



SMSF Loans Pty Limited

Set-up Guide for Advisers

October 2010

This information is provided as a general guide. SMSF Loans Pty Ltd and its associates accept no responsibility for people relying on this guide.

General Advice Warning:

This is **General Advice** about SMSF lending products and structures. We have not taken into consideration your personal or financial circumstances, needs and objectives and this guide does not constitute a specific recommendation. You should seek independent advice from your accountant and/or financial planner in considering whether borrowing through your SMSF is appropriate to your circumstances, needs and objectives. You must undertake your own enquiries in determining if the structures involved in borrowing through a SMSF meet your requirements with regard to your legal position, investment strategies and taxation.

Arranging for an SMSF to borrow to purchase real estate

Introduction

Superannuation funds can now borrow money to purchase real estate. Investors can have just as much choice and control over investment properties inside as outside their superannuation fund.

This document provides assistance for Accountants and other Advisers to set up a SMSF lending structure. The information on which this Guide has been based has been taken from professional sources that SMSF Loans Pty Limited (**SMSF Loans**) believes to be credible and all care has been taken in the compilation of this information, however the Guide is provided only as a general guide.

SMSF Loans is the premier SMSF service provider in Australia. SMSF Loans is not a lender. Instead it engages all lenders that have brought SMSF lending products to market and matches those to the needs and goals of SMSF Trustees and their Advice Team.

Basic Structure

The *Superannuation Industry (Supervision) Act 1993 (SIS Act)* was amended in late 2007 to enable superannuation funds to borrow money and charge assets provided the borrowing complies with the following.

- The superannuation fund may select any property (residential, commercial, retail or holiday units). The purchase must usually be an arms length transaction (i.e. the property is purchased from a "stranger"). There is an exception for "business assets" (i.e. property leased to a tenant who conducts a business in the property). In this case, the property may be purchased from a "related party" of the superannuation fund.
- The legal title to the property must be held on trust by an independent trustee (called the "Security Trustee" in these notes). The Security Trustee must not be the Trustee of the SMSF. The Security Trustee can be another company owned or controlled by a member of the SMSF.
- Beneficial ownership of the property will be held by the SMSF.

- The Lender will lend to the SMSF on a limited recourse basis (i.e. The Lender's recourse **to assets of the SMSF** will be limited to the property, thereby providing the SMSF absolute protection for its other assets). The SMSF will charge its beneficial interest in the property to the Lender. In addition, the Security Trustee will grant a mortgage over the legal estate to the Lender. Depending on the lender involved, personal guarantees may be required from members of the SMSF.
- Depending on the lender & loan product, rents may be paid directly to the SMSF, or to a 'Warrant Trust' with proceeds net of capital allowance and property deductions flowing to the SMSF.
- The SMSF will make loan repayments to the Lender in the ordinary way.
- SMSF's can deal with the property however and whenever they like, in the same way as you can deal with "normal" investment properties (e.g. lease, renovate, repair, or sell).
- The SMSF can pay out or reduce the mortgage at any time (subject to the terms of the relevant loan).
- When the mortgage is paid out in full, title to the property may be transferred to the SMSF by the Security Trustee without Stamp Duty or CGT implications (please note that at the time of writing Stamp Duty may be payable in South Australia).

It is important that the structure clearly complies with all the above requirements. Failure to do so may result in the SMSF becoming a "non-complying" superannuation fund within the meaning of the SIS Act.

The diagrams at Appendix 1 provide graphical representations of common SMSF borrowing structures.

This document is divided into several sections as follows

- Part 1: Legal background.
- Part 2: Commonly asked questions.
- Part 3: Reference guide

Part 1: Legal background

Until recently the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* provided:

- A superannuation fund must not borrow money – section 67;
- Superannuation fund trustees must not give a charge over or in relation to an asset of the fund – regulation 13.14.

Recent amendments to the SIS Act were introduced to allow superannuation funds to invest in any kind of asset and to borrow, charging those assets so long as there is no recourse for the borrowing against the superannuation fund.

New section 67(A) provides that a fund can borrow money if:

- (a) the money borrowed is applied for the purchase of an asset;
- (b) the asset is held on trust so that the fund acquires a beneficial interest;
- (c) the fund has the right to acquire legal ownership by making payment;
- (d) the rights of the lender against the fund for default are limited to the security.

This section clearly contemplates that the lender will have "rights relating to" the security. However, those rights cannot be created unless the fund charges its beneficial interest, apparently in contravention of regulation 13.14.

