Australian Government
Australian Taxation Office

Limited recourse borrowing arrangements by self-managed super funds - questions and answers

Scope and purpose of this document

This document provides general guidance on the Australian Taxation Office's (ATO) current views regarding the application of the superannuation law (specifically the *Superannuation Industry (Supervision) Act 1993* and related super rules) to limited recourse borrowing by self-managed super funds (SMSFs).

This document does not deal with tax issues other than general references when discussing the application of the super law.

Matters trustees should take into account

Trustees should always consider the quality of the investment they are making and whether their fund can meet all of the future obligations under the arrangement. A trustee of an SMSF can only enter into such an arrangement where this is consistent with the investment strategy of the fund.

The governing rules of an SMSF must allow the trustee of the fund to borrow before any instalment warrant type arrangement or any other limited recourse borrowing arrangement can be entered into.

For more information about trustee/member obligations, refer to **Running a self-managed super fund**.

What ATO assistance is available?

You can apply for self-managed super funds specific advice (SMSFSA) about:

- your own SMSF's affairs
- another's SMSF's affairs if you are their agent or legal personal representative.

A SMSFSA sets out the Commissioner's opinion about the way the super law applies, or would apply, to your SMSF in relation to a specified arrangement or circumstance.

For more information, refer to **How to apply for SMSF specific advice**.

General prohibition on borrowing

Subject to limited exceptions allowed under the *Superannuation Industry (Supervision) Act 1993* (SISA), trustees of self-managed super funds are prohibited from borrowing money.

Advice about the general prohibition and a list of exceptions is given in self- managed super funds ruling **SMSFR 2009/2** Self Managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the *Superannuation Industry (Supervision) Act 1993.*

Amendments to the super law that applied from 24 September 2007 - limited recourse borrowing arrangements

From 24 September 2007 super funds could invest in certain limited recourse borrowing arrangements involving borrowing money to acquire a permitted asset. Those arrangements must meet the conditions stipulated by the law in former subsection 67(4A) of the SISA.

Those rules continue to apply to limited recourse borrowing arrangements that were entered into before 7 July 2010, but new rules apply to new arrangements.

The rules apply to all regulated funds, not just SMSFs; however, this document only provides guidance in respect of the application of the law to SMSFs.

How is the ATO dealing with those SMSFs that invested in instalment warrant products before 24 September 2007?

If you are a trustee or director of an SMSF and you invested before 24 September 2007 in an instalment warrant that former subsection 67(4A) of the SISA allows, we will not issue a notice stating your fund is a non-complying fund solely on the basis of the investment.

However, if you invested before 24 September 2007 in an instalment warrant product that does not meet the requirements of former subsection 67(4A), we will decide on a case-by-case basis what action will be taken.

Amendments to the super law that apply from 7 July 2010 - changes for limited recourse borrowing arrangements

The super laws have been amended for limited recourse borrowing arrangements by super funds entered into on or after 7 July 2010 so that:

- super fund assets are better protected in the event of a default on a borrowing
- the asset within the arrangement can only be replaced by a different asset in very limited circumstances specified in the law
- super fund trustees cannot borrow to improve an asset (for example, real property)
- the borrowing is permitted only over a single asset or a collection of identical assets that have the same market value
- the asset within the arrangement is not subjected to a charge other than to the lender in respect of the borrowing by the super fund trustee.

The new rules are in **section 67A** and **section 67B** of the SISA.

Requirements under the super law for limited recourse borrowing by super trustees

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

An SMSF is not prohibited from borrowing money, or maintaining a borrowing of money, providing the arrangement entered into satisfies each of the following conditions:

- the borrowed monies are used to acquire an asset which the fund is not otherwise prohibited from acquiring
- the asset acquired (or a replacement asset) is held on trust (the holding trust) so that the fund receives a beneficial interest in the asset
- the SMSF has the right to acquire legal ownership of the asset (or, if applicable, the replacement asset) by making one or more payments after acquiring the beneficial interest
- any recourse that the lender has under the arrangement against the SMSF trustee is limited to rights relating to the asset acquired (or, if applicable, the replacement asset). For example, the lender can have the right to recover outstanding amounts where there is a default on the borrowing by repossessing or disposing of the asset being acquired under the arrangement, but cannot have the right to recover such amounts through recourse to the fund's other assets.

