

## Limited Recourse Borrowing Arrangement Guide

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# Limited Recourse Borrowing Arrangement Guide

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## Superannuation Funds can now Borrow

Until September 2007 the *Superannuation Industry (Supervision) Act 1993* ('the SIS Act') prevented Superannuation Funds from borrowing, except for some temporary purposes. However, in September 2007, legislation was passed by the Senate to allow borrowing by Superannuation Funds; and those rules apply to instalment warrant structures put in place before 7 July 2010. New rules introduced on 7 July 2010 are contained within section 67A of the SIS Act which is included in this guide. The relevant section is headed 'Exceptions – Limited recourse borrowing arrangements' and authorises any borrowings made by a Superannuation Fund provided that:

- the borrowed money is applied for the purposes of acquiring a single asset or collection of assets including:
  - expenses in connection with the borrowing or acquisition, or in maintaining or repairing it (but not improvement expenses); or
  - money applied to refinance a borrowing;
- the Fund Trustee is not prohibited from acquiring the asset;
- the asset is held on trust so that the Fund Trustee acquires the beneficial interest in the asset;
- the Fund Trustee has a right to acquire legal ownership of the asset;
- the rights of the lender or any other person against the Superannuation Fund for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the asset; and
- the asset is not subject to any other charge except under the limited recourse borrowing arrangement.

Effectively this means that any borrowing arrangement that is allowed under section 67(A) of the SIS Act must be done so on a limited recourse basis. Consequently the existing assets of the Fund may not be used as security regardless of the performance of the new investment.

## How the legislation affects you

The new legislation means that you can structure borrowing through your Superannuation Fund so as to allow the Fund to acquire any asset that is permitted under the SIS Act.

If properly structured through a limited recourse borrowing arrangement, a Fund can borrow to acquire an asset. Examples of where a Fund might seek to borrow are:

- to allow the Fund to acquire an investment property;
- to allow the Fund to acquire a share portfolio; or
- to acquire units in a Unit Trust (for example a small group of persons might want to set up their own Unit Trust to acquire a substantial investment property).

## Replacement of Assets

Section 67B of the SIS Act which also took effect from 7 July 2010 sets out the circumstances in which an asset under a limited recourse borrowing arrangement can be replaced. For instance, a share in a company (or collection of shares) can be replaced by a share in another company if the replacement occurs because of a takeover, merger, demerger or restructure of the first company (ss 67B(5))

## Prohibited Assets

The reference to assets which the Fund is prohibited from acquiring is a reference to section 66 of the SIS Act, which prohibits the Trustee or an investment manager of a regulated Superannuation Fund from intentionally acquiring an asset from a Member or from an associate of a Member, unless that asset is an 'excepted asset'; i.e. business real property and listed securities. Acquisitions must also be made at the present market value.

## Beneficial Ownership

The Fund Trustee is not allowed to be the legal owner of the asset however it must be the beneficial owner of the asset. For that reason an entity must hold the asset on trust for the Fund Trustee, such as a separate Trustee Company (not the Corporate Trustee of the Fund).

Furthermore the trust must not be an "active trust" as there may be adverse capital gains tax consequences when the Fund Trustee calls for transfer of the legal title. The entity holding the asset will hold it as a Bare Nominee so, as a result, the asset must be managed by the Fund Trustee. For example if the asset is real estate the Fund Trustee must collect rent and attend to repairs.

## Funding

The essence of the legislation is to allow Funds to make limited recourse borrowings.

There is no requirement as to who the lender might be but the most obvious arrangement is for a bank to lend directly to a Fund; some banks have been slow to recognise this new legislation. An alternative is for a Member to borrow from a bank and lend those borrowed monies to the Fund or for the Member to lend their own capital to the Fund.

As security, the Fund can only provide the asset itself and income generated from the asset. In some circumstances the Member may also be required to provide the lender with additional security, external to the Fund, as collateral over the borrowing but any right of a person to be indemnified by the Fund because of a personal guarantee given by that person in favour of the lender is limited to rights relating to the asset only.

## Trustees of the Limited Recourse Borrowing Arrangement

The Bare Trustee should not be the Fund Trustee. It would be preferable if a Corporate Trustee Company was established due to the legal protections and limited liability structure this provides but the Members can also be Bare Trustees providing they are not the Trustees of the Fund.

## Capital Gains Tax

The Trustee must be a 'Bare Trustee' in order to avoid capital gains tax and stamp duties on transfer of an asset from the Bare Trustee to the Fund Trustee. This means that the Bare Trustee must not provide any active services and need not even hold a bank account.