However, regulation 13.15 states that the restriction on the granting of charges by superannuation funds in regulation 13.14 do not apply to a charge that is permitted, expressly or by necessary implication, by the Act. Therefore, as section 67(A) contemplates that the lender will have "rights relating to the security", it follows that SMSF's complying with the provisions of section 67(A) will be permitted to grant charges over the assets.

This view is reinforced because paragraph 3.18 of the explanatory material accompanying amendments to the SIS Act noted that the ATO and the APRA had determined that such an arrangement involves the granting of a charge in breach of regulation 13.14. Accordingly, it was clearly the intention of the legislature to override that determination.

Part 2: Commonly asked questions

Q1. How does my SMSF purchase a property?

- The SMSF chooses the property it wishes to invest in, in the ordinary way. Residential property must be purchased from an arm's length vendor. Non-residential property can be purchased for full value from "related vendors" so long as the property is let for business purposes. **The Contract for Sale to purchase the property must be entered into in the name of the Security Trustee (as owner of the legal interest in the property).**
- The SMSF obtains a loan approval. The loan will be in the name of the SMSF.
- The SMSF's own lawyer/conveyancer acts on the purchase in the ordinary way.
- The SMSF pays the deposit, the balance purchase money (less the amount borrowed), the legal costs, and stamp duty in the ordinary way.

- On completion of the purchase, the SMSF borrows from the Lender and charges its beneficial interest in the property to the Lender, and the Security Trustee mortgages the legal title to the property to the Lender.
- The SMSF then manages the asset in the same way as you would with any other real estate investment.

Q2. What paperwork is involved?

- **Security Trust Deed** under which the Security Trustee holds the property as trustee for the SMSF.
- **Contract of Sale** to purchase the property.
- **Loan Agreement** between the Lender and the SMSF, or simultaneously between the lender and the members and the members and the SMSF; depending on the lending structure chosen.
- **Mortgage** over the property between the Lender and the Security Trustee.
- **Personal Guarantee** by members of the SMSF may be required, dependant on lender & loan product.

Q4. Can fund members occupy residential property?

No. If fund members or related persons occupy residential property, the "in-house asset rule" will have been breached. The fund may, however, purchase a property that the members intend to live in after retirement. Under these circumstances the property will have to be transferred to the members following retirement.

The above restrictions do not apply to commercial property as long as normal commercial leases are in place at 'market value'.

Q5. I thought super funds could not borrow or charge their assets. Is this correct?

That was correct, until amendments to the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* made in September 2007.

Under the new section 67(A) of the SIS Act, SMSF's can borrow providing the following conditions are satisfied.

- The borrowed funds are used to purchase an asset (e.g. real estate).
- The asset is held on trust for the SMSF by another entity.
- The SMSF must have the right to acquire legal ownership of the asset by making payment.
- The lender's recourse against the SMSF must be limited to the underlying asset. The lender must not have a right of recourse against other assets of the fund.

Q8. What other restrictions apply?

The SMSF must comply with all regulations applying to superannuation funds.

SMSF's must ensure that the level of investment in real property is in line with the fund's investment strategy, including diversification of assets, liquidity, and maximisation of member returns in the fund.

The government has also made it clear that super funds investing in these types of investments must have appropriate risk management measures in place and must understand the risks of investment.

Q9. Who pays what and when?

As the beneficial owner of the property and the borrower of the loan, the SMSF is responsible for paying all the usual amounts that you would expect to if you had bought an investment property and borrowed money on it outside a super fund. For example, the SMSF will be required to pay:

- council rates, water rates, and land tax (if any);
- interest and other loan repayments;
- the Lender's fees;
- repairs;
- property management costs; and
- insurance premiums

Depending on the structure utilised some of these costs may be paid by the 'Warrant Trust' from rental receipts on behalf of the SMSF.

Q10. What about land tax?

As the SMSF is the beneficial owner of the property, land tax is payable by the SMSF or 'Warrant Trust' on its behalf. The SMSF will only be liable for land tax if the total land value of properties owned by the SMSF exceeds the prescribed amount. Land tax is payable in all States and Territories except the Northern Territory.

Q11. How can I transfer the property?

The SMSF can direct the Security Trustee to sell to any third party (subject to paying out your mortgage loan and any other amounts which might be outstanding).

Part 3: Reference guide

This part explains the steps required to allow a SMSF to purchase real estate and borrow. The process is represented diagrammatically at the end of this part.

1. Obtain loan approval

SMSF Loans can obtain an indicative approval prior to the client going to the expense of establishing the SMSF and/or Security Trust. For many clients this is an essential first step.