Arrangements entered into on or after 7 July 2010

An SMSF is not prohibited from borrowing money, or maintaining a borrowing of money, providing the arrangement entered into satisfies each of the following conditions:

- the borrowed monies are used to acquire a single asset, or a collection of identical assets that have the same market value (that are together treated as a single asset), which the fund is not otherwise prohibited from acquiring (called the 'acquirable asset'). The new law makes it explicit that borrowed money applied to expenses incurred in connection with the borrowing or acquisition (such as loan establishment costs or stamp duty), or expenses incurred in maintaining or repairing the acquirable asset, is allowed
- the borrowed monies are not applied to improving an acquirable asset
- the acquirable asset is held on trust (the holding trust) so that the SMSF trustee receives a beneficial interest in the asset
- the SMSF trustee has the right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest
- any recourse that the lender *or any other person* has under the arrangement against the SMSF trustee is limited to rights relating to the acquirable asset. This limitation applies to rights directly or indirectly relating to a default on the borrowing and related charges or directly or indirectly relating to the SMSF trustee's rights in respect of the acquirable asset (for example, rights to income from the asset)
- the acquirable asset is not subject to a charge other than as provided in relation to the borrowing by the SMSF trustee

- the acquirable asset can be replaced by another acquirable asset that the SMSF is not otherwise prohibited from acquiring, but only in very limited circumstances as listed in the super law.

These rules are in **section 67A** and **section 67B** of the SISA.

Special in-house asset rule

The holding trust in most limited recourse borrowing arrangements is, under the super law, a related trust to the SMSF investor - for example, because the SMSF has an entitlement to the majority of the income from the trust. The interest of the SMSF in the holding trust represents an investment in that trust for the purposes of the in-house asset rules. However, the in-house asset rules have an exception (specifically in **subsections 71(8) and 71(9)** of the SISA) to ensure that the SMSF's investment in the holding trust is not an in-house asset, provided each of the following conditions are satisfied:

- the holding trust is part of an arrangement that meets all of the requirements of the super law in connection with a borrowing by the SMSF
- the only property of the trust under the arrangement is the acquirable asset (referred to as the original asset or its replacement under the pre-amendment law)
- the asset held by the holding trust would not be an in-house asset of the SMSF if the SMSF owned the asset directly.

For more guidance on in house assets, refer to self-managed super funds ruling **SMSFR 2009/4** Self-Managed Superannuation Funds: the meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the *Superannuation Industry (Supervision) Act 1993.*

When can an acquirable asset be replaced in an arrangement that commenced on or after 7 July 2010?

The circumstances when an acquirable asset in a limited recourse borrowing arrangement can be replaced are listed in section 67B of the SISA.

Regulations can be made to allow for replacement in additional circumstances, but as at 26 July 2010 no regulations have been made for this purpose. The circumstances listed in section 67B are:

1. A share in a company (or collection of such shares) can be replaced by a share (or collection of such shares) in the same company if, at the time of replacement, the original asset and replacement have the same market value (for example, if there is a share split). (Subsection 67B(3)).
2. A unit in a unit trust (or collection of such units) can be replaced by a unit (or collection of such units) in the same unit trust if, at the time of replacement, the original asset and replacement have the same market value. (Subsection 67B(3)).
3. If the original asset is an instalment receipt that converts to a share or collection of shares in a company, then that share (or collection of shares) is allowable as a replacement asset. (Subsection 67B(4)). For these purposes an 'instalment receipt' is defined to mean an investment under which a listed security is held in a trust until the purchase price of the security is fully paid and the security, and property derived from the security, is the only property of that trust. (Subsection 10(1)).
4. A share in a company (or collection of such shares) can be replaced by a share (or a collection of such shares) in another company if the replacement occurs because of a takeover, merger, demerger or restructure of the first company. (Subsection 67B(5)).
5. A unit in a unit trust (or collection of such units) can be replaced by a unit (or collection of units) in another unit trust if the replacement occurs because of a takeover, merger, demerger or restructure of the first trust. (Subsection 67B(5)).
6. A share in a company (or collection of such shares) can be replaced by a stapled security (or collection of such securities) if the replacement occurs under a scheme of arrangement of the company - for example, as part of a restructure. The stapled security must consist of a share (or a single collection of shares of the same class) stapled together with a unit (or a single collection of units of the same class) in a unit trust. (Subsection 67B(6)).
7. A unit in a unit trust (or collection of such units) can be replaced by a unit (or collection of units) in that trust if the replacement occurs as a result of an exercise of a discretion granted to the trustee of that unit trust under the trust deed (for example, a managed investment scheme trustee exercises a discretion to split or consolidate units). (Subsection 67B(7)).

Explanatory Memorandum on replacement assets

The Explanatory Memorandum circulated in Parliament for the amended rules applying to limited recourse borrowing arrangements entered into on or after 7 July 2010 gives the following additional information about replacement assets

(at paragraph 1.29):

1.29 Examples of circumstances not permitting a replacement asset include:

- securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy
- money or cash is not eligible as a replacement asset under **any** circumstances - includes circumstances where the original asset would otherwise be replaced with an eligible replacement asset plus cash - for example, shares in X Ltd replaced by shares in Y Ltd and a pool of cash as a result of a takeover of X Ltd by Y Ltd
- replacement asset arising from an insurance claim covering the loss to the original asset
- the replacement by way of improvement of real property
- a series of titles over land replacing a single title over land that has been subdivided, and
- a replacement of a title over real property as a result of Government action such as the resumption of all or part of a property or re-zoning.