## Negative Gearing

It is possible that any rent received by the Fund (when the underlying asset is real estate) will be insufficient to meet interest expenses incurred by the Fund. Any shortfall may be met by tax deductible contributions made to the Fund or by other Fund assets. The ability of the Fund to cater for any such shortfall should be addressed in the Investment Strategy.

## Requirements & Considerations

- A Self-Managed Superannuation Fund ('the Fund').
- The Fund Trustee needs to possess the power to borrow under certain limited recourse arrangements to acquire a permitted asset.
- The investment strategy of the Fund needs to accommodate the limited recourse borrowing arrangement. An amendment to the Fund's Investment Strategy is included in this package.
- A Bare Trustee, which will acquire the asset and hold the legal title of the asset on trust for the Fund.

The Bare Trustee cannot be the Trustee of the Fund. The Bare Trustee may be an Individual or Individuals; however a Corporate entity is preferable given the legal protection it provides.

- A Contract in which the Bare Trustee enters to acquire the asset.

The Bare Trustee must be a "Bare Nominee" for the purposes of Capital Gains Tax, as discussed in this guide.

- The Fund is responsible for managing the asset; for example, if the asset is real estate then the Fund must collect the rent and manage all repairs.
- Capital raised by the Fund to allow the Bare Trustee to pay the vendor for the asset being acquired.

In order for the Bare Trust to take effect the Fund Trustee must utilise the funds borrowed to acquire the asset; Funds may be borrowed from a financial institution or an Individual. This package contains a loan agreement applicable where a Member of the Fund is providing the monies. A financial institution may, however, require the Bare Trustee to provide a mortgage on any acquisition of property.

- A Bare Trust Deed executed by the Bare Trustee and the Trustee of the Fund is included in this package.
- An investment, which is to be acquired by the Bare Trustee as a Bare Nominee for the Fund.



# Limited Recourse Borrowing Arrangement Excerpt

## Section 67 – Borrowing & Section 67A – Limited recourse borrowing arrangements

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### **SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993 – SECT 67**

#### **Borrowing**

##### *Prohibition*

- (1) Subject to this section and section 67A, a trustee of a regulated superannuation fund must not:
  - (a) Borrow money; or
  - (b) Maintain an existing borrowing of money.

### **SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993 – SECT 67A**

#### **Limited recourse borrowing arrangements**

##### *Exception*

- (1) Subsection 67(1) does not prohibit a trustee of a regulated superannuation fund (the **RSF trustee**) from borrowing money, or maintaining a borrowing of money, under an arrangement under which:
  - (a) the money is or has been applied for the acquisition of a single acquirable asset, including:
    - (i) expenses incurred in connection with the borrowing or acquisition, or in maintain or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset), and  

Example: Conveyancing fees, stamp duty, brokerage or loan establishment costs.
    - (ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and
  - (b) the acquirable asset is held on trust so that the RSF trustee acquires a beneficial interest in the acquirable asset; and
  - (c) the RSF trustee has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and
  - (d) the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) default on:
    - (i) the borrowing; or
    - (ii) the sum of the borrowing and charges related to the borrowing;are limited to rights relating to the acquirable asset; and

Example: Any right of a person to be indemnified by the RSF trustee because of a personal guarantee given by that person in favour of the lender is limited to rights relating to the acquirable asset.

- (e) if, under the arrangement, the RSF trustee has a right relating to the acquirable asset (other than a right described in paragraph (c)) - the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the acquiring asset; and
- (f) the acquirable asset is not subject to any charge (including a mortgage, lien or other encumbrance) except as provided for in paragraph (d) or (e).

#### *Meaning of acquirable asset*

- (2) An asset is an *acquirable asset* if:
  - (a) the asset is not money (whether Australian currency or currency of another country); and
  - (b) neither this Act nor any other law prohibits the RSF trustee from acquiring the asset.
- (3) This section and section 67B apply to a collection of assets in the same way as they apply to a single asset, if:
  - (a) the assets in the collection have the same market value as each other; and
  - (b) the assets in the collection are identical to each other.

Example: A collection of shares of the same class in a single company.