Loan approval should be obtained from the Lender in the ordinary way. SMSF Loans has a range of lender products specially designed to cater for SMSF borrowing arrangements.

The structure of the loan is either:

- (a) [Third Party Loan] Loan to the SMSF (supported by personal guarantees on a case-by-case basis):
 - (i) Borrower: SMSF fund
 - (ii) Security:
 - (A) a charge over the SMSF's beneficial interests in the property, with recourse for repayment of the loan limited to the property;
 - (B) a mortgage over legal estate owned by the Security Trustee, again with recourse limited to the security;
 - (C) a personal guarantee by the fund's members depending on the requirements of the lender. May be influenced by factors such as; how long the SMSF has been in existence, its 'income' position, LVR to be borrowed.

OR

- (b) [Related Party Loan] Loan to the member/s of the SMSF secured by assets external to the SMSF with a simultaneous loan from the member/s to the SMSF secured by the 'SMSF security property':
 - (i) Borrowers:
 - (A) The member/s of the SMSF fund are the borrowers from the lender;
 - (B) SMSF Fund is the borrower from the member/s;
 - (ii) Security:
 - (A) a charge over the SMSF's beneficial interests in the property, with recourse for repayment of the loan limited to the property;

- (B) a mortgage over legal estate owned by the Security Trustee, again with recourse limited to the security;
- (C) the lender has recourse to the member/s of the SMSF as they are borrowers in their own rights;
- (D) the member/s' recourse is limited to the security property only.

In all cases:

- (a) The SMSF fund cannot give collateral security.
- (b) The loan proceeds can only be used to purchase the property and there can be no subsequent advances.

2. Establish/review the SMSF

- (a) The Trust Deed establishing the SMSF must give the Superannuation Fund Trustee power to:
 - (i) purchase real estate,
 - (ii) borrow money, and
 - (iii) mortgage property to secure repayment of that borrowing.
- (b) The proposed investment must comply with the requirements of the SIS Act (including the "sole purpose test" - see section 62 of the SIS Act which requires that regulated superannuation funds are obtained solely for the provision of retirement benefits to members).
- (c) Ensure that the investment in real property is in line with the SMSF's overall investment strategy (note that superannuation funds must have a written investment strategy), and the proposed purchase complies with all other requirements of the SIS Act (including but not limited to the "in-house asset rules" and the restrictions on acquiring assets from "related parties").

3. Establish the Security Trust Deed

The Security Trust Deed is a key document. Care is required to ensure there are no adverse GST, taxation or stamp duty consequences.

4. Instructions to Solicitors/Conveyancer

Accountants should ensure that the lawyer / conveyancer acting for the SMSF on the purchase of the property understand that the property must be purchased in the name of the Security Trustee. This is an essential part of the structure – the SMSF cannot be the registered proprietor.

5. Contracts exchanged

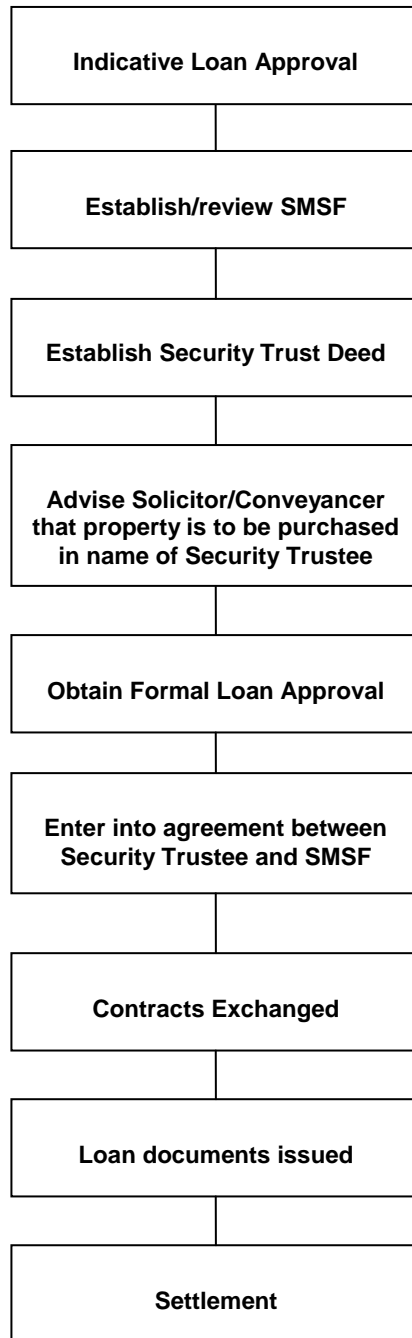
When contracts are exchanged between the seller as vendor and the Security Trustee as purchaser, the deposit will be paid by the SMSF. There is no need for the deposit to be paid through the Security Trustee.