What are the consequences if the limited recourse borrowing arrangement does not satisfy all of the required conditions?

If the required conditions are not strictly satisfied, borrowing money under the arrangement will result in a contravention of one or more of the super laws. Such a contravention may have civil or criminal consequences.

Changes to other laws relating to limited recourse borrowing arrangements

Announced tax changes

On 10 March 2010, the Assistant Treasurer, Senator the Hon Nick Sherry, announced that the government will introduce legislation to amend the income tax treatment of 'traditional instalment warrants'.

On the same day the Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced that the government will introduce legislation to amend the income tax treatment of limited recourse borrowings of complying super funds.

Specifically, it was announced that the government will legislate to treat:

- the owner of an instalment warrant over an exchange traded security as the owner of the security
- a super trustee who enters into a limited recourse borrowing arrangement for the purpose of purchasing an asset, as permitted under the SISA, as the owner of the asset.

For more information, refer to the media releases:

- **Tax relief for investors in instalment warrants**
- **Financial services consumer protection framework extended to superannuation borrowing arrangements**.

A consultation discussion paper is also available on the **Treasury website**. After the initial consultation on the design of these amendments, it was announced that the government will release an exposure draft of the legislation.

Consumer protection changes

On 10 March 2010 the Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced that the government will extend the consumer protection framework to include limited recourse borrowing arrangements by super fund trustees. Under the proposals these arrangements will be 'financial products' under the *Corporations Act 2001*. The minister said that this will ensure that only appropriately licensed financial services providers will be able to offer these arrangements to super funds.

For more information, refer to the media release **Financial services consumer protection framework extended to superannuation borrowing arrangements**.

The arrangement and refinancing

Are only marketed instalment warrant products allowable for SMSFs under the limited recourse borrowing rules?

No. Borrowing is allowed under any arrangement that meets the requirements of the super law, not just financial products marketed as instalment warrants. Conversely, it does not automatically follow that a product marketed as an instalment warrant meets the conditions of the super law.

Are only instalment warrant investments over listed securities allowable for SMSFs under the limited recourse borrowing rules?

No. The rules allowing limited recourse borrowing are not limited to investments in instalment warrants traditionally offered by financial institutions where the underlying asset is a listed security. Other arrangements or products are allowed if they satisfy all of the requirements of the super law.

What changes to a borrowing or other attributes of a limited recourse borrowing arrangement result in a new arrangement for the purposes of the super law?

If the parties adopt a change to the terms or conditions of an arrangement (either expressly or by inference) that goes to the root of the arrangement - that is, it alters the character of the arrangement in a significant way - then there is a new arrangement from that time and the earlier arrangement has come to an end. If that change happened after 7 July 2010, the requirements of section 67A of the SISA apply to the arrangement.

Changes resulting in a new arrangement include:

- the borrowing under the original arrangement is refinanced - refer to
  - **Can an SMSF trustee refinance a limited recourse borrowing without contravening the superannuation law?**
  - **Is every variation to the terms of a limited recourse borrowing regarded as a refinancing?**
- there is a borrowing (drawdown) that is inconsistent with the earlier arrangement - for example, borrowing to acquire an asset or class of asset clearly not contemplated under the original arrangement
- there has been a change to the ultimate beneficiaries of the arrangement resulting from selling a structure involving a pre-existing arrangement.

Example: New arrangement

There is a limited recourse borrowing arrangement that meets the requirements of former subsection 67(4A) of the SISA entered into by a corporate SMSF trustee and a private company lender before 7 July 2010. On or after 7 July 2010, new directors of the corporate SMSF trustee (and members of the SMSF) and new directors of the private company lender are appointed, replacing all of the former members. The Commissioner will treat the limited recourse borrowing arrangement now controlled by the new ultimate beneficiaries as a new arrangement. The new arrangement must meet the requirements of section 67A of the SISA.

Example: No new arrangement

There is a limited recourse borrowing arrangement that meets the requirements of former subsection 67(4A) of the SISA entered into by a corporate SMSF trustee and a private company lender before 7 July 2010. On or after 7 July 2010 two new members of the SMSF are admitted as a result of changing family circumstances. The Commissioner will not treat the limited recourse borrowing arrangement as a new arrangement on this basis alone.

Can an SMSF trustee refinance a limited recourse borrowing without contravening the super law?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010, then refinanced on or after 7 July 2010.

