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LRBAs — current tips and traps

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The limited recourse borrowing arrangement ('LRBA') lending market has undergone a significant shift in recent years, with most first-tier bank lenders withdrawing their LRBA offerings for purchasers of residential property. As a result, several smaller second-tier lenders have emerged to fill the void created by the departure of the big banks.

One of the underappreciated consequences of this change is that borrowers have needed to adapt to the processes and documentation requirements introduced by the new breed of second-tier LRBA lenders. This is broadly because a number of the conventions and practices that were previously accepted by the big banks no longer apply. In many cases, this state of affairs has left SMSF trustees in an uncertain position regarding the requirements that apply to LRBA acquisitions.

In light of the new lending market, this article examines the following common LRBAs pitfalls:

- The question of whether or not to name the bare trust.
- How the deposit should be paid.
- Guarantee and indemnity agreements.

Bare trusts — what's in a name?

One of the key legal requirements for LRBA investments is that the asset being acquired must be held on trust by a bare trustee/custodian for the benefit of the SMSF trustee under s 67A of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA').

In the past, there was some debate about whether or not a name should be given to the bare trust required as part of such an arrangement. Subject to any requirements that were imposed by the lender or the jurisdiction of the property being acquired, this argument was commonly settled by the tax considerations that weighed in favour of creating a transparent bare trust.

In particular, it was considered preferable not to name the LRBA bare trust to reinforce the fact that the bare trust should effectively be ignored for tax purposes. Having a named bare trust could raise the question of whether the bare trustee should be lodging tax returns separately and in addition to the SMSF trustee. In that case, the tax (including CGT) treatment of the LRBA would need to be carefully considered where the property was ultimately transferred from the bare trustee to the SMSF trustee.

To overcome this issue, it was generally recommended that the bare trust not be named unless:

- there was a jurisdictional reason to name the bare trust (eg, in Queensland a trust relationship can registered on title); or
- the SMSF trustee was required to utilise the lender's own bare trustee and bare trust product, in which case, the option not to name the trust is unavailable.

The introduction of ss 235-820(2) and 235-840 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') in 2015 (with retroactive effect from 24 September 2007) helped address the above tax concerns. These provisions broadly provide that:

An act done in relation to an instalment trust asset of an instalment trust by the trustee of the trust is treated as if the act has been done by the investor (instead of the trustee).

Example: A trustee disposes of an asset. Any capital gain or loss is made by the investor, not the trustee.

The consequence of these provisions is that the LRBA bare trust is considered a transparent investment vehicle for tax purposes (ie, SMSF trustee is identified as the relevant taxpayer). Accordingly, the historical tax reasons for not naming a bare trust no longer apply.

Indeed, in light of the new lending environment and to ensure that the conveyancing process runs smoothly, we now recommend that SMSF trustees/members consider naming the bare trust as a matter of course.

Broadly, we are aware that a number of second tier lenders are now requiring SMSF trustees to have a named bare trust regardless where the property is located. Imposing this condition on property purchases outside of Queensland is a departure from the prior established practice, and many advisers and SMSF trustees have been caught unaware by this new requirement. In many cases, SMSF trustees and advisers who have not arranged for a named bare trust have faced additional hurdles and costs. Thus, having a named bare trust in place from the outset can potentially prevent numerous headaches and problems in the new lending environment.

Of course, property law and stamp duty consequences remain a critical consideration for LRBA purchases. Before entering into a contract of sale (‘Contract’), SMSF trustees should ensure that they have regard to the jurisdiction of the property being purchased, including the following aspects:

- Whether or not to name the bare trust.
- The timing sequence of when the bare trust deed and Contract must be executed.
- How the purchaser is described in the Contract.
- Whether the purchaser can nominate an additional or substitute purchaser.
- Whether the beneficial owner of the property is to be registered on title.
- The transactions eligibility for relevant stamp duty concessions or exemptions.

Naturally, property and stamp duty laws vary across each jurisdiction and expert advice should be obtained at the pre-contractual stage of the purchase. Further, SMSF trustees looking to enter into an LRBA investment should have an upfront discussion with their lender regarding their LRBA lending requirements.

Who pays the deposit?

The deposit for an LRBA investment should always be paid from the SMSF’s bank account with clear evidence of this being retained.

This is important to ensure a smooth lending approval process and conveyance, and to help ensure the SMSF’s eligibility for any stamp duty concessions or exemptions.

In a typical LRBA, there are likely to be two relevant (dutiable) transfers over the lifetime of the asset, assuming the asset is not sold:

1. the initial purchase of the property (eg, from a third party vendor); and
2. the transfer of the property from the bare trustee to the SMSF trustee once the loan is fully repaid./li>

Each jurisdiction provides different stamp duty concessions and exemptions in relation to the above transactions. This article focuses on the second transaction and how the deposit affects the SMSF’s eligibility for duty concessions/exemption.

