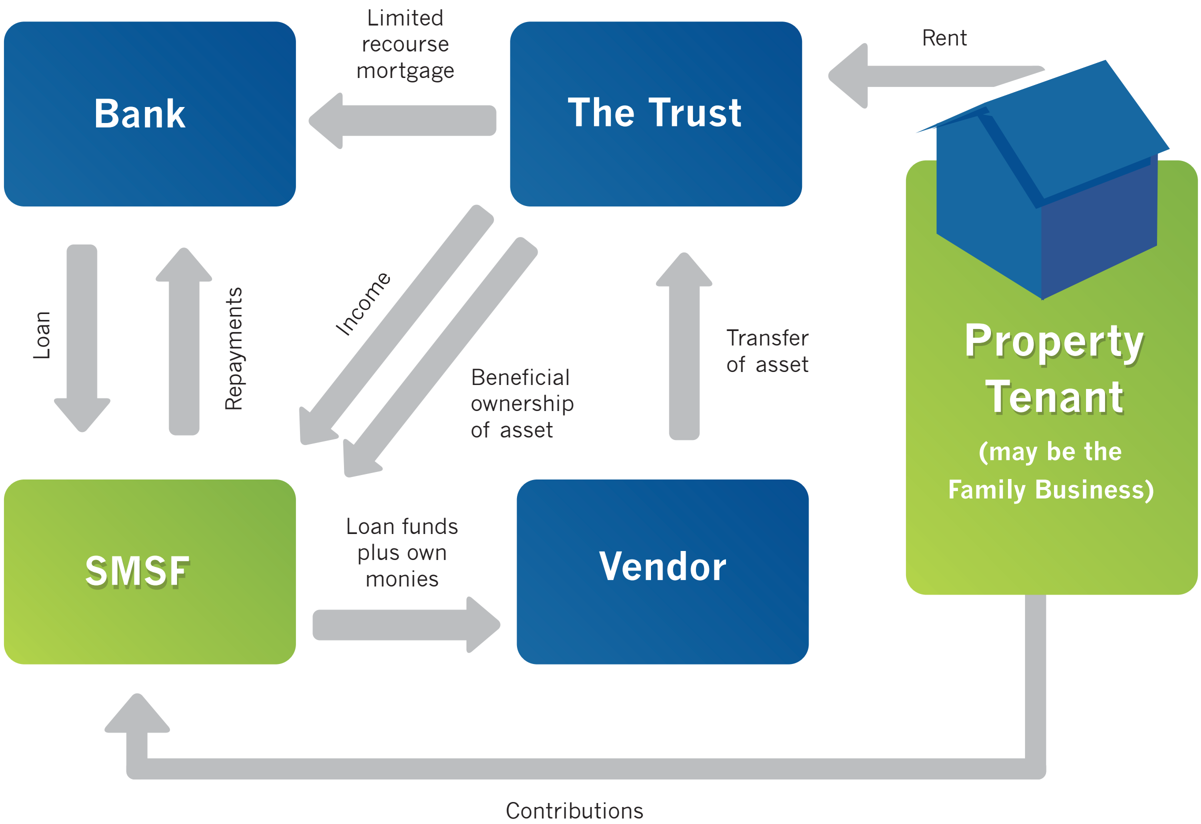
Supporting SMSF Lending

Mortgage Settlements Australia (MSA) provides the following services:

- Prepare and settle the lending documents
- Review the SMSF Trust Deed and Security/Holding Trust Deed
- Create the Security/Holding Trust Deed, if and when required by the customer.
- Proactively meet with your primary trust deed providers to preapprove their trust deeds allowing you to benefit from discounted review fees

A Typical Self Managed Super Fund Lending Structure



- The SMSF Trustee must be permitted to borrow under the SMSF Trust Deed
- A separate company entity is required to hold title to the property on trust for the SMSF
- A trust arrangement deed is required (between the SMSF and the property custodian) specifying the roles and duties for future asset acquisitions by the SMSF
- The vendor must be an unrelated party if residential property is being purchased
- The SMSF has beneficial right to the property (title transfer normally affected on full loan repayment)
- The SMSF must be able to service the loan from its own income sources
- The bank takes a mortgage which is limited in recourse to the property asset only – all other SMSF assets are protected

Non-Complying SMSF - Consequences

Overview

For an SMSF to borrow, compliance with superannuation law becomes paramount. The following details some of the consequences which may occur if the SMSF is non-complying. *It is very important that you engage a legal service provider experienced with the legal requirements for an Limited Recourse Borrowing Arrangement MSA has such experience.*

The ATO's Powers

The ATO has some flexibility to determine whether an SMSF is complying. However, in some cases, the ATO has no flexibility (e.g. if an SMSF does not satisfy the residency rules).