Yes, SMSF trustees can refinance the borrowing, but the refinanced arrangement must meet the requirements of the law applying to limited recourse borrowing arrangements entered into on or after 7 July 2010.

A new borrowing that takes the place of the old borrowing, such that the application of the new borrowing is solely to extinguish the previous borrowing and meet associated costs, satisfies the requirement that borrowed funds are applied for the acquisition of the relevant asset.

However, refinancing the borrowing is entering into a new limited recourse borrowing arrangement at the time of refinancing. Any arrangement refinanced on or after 7 July 2010 must meet the requirements of the super law (section 67A of the SISA) applying to arrangements entered into on or after 7 July 2010.

Where a new trust is created to hold the asset, SMSF trustees must ensure that the asset is transferred directly to that new trust and that the SMSF does not temporarily obtain title to the asset at that time, otherwise a contravention of the super law will occur.

For more information, refer to **Is an SMSF allowed to put an existing fund asset into a limited recourse borrowing arrangement?**

Arrangements entered into on or after 7 July 2010 and then refinanced at a later date.

Yes, provided the re-financed arrangement meets the requirements of section 67A of the SISA.

See **Requirements for limited recourse borrowing by super trustees** for arrangements entered into on or after 7 July 2010.

Section 67A explicitly allows re-financing of a borrowing (including any accrued interest) under an arrangement if the new borrowing arrangement is over the acquirable asset from the first arrangement (including an asset from the first arrangement that is a replacement asset under section 67B of the SISA) and no other acquirable asset.

Where a new trust is created to hold the asset, SMSF trustees must ensure that the asset is transferred directly to that new trust and that the SMSF does not temporarily obtain title to the asset at that time, otherwise a contravention of the super law will occur.

For more information, refer to **Is an SMSF allowed to put an existing fund asset into a limited recourse borrowing arrangement?**

Is every variation to the terms of a limited recourse borrowing regarded as a refinancing?

No. The question is whether a variation to the contract of borrowing led to the extinguishment of the previous borrowing and the creation in its stead of a new and different borrowing (a refinancing). This depends upon the nature and extent of the variation and the intention of the parties.

Example: Extension of borrowing

Suppose a borrowing is extended by a variation to the terms of a contract. An agreement to extend the period of the borrowing could be so inconsistent with the original agreement that it results in a new contract for borrowing. Some factors which are relevant in deciding this question are:

- whether the original loan agreement provided for the parties to agree to extend the term
- the period of the extension in relation to the period of the original loan
- whether other terms of the loan were changed by the later agreement.

In Roberts v I.A.C (Finance) Pty Ltd (1967) VR 231, the parties agreed to extend a three-year borrowing for a further two months. It was held the extension was not totally inconsistent with the terms of the original agreement as the variation left the terms and conditions of the original agreement in intact, except to the limited extent that the due date was extended by two months. As the contract was modified to a limited extent, the rights and obligations of the parties were not affected by the variation. In these circumstances, the loan extension did not discharge the original obligation to pay and create a new obligation to pay in its place.

The loan and the lender

Is an SMSF allowed to borrow from a related party?

The law does not prohibit the lender from being a related party. However, SMSFs must continue to comply with other legislative requirements. For example, the SMSF must satisfy the sole purpose test and comply with existing investment restrictions such as those applying to in-house assets and prohibitions on acquiring certain assets from a related party of the fund.

For more information on acquisitions from a related party, refer to self-managed super funds ruling **SMSFR 2010/1** Self-Managed Superannuation Funds: the application of subsection 66(1) of the *Superannuation Industry (Supervision) Act 1993* to the acquisition of an asset by a self managed superannuation fund from a related party.

Does interest on a borrowing from a related party need to be at commercial rates?

A trustee of an SMSF or its investment manager must ensure that all investments are conducted on an arm's length basis or, if the parties are not at arm's length, that the terms of the investment are no more favourable to the other party

than they would be if the parties were dealing at arm's length.

'Invest' is defined in subsection 10(1) of the SISA to mean applying assets in any way, or making a contract, for the purpose of gaining interest, income, profit or gain.

When entering into the limited recourse borrowing arrangement, the SMSF trustee is investing. Subsection 109 (1) of the SISA imposes requirements with respect to transactions relevant to investments made by SMSF trustees. Borrowing money under the limited recourse borrowing arrangement is a transaction entered into in the course of making an investment.

This means that an SMSF trustee or investment manager cannot allow a related party lender to charge the fund more than an arm's length rate of interest under the arrangement.

The SMSF trustee must be able to demonstrate that the SMSF was not paying in excess of an arm's length rate of interest to a related party. The calculation of a rate that represents an arm's length rate of interest needs to be based on reasonably objective and supportable data - for example, the rates charged by arm's length financial institutions for a similar borrowing.

