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LIMITED RECOURSE BORROWING

Mark Ratcliff

What is limited recourse borrowing?

Limited recourse borrowing – also sometimes referred to as "non-recourse borrowing" is a particular type of borrowing which permits the lender recourse on the asset used as security for the loan only. This means that any other assets that the borrower has ownership of are safe from any possible claims that the lender may attempt, if the lending comes into dispute or becomes unpaid.

In relation to a self-managed superannuation fund (SMSF), limited recourse borrowing arrangements provide a layer of security to the members by protecting the trustee from legal action or claims; hence protecting the assets of the SMSF. Obviously the reduced exposure to claim against the SMSF and its assets is very positive – however this type of borrowing can lead to higher interest rates and lower loan to valuation ratios (LVR), as the borrower is taking on a higher level of inherit risk.

History of borrowing in superannuation

Section 67 (1) of the Superannuation Industry (Supervision) Act of 1993 (SIS Act) states that a trustee of a regulated superannuation fund must not borrow money or maintain a borrowing of money through the superannuation fund. Applying this to a SMSF, the trustee is unable to enter into a borrowing arrangement or maintain any level of borrowing on behalf of the members of the SMSF.

Section 67 does, however, provide some exceptions to the above restrictions. The exceptions that are do not breach SISA s67 (1) include:

- Payment to a beneficiary of a superannuation fund as required by law or the governing rules of the fund, which does not last for a period longer than 90 days and the amount borrowed is not greater than 10% of the value of the assets of the superannuation fund,
- Payment of surcharge on behalf of a member for which the borrowing does not last for longer than 90 days and the amount is not greater than 10% of the value of the assets of the superannuation fund;
- Temporary borrowings to settle securities transactions, where the borrowing period is not longer than 7 days and the borrowed amount is not greater than 10% of the value of the superannuation fund.

In order to circumnavigate these restrictive requirements on borrowing in superannuation, trustees utilised different investment products to indirectly introduce gearing to their superannuation funds. The most popular of these products were instalment warrants.

An instalment warrant is a "part payment" on a share or class of shares with the outstanding balance due in a later time period. The investment would be held on trust until such time as the outstanding amount was fully repaid. The owner of the instalment warrant has all the benefit of dividend income and franking credit entitlement – even though the underlying asset is only part-paid. The holder of the instalment warrant pays interest to the issuer which can be a tax deductible expense to the warrant holder, i.e. the superannuation fund.

Arguably the most common and well known instalment warrant arrangement was the Australian Government's float of Telstra, through the T3 offering. This offering was based on an initial part payment with the balance due at a later date. It is rumoured that 40% of all investors in the T3 float were superannuation funds – including SMSFs.

The concern from the Australian Taxation Office and Australian Prudential Regulation Authority (APRA) were that these types of investments breached s67 of the SISA, through the entering into a borrowing style arrangement – even though there was no official borrowing or lending arrangement.

Introduction of limited recourse borrowing

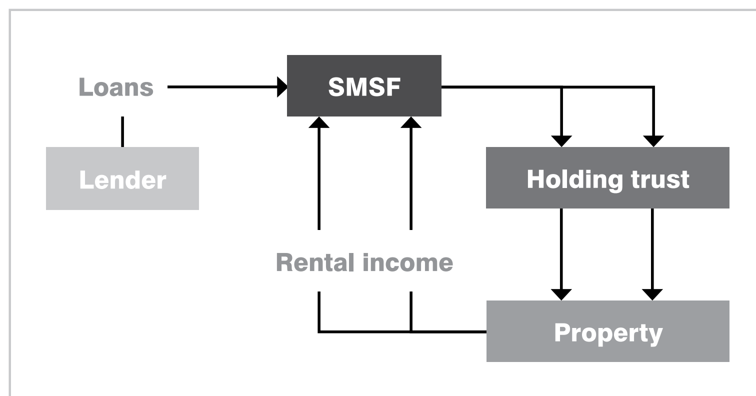
The introduction of borrowing inside superannuation funds initially gained traction through the instalment warrant style investments as described above and was officially introduced into the SIS legislation on September 24 of 2007, through the inclusion of s67(4). The inclusion of this section effectively permitted superannuation funds to enter into and maintain a borrowing arrangement, subject to strict requirements. These requirements specifically included:

- Borrowed funds were applied to the purchase of an allowable asset under the SIS Act on behalf of the superannuation fund,
- The asset is held on trust for the superannuation fund,
- The trustee of the superannuation fund is able to take legal ownership after making one or more payments to the lender,
- The rights of the lender are limited to the rights of the asset for which the funds are borrowed.

The introduction of s67(4) by the Australian Government was seen as a big step in the right direction for superannuation funds, SMSFs in particular, and opened new investments opportunities and entirely new investment classes, which until that date were inaccessible to superannuation most funds.

Of the new investment classes, the most common and arguably the most popular investment class is direct real property – either residential or commercial. The ability for superannuation funds to use borrowings with tax deductible interest payments has introduced new planning and strategy options to trustees of superannuation funds – and has arguably been a significant factor in the continuing growth of the SMSF sector.

