

Limited recourse loan arrangement - Internal Lender

Steps to be taken by SMSF trustees to purchase property under Sec 67A 67B SISA

Disclaimer: *This document is prepared to assist trustees of SMSF, advisors, accountants, auditors and solicitors acting for trustee of the SMSF, to purchase property with borrowing, where the lender is a related party. No guarantee is given that information given below is accurate; trustees must take their own legal and financial advice and not only rely on information contained in this document)*

Limited recourse loan arrangement - Internal Lender - Procedure to follow

Below is suggested procedure prepared to assist trustees of SMSF's and their advisors to implement "borrowing strategy" within their SMSF. These steps below will ensure that the fund complies with the borrowing rules under Sec 67A & 67B of SISA where the lender to the SMSF is a related entity.

Steps before Exchange of property

1. Find Suitable property; The member(s) of the SMSF should find a suitable target property for their fund. Please note that nothing happens till the target property is finalized and the correct address is known as the property address has to be embedded in all documents including Property Custodian Trust deed (PCT deed) and related legal documents.

2. Name of buyer on Contract for Sale of Land; The advisor must ensure that the name of "trustee of the Property Custodian Trust" is on the exchange document as buyer of the property on the "sale of land" document.

The solicitor must ensure that <name of the trustee of the PCT> appears on the transfer records and not the <name of trustee of SMSF>. This is done because although the "real owner" of the property is the trustee of the SMSF, but under Sec 67A & 67B of SISA when the SMSF borrows

and mortgages the property, the property has to be "held on trust" for the SMSF, and not held by the SMSF (in the name of the trustee of the SMSF). However, the "apparent owner" is the trustee of property custodian trust (PCT). As all trust assets are held in by its trustee, the legal owner of property purchased will be the "trustee of the PCT".

There is some debate among experts on who can be the trustee of the property custodian trust, where some have suggested it can be an individual member or a related individual. Our solicitors have drafted the PCT deed in a manner that the trustee of the property custodian trust is a corporation where one or all members of the SMSF are directors / shareholders.

This PCT is basically a "bare trust". In other words, the property is held by the trustee of the Property Custodian Trust "as trustee for" the trustee of the Self Managed Super Fund whilst the borrowing and mortgage is in place by the trustee of the SMSF.

3. Who will be the lender? ; The advisor has to determine who is going to lend money to the SMSF - member(s) or a related party (e.g. a related trust or company).

If the member has equity in its own home loan - the member can draw on this equity and on-lend to the SMSF. The bank lends to the member and the member lends to the SMSF. The SMSF pays interest to the member and the member pays interest to the bank.

This lender can be a related party - like a family trust or a company (preferably loss making) - as a tax minimizing strategy it should be someone whose tax rate is lower than 15% as the SMSF will be able to claim a deduction on interest paid - in the same token interest received becomes income of the person who has lent the money to the SMSF.

4. Check if the SMSF trustee has enough money to complete the purchase; Before paying a deposit for the property from the SMSF bank account, trustees must ensure that the full amount required including cost price of the property, stamp duty and legal expenses are available to the SMSF trustee at the right time to complete the purchase.

The initial deposit is paid by the SMSF to the vendor (say 10%), the balance can be paid by two methods. First the related lender can deposit the money in the SMSF bank account and the SMSF pays the remainder amount (say 90%) or the trustee of the SMSF can instruct the lender to pay directly to the Vendor at the time of settlement (say 90%).

Remember, since there is no limit on how much the SMSF can borrow from the related entity, it can be 100% or 110% to cover the cost of legal's, stamp duty etc. However, the interest rate charged by the related party must be market rate.

To determine this market rate, we suggest to taken an average interest rate of 3rd party lenders such as Westpac, NAB, St George bank.

5. If the trustee of your SMSF are Individuals; If the trustees of your SMSF are individuals then you cannot use our documents. Our solicitors have determined that to comply with SISA, stamp duty, Capital Gain Tax and trust laws, the trustees of the SMSF MUST be a corporation.

Further, it is possible that the borrowing may last over two decades and during this time, new members (children of the current members) may join the fund or existing member may die, whilst the fund is in borrowing phase. In any case, if the members of SMSF do not want to change individual trustees to corporate trustee - the fund cannot use our legal documents.

Changing to corporate trustee is very easy; the steps are as follows

- a. Create a new Special Purpose Trustee Company
- b. Retire all members as trustees
- c. Execute consent to act as directors of trustee company
- d. Lodge NAT 3036 with ATO
- e. Update SMSF trust deed to show name of new trustee
- f. Change ownership names of all the other assets of the SMSF to reflect the new corporate trustee

Our online module to change individual trustees to corporate trustee is available under the tab "SMAF Tools".

Please note Step number (f) is very important - when the trustee is changed to a corporate trustee, ownership of all other existing assets of the SMSF, must also be changed to the new corporate trustee as per Sec 52 (d) of the SIS Act.