If an SMSF becomes non-complying, then the trustees are taxed:

- at 45% on the SMSF's "assets less undeducted contributions". So the liability is assessed without reference to any liabilities which appear on the SMSF's balance sheet — that is, the ATO looks only at the value of the assets.
- The SMSF is then also subject to tax at 45% on net income for the year in which the SMSF becomes non-complying (and all later years, for as long as it remains non-complying).
- You must also be mindful that the SMSF documentation has been properly drafted to remove deeming of unnecessary dutiable transfers/events. Failure to do so may have CGT and stamp duty consequences.

Lender's Powers

Becoming a non-complying fund will most likely be a default under the loan and security documents. The lender may then make demands for the loan to be immediately repaid in full and default interest may apply.

Conclusion

There are serious consequences for non-complying SMSF structures and borrowings. We have only been engaged to prepare and settle SMSF lending documents and review and amend SMSF trust deeds and Security/Holding trust deeds for lending purposes. We do not provide advice as to whether the SMSF borrowings, structures and associated documents (purchase contracts and lending/security documents) are appropriate and compliant from the borrower's perspective.

It is the borrower's sole responsibility and those of their solicitor to ensure that the trusts and entities created are appropriate for their SMSF needs and comply with the relevant laws. It is strongly recommended that the borrower engages a solicitor to ensure compliance and that their solicitor, at the very minimum, addresses the issues detailed below.

MSA can provide you with a list of reputable SMSF trust providers in each State to assist your introducers facilitate SMSF deals.

SMSF Borrowings - Compliance Issues

The following is a brief and non-exhaustive commentary on issues the borrower's lawyer must address in relation to whether your SMSF can borrow.

SMSFs are permitted to borrow if:

- **Loan and security:** There is a loan made to the SMSF, supported by a form of security (for example, a mortgage or charge);
- **New assets only:** The money borrowed is applied solely for the acquisition of a single acquirable asset;
- **Asset a permissible investment:** The asset is one that the SMSF is not otherwise prohibited by superannuation law (or any other law) from acquiring;
- **Custodian must hold asset:** The asset is held on trust for the SMSF under an appropriate custody arrangement. The relevant custodian must then provide the mortgage or charge to the lender;
- **SMSF may obtain title once loan repaid:** The SMSF has the right (but not the obligation) to acquire legal ownership of the asset after making the final instalment payment under the super borrowing arrangement (that is, under the loan agreement); and
- **Lender has limited recourse:** The rights of the lender under the borrowing arrangement must be of a limited recourse nature - that is, if the borrower defaults, then the lender's rights to recover its money are limited to exercising its right in respect of only the asset purchased with the borrowed money. A common trap is that a member's guarantee is not limited and may be "all monies" by nature. This technically breaches the law for such member may then sue the SMSF for the monies it has paid under the guarantee. A limited recourse clause must be inserted in such guarantee and supporting security. This is a requirement for the Lender's precedent and compliance team to review and resolve.

Compliance Risks

Compliance requirements are increased if an SMSF incurs debt:

- **Investment strategy:** the SIS Act requires the trustees to 'formulate and give effect to' an investment strategy for the fund. The existence of debt:
  - brings the investment strategy into sharp relief: for example, does the investment strategy take into account debt on the balance sheet and the increased exposure to a particular class of assets? and
  - requires a constant re-evaluation of the investment strategy in order that it is adjusted in response to any unexpected good, or poor, performance.

- **Asset "not otherwise prohibited":** It is a condition of the exception for an SMSF to borrow that the asset purchased is not an asset the trustee is prohibited by the SIS Act or any other law from acquiring.

- **Residency rules** - the residency requirements are that for a SMSF to qualify for tax concessional status it must be an "Australian superannuation fund". This requires it to:
  - be established in Australia, or have an asset situated in Australia;
  - have its central management and control in Australia; and
  - meet the active members requirement.

