Property: To gear or not to gear?

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With reduced contribution caps and members' total superannuation balances limiting the future ability for many SMSF members to accumulate sizeable superannuation benefits in their fund to invest in property, it is expected, more and more SMSFs will look to consider investing in property, in conjunction with other parties.

This paper looks at the various ways an SMSF trustee can structure arrangements, with related and unrelated parties and considers the associated advantages and disadvantages. We consider the most common structures, which include:

- Direct ownership
- Tenants in common
- Private (unrelated) unit trusts
- Related (ungeared) unit trusts
- Pre-1999 unit trusts

We also envisage that more SMSFs will need to borrow to assist with funding their investment. However, given the strict rules that must be met for an SMSF trustee to have a complying limited recourse borrowing arrangement (LRBA), gearing may not always be the default choice. Restrictions on SMSFs ability to borrow to improve an existing fund asset or the ability to substantially improve the property before the loan is extinguished, all limit the attractiveness of a LRBA. The complexity of using an LRBA is also compounded by the rules of dealing with a related party lender as the number of third party financiers prepared to lend on a limited recourse nature has reduced.

As an alternative, we explore the option of SMSFs borrowing under a LRBA to acquire units in a related or unrelated trust which invests in real property. Although an SMSF borrowing to invest in a trust does not need to be concerned with some of the LRBA restrictions, the reality is that it will be difficult to identify an arm's length lender that would provide finance and accept security over the units rather than the underlying real property. This inevitably means that an SMSF will need to rely on a related party loan so it is imperative that the loan arrangement is, at all times, on arm's length terms.

In this paper, comments are limited to unit trusts, which are typically the preferred structure for owning property, due to their flow through from a tax and income perspective. However, SMSFs may also be able to structure their arrangements to involve related or unrelated private companies, including pre-1999 companies.

For more, please read the following SMSF Association technical resources:

- Go-To Guide: Limited Recourse Borrowing Arrangements (LRBA) – December 2020
- Technically Speaking: SMSF property development (Part 1) – June 2021
- Technically Speaking: SMSF Property development (Part 2) – July 2021

SMSF with LRBA

SMSF trustees are prohibited from borrowing unless an exception applies. The most significant exception is the ability to enter into a LRBA under sections 67A and 67B of the

SIS Act. (Please note that that different rules apply to LRBAs entered into between 24 September 2007 and 6 July 2010).

For more information on the main requirements of an old or new complying LRBA please refer to our LRBA Go-To Guide. This guide also addresses correctly structuring a new LRBA and the acceptable use and improvement of a property purchased using borrowed money.

For more on the ATO's acceptable terms for related party loans, please refer to PCG 2016/5. The PCG is commonly referred to as the 'Safe Harbour' terms on which SMSF trustees can structure their LRBAs consistent with an arm's length dealing, so that the NALI provisions do not apply.

Advantages

Some of the advantages of an LRBA include:

- Leveraging superannuation benefits – Allows the SMSF to acquire beneficial interest in the real property that it may not normally be able to afford.
- Aids in diversification – Allows the fund to invest a smaller proportion of the fund's assets in property rather than directing a large portion of the fund's assets in one lumpy asset.
- Derivation of income – All income generated by the property is derived by the SMSF and can be used to fund related fees and interest charges.
- Tax concessions – All income generated by the property is concessional taxed in the SMSF and borrowing expenses, including interest is tax deductible.
- Capital gains tax concessions – If structured correctly and the SMSF is the beneficial owner of the property, there should be no CGT event when the property is transferred to the SMSF from the holding trust, once the loan has been repaid.
- Stamp Duty concession - Provided the LRBA has been set up correctly, once the debt is extinguished, the property can generally be transferred from the holding trust to the SMSF without stamp duty.
- Asset protection – If the SMSF defaults on the loan facility used to acquire the property, recourse is limited only to that asset, and not to other assets of the fund.