This means if the SMSF has an existing bank account or owns shares or managed funds, the advisor may have to write to the share registry to get the share transferred to the new trustee's name. Note that this is not a CGT event or a resettlement of SMSF trust - just a change in trusteeship.

At the time of changing the bank account of the SMSF, some banks may insist on providing them a copy of the SMSF trust deed with the new corporate trustee's name on it. At this point of time, the advisor must update the trust deed and ensure that the trust deed allows the SMSF to borrow under Sec 67A & 67B.

6. Does your SMSF trust deed allow borrowing? If the SMSF trust deed does not allow borrowing, the advisor should log on to our website and update their client's trust deed, If you purchase our conversion pack from Individual trustee to corporate trustee, clause 119 empowers the trustee to borrow.

7. Establish Corporate Trustee of Property Custodian Trust; The trustee of the Property Custodian Trust MUST also be a corporate entity. This entity can have one or all four members SMSF as directors / shareholders.

Corporate Trustee of the SMSF cannot be trustee of the PCT. You will need two separate companies. It is advisable that corporate trustee of the PCT is a newly established company or has never traded before - this company is not intended to conduct a business but only to act as trustee of the PCT and it's only purpose is to hold the asset in trust for the trustee of the SMSF.

Note this company is not a "Special purpose company", which means that this company will pay \$267 Annual Review Fee each year. Advisor's should note there is no need for this company to have a tax file number, ABN or a bank account etc.

Steps before and at the time of Exchange

8. Pay Deposit to the Vendor; At the time of exchange of “property purchase contract of sale document” the trustee of the SMSF must pay a deposit to the Vendor or vendor’s agent (say 10% of purchase price) for the underlying property.

The receipt of the money should have the name of the trustee of the SMSF as the purchaser.

9. The purchase process; The effect of the name of the trustee of PCT on the front page of the purchase contract is that it is the “apparent owner” of the property. The Office of State Revenue (OSR) has to be informed that the trustee of SMSF is the real owner and all monies for the purchase are being paid by the SMSF (Sec 55 of NSW Duties Act 1997 - for other states please phone our office).

The PCT deed must be stamped with OSR with \$50 duty in NSW before transfer of property. Amount of Stamp duty depends on the state laws where the deed is executed. These requirements change from time to time; hence it is advisable to check with your local office. See below for full contact details of state and territory office of state revenue.

We provide a statutory declaration with our documents which must be lodged (by your solicitor) with the OSR to establish the bare trust relationship between the real owner and the apparent owner that states that the bare trustee is merely holding the property as custodian or as “apparent owner” that is “In Trust For” the trustee of the SMSF, who is the “real owner” of the property and has paid to purchase the property.

This role of the trustee of the property custodian trust is spelled out in our bare trust deed.

When the borrowing is paid out by the trustee of the SMSF, the trustee of SMSF has two choices;

- Sell the property to an outside 3rd party, or
- Transfer the property to itself. That is from the trustee of the PCT to the trustee of the SMSF. At the time of this transfer, no stamp duty is paid as the “ultimate owner” or “real owner” was always the trustee of the SMSF whilst the “apparent owner” was the trustee of the PCT.

10. Capital Gain Tax issues; Since the PCT is holding the property for the trustee of the SMSF on the transfer from the PCT to the SMSF, no CGT event occurs as the trustee of the SMSF is the “absolute owner” of the property from the very beginning.

The trustee of PCT role is only to act as custodian of the property merely to satisfy Section 67A & 67B of SIS Act.

Note the property should not (cannot) be transferred from the trustee of the PCT to the trustee of the SMSF whilst the borrowing is in place - if that happens then the fund would have borrowed and breach to Section 67 (1) of SISA.

However, the PCT trust deed MUST allow for the property to be transferred to the SMSF AT ANY TIME, even whilst the borrowing is in place, this is necessary as to establish the true ownership of the property which at all times lies with the trustee of the SMSF - The trustee of the SMSF must be seen as the “absolute beneficiary” or the “absolute owner” AT ALL TIMES.

Warning: *Some other PCT deed providers do not allow transfer of property from trustee of the PCT to the trustee of the SMSF AT ALL TIMES, this jeopardizes the status of the trustee of the SMSF as the “true owner” or “absolute owner”. This means, under those deeds, when the property is ultimately transferred from PCT to SMSF, SMSF could be liable for Stamp Duty for second time.*

Remember the trustee of the PCT is holding the asset under a bare trust relationship for the trustee of the SMSF AT ALL TIMES.

11. Order PCT deed from us; Before exchange has takes place, you must order the property custodian trust deed from us (typically the PCT trust deed should be executed on the date of exchange = the PCT deed MUST be existing before exchange happens - the morning of the day of exchange - please check with your solicitor).