Graph 1
Comparison of 10 yr returns from listed and unlisted property funds



How limited recourse borrowing arrangements are structured

A limited recourse borrowing arrangement can seem a difficult arrangement to enter into; however this is fundamentally not the case. The lender can be a recognised lending institution, such as a bank or building society – the lender is also able to be a related party. This gives rise to a planning opportunity for superannuation fund members with significant cash assets outside super that they are trying to contribute to their fund. If a large cash balance is held outside of the superannuation environment, a relatively simple related party borrowing arrangement will allow the superannuation fund to increase the underlying investment asset exposure through the concessionally taxed superannuation environment.

A diagram outlining a superannuation borrowing arrangement can be seen in graph 1 below.

It is important that the superannuation fund has beneficial ownership of the underlying asset. All rental income should be paid directly the fund with all associated expenses being paid by the fund as well.

Amendments made 7 July 2010

Changes which were passed in early July of 2010 further extended the legislative requirements around borrowing in superannuation – the changes were made to the original borrowing rules contained in section 67(4(A)) and were amended and re-introduced through sections 67 A & 67B – all of the SIS Act.

These changed were and have widely been recognised as encouraging for the industry as a whole, with the borrowing limitations becoming more simplified and more relaxed in some areas. On the other side of the coin however, there have been some new features which have been somewhat limiting in some instances.

The key changes from the introductions of the new sections – 67A and 67B – were:

- Definition of a single acquirable asset,
- The ability to re-finance loans,
- Further clarification on a replacement asset and its definition,
- Definition of repair vs. capital expense,
- The use of personal guarantees for superannuation borrowings

Of the above changes, I believe that the most significant to SMSFs was the definition of a single acquirable asset and the ability to re-finance loans. Section 67A clearly states that a trustee of a regulated superannuation fund is able to enter into and maintain a borrowing of money on behalf of the fund which is used to purchase a 'single acquirable asset.'

That particular section continues and provides advice on incidental expenses of asset acquisition, such as borrowing costs, stamp duty and brokerage. This particular section – s67A(1)(a)(i) - also states that

costs incurred in maintaining or repairing the asset are able to be financed using borrowed funds. The section also clearly states that borrowed funds are not to be used in capital improvements of the asset which has associated borrowings.

The definition of a single acquirable asset can also be applied to a collection of assets, as outlined in s67A(2) of the SIS Act, ensuring that the following specific conditions are adhered to:

- The assets in the collection have the same market value as each other; and
- The assets in the collection are identical to each other

A simple practical example of this would be a collection of listed shares, assuming that the transaction was entered into with assets with the same market value and of the same type, for example ordinary shares.

The ability for trustees of superannuation funds to re-finance existing superannuation borrowings was also seen as a positive – especially for trustees who had entered into a borrowing arrangement prior to July of 2010 which may not have had terms which were favourable to the superannuation fund.

As discussed previously, the use of borrowing strategies for superannuation funds and the requirement of limited recourse borrowing saw initial loans being charged at higher interest rates than other available funds. The flexibility provided under s67A(1)(ii) allow trustees to ensure that they have the best available lending option for their fund and ultimately the members of the fund.

Uncertainties arising from introduction of s67A and s67B

The changes introduced successfully cleared a few questions however, as expected, also managed to provide a few more eyebrow raising concerns. Some of these concerns included:

- The use of borrowing strategies to acquire off the plan (OTP) properties,
- Acquisition of single properties with multiple titles attached,
- Use of holdings trusts for asset purchases and the GST concern.

The purchase of off the plan properties by superannuation funds has seen significant debate since July of last year. This issue was raised and discussed by the Superannuation technical group of the National Tax Liaison Group (NTLG) September of 2010. The concern was the purchase of this type of investment and the application of the amended borrowing rules, through s67A and s67B.

Unfortunately there was no direct and final answer was given – the point was raised that each transaction differs, and whether the borrowing was entered into before the property was completed or part-way though. The Australian Taxation Office (ATO) declared that they would require more information and specific examples before they could form and deliver a proper view on this type of investment transaction.

Another problem was raised through properties which have more than one title attached. The wording of the legislation allows for a "single acquirable asset" to be purchased using borrowed funds.

The concern here is that a property which has a dwelling and an associated car park or storage area on separate title would not be permitted under s67A(1). The issue arising here is that each title would require a separate borrowing arrangement for each title – obviously this can become an expensive barrier to entry for superannuation funds looking to purchase this type of investment.

The original legislation introduced in September of 2007 allowing superannuation funds to borrow made it mandatory for the asset to be held on trust. The legislation provided no compulsory or distinct type of trust – it merely states that the asset must be held on trust until all borrowings are exhausted.

The most common type of trust used in the industry for superannuation borrowings is a holding or bare trust. These types of trust are popular due to the savings on ongoing expenses, such as GST. Holding or bare trusts are not required to be registered and hence report for GST but have the ability to use the Australian Business Number (ABN) of the beneficiary for GST reporting purposes.