Additional compliance risks arise out of the conditions (or compliance requirements) which apply to SMSFs only if they have borrowing arrangements.

- **Structural requirements:** the structural requirements described in the diagram on page 2 must be put in place and maintained throughout the borrowing arrangement. Consequently, specific compliance requirements include that:
  - the SMSF needs to appoint a custodian (Security Trustee) under a suitable custody arrangement;
  - the custodian needs to hold legal title to the relevant asset(s); and
  - the form of security (mortgage, guarantee or charge) must be of a limited recourse nature.

- **Loan terms:** the terms of the loan must comply with Super law: For instance, concerning interest payable under the loan:
  - Interest payable at a greater than commercial rate (effectively, funnelling funds out of the SMSF) presents problems:
    - It may, arguably, be a breach of the section 52 sole purpose test: using SMSF assets to divert wealth out of the SMSF for purposes other than retirement;
    - It may, arguably, be a breach of the release conditions (Schedule 1 to the regulations made under the SIS Act); and
    - It may, arguably, be a breach of the section 65 lending (financial assistance) to members and relatives;

  - Interest payable at a less than commercial rate (or 0%, but still with obligation to repay) may mean the loan is characterised as a contribution to the fund. This may be taxed at 15%, and may create a liability for "excess non-concessional contributions tax" under Division 292 of the ITAA97. The ATO has recently made reference to a related party loan with 0% interest would not be in breach of s 67A (NTLG minutes for June 2012). This is basically a follow on from ATO ID 2010/162 re: arms length terms. Tax and legal advice should be sought; and
    - Capitalising interest may offend the requirement that "the money borrowed is or has been applied for the acquisition of an asset". The ATO has stated that arrangements in respect of capitalising interest will continue to satisfy the requirements of section 67a and 67b in limited circumstances, namely if:
      - the amounts capitalised are costs of the original borrowing;
      - the original borrowing is applied to acquire the underlying asset; and
      - the lender's rights against the SMSF in the event of a default in repaying the capitalised amounts remain limited to rights relating to that asset (or replacement asset).

Compliance Risks (cont'd)

The following compliance requirements are common to all SMSFs but are worth revisiting regularly - particularly when lending arrangements are being considered.

- **Related party transaction rules** - Section 66 of the SIS Act prohibits acquisitions of certain assets from members of the SMSF. For example acquiring property, which is not business real property, from a related party.
- **In-house asset rules** - Assets acquired (or any replacement) under the borrowing arrangement must not offend the in-house asset rules in Part 8 of the SIS Act (sections 69-85).
- **Arm's length dealings** - Section 109 of the SIS Act requires an SMSF's investments (including dealings in relation to all aspects of the super borrowing arrangement) to be either at arms length or made on an arms length basis Primarily, in the context of super borrowing arrangements, these arm's length issues may arise in relation to the interest rate agreed between the SMSF and the lender.
- **Prudence and standard of care** - In addition to the requirements of section 52 of the SIS Act concerning a SMSF's investment strategy (discussed above), section 52 also requires other standards of behaviour in relation to trustees and directors of corporate trustees, such as section 52(2)(b):
  - to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide.
- **Contract to Acquire the Property** - a common mistake made by parties is that they sign contracts to acquire property in their own name and then they try and change the purchaser details into the name of the Security Trustee. This may have stamp duty implications. It is advisable that if a person wishes to acquire property with the intention of using SMSF borrowing structures and they have yet to establish the appropriate structure that they insert a substitution of buyer clause into the contract to accommodate the creation of the Security Trustee and substituting the original purchasing party to the Security Trustee.
- **Multiple Assets and Construction** - the law provides that the SMSF borrowing structure you establish is to be used to "acquire" an asset. Therefore, using the funds to construct an asset may not comply with this requirement and using the same Security Trust for acquiring multiple assets is prohibited. There are ways to facilitate multiple asset acquisitions under Security Sub-Trusts provided the primary Security Trust deed accommodates such flexibility. The preferred and safer method is to establish a separate Security Trust per asset acquired. There are exemptions in relation to substituting an asset but tailored legal advice should be obtained prior to undertaking such an exercise.

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As a National Law Company we can provide you with coverage and expertise across Australia. We have offices in Brisbane, Sydney, Melbourne, Perth, Adelaide and Hobart. You can contact each office at the address and numbers below.

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