6. Loan documents issued

The Lender's lawyers will prepare the loan documents in the ordinary way and send them to the SMSF's lawyer/conveyancer for signing and return.

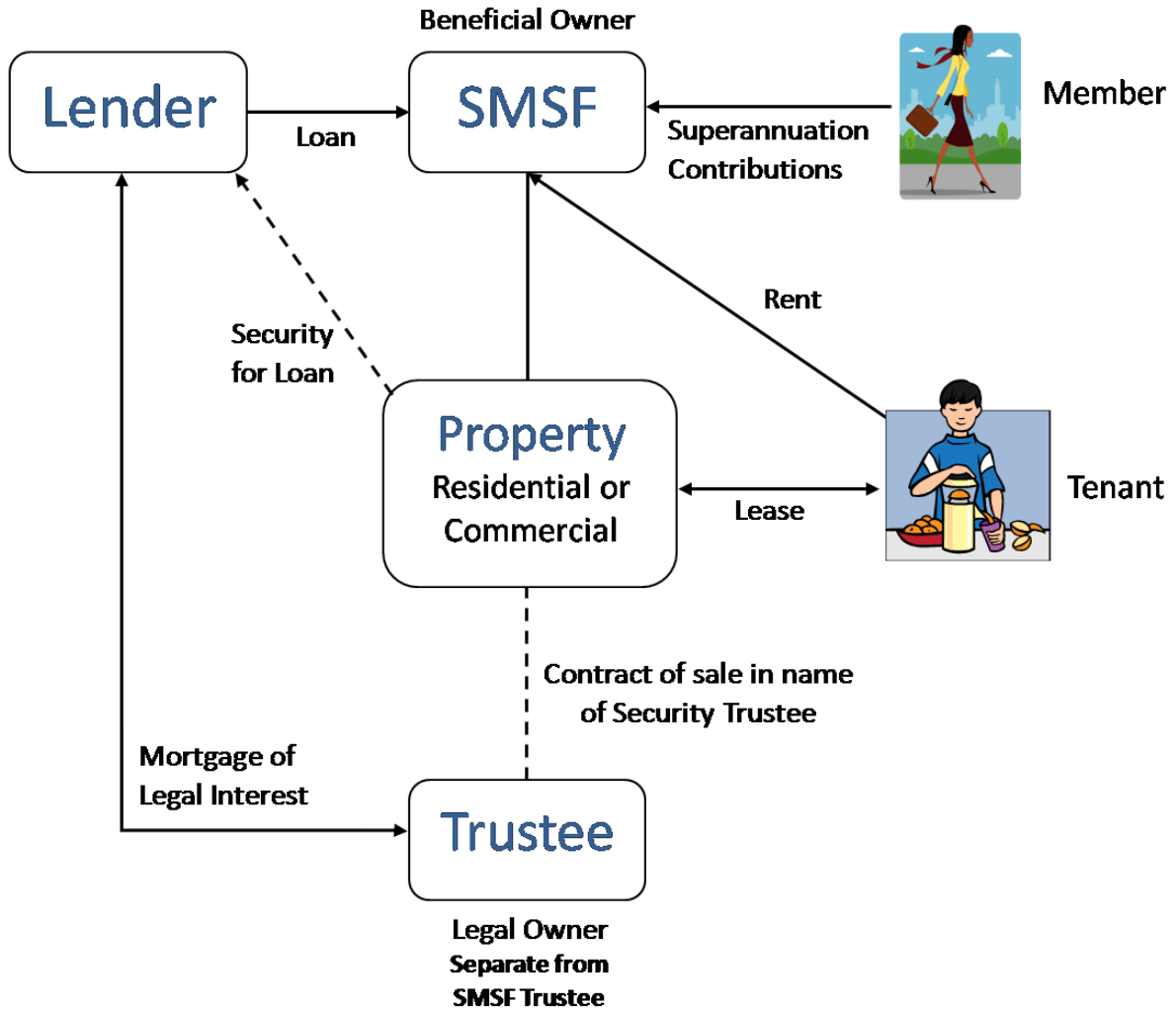
7. Settlement

The purchase is completed. After registration of the transfer on the mortgage, the transaction/title documents will be held by the Lender.