In Victoria, s 34 of the *Duties Act 2001* (Vic) provides a stamp duty exemption for a dutiable transaction from an apparent purchaser (the bare trustee) to the real purchaser (the SMSF trustee) when the real purchaser has paid the full purchase price for the property. If the relevant deposit is paid by an entity that is not the SMSF trustee, this duty exemption may be unavailable to the SMSF. This is because the SMSF trustee may not be able to show that it was the real purchaser because it did not pay the deposit. Similar issues can arise in other jurisdictions.

See the following linked article for further discussion of what steps can potentially be taken where the SMSF trustee has not paid the deposit:

https://www.dbalawyers.com.au/contributions/why-should-the-deposit-be-paid-by-the-smsf-trustee/

Providing a guarantee

Under s 67A of the SISA, the LRBA lender's recourse against the borrower must be limited to the single acquirable asset that is held on trust by the custodian/bare trustee. In the event of default on the loan, there is a greater risk that the lender may not be able to recover the full loan amount (plus any applicable costs), eg, due to a decline in the property's value.

To mitigate this risk, lenders often require a guarantee and indemnity to be provided by the individual SMSF trustees/members.

If this is the case, the parties providing the guarantee and indemnity will need to turn their mind to the taxation and compliance risks associated with such guarantee and indemnity agreements as these agreements can be quite problematic if exercised by the lender against the guarantor.

For example, if a related party pays out a lender in respect of a guarantee and indemnity agreement tied to an LRBA and the related party releases or does not pursue the SMSF trustee for payment, the ATO view this as a contribution to the SMSF. This is because the SMSF's liability to a third party is extinguished thereby increasing the capital of the SMSF (see TR 2010/1). Accordingly, guarantee and indemnity agreements can give rise to contribution risk when exercised by the guarantor.

There are also questions regarding whether guarantees can give rise to non-arm's length income, eg, where the SMSF trustees/members have not been remunerated on an arm's length basis for providing the guarantee (which is not common practice).

In particular, the terms and conditions of the guarantee and indemnity agreement must be carefully considered before being entered into. Generally the agreement is drafted to provide the lender (as guarantee) with greater options to recover any outstanding loan debt against the assets of the SMSF trustees/members outside of their SMSF.

To facilitate this, we are aware of numerous guarantee and indemnity agreements which seek to include a mechanism for the lender to recover against:

- assets held by the SMSF trustees/members personally; and
- assets held (indirectly) by the members in interposed entities.

This mechanism requires the SMSF trustees/members to provide the guarantee and indemnity in their personal capacity and as trustee of any trust, including any deceased estate, discretionary/unit/fixed or other trust.

This kind of clause is problematic, and SMSF trustees/members should generally not execute such guarantee and indemnity agreements without obtaining expert advice.

This mechanism could be problematic for the following reasons:

- If the guarantor is an individual trustee of their SMSF, the recourse of the lender could include other fund assets (as an SMSF is a special type of trust) contrary to the requirements of s 67A of the SISA.
- If the guarantor is an individual trustee of a non-geared unit trust and the SMSF is a unitholder in this unit trust, the SMSF's unitholdings in the unit trust could become in-house assets due to the guarantee potentially triggering reg 13.22D of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (eg, if the assets of the unit trust become subject to a charge).

Due to the above, we recommend that caution be exercised before entering into any LRBA-related guarantee and indemnity agreements.

Accordingly, advisers who are involved with LRBA matters where guarantee and indemnity issues arise should strongly encourage all relevant parties to obtain expert advice from a law firm. Naturally, advisers who provide advice on the legal aspects of these arrangements will be exposed to risk of unqualified legal practice and other potential claims.

Conclusions

While the emergence of numerous second-tier lenders for LRBA loans has created welcome opportunities for SMSF trustees, it must be borne in mind that it has also exacerbated the risks that may arise. As outlined above, many of the new lenders have processes and protocols that differ from previously established practice with the major banks, and the documents in use (e.g., guarantee documentation) may not always be appropriately drafted from a superannuation law perspective.

LRBAs involve significant complexity with numerous regulatory and tax risks that must be navigated. Accordingly, it is strongly recommended that SMSF trustees and members should seek expert financial, legal and property law advice before proceeding with any LRBA transaction.

DBA Lawyers offers a range of documentation and consulting services in relation to LRBA matters, including our premium borrowing services for LRBA documentation which is recommended where there are any doubts or questions that arise.

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