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CHANGE IS THE ONLY CONSTANT WITH LRBA_s

Peter Townsend and Michael Hallinan

It has been six years since limited recourse borrowing arrangements (LRBAs) were introduced for SMSFs to acquire assets using gearing, and SMSF trustees can learn a number of things from the experience of the last half decade.

Rent

Rent is particularly important for commercial property with a related party tenant (in-house asset rules would be triggered if a related party tenant occupies or uses a residential property). The SIS Act provides in s109 that when related parties deal with the fund that it must be at arm's length.

The rent should be no more favourable to the tenant than if the SMSF landlord was an unrelated party. It is also worth noting that an inflated rent which is above market value would also fail to satisfy the arm's length test and could even result in an assessment that deemed contributions are being made to the fund.

Refinancing the existing loan

If you are looking to refinance the loan made to the fund trustee with another financial institution, many banks require a certificate of compliance. This is a legal review of the transaction documents and a statement from your superannuation lawyer that the original transaction complied with the SIS Act.

In addition to this, some lenders have a compulsory in-house holding trustee or custodian that is mandatory for you to use when establishing a LRBA.

If your current lender has an in-house Holding Trustee as part of your LRBA and you are refinancing with a different lender you will need to arrange for a new holding trustee to be established and appointed, since the original bank's in-house holding trustee will no longer be used after the refinance.

After that appointment you will need to organise for the transfer of title for the property from the previous (in-house) holding trustee to the new holding trustee.

If the loan is from a related party lender (for instance a member), they may wish at some stage to change the terms of the loan. Depending on the nature of the change required, this too might result in what would be considered a refinance of the original loan.

Unwinding the LRBA when the loan has been repaid

It is important to stay aware of the balance of the loan. When it has been paid out, the property must be transferred from the holding trustee to the fund trustee as soon as practicable.

If there are no longer any moneys owing on the property and it remains in the holding trust it is no longer considered to be part of the LRBA. Without the LRBA exemption the holding trust now becomes a related trust and you will encounter in-house asset test issues.

Insurance

If an SMSF uses limited recourse borrowing for a property purchase, then it must be decided whether the fund trustee or the holding trustee takes out the property insurance and landlord's protection insurance.

The final answer is that both the fund trustee and the holding trustee have an insurable interest in the land, and both are eligible to be the owner of the property insurance and landlord's protection insurance over the property.

The fund trustee is entitled to take out insurances for the property as the fund is liable under the loan and is also absolutely entitled to the benefit of the property.

As the fund is ultimately the party that is detrimentally affected should anything happen to the property, the trustee should ensure that the fund is able to claim for any damage that might occur.

The holding trustee is the legal owner of the land and is entitled to insure the property against damage, and likewise for landlord insurance. Some lenders may also insist that the registered proprietor of the property holds an insurance policy for the property.

But, it is important to keep in mind the nature of the arrangement between the SMSF trustee and holding trustee should insurance be taken out by the holding trustee.

As the holding trustee is a bare trustee, it must make sure that it does not take any action unless it is directed to do so by the fund trustee, who is absolutely entitled to the property.

This direction by the fund trustee should be done formally and in writing and confirmed by the holding trustee executing minutes to confirm this action.

The final answer is that both the holding trustee and the SMSF trustee can take out the property insurance and landlord's protection insurance over the property.

In both instances all amounts payable in respect of the insurance should be paid by the fund trustee. Obviously the holding trustee must hold any policy proceeds on trust for the SMSF.

From a purely administrative position it would be easier for the SMSF to hold the insurances to avoid the constant but mandatory interplay between the SMSF and its bare trustee, the holding trustee. But the insurance company may have its own requirements as might the fund's lender.

Discuss the issue with the fund's broker and check with the lender for any requirements. The need for this insurance should also be considered by the fund's accountant or financial planner.

SMSF deeds must be up-to-date

Rapidly changing laws for SMSFs are placing trustees in danger of having out-of-date deeds which will render the SMSF unable to do what the members are needing or wanting to do.

Further clarification by the Australian Taxation Office of certain issues relating to limited recourse borrowing arrangements should be incorporated into the governing rules.

Given this, it is vital to ensure that the trust deed accommodates all these developments to avoid potential legal and tax problems and other associated penalties.

A wide ranging number of areas other than the SIS Act can affect the operation of your SMSF trust deed, including changes to Federal and State legislation and regulations as well as pronouncements by the ATO and ASIC.

If the deed was last updated before 2010 it may not permit the fund to engage in limited recourse borrowing under s67A arrangements.

If your deed was last updated before 2007 it probably does not permit payment of transition to retirement pensions.

If the deed was last updated before 2008 it may not permit the making of SMSF-specific Binding Death Benefit Nominations.

A number of significant changes to superannuation will occur, or are currently proposed to happen in 2013.

ATO alert on super borrowing

The Australian Tax Office issued a new Taxpayer Alert TA 2012/7 on 20 November 2012 which outlines the ATO's concern with a number of scenarios relating to limited recourse borrowing arrangements (LRBA) by SMSFs.

The Alert deals with issues under two main headings – property investments using limited recourse borrowing arrangements (LRBAs) and property investments using related unit trusts. This article comments only on the first of these.

