BUILD YOUR BUSINESS & GROW YOUR WEALTH

What is the rule on borrowing to invest in Self Managed Super?

Self Managed Super Funds (SMSF) are allowed to borrow to acquire assets which can include direct property and shares – as long as a Limited Recourse Borrowing Arrangement is used for the transaction.

What is a Limited Recourse Borrowing Arrangement (LRBA)?

An LRBA is a financial arrangement which enables an SMSF to purchase property or shares with borrowed money. It is limited recourse because if the trustee defaults on the loan, the lender's recourse is generally limited to the asset acquired which protects the value of the other assets of the fund.

Financing options are fairly broad with trustees able to borrow from members or from lending institutions. Banks generally require that the SMSF will contribute some equity to the purchase. The lender will take security over the property or shares being acquired.

Since an SMSF cannot own an asset directly that is geared, the asset must be held on trust until the loan is repaid. A bare trust is established to hold the asset as custodian but the SMSF has full beneficial interest in that property or shares, and as a result will receive all rent paid by the tenants or dividends generated by the shares. Tax at the concessional rate of 15% is payable on this income by the fund.

Your SMSF pays interest on the loan and fees to the lender. In the case of a property it also pays for repairs, maintenance and property management expenses. These are deductible to the fund.

One of the main attractions of borrowing to purchase shares or property within an SMSF is that capital gains are concessionally taxed. For example, a capital gain on a property held for longer than 12 months is taxed at only 10%, and in pension phase any capital gains are tax free.

What are the options at the end of the term?

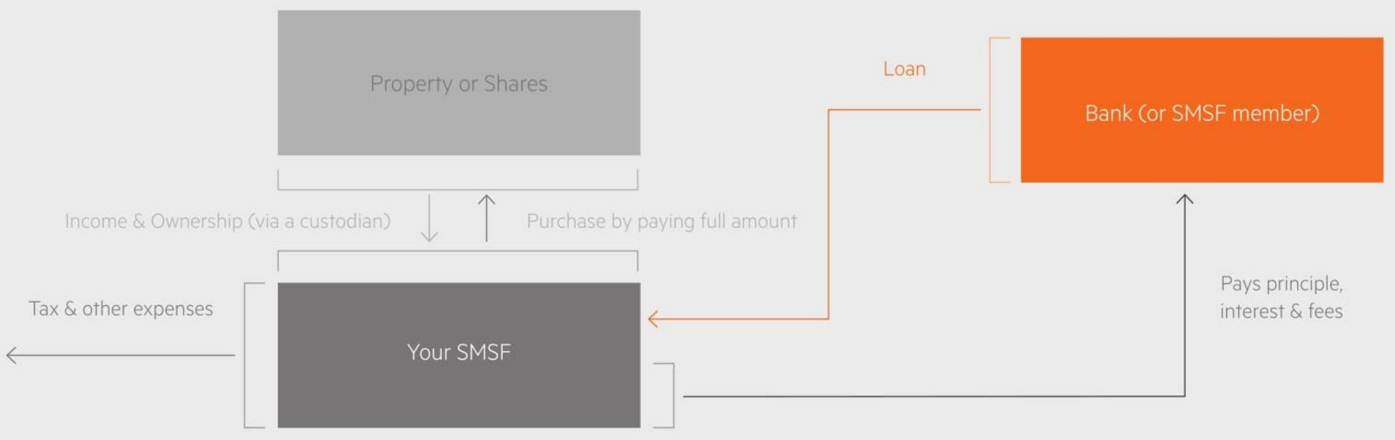
Borrowings are typically from 1 – 20 years. The SMSF has the option to:

- Repay the loan and acquire full ownership of the asset, or
- Sell the asset during the term, with the proceeds applied to the outstanding loan and other associated costs, with any leftover going to the SMSF.

Who should use LRBAs?

LRBAs will suit those members of SMSFs who meet one or both of these criteria:

How LRBAs work – (A simplified example)



MORE THAN NUMBERS

BUILD YOUR BUSINESS & GROW YOUR WEALTH

- Need to build their retirement savings faster
- Want to hold a key property inside the low tax super environment (e.g. their business premises).

Some important points

Borrowing inside your SMSF is not a simple process and professional advice is required.

Some points you need to be aware of include:

- Your SMSF can only invest in assets which meet SIS regulations
- Your SMSF can only borrow to acquire assets if the trust deed allows it to – this may require a review of your SMSF trust deed
- You'll also need to establish a security custodian to facilitate the acquisition
- The contribution limits on super contributions do not apply to the loan amount
- The loan used to purchase the asset can only be a 'limited recourse' loan which means the lender generally has no claim on any other assets in your SMSF other than the asset purchased with their money. The lender may, however, require guarantees from members.

Pros

- Your SMSF has more money invested than if it hadn't borrowed – and therefore your SMSF could potentially benefit from higher investment income and capital growth
- Investment income is taxed at just 15% maximum (compared to up to 45% outside of superannuation)
- Capital gains tax is only a maximum of 15% (compared to up to 45% outside of superannuation)
- The asset is generally fully protected from future litigation & bankruptcy you or your business may face (as long as it was not placed in your SMSF for protection against a specific litigation or bankruptcy you were aware of)

Cons

- Increased level of risk due to the investment of money which isn't yours
- The cost of borrowing is deductible at only 15% (compared to up to 45% if borrowing used outside of superannuation)
- Additional administration for SMSF trustees
- There is a cost to set up a limited recourse borrowing arrangement and the bare trust
- Possible additional costs and tax consequences if asset is sold prior to full repayment of loan

australianunity.com.au/pfs