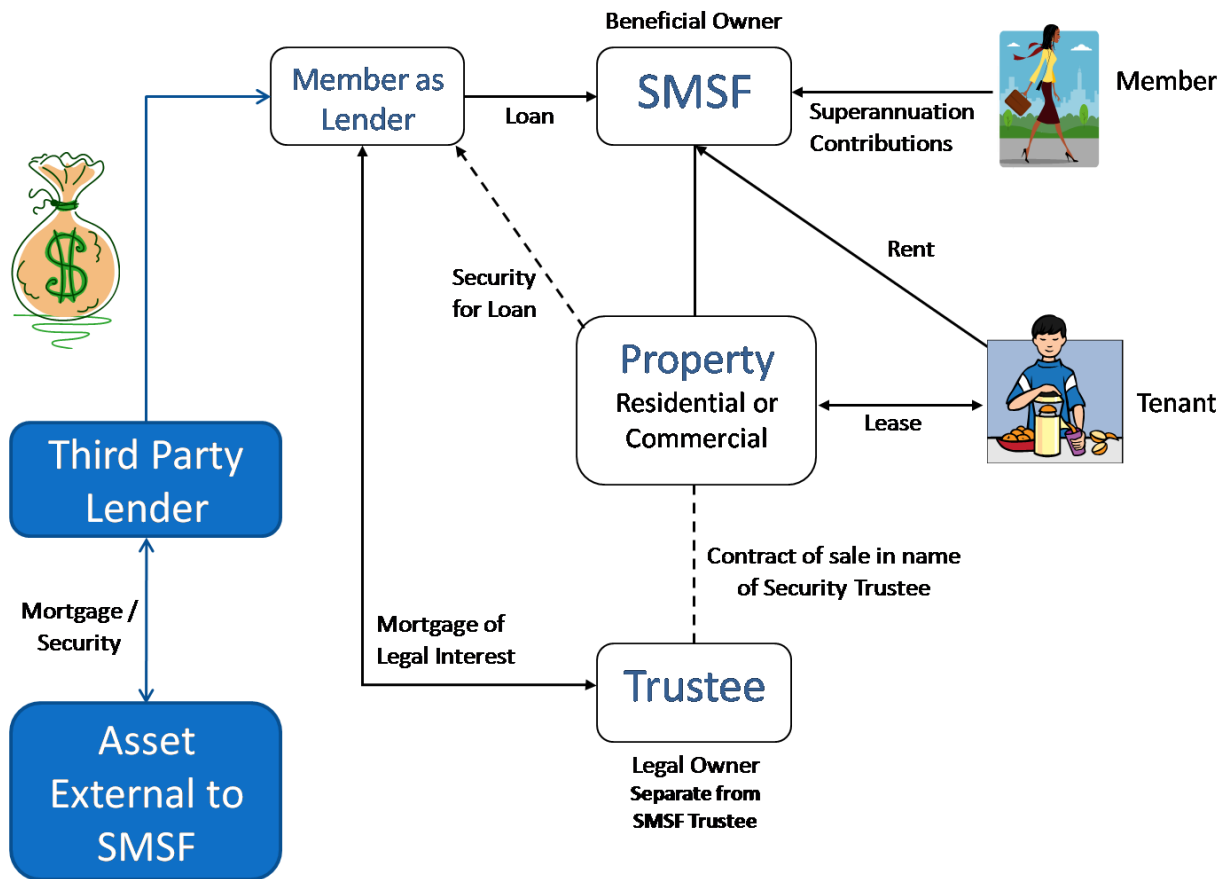
Appendix 1 – Alternative structures

3rd Party Loan from Lender to SMSF



The Diagram above depicts a SMSF Loan / Borrowing structure common to many lenders. In this structure the loan is made to the SMSF and the lender has limited recourse to the assets of the SMSF – recourse to the security property only. In this structure lenders will routinely require personal guarantees from members of the SMSF.

Related Party Loan from the member(s) of the SMSF – utilising external borrowings



This is an example of a structure in which the member(s) of the SMSF raise funds ‘outside Super’ by borrowing against another asset and then make a loan to the SMSF. You will note that the structure is the same as when a SMSF borrows from the Third Party Lender directly, except that in this case the Member(s) of the SMSF take on the role of Lender to the SMSF. The same would apply if the Member(s) had cash resources external to Super that they loaned to the SMSF, except that there would then be no Third Party Lender involved nor requirement for external ‘security’ to be given.



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