SMSF borrowing

Bank v private funding

Most of the major banks now offer SMSF loan products for 'instalment-warrant' style borrowings. However, we are noting more and more advisers who are attracted by the related party loan arrangements. This could be a loan from a family trust, company or even one or more SMSF members. In many cases these related party loans could in turn be funded by a typical bank loan.

The ATO has confirmed that the borrowing laws do not preclude an SMSF trustee from borrowing from a related party lender, provided all other laws are complied with. Therefore, if properly implemented, related party borrowings are legitimate and can be an alternative to a direct bank loan to an SMSF.

Benefits of private funding arrangements

The terms on which an SMSF trustee borrows from a related party must be arm's length, so it should not make any difference to an SMSF whether it borrows from a bank or related party. However, private funding arrangements generally offer greater flexibility.

Flexibility

A related party may, for instance, source moneys to on-lend to an SMSF from its existing cash resources or borrow from a bank (including via an existing loan facility) or a combination of these.

Being able to draw on equity in non-super structures is an advantage for clients who are restricted by the contribution caps. By drawing on non-super assets, clients can harness gearing within their SMSF. The arm's length interest is then payable by the SMSF to the related party lender. Many find this advantageous compared to paying the same interest to a bank.

If the related party borrows to on-lend to the SMSF, the related party's own borrowing is not subject to SIS laws which means it can borrow against any assets it chooses, including the family home or other assets outside the fund.

More options for refinancing

The ATO is currently considering whether re-financing is permitted under s 67(4A). Some argue it is not since it is not a borrowing to acquire an asset.

There is also a general concern that, if any restrictions were introduced in future to stop or limit SMSF borrowing, any existing borrowing would hopefully be 'grandfathered' and it may become critical that the loan stays in place to preserve any special grandfathered status.

SMSF trustees who borrow directly from a bank are limited given the possibility that re-financing is not permitted under s 67(4A) (or if loans cannot be refinanced to remain grandfathered).

On the other hand, if they have borrowed from a related party, the back-end finance behind the related party could be re-financed and this may be able to be passed on to the loan to the SMSF.

Process when borrowing from banks

Bank loans can give rise to delays involved with the approval process and the establishment costs also need to be considered (including the bank's lawyers' fees to review and sign-off on all documents).

A related party might also allow greater flexibility for providing finance in respect of certain assets such as shares. SMSF trustees must borrow from a related lender on arm's length terms, however the fact that a number of banks currently do not offer a facility for shares does not necessarily mean the arrangement is not arm's length. The courts have said of the expression 'arm's length' (for the purposes of that term in the SIS Act):

a useful test to apply is whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment. [APRA v Derstepanian (2005) 60 ATR 518].

Potential for the related lender to make a profit

Related parties who lend to SMSFs often make a profit, even if the related party must borrow to on-lend. This is because the related party's own cost of finance is generally lower than the interest rate it charges the SMSF (which, when benchmarked to what SMSFs are charged in the market, will generally reflect a premium due to the strictly limited recourse nature of SMSF loans). In effect, a related party often 'marks-up' the interest rate when it on-lends.

Of course, SMSF trustees must comply with the sole purpose test and should not borrow to help a related entity make a profit. However, provided the terms are arm's length and the borrowing and asset purchase are consistent with the SMSF's investment strategy,

this should not create concerns about the sole purpose test, even if the loan happens to return a profit to the related party.

Managing a private funding arrangement

When borrowing from a related party, clients should be aware that the ATO has stressed the importance of borrowing on arm's length terms (see TA 2008/5 and the ATO's Q&A guide to super borrowings). A related party borrowing could attract closer scrutiny and clients and advisers should be prepared to implement the loan carefully.

However, this can be managed and if done properly, should not create undue risks. Clients who have collected and retained objective evidence of what is offered to SMSFs in the market place (eg, loan-to-value ratio and interest rate, etc) will be able to demonstrate that their loan is indeed on arm's length terms.

Of course, the parties should document the loan via a binding loan agreement to show there is a genuine loan and that they are dealing at arm's length. This should be prepared by lawyers with expertise in SMSF borrowings. We have found many standard documents contain numerous clauses which would infringe the SIS laws and may give rise to undue tax risks. SMSF loan documents must also carefully tie in with the unique role of the 'bare trustee' (aka security trustee) so it is preferable to have the entire arrangement documented by lawyers with SMSF and tax expertise.

Pension exemption hotspots

An SMSF's pension exemption (from income tax and CGT) is under increasing scrutiny. Now is the time to ensure your pension planning is strategic; especially in view of recent market conditions and the difficulty that some SMSFs are now having paying the minimum pension payment.

Some may not realise that failing to meet minimum annual pension payment could have serious consequences, ie, the exemption may be jeopardised for the entire financial year. If an SMSF trustee falls short of paying the minimum, a common approach previously has been to record a 'sundry creditor' and pay that shortfall as soon as possible in the next financial year.

The ATO's current view however appears to be that there is technically no scope for this under the SIS regulations. Therefore, advisers should plan to ensure the minimum payment will be comfortably met for each pensioner. Advisers might factor in a 'buffer' when calculating minimum payments. For example, adding $1,000 or 10% on the minimum, whichever is higher, might ensure an SMSF trustee actually pays the minimum.

It is also important to ensure that pension documents stack up. In order to qualify as a pension, the documents must reflect all of the rules required by the SIS regulations for that particular type of pension. If each rule is not fully spelled out in the pension documents (which may include resolutions, an agreement, deed and/or other governing rules), the pension exemption may also be at risk. (We have seen numerous cases where the documents do not satisfy each rule as required by the SIS regulations.)

Failing to satisfy the pension rules may result in further penalties in addition to a loss of the pension exemption. The status of the payments made to a member if the SIS regulations are breached also has to be considered, eg, has a lump sum been paid instead of a pension?

You should also consider whether the segregated or unsegregated method is now more appropriate for claiming the pension exemption. Segregation can be attractive when there are capital gains. However, if there are capital losses an unsegregated basis is generally beneficial (as capital losses are retained).

Now might also be an ideal time to review the need to simplify things. For example, if a member has several pensions these could possibly be combined into one pension. However, what impact will that have on the tax free versus taxable proportions?

Further, as the pension exemption generally ceases on death the client's estate planning strategy should be reviewed to determine whether there is a reversionary beneficiary, whether a binding death benefit nomination is required and whether these are consistent with the client's overall estate plans.

Given the uncertain investment markets, a review of each SMSF's strategy is now very worthwhile!

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