Effect of borrowing arrangements and the Cooper review

The highly publicised review into the governance, efficiency, structure and operation of Australia's superannuation system – more commonly referred to as the "Cooper review" – discussed the issue of leverage in superannuation. The panel stated that they had concerns on the entire concept of borrowings in superannuation, especially in relation to SMSFs. The panel's view was that borrowing and the use of leverage should not be the core focus of SMSFs as an option for retirement savings.

The panel compared funds regulated by APRA and SMSFs, who are regulated by the ATO. The review acknowledged the continued growth of the SMSF sector and the ability for trustees to invest in more complex products, which include levels of borrowings.

The panel described their view and concern that SMSFs are at greater risk than APRA funds, due to the higher level of regulation of APRA funds, which is directly influenced by the licensed trustee and seemingly more comprehensive risk management strategies.

The panel also stated that by allowing borrowings through superannuation funds another Global Financial Crisis (GFC) would see losses incurred by trustees amplified.

The interesting part of the review and the discussion of borrowings in superannuation and in particular SMSFs, was stated in recommendation 8.10 of the Cooper review, which stated, "The 2007 relaxation of the borrowing provisions ... should be reviewed by government in two years' time to ensure borrowing has not become ... a significant focus of superannuation funds." This provides some re-assurance to SMSFs that the current borrowing arrangements will remain for at least 2 years – beyond that is still being debated and will continue until final determination is passed.

Stamp Duty Considerations – get it right the first time

As with most purchases of property, the borrower – for example a SMSF – is liable for stamp duty upon acquisition of the asset. As discussed previously, this expense is allowed to be packaged up as part of the borrowed funds and is commonly defined as a capital cost of acquisition.

The concern arises when the holding trust is wound up, after the SMSF has repaid the outstanding loan amount. Once the loan has been repaid, the ownership of the underlying asset reverts to the SMSF and is no longer held on trust. A pitfall from this transfer can be a second payment of stamp duty – only if the borrowing arrangement was entered into incorrectly initially.

There are exceptions available to trustees of SMSFs to ensure that this is not the case. A commonly utilised exception is that of the "apparent purchaser." Although this exception does not exist in all states and territories of Australia, Western Australia, Tasmania, the Australian Capital Territory, Victoria and New South Wales all allow stamp duty free transfers once the borrowing arrangement has ceased.

It is important though to ensure that the transaction is drafted and executed correctly to ensure that the transfer does not incur unnecessary stamp duty expense. The requirements for title and description vary between jurisdictions – it is vital that each transaction be revised and considered appropriately before finalisation of the required documentation.

Important factors and risks SMSF specific

There are several important and unique factors of SMSF borrowings which must be adhered to, to ensure that the borrowing is allowable under the updated legislation. It is important that the following characteristics are contained in the borrowing arrangement:

- Acquired asset is held on trust for the SMSF – the type of trust is not defined or required, however the necessity of the SMSF having a beneficial interest in the trust is,
- Borrowing is completed by the SMSF and not by another party and then passed to the SMSF, as mistakes can be counted towards the contribution caps and have inefficient tax consequences,
- The trustee takes control and full entitlement of the asset once the loan is extinguished – after one or more payments have been made to the lender,
- The loan is limited recourse in nature – that is the loan does not expose the SMSF to claims on any other assets.

The changes made to the legislation relating to borrowings in SMSFs have made the use of borrowings more popular and more accessible to more Australians. The changes mentioned above can be seen as difficult to implement for a trustee that is inexperienced or does not have the appropriate knowledge or understanding of the transactional details. The measures put in place by the changes to legislation have provided some security to trustees, mainly through the combination of the holding trust and the limited recourse borrowing requirements.

Problems with borrowings in SMSFs

Borrowing to invest through superannuation – especially SMSFs – can be a fantastic way to utilise the benefits of having such a flexible retirement savings vehicle. There are, however, some pitfalls that must be recognised and appropriate measures put in place to ensure that the borrowing experience does not disintegrate into a negative one. Pitfalls of borrowings in superannuation can include:

- Capital repairs required to a property,
- In-adequate insurance levels,
- Stamp duty on extinguishment of the loan,
- Inappropriate investment strategy

Of the above problems, most are relatively simple to overcome and pose no real threat, if completed correctly and accurately. For example, the investment strategy of the fund should contain appropriate mention of the borrowings and how these form part of the overall strategy of the fund – as described in s52(2)(f) of the SIS Act. The issue of under-insurance can be simply negated by having appropriate insurance policies in place to cover the value of the asset. The stamp duty concerns can mostly be nullified as previously discussed, ensuring that the transaction to acquire is entered into appropriately.

An issue which is sometimes overlooked is that of capital repair compared to an actual repair. The legislation states that the asset must not be improved from its original condition, however repairs are allowed. ATO has taken a stance on this particular piece of legislation and have advised that replacement asset rules will apply, if capital improvements are made to a property where a borrowing arrangement is in place.

This may not seem like a significant issue; however the situation can quickly deteriorate if the asset is not able to be repaired to a level as it originally was, such as the unavailability of particular materials. The effects of natural disasters, for example the flooding in Queensland earlier this year had trustees of SMSFs concerned that owned property with borrowings attached in the area, as if the asset had been damaged, it would require repair – with a worry that some repairs would be considered capital in nature. **FS**