Paying a member or relative of a member an excessive rate of interest would also contravene the prohibition on SMSF trustees giving financial assistance to members or their relatives using the resources of the SMSF.

For more information about the prohibition on SMSF trustees giving financial assistance to a member of the fund or relative of a member, refer to self-managed super funds ruling **SMSFR 2008/1** Self-Managed Superannuation Funds: giving financial assistance using the resources of a self managed superannuation fund to a member or relative of a member that is prohibited for the purposes of paragraph 65(1)(b) of the *Superannuation Industry (Supervision) Act 1993.*

Does the arrangement entered into by the SMSF trustee actually involve a borrowing?

It is essential that appropriate documentation clearly reflect that the trustee of an SMSF has made a genuine borrowing to acquire an asset, particularly where the monies provided to acquire the asset are from a related party. If there is not adequate documentation to prove the money provided by a related party was actually borrowed, the amount provided by the related party might be considered to be a contribution received by the fund. This could lead to significant tax consequences if it results in a contributions cap being exceeded.

Can a related party borrow on a full recourse basis and on-lend the money to the SMSF under a limited recourse borrowing arrangement at a higher rate of interest?

Yes, provided:

- the limited recourse loan to the SMSF by the related party is appropriately documented
- the SMSF is not charged higher than an arm's length rate of interest for borrowing
- the arrangement under which the SMSF borrows from the related party otherwise meets the requirements of the super law.

For arrangements entered into on or after 7 July 2010, the super law specifically prohibits the asset being acquired by the SMSF trustee under the arrangement from being used as security for the borrowing of the related party.

For more information, refer to **Can the asset being acquired be used as security other than in respect of the borrowing by the SMSF trustee?**

Does a drawdown from a credit facility give rise to a new borrowing?

Yes. The Commissioner considers that each drawdown of funds from a loan facility or similar arrangement constitutes a separate borrowing, even if the facility or arrangement makes provision for redraws arising from earlier repayments. This view is more fully explained in paragraph 93 of self-managed super funds ruling **SMSFR 2009/2** Self-Managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the *Superannuation Industry (Supervision) Act 1993.*

The terms of a single limited recourse borrowing arrangement may allow multiple drawdowns by the investor. Each drawdown must be reviewed to determine whether the borrowing meets the requirements of the super law applying to the particular arrangement.

If a drawdown is put to a purpose that does not meet the requirements of the super law - for example, the cash is put into a member's account - there is a contravention of the super law (specifically, subsection 67(1) of the SISA). Conversely, if the drawdown is put to a permitted purpose, such as the capitalisation of interest, then it does not result in a contravention of the super law.

For real property held by the holding trust in a limited recourse borrowing arrangement, can an SMSF trustee draw down under the arrangement to make capital improvements to the real property without contravening the super law?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes. When improvements materially alter the character of the original asset, they create a replacement asset for the purposes of subsection 67(4A) of the SISA. Under subsection 67(4A), the replacement asset is not limited to any particular type of asset but must be an asset that the SMSF trustee is not prohibited from acquiring. Assuming that the original property was an asset that the SMSF trustee was permitted to acquire, the improved property will be a permitted replacement asset.

If the terms of a limited recourse borrowing arrangement allow the SMSF trustee to make drawdowns, then any drawdowns must be used for the acquisition of the original asset or its permitted replacement.

Drawdowns to pay for capital improvements to the original asset meet this test, as do drawdowns to capitalise interest, maintain the asset and meet other costs of the arrangement. However, an SMSF trustee cannot make a drawdown to extract cash from the arrangement.

SMSF trustees must not attach an existing fund asset to the real property or otherwise subject an existing fund asset to a charge under the arrangement.

For more information, refer to **Can an SMSF trustee borrow under a limited recourse borrowing arrangement to build a house on vacant land owned by the fund?**

Arrangements entered into on or after 7 July 2010

No. The super law applying to these arrangements specifically prohibits borrowing to make improvements under subparagraph 67A(1)(a)(i) of the SISA.

However, drawdowns to capitalise interest, maintain the asset and meet other costs of the arrangement continue to be allowed.

Does an arrangement that permits capitalisation of interest or other borrowing charges satisfy the super laws?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes, provided:

- the amounts capitalised are costs of the original borrowing (for example, interest or other charges directly incurred under the borrowing)
- the original borrowing is applied to acquire the underlying asset
- the lender's rights against the fund in the event of a default in repaying the capitalised amounts remain limited to rights relating to that asset (or a replacement asset).

A further amount drawn down under the arrangement to pay interest on the outstanding loan amount or to pay other fees and charges associated with the borrowing is considered to be money applied for the purpose of acquiring the asset.

Arrangements entered into on or after 7 July 2010

Yes. The super law (specifically, subparagraph 67A(1)(a)(i) of the SISA) applying to these arrangements explicitly provides that, under a limited recourse borrowing arrangement, the SMSF trustee can apply borrowed money towards expenses incurred in connection with the borrowing.

Example: Dividend income to reduce loan principal

Under an arrangement that otherwise meets the requirements of the super law, any dividend income on the underlying share is applied first in reducing the loan principal amount. At one point in the year, the loan principal amount is increased by the capitalisation of the interest amount. This is permitted under subsection 67(4A) applying to arrangements entered into before 7 July 2010, because each amount so drawn down is applied as a cost of acquiring the underlying share. It is also permitted under section 67A applying to arrangements entered into on or after 7 July

2010.

Example: Dividend income paid to the investor

Under an arrangement that otherwise meets the requirements of the super law, all dividend income on the underlying share is paid to the investor. The loan is drawn down annually and applied to pay the interest amount. This is permitted under subsection 67(4A) applying to arrangements entered into before 7 July 2010, because each amount so drawn down is applied as a cost of acquiring the underlying share. It is also permitted under section 67A applying to arrangements entered into on or after 7 July 2010.

Lenders recourse and charging the asset being acquired

Will granting the lender a right of recourse over the underlying asset lead to a contravention of the prohibition against charging a fund asset?

The granting to the lender of a right of recourse to the underlying asset at the same time that the trustee of an SMSF acquires the beneficial interest in the asset is a necessary feature of a limited recourse borrowing arrangement contemplated by the super law.

Granting of such a right in these circumstances will not contravene the existing prohibition in the law against giving a charge over a fund asset, provided that the arrangement complies with all the conditions of the super law.

Can an SMSF member provide a personal guarantee to the lender in a limited recourse borrowing arrangement?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes. The recourse of the lender against the SMSF trustees in the event of a default on the borrowing must be limited to the asset that is being acquired under the arrangement. A third party may put up their own assets as a guarantee to provide additional security to the lender.

It is not required that a third party guarantor waive their usual rights of indemnity against the principal debtor (the SMSF trustee) in the event of a call on the guarantee. However, SMSF trustees should carefully consider the risks to the assets of the SMSF (other than the asset being acquired under the limited recourse borrowing arrangement) that an unlimited guarantee might represent. The rights of indemnity given in favour of a guarantor may be excluded or limited by the express terms of the guarantee.

Arrangements entered into on or after 7 July 2010

Yes, provided the guarantors rights against the principal debtor (the SMSF trustee) are limited to rights relating to the asset being acquired under the arrangement.

Under the super law applying to these arrangements, the recourse of the lender **or any other person** against the SMSF trustees in connection with, or as a result of, a default on the borrowing (either directly or indirectly) must be limited to rights relating to the asset that is being acquired under the arrangement.

This means, for example, that for an arrangement to meet the requirements of the super law, any guarantor must not have general rights of indemnity against the principal debtor (the SMSF trustee) that might crystallise in the event of a call on the guarantee. However, the guarantor may have rights of subrogation of the lender's rights (that is, the right to exercise the lender's limited rights of recourse to the asset being acquired under the arrangement) that might crystallise in the event of a call on the guarantee.

Personal guarantees and contributions to the SMSF

If a guarantor makes a payment to the lender under an arrangement where they have foregone their usual rights of indemnity against the principal debtor (the SMSF trustee) in respect of the guarantee, this is a contribution to the SMSF if it satisfies a liability of the SMSF. This might happen, for example, if the guarantor paid the borrowing and the acquirable asset was transferred to the SMSF trustee under the arrangement.

In contrast, there is no contribution if the SMSF trustee has exercised a right to 'walk away' from the arrangement (and has lost the acquirable asset to the lender) and has no further liability, but the lender still exercises a right to call on the guarantee for a shortfall after disposal of the original asset.

For more information about super contributions, refer to Taxation Ruling **TR 2010/01** Income tax: superannuation contributions.

Can a related party to the SMSF give a mortgage to the lender over an asset of the related party?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes. Under the super law the recourse of the lender against the SMSF trustees in the event of a default on the borrowing must be limited to the asset that is being acquired under the arrangement. However, a third party can mortgage one of their assets (in which the SMSF does not have an interest) to the lender to provide the lender with additional security.

Arrangements entered into on or after 7 July 2010

Yes, provided the related party or any other person has no rights of recourse against the SMSF trustee in the event that the mortgage is exercised by the lender (for example, if the SMSF trustee defaults on the borrowing), other than rights relating to the asset being acquired under the arrangement.

