Guide to Limited Recourse Borrowing:
BORROWING PROPERTY THROUGH YOUR SMSF

Subject to certain exceptions, the trustees of superannuation funds, such as self managed superannuation funds **(SMSFs)** are prohibited from borrowing money under the Superannuation Industry (Supervision) Act 1993 (Cth) **(SIS Act)**. This presents certain obstacles, particularly for SMSFs which may wish to borrow from a bank in order to purchase a property.

One of the exceptions to the borrowing restriction is a limited recourse borrowing arrangement.

In this guide, we step out the conditions that need to be met in order to comply with the strict requirements under the SIS Act in respect of limited recourse borrowing.

WHAT IS LIMITED RECOURSE BORROWING?

Limited recourse borrowing is where a trustee of a superannuation fund who wishes to borrow money to purchase an asset on behalf of the fund, enters into an arrangement whereby the lender's rights against the trustee (and therefore the assets of the superannuation fund) in the event of default are strictly limited to the asset purchased. The asset is held in a separate trust, however all returns on the asset (after expenses), such as rent or dividends are paid to the superannuation fund.

HOW DOES LIMITED RECOURSE BORROWING WORK?

In practice, how this works is:

1. Michael is the trustee for the Michael Superannuation Fund. Michael wants the fund to purchase an investment property, however the fund does not have the cash to purchase the property outright.
2. Michael approaches 123 Bank, who have agreed to give Michael (as trustee for the superannuation fund) a loan to purchase the property for the fund.
3. At settlement of the purchase, the property will be held in a new trust which is distinct to the superannuation fund. However, all rent from the property will be paid to the superannuation fund, and the property will eventually be transferred across to the superannuation fund once it is paid off.
4. 123 Bank has a mortgage over the property. This is permitted under the SIS Act, because the property (and therefore the debt) is held in a separate trust to the Michael Superannuation Fund.
5. Essentially in the event that Michael (as trustee for the superannuation fund) fails to make payment under the mortgage and defaults, 123 Bank has "limited recourse" in that it can only seize and sell the property purchased. 123 Bank has no recourse to the other assets of the Michael Superannuation Fund. If 123 Bank could access the other assets in the Michael Superannuation Fund, then this would breach the SIS Act. That is, their recourse is limited to one asset.

WHEN SHOULD YOU CONSIDER LIMITED RECOURSE BORROWING?

Limited recourse borrowing allows you to invest the funds accumulated in your SMSF. A common investment strategy for Australian business owners is to purchase their business premises through their SMSF and lease it at market rates to their business trading entity.

There are other situations where limited recourse borrowing is suitable, subject always to financial asset advice.

WHAT CONDITIONS MUST THE ASSET MEET?

The relevant asset being purchased must:

1. meet the 'sole purpose test' of solely providing retirement benefits to fund members;
2. not be acquired from a related party of a member; and
3. not providing benefits to any fund members' related parties, such as living in a property owned in a separate trust.

WHAT ARE THE LENDING AND BORROWING CONDITIONS THAT MUST BE MET?

The following are the key conditions that your borrowing arrangement must meet in order to be compliant with sections 67A and 67B of the SIS Act:

1. the borrowed money is, or will be applied for the acquisition of a single asset (such as a commercial or residential property) or collection of identical assets that have the same market value (such as shares);
2. the asset must be held in a separate trust and the sole beneficiary of the trust must be the superannuation fund;
3. the borrowed money must not be applied to improving the asset;
4. the beneficiary must have the right to acquire legal ownership of the asset upon paying off the loan;
5. the lender may only have recourse to the specific asset purchased in the event of default, no other assets of the superannuation fund may be exposed; and
6. the asset must not be subject to an encumbrance, other than the mortgage taken by the lender.

KEY POINTS TO CONSIDER

If you are looking to use limited recourse borrowing to make an investment through your SMSF, you should carefully consider whether this is the right decision for you. Some questions you should ask yourself are:

1 What is the value of the asset?
TIP have the asset independently valued and ensure that you have it appropriately insured.

2. What are the real costs? Key costs include set up costs, repayments and interest, as well as the ongoing costs of advertising, maintaining and insuring the asset and paying an agent commission.
TRAP setting up a loan can be a costly exercise, as banks charge higher fees for limited recourse loans.

3. Are you required to give a personal guarantee under the loan? This means that if you default and the asset is sold and the sale price is less than the mortgage owing, you will be personally liable for the balance owed to the bank.
TIP negotiate out of providing a guarantee based on the asset value.

In the event that you wish to discuss limited recourse borrowing arrangements, please contact one of our team members to discuss.