SMSF & RELATED PARTY LOANS

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The ability of a Self Managed Superannuation Fund (SMSF) to borrow through a "limited recourse borrowing arrangement" presents a great opportunity for investors to create considerable wealth within the tax concessional environment of a SMSF.

A related party loan from a member (or other related party) to their SMSF can reduce the cost and complexity of a limited recourse borrowing arrangement, facilitate a transfer of funds into an SMSF that is not affected by the superannuation contribution cap restrictions, and create considerable income tax benefits.

Until recently the ATO held the view that funds lent by a related party to a superannuation fund had to be charged at a commercial rate of interest (i.e. comparable with that charged by a lender such as a bank).

Following on from this the ATO suggested that:

- If the interest rate charged was higher than market rates the structure could be viewed as an "early access scheme" or be considered as a breach of the sole purpose test as it provided a "non-retirement" benefit to the Members;
- Conversely, if the interest rate charged was lower than market rates a benefit had been provided to the SMSF and this benefit could be considered to be a superannuation contribution to the SMSF.

On 9 September 2010, the ATO released an Interpretative Decision (ID) ID 2010/162 which is applicable for the year ending 30 June 2009. The ID relates to section 109 of the Superannuation Industry (Supervision) Act 1993 (SIS Act) and indicates that this section does not prohibit loans from related parties to an SMSF where the terms are favourable to the SMSF. This ruling confirms that an SMSF can borrow from a related party and pay an interest rate that is lower than the typical interest rate charged from an unrelated lender.

Key points to note in respect of the ID are:

- It only relates to instances where a lower interest rate than that which is commercially available in the market has been agreed between the parties;
- The other terms and conditions of the loan must be on terms that are "arm's length" (not more favourable to the related party) and supported by documentation and appropriate record keeping; and
- It does not apply where a loan is made by the SMSF to a related party which is at arm's length and on favourable terms to the SMSF.

Related parties definition

It is important that a trustee of a SMSF has a clear understanding of the related parties of the SMSF.

Simplistically a related party includes any member, a relative of any member, a relative of the spouse of any member, and an entity (such as a company or trust) controlled by one or more of the above individuals.

Furthermore, the combined interests of the member and parties related to them (as detailed in the previous point) are used to assess if a member controls a trust, or sufficiently influences or has a majority ownership of a company.

Who will benefit from a related party loan?

Related party loans are not for everyone and typically they benefit three distinct types of investors:

- Those that have substantial cash balances held outside of the SMSF that can be lent to the SMSF;
- Those that have unused equity, usually in property, owned outside of the SMSF that can be used to secure a third party loan. These borrowed funds are then lent to the SMSF (usually at the same interest rate);
- Those that do not have sufficient equity and/or assets that can be sold easily within their SMSF to create the equity needed to support a third party loan. For example, due to lower bank "loan to value ratios" (LVR) a SMSF would usually require around 30-35% equity for a residential property loan and more for a commercial property loan.

Advantages of related party lending

Related party loans to a SMSF have many advantages and compare very favourably to limited recourse loans offered by third party lenders such as the major banks including:

- Reduced upfront costs and establishment fees. For example, it has been our experience that major bank lenders will want to review the trust deed of the SMSF, and the bare trust required to hold the asset, and they will charge around $1,500 to do this;
- Simplified SMSF loan documentation;
- The interest rate paid by the SMSF will be comparable to an investment loan in a personal name. It is common for third party lenders to charge a higher interest rate for a limited recourse loan to a SMSF compared to a loan to an individual;
- Third party lenders will usually require personal guarantees from the trustees of a SMSF for a limited recourse borrowing arrangement and this can create compliance issues and problems if the guarantee is called upon. A related party loan will not usually require this as the funds are either available cash or are funds borrowed against an asset owned outside of the SMSF;
- Funds lent to a SMSF are not subject to a “condition of release” and, therefore, are not trapped in the SMSF. They can be repaid by the SMSF in accordance with the terms of the loan agreement or as negotiated with the related party lender;
- The loan repayment terms will be more flexible and easier to modify. For example: as the lender and at least one of the trustees of a SMSF are related it should be quite easy to extend a loan term, change the loan repayment cycle, or make early repayment;
- The SIS Act has never stated that a SMSF borrowing can or cannot be refinanced. This uncertainty has led many including third party lenders, to conclude that a SMSF borrowing may not be refinanced. Recent changes to the legislation specifically allows a SMSF borrowing to be refinanced if it is made solely to extinguish a previous borrowing and meet the associated costs of placing the original asset into the new arrangement. This means that a related party loan can now be refinanced;
- Funds well in excess of the superannuation contribution thresholds can be lent to the SMSF. Once these funds are invested within the SMSF their earnings and any realised capital gain are taxed at a maximum rate of 15% (10% for realised capital gain on investments held at least 12 months) while the SMSF is in “accumulation phase” and 0% once it is paying a pension;
- Subject to the superannuation contribution thresholds, funds lent by a related party to their SMSF can over time be “forgiven” and be considered as superannuation contributions. For example, a person could lend $1,000,000 to their SMSF. Each year that the lender is eligible to make after tax contributions into superannuation they could consider $150,000 of the related party loan to be repaid. Rather than actually repay these funds to the related party lender they could retain these funds in the SMSF as an after tax contribution;
- Some high value assets can be transferred into a SMSF as a part of a loan structure without affecting the superannuation contribution caps. For example: rather than lend funds to the SMSF, a related party lender could transfer an asset such as a factory into the SMSF (into a bare trust established specifically to hold the asset) and a formal loan agreement could then be implemented between the related party lender and their SMSF;
- Subject to the superannuation contribution caps, salary sacrifice could be used to build up a property loan deposit or to support property borrowings of the SMSF;
- Typically a third party lender will lend around 65-70% of an investment property’s value if it is held within a SMSF. If the SMSF wanted to borrow 100% of an investment property’s value, it would be possible for a member of a SMSF to borrow against another asset owned outside of the SMSF and lend these funds to the SMSF;
- The interest cost of funds borrowed to invest is generally tax deductible. While considerable care is required to ensure that a related party loan is structured with commercial terms, the interest cost of the borrowing would usually be tax deductible to the SMSF.

Disadvantages

Related party loans to a SMSF have a few disadvantages including:

- If a related party loan is secured against a non-SMSF asset its equity will not be available for future use unless the asset generates additional equity through investment growth, or the loan is at least partially repaid;
- Access to non-SMSF funds used in a related party loan will be lost until the loan is refinanced or at least partially repaid;
- Under current legislation, the only time the SMSF can leverage an asset, such as an investment property, is at the time of its purchase. Once the investment loan is repaid the asset within the SMSF cannot be used to secure subsequent borrowings;
- While the funds lent by a related party to a SMSF are not subject to a “condition of release” the asset purchased with these funds, and its growth, are trapped during the accumulation phase of the SMSF;
- A properly drawn up loan agreement between the related party lender and the SMSF is required.

A related party loan to a SMSF is a very powerful investment tool that further enhances the considerable benefits of a limited recourse borrowing arrangement.

There has been considerable growth in the number and size of SMSFs in recent years and we see no reason for this growth to stop. In fact, we expect this growth to accelerate as investors realise the significant benefits of borrowing funds to invest within a SMSF.

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