Disadvantages

The primary risks or practical problems faced by SMSFs using LRBAs include:

- Establishment and ongoing maintenance costs of the holding trust – Increased costs and generally not tax deductible.
- Difficulty funding ongoing property maintenance – Generally, the trustees cannot borrow to fund ongoing maintenance and property repair costs.
- Preserved capital – All member contributions used to buy the property or pay for maintenance costs, is capital locked away and subject to the preservation rules.
- Improvements to property limited – The borrowing provisions are breached if the character of the property changes, creating a new asset (i.e. a replacement asset)
- Personal guarantees – Members typically required to provide personal guarantee to meet external lender requirements and to meet ATO's safe harbour.

- Related party lenders –External lenders providing LRBAs are limited, so increased risk of non-arm's length income (NALI) as SMSFs rely on related party loans.
- Adverse tax considerations - Negatively gearing a property in an SMSF is less beneficial compared with negatively gearing the same asset outside the SMSF.

Direct Ownership

The simplest way for an SMSF to purchase a property is to purchase the property directly without any interposed entities. Where significant wealth has accumulated within the SMSF, purchasing the property outright without any gearing may be an option.

Advantages

Some of the advantages of owning property directly, include:

- Reduced costs – Acquiring the property outright eliminates all costs associated with an LRBA, including the documentation costs, the borrowing costs and interest charges.
- Derivation of income and capital – All income and capital gain is derived by the SMSF and subject to concessional tax, provided it is at arm's length.
- Property development – Provided there is no borrowing required, the SMSF is not limited in its ability to improve the property it owns.
- LRBA – Provided all the criteria is met, an SMSF can borrow to acquire property.

Disadvantages

Some of the risks or practical problems faced by SMSFs owning property direct, without an LRBA include:

- Lack of diversification – Trustees may be required to commit a large proportion of available funds to acquire the property.
- Lumpy asset – Liquidity issues may arise with SMSF's investment in an indivisible asset.
- Limited use by related parties – The property can only be leased to a related party, provided it is business real property (BRP), otherwise, risk of in-house asset breach.
- Unable to charge asset – The trustee cannot grant a charge over the property to assist with cash shortfalls.

Tenants in common with related parties

Where an SMSF acquires real property as tenants in common, the SMSF has rights to a distinct proportion (or fraction) of the property. The distinct features of a tenants in common arrangement include:

- ownership may be held in different proportions;
- each tenant in common's interest is separate and distinct from the other owners; and
- each owner has the ability to dispose of their share independently of other owners.

Advantages

Some of the advantages of the SMSF owning the property as a tenant in common include:

- Cheaper option – Overcomes the cost of borrowing or using an interposed entity.
- Proportionate income and expenses – Easy to administer with income and expenses shared between investors, based on their fractional interest in the property.
- Alternative to gearing – Members and related parties can hold property with their SMSF without breaching the in-house asset rules (IHA) provided it is not subject to a lease with a related party.
- Exposure to property – An SMSF can progressively increase its interest in the property as there are no limitations on acquiring the other tenant's interest, if they are unrelated.
- Business real property acquisition – If the property is BRP, the SMSF can gradually acquire the related party's interest in the property. Can acquire up to 100%.
- Related party lease – If the property is BRP, it can be leased to a related party without breaching the in-house asset rules.
- LRBA – An SMSF can borrow to acquire the property, provided the loan is only secured against the fund's fractional interest in the property and all the other loan criteria is met.

Disadvantages

Some of the primary risks or practical problems faced by SMSFs investing in property as tenants in common:

- Part 8 associates trap – The ATO views tenants in common deriving rental income as a tax law partnership. This makes the tenants Part 8 Associates and so related parties of each other for the purposes of the of acquisition of assets from related parties and the in-house asset rules.
- Residential property and in-house asset limits -The SMSF cannot lease the property to a related party unless the value of the leased residential property does not exceed 5% of the market value of the SMSF.
- Charging asset – SMSF's position may be compromised where the other tenant gives a charge over their proportionate interest in the property. If dealing with a related party, it may result in the direct or indirect provision of financial assistance.
- LRBA – Increased risk of non-arm's length income. SMSFs rely more heavily on related party loans due to limited external providers lending on the basis of a fractional interest in an asset.
- Exiting parties – SIS restrictions apply on acquiring the other tenants' interest in the property, when dealing with a related party. For example, the SMSF is prohibited from acquiring the other