Can the asset being acquired be used as security other than in respect of the borrowing by the SMSF trustee?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

SMSF trustees need to be careful that such a charge over the asset held in the holding trust does not contravene the law. For example, all of the SMSF trustee's dealings in respect of the arrangement must meet the arm's length requirements in **section 109** of the SISA, no member or relative of a member can be financially assisted by the SMSF trustee using the resources of the SMSF, and the maintenance of the fund must be in accordance with the sole purpose test.

There may be limited circumstances where such a charge does not result in a contravention of the SISA, but for the reasons given above the ATO would not encourage it.

Arrangements entered into on or after 7 July 2010

No. The super law (specifically, paragraph 67A(1)(f) of the SISA) applying to these arrangements prohibits any charge over the asset other than in respect of the borrowing by the SMSF trustee under the arrangement.

The asset being acquired and replacement assets

Is an SMSF trustee allowed to acquire the underlying asset from a related party vendor?

The laws which prohibit the acquisition of assets from related parties apply to limited recourse borrowing arrangements.

However, the exceptions provided for in the rules against the acquisition of assets from related parties, such as those allowing for the market value acquisition of listed securities or business real property, continue to apply.

This question is different to that where the legal ownership of the asset is transferred from the holding trust to the SMSF once all the instalments are paid.

Does the requirement that the asset be held on trust for the SMSF mean that the fund acquires an asset from a related party on repaying the borrowing?

It is a necessary feature of an arrangement contemplated that the SMSF be able to acquire full ownership rights over the underlying asset once the borrowing is repaid.

The holding trust which holds the asset underlying a limited recourse borrowing arrangement will generally be a related party of an SMSF investor. In these circumstances, the legal interest in the asset may be considered to be acquired from the holding trust when the borrowing is repaid. The ATO considers that, under the new laws, this would not contravene the existing prohibition on acquiring assets from related parties.

This question is different to that where the original vendor of the asset is a related party.

Is an SMSF trustee allowed to put an existing fund asset into a limited recourse borrowing arrangement?

No. The money borrowed must be used to acquire a new asset (or replacement asset). This means, for example, that investments under 'shareholder application' or 'cash extraction' arrangements are not allowed. The giving of a charge over an existing asset of the fund, as would generally occur under such arrangements, would result in a contravention of the super law.

Can an SMSF trustee borrow under a limited recourse borrowing arrangement to build a house on vacant land owned by the fund?

No. An existing SMSF asset cannot be put into a limited recourse borrowing arrangement. The giving of a charge over an existing asset of the fund (the vacant land), as would generally occur under such arrangements, would contravene

the super law.

Under the super law can cash, representing borrowed money and/or a deposit, be transferred to the holding trust trustee?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes, provided the asset purchased by the holding trust trustee using that money is, under the super law, an asset that the SMSF is permitted to acquire.

Arrangements entered into on or after 7 July 2010

Yes, provided the transactions are to facilitate the acquisition of the acquirable asset. This is consistent with the Commissioner's approach to acquisitions in general - refer to paragraph 111 of self-managed super funds ruling **SMSFR 2010/1** Self-Managed Superannuation Funds: the application of subsection 66(1) of the *Superannuation Industry (Supervision) Act 1993* to the acquisition of an asset by a self-managed super fund from a related party.

The super law that applies to these arrangements specifically prohibits the acquirable asset from being money.

Can the holding trust trustee operate a cash account for an arrangement entered into on or after 7 July 2010?

Yes, provided the cash account is not part of the acquirable asset. That is, it is acceptable for the holding trust trustee to operate a cash account to deal with income, expenses and the like. It would not be acceptable for the holding trust to operate a cash account as a trading account for investment purposes.

Are SMSFs permitted to use a limited recourse borrowing arrangement to buy a spread of blue-chip shares or is a separate borrowing required for each shareholding?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

More than one asset may be acquired under a particular arrangement. The assets acquired need not be all of the same form or type. Thus, a portfolio of shares in different companies can be acquired under a single arrangement.

Arrangements entered into on or after 7 July 2010

Separate arrangements must be used for shares in different companies or different classes of shares in a company.

The asset being acquired under one arrangement must be:

- a single asset
- a collection of assets that are identical, have the same market value as each other, and are treated as a single asset (that is, bought and sold together as a collection) - for example, a collection of shares of the same class in a single company.

Can an SMSF use a limited recourse borrowing arrangement to purchase exchange traded options over shares?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes, and if it is permitted under the terms of the particular arrangement the options may be exercised on behalf of the SMSF trustee while still within the limited recourse borrowing arrangement.

Arrangements entered into on or after 7 July 2010

Yes, however the arrangement must be brought to an end at or before the time the options are replaced by another asset (such as cash or shares). The conversion of an option to another asset is not a permitted replacement asset within a limited recourse borrowing arrangement.

Can assets be sold and bought on behalf of the investor within the holding trust of a limited recourse borrowing arrangement?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes. The replacement assets will take the place of the original asset in the arrangement and all other aspects of the arrangement must continue to satisfy the requirements of the super law. The replacement asset is not limited to any

particular type of asset but must be an asset that the SMSF trustee is not prohibited from acquiring.

Arrangements entered into on or after 7 July 2010

No. The super law applying to these arrangements restricts replacement of the asset (or collection of identical assets) within an arrangement to circumstances specifically listed in the law.

It is not permitted for a portfolio of assets to be managed within a limited recourse borrowing arrangement.

Can shares issued under a dividend reinvestment plan be retained in the arrangement?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes. The new portfolio will take the place of the original asset in the arrangement. All other aspects of the arrangement must continue to satisfy the requirements of the super law.

Arrangements entered into on or after 7 July 2010

No. For an arrangement over a collection of shares, if additional or bonus shares are issued in respect of that collection of shares, they cannot simply be added to the collection as that is not a permitted replacement asset. If the arrangement is to continue, the additional shares need to be transferred out of the arrangement - for example, in a similar way that a cash dividend might be.

Can an SMSF trustee acquire more than one real property title under a single limited recourse borrowing arrangement?

Arrangements entered into on or after 24 September 2007 and before 7 July 2010

Yes. More than one asset may be acquired under a particular arrangement.

Arrangements entered into on or after 7 July 2010

No. The asset being acquired under one arrangement must be:

- a single asset
- a collection of assets that are identical, have the same market value as each other, and are treated as a single asset (that is, bought and sold together as a collection).

Real property on separate titles is not allowed, even if the properties are substantially the same at the time of acquisition.

The in-house asset rules

What is the purpose of the special in-house asset rule for limited recourse borrowing arrangements?

The holding trust in a limited recourse borrowing arrangement will generally be a related trust of the SMSF. An investment by an SMSF in a related trust is an in-house asset of the SMSF unless an exemption applies.

The special rule ensures that a limited recourse borrowing arrangement entered into by an SMSF which meets the other requirements of the super law will not automatically result in an in-house asset arising from the investment made in the holding trust. Such an investment will only be an in-house asset where the underlying asset would itself be an in-house asset of the SMSF if held directly.

For more information, refer to **Special in-house asset rule**.

Can the holding trust trustee continue to hold the property for the investor after the borrowing has ended?

Yes, but the SMSF's interest in the holding trust will be an in-house asset of the SMSF if the interest represents an investment of the SMSF trustee in the holding trust. This is because, under subsection 71(8) of the SISA, once a limited recourse borrowing arrangement has ended, even if there are other amounts outstanding, the in-house asset exception ceases to apply.

There is a contravention of the super law if:

- the asset is not transferred to the SMSF or the interest in the holding trust does not otherwise end once the borrowing comes to an end
- the interest in the holding trust becomes an in-house asset of the SMSF and this causes the SMSF to exceed the permitted 5% level of in-house assets.

For more information about the in-house asset rules applying to SMSFs, refer to self-managed super funds ruling **SMSFR 2009/4** Self-Managed Superannuation Funds: the meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the *Superannuation Industry (Supervision) Act 1993*.

If the property owned by the holding trustee is leased to a related party of the SMSF investor, is the SMSF's interest in the holding trust an in-house asset?

Yes, unless the leased asset would not be an in-house asset of the SMSF if it were owned by the SMSF directly. For example, if the leased asset would be business real property of the SMSF if owned directly, then the SMSF's interest in the holding trust is not an in-house asset as long as the limited recourse borrowing arrangement meets all of the requirements of the super law.

In the case of real property that is being leased by the holding trust trustee (for example, so that rent flows to the SMSF trustee) while the borrowing is paid off, the Commissioner takes the view that the existence of the lease does not cause the investment to fail the tests for the **special in-house asset rule** to apply.

For more information about the application of the super laws generally to business real property, refer to self-managed super funds ruling **SMSFR 2009/1** Self-Managed Superannuation Funds: business real property for the purposes of the *Superannuation Industry (Supervision) Act 1993.*

The holding trust

Does the super law specify the type of trust that must be used as the holding trust in a limited recourse borrowing arrangement?

No. The law specifies only that the SMSF trustee must have a beneficial interest in the asset being held in the holding trust and the right to acquire legal ownership of that asset after making one or more payments. In addition, for the special in-house asset rule to apply, the asset must be the only property of the holding trust.

More complex trusts are unlikely to satisfy the requirement that the SMSF trustee has the necessary interest in a particular asset of the holding trust. For example, a discretionary trust could not be used, nor could the SMSF trustee be one of a number of unit holders in a unit trust.

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