We will provide the following documents to you

1. Property Custodian Trust Deed (bare trust).
2. Sample Investment Strategy to include borrowing strategy for the SMSF
3. Minutes to incorporate limited recourse borrowing arrangement
4. Loan application by trustee of the SMSF to the related party Lender
5. Loan Document between the Lender and the borrower, namely trustee of the SMSF
6. Statutory Declaration to create beneficial interest of the SMSF as discussed above.

Steps at Settlement

12. Related party advance loan to SMSF; At the time of settlement - the internal lender should advance the loan to the SMSF and the trustee of the SMSF should pay directly to the vendor via bank cheques as instructed by the solicitor or the related party lender can pay directly to the vendor under instructions from the trustee of the SMSF. Note all payments to the vendor and stamp duty etc MUST be made by the trustee of the SMSF directly or under instructions to the lender.

Steps after settlement

13. Rental Income of property; Once the property is held by the trustee of the property custodian trust, it can be rented; please note residential property cannot be rented to any related party (part 8 associates).

However, a business real property can be rented to related party and do not form a part of in-house asset of the SMSF. If the tenant is a related entity (trading entity of the member), advisor should ensure that the related party pays market rent to the SMSF and there is a legal lease document in place. This lease document can be purchased from us. This document is currently not available online.

14. Mortgage over the purchased property; The internal lender may place a mortgage over the property - this may seem un-necessary - although it is recommended by us to complete the authenticity of the lending process and to satisfy the fund's auditor. If no mortgage is in place, ATO may consider the deposit of loan as a contribution.

15. Lease to an un-related party; Any lease to a related party or to an outside 3rd party must note that the "real owner" of the property is the trustee of the SMSF. If the property is already leased, managing agents must be notified of the change of ownership.

16. Reporting of income and expenses; All rents have to be collected by the trustee of the SMSF on direction by the trustee of the property custodian trust. All expenses of the property are paid by the trustee of the SMSF under direction by the trustee of the property custodian trust.

The trustee of the PCT does not prepare an income tax return, all income and expenses are to be reported by the trustee of the SMSF in the super fund's income tax return.

17. GST Issues; If the property is a commercial property, the SMSF has to be registered for GST before settlement so that any GST paid can be claimed back from ATO. Further, the rent received on commercial property may have GST component which the SMSF must collect and pay to ATO via quarterly Business Activity Statements (BAS), please refer to Paragraph 37 of GSTR 2008/3.

18. Pay principal and interest to the lender; The trustee of SMSF can use the rental income of the property and any other income (or contributions from member(s)) of the fund to pay interest and principal amount of the loan to the internal lender. In our loan document (with related party) any amount of principal can be repaid at any time.

Our loan document has a notional rate of interest at the beginning of the loan; however, the lender (related party) can increase / decrease the interest rate by giving the borrower (trustee of the SMSF) 30 days notice.

If the lender (related party) has itself borrowed from a 3rd party - like a bank - the lender (related party) can vary the interest which is being charged to the trustee of the SMSF.

19. Sale of property; The property can be sold at any time whilst the borrowing is in place. When the property is sold to a 3rd party, it triggers a CGT event which the SMSF must report to the ATO in its income tax return and pay tax accordingly.

Some advisors are recommending selling the property when the fund moves to pension phase to avoid paying any CGT. If the property is a residential property and the member(s) want to live in the property at retirement, the advisor should be aware of Sec 71 of the SIS Act which restricts a lease to a related party. In this situation, the advisor should consider selling the SMSF property to the member(s) at market value.

Disclaimer: When you purchase documents from us, our solicitors Batallion Legal give you a guarantee that they comply to SIS Act on the date of purchase, no advice is considered to your specific transaction. Neither our solicitors nor trustdeed.com.au, can recommend a borrowing strategy to any SMSF trustee. Our solicitors can, for a fee, advise you on your specific transaction including conveyance of the property.

Stamp Duty Offices

State/Territory	Revenue office contact details
Victoria	State Revenue Office GPO Box 1641N Melbourne VIC 3001 Ph: 13 21 61
Queensland	Office of State Revenue GPO Box 2593 Brisbane QLD 4001 Ph: 1300 300 734
New South Wales	Office of State Revenue GPO Box 4042 Sydney NSW 2001 Ph: (02) 9689 6200
Tasmania	State Revenue Office GPO Box 1374 Hobart TAS 7001 Ph: 1800 001 388
South Australia	Revenue SA GPO Box 1353 Adelaide SA 5001 Ph: 1800 637 778
Western Australia	Office of State Revenue GPO Box T1600 Perth WA 6845 Ph: (08) 9262 1400
ACT	ACT Revenue Office GPO Box 293 Civic Square ACT 2608 Ph: (02) 6207 0028
Northern Territory	Territory Revenue Management GPO Box 154 Darwin NT 0801 Ph: 1300 305 353