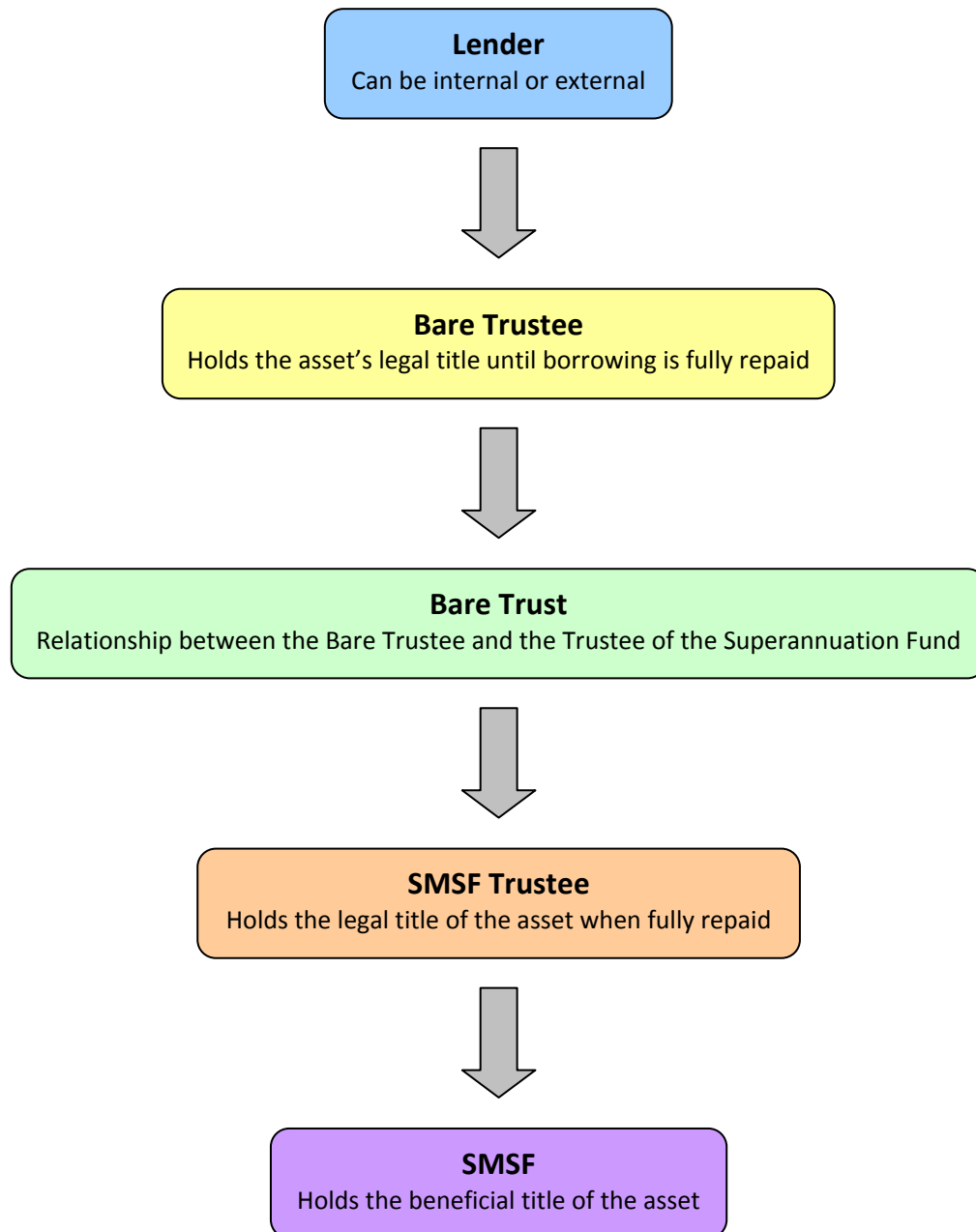
- (4) For the purposes of this section and section 67B, the regulations may provide that, in prescribed circumstances, an acquirable asset ceases to be that particular acquirable asset.

#### *RSF trustee*

- (5) Paragraphs (1)(d) and (e) do not apply to a right of:
  - (a) a member of the regulated superannuation fund; or
  - (b) another trustee of the regulated superannuation fund;to damages against the RSF trustee for a breach by the RSF trustee of any of the RSF trustee's duties as trustee.
- (6) A reference in paragraph (1)(d) or (e) (but not in subsection (5)) to a right of any person against the RSF trustee includes a reference to a right of a person who is the RSF trustee, if the person holds the right in another capacity.