In relation to common or garden variety LRBAs the ATO lists six scenarios that cause them difficulty. They are:

- the borrowing and the title to the property is held in the individual's (sic) name and not in the name of the trustee of the holding trust and the SMSF pays part of the initial deposit and the ongoing loan repayments
- title to the property is held by the SMSF trustee not the holding trustee
- the trustee of the holding trust is not in existence at the time of the purchase contract and nor is the holding trust
- the SMSF trustee acquires residential property from the SMSF member
- the acquisition comprises two or more titles that can be dealt with separately
- the asset is a vacant block of land that the SMSF intends to improve by building a house

We have consistently advised that these scenarios are non-compliant with the law and we have never allowed a client of ours to enter an LRBA using any of the six scenarios. Specifically we note in respect of each of the scenarios listed above:



The quote

If the deed was last updated before 2010 it may not permit the fund to engage in limited recourse borrowing under s67A arrangements.

- the SIS Act requires that the property be purchased by and be held in the name of the holding trustee, not an individual member
- again, the holding trustee must be the owner not the SMSF trustee
- see our comment below
- only “business real property” (as defined) can be purchased from a related party
- only a single acquirable asset can be purchased using an LRBA, so multiple titles that can be dealt with separately must involve multiple LRBAs
- a vacant block purchased using an LRBA and which is then improved becomes a replacement asset that does not comply with the s.67B of the SIS Act.

Some confusion in the market surrounds the scenario where the trustee of the holding trust is not in existence and the holding trust is not established at the time the contract to acquire the asset is signed. Note that this scenario has two limbs, namely that the holding trustee is not in existence AND that the holding trust is not established at the date of the contract.

We agree totally with the ATO that the holding trustee must be in existence when the contract to acquire the asset is signed because it is the holding trustee who is acquiring the property.

However it is not possible in some States (NSW, ACT and TAS) to execute the holding trust deed before the contract to acquire the asset as this could lead to full ad valorem duty being levied twice – once on the declaration of trust and once on the contract (see for example *Platinum Investment Management Ltd v Chief Commissioner of State Revenue (No.2)* [2010] NSWSC 1).

The ATO appears to be concerned, and rightly so, that if the contract were signed before the holding trustee was even in existence (and therefore before the holding trust could exist) the deposit paid by the SMSF and or the loan repayments by the SMSF may be considered as a payment of superannuation benefits given the requirement that the title of the property be held by the trustee of the holding trust.

However, provided the holding trustee is in existence and enters the contract, the mere fact that the holding trust deed is signed thereafter does not invalidate the LRBA. Provided all the deposit is paid by the SMSF, the holding trustee holds the property in a resulting or implied trust until the deed is actually executed thereby formalising the trust. Normally all of this occurs before completion of the purchase making the situation clearly compliant when the purchase takes place.

The minutes of both the holding trustee and the SMSF trustee, which we provide with our document pack and which we advise be signed before the contract, make the situation quite clear.

The process of executing the holding trust deed after the contract will safeguard against double stamp duty in NSW, ACT and TAS and will not of itself breach the requirements of the SIS Act in respect of LRBAs. **FS**

Bonnie and Clyde change holding trustees

Those familiar with limited recourse borrowing arrangements will appreciate that the property, once purchased, is held by a so-called ‘bare trustee’ that the ATO prefers to call a ‘Holding Trustee’. The Holding Trustee is usually a passive entity that simply holds the property title while the loan is being repaid. However, some clients may find that a few years into the LRBA the entity appointed to act as the Holding Trustee needs to be replaced or substituted.

Say if Bonnie and Clyde have purchased a property with their SMSF using limited recourse borrowing, where the original finance for the property is with a Lender which uses its own Holding Trustee.

Now if in a few years from their initial purchase, Bonnie and Clyde decide they wanted to refinance the loan over the property and change lenders, or lend themselves to their SMSF, the property will need to be transferred to a new Holding Trustee.

Apart from ensuring that the refinancing of the loan is properly taken care of, Bonnie and Clyde need to ensure that they consider the following:

- preparing and executing a Deed to affect the appointment of the new Holding Trustee and the retirement of the Lender’s Holding Trustee;
- whether there is a requirement to register this Deed on the General Register of the relevant State;
- how to meet the requirements to obtain concessional stamping on the Transfer at the relevant Duties Office;
- registration of the Transfer with the relevant Titles Office (along with the Discharge of the previous Mortgage and registration of the new Mortgage, if relevant);
- written resolutions of the Fund Trustee relating to the appointment of the new Holding Trustee and the Transfer;
- written resolutions of the new Holding Trustee relating to its appointment as the Holding Trustee and the Transfer;
- ensuring that a formal direction from the Fund Trustee to the new Holding Trustee is given to allow the new Holding Trustee to execute the documents required for the Transfer.

As with any documentation for LRBAs, Bonnie and Clyde must ensure that all documentation is correctly prepared and executed in the right order so as to maintain the compliance of the arrangement. They also need to ensure that the Transfer is fully completed so that the new Holding Trustee is the registered proprietor of the property.



The quote

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