# Simplified limited recourse borrowing arrangement structure

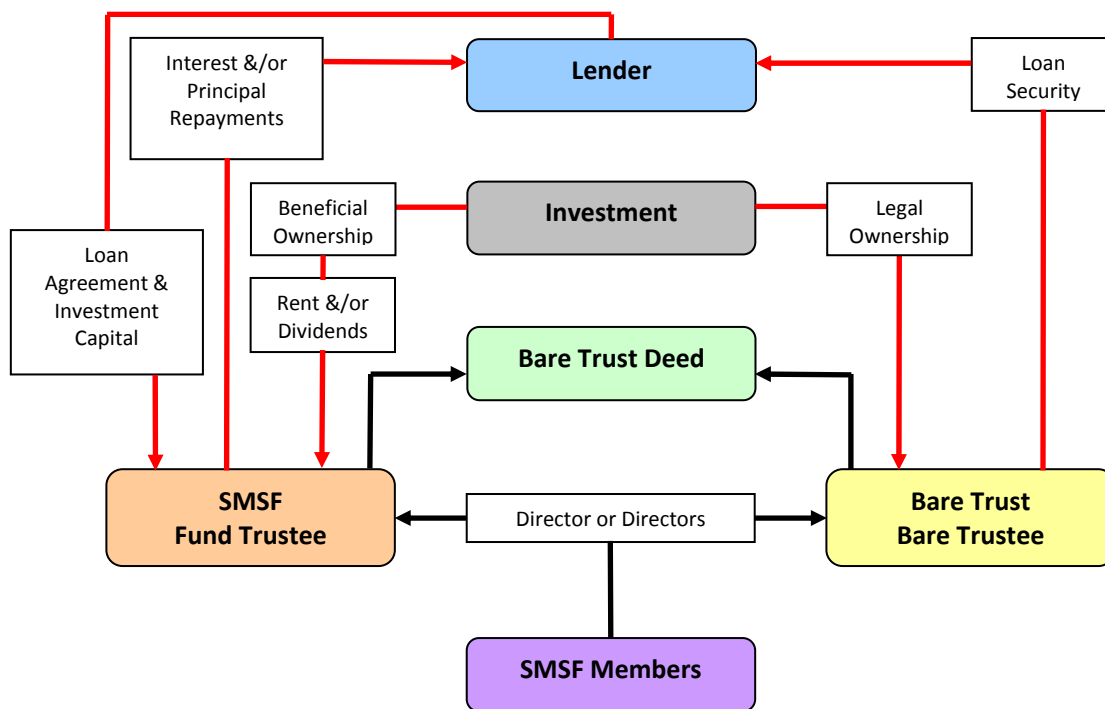
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# Typical limited recourse borrowing arrangement set-up

## Corporate trustees



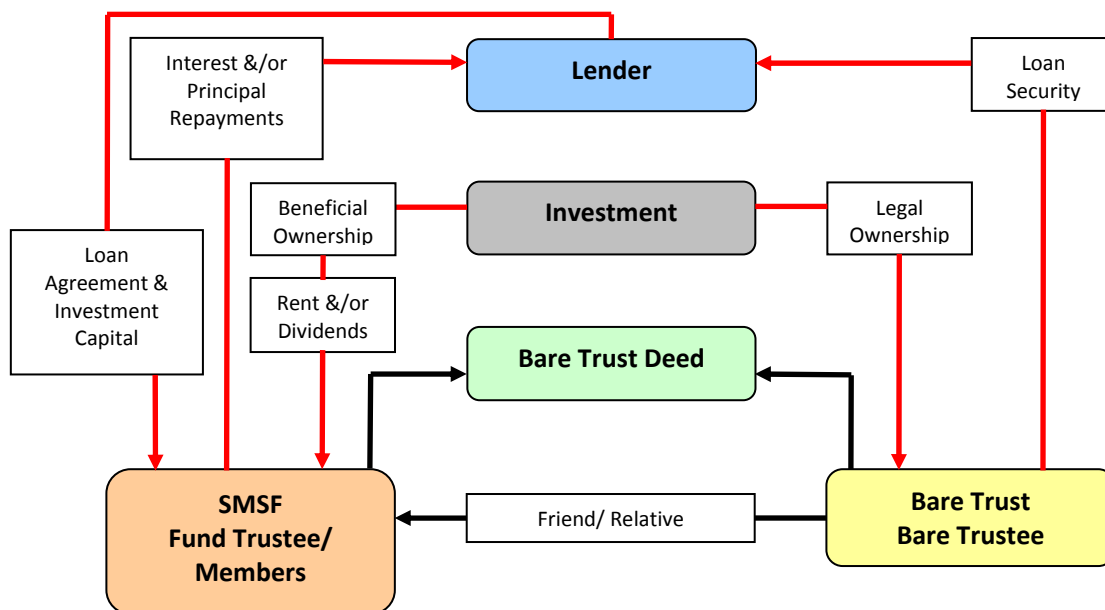
Please note:

- Red arrows represent the legal processes that occur for the limited recourse borrowing arrangement to be implemented correctly.
- Black arrows represent the relationship between the two trust structures, the Fund Trustee, the Bare Trustee and the SMSF Members.
- The SMSF & Bare Trust Deed cannot have the same trustee, however, they can have the same directors of different corporate trustees.
- The member or members of an SMSF can also perform the function of the Lender, and it is up to the Lender and SMSF Members to determine the loan security, and the frequency and structure of repayments. If a financial institution is the Lender and requires additional security over the amount borrowed then professional advice should be obtained.



# Typical limited recourse borrowing arrangement set-up

## Individual trustees

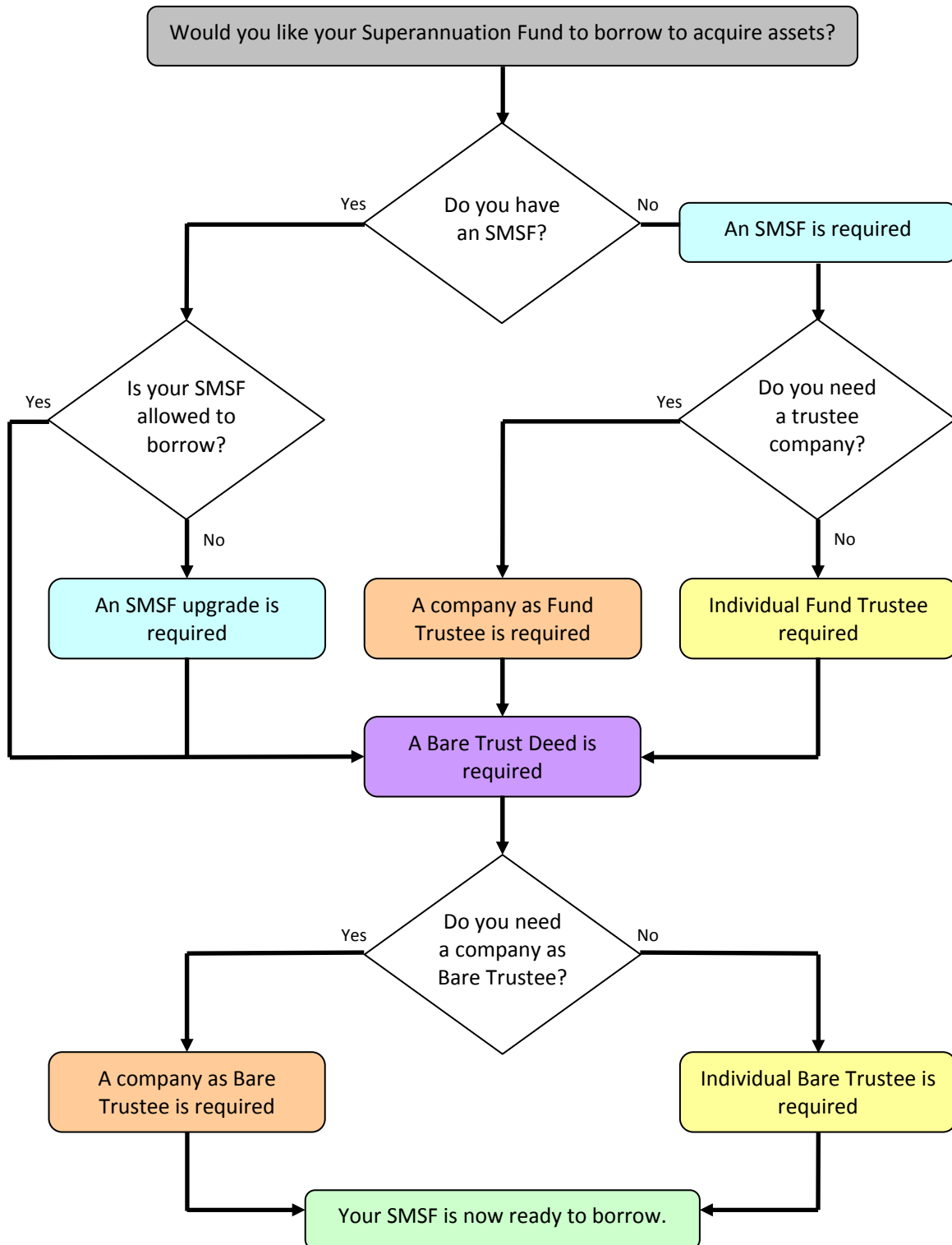


Please note:

- Red arrows represent the legal processes that occur for the limited recourse borrowing arrangement to be implemented correctly.
- Black arrows represent the relationship between the two trust structures, the Fund Trustee, the Bare Trustee, and the SMSF Members.
- The SMSF & Bare Trust Deed cannot have the same trustee, however, they can have the same directors of different corporate trustees.
- The member or members of an SMSF can also perform the function of the Lender, and it is up to the Lender and SMSF Members to determine the loan security, and the frequency and structure of repayments. If a financial institution is the Lender and requires additional security over the amount borrowed then professional advice should be obtained.



# Flowchart: limited recourse borrowing arrangement





# Suggested investment strategy amendment

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## Real property

The trustees have considered borrowing through a limited recourse borrowing arrangement to fund the acquisition of real estate. The following matters were considered:

- the risks involved in making, holding and realising the property under a limited recourse borrowing arrangement;
- the likely return from the property under a limited recourse borrowing arrangement;
- the diversity of investments generally;
- the liquidity and cash flow consequences of holding the property under a limited recourse borrowing arrangement;
- the time the members have until they retire;
- the fund's cash flow requirements; and
- the investment risk tolerance of the members.

The Fund Trustee will borrow to acquire the beneficial interest in real estate. The lenders' rights on any default of the borrowing or the sum of the borrowing and charges related to the borrowing are limited to rights relating to that real estate or any replacement to the real estate.

## Listed securities

The trustees have considered borrowing through a limited recourse borrowing arrangement to fund the acquisition of listed securities. The following matters were considered:

- the risks involved in making, holding and realising the listed securities under a limited recourse borrowing arrangement;
- the likely return from the listed securities under a limited recourse borrowing arrangement;
- the diversity of investments generally;
- the liquidity and cash flow consequences of holding the listed securities under a limited recourse borrowing arrangement;
- the time the members have until they retire;
- the fund's cash flow requirements; and
- the investment risk tolerance of the members.

The Fund Trustee will borrow to acquire the beneficial interest in listed company shares provided. The lenders' rights on any default of the borrowing or the sum of the borrowing and charges related to the borrowing are limited to rights relating to those listed securities or any replacement to the listed securities.

The trustees acknowledge that the Fund will not enter into any dividend reinvestment plan as this would breach the legislation relating to limited recourse borrowing arrangements.



# Checklist: Limited recourse borrowing arrangements

The checklist below is provided for guidance and assistance to set-up the limited recourse borrowing arrangement package for your SMSF to borrow.

Task	Checked	Date
<p>Ensure that your SMSF Deed is allowed to borrow through a limited recourse loan.</p> <p>(if you purchased a Reckon Docs SMSF with this limited recourse borrowing arrangement package, then your Fund will allow this)</p>		
<p>Ensure that the Fund's investment strategy allows for or has been amended to allow for the SMSF to borrow through a limited recourse borrowing arrangement.</p> <p>(if the Investment is real estate or listed securities then this package includes suggested amendments to the Fund's investment strategy)</p>		
<p>Identify an investment and ensure that it:</p> <ul style="list-style-type: none"> <li>• can be acquired under the SIS legislation;</li> <li>• is suitable for the Fund, considering the trust Deed and investment strategy;</li> <li>• is suitable for the Members of the Fund; and</li> <li>• is appropriately managed.</li> </ul>		
<p>Determine the total amount of monies required to acquire the Investment, along with the amount to be borrowed.</p> <p>Select a suitable financier from which the monies will be borrowed to acquire the Investment on a limited recourse basis.</p>		
<p>Hold a meeting of Trustees of the Fund to agree to the borrowing.</p> <p>(this limited recourse borrowing arrangement package includes the relevant minutes for this meeting – the Fund Resolution)</p>		
<p>Hold a meeting of the Bare Trustee to agree to execute the Bare Trust Deed.</p> <p>(this limited recourse borrowing arrangement package includes the relevant minutes for this meeting – Bare Trustee Resolution)</p>		
<p>Ensure that the attached Bare Trust Deed and management agreement (if applicable) are completed.</p>		
<p>All documents are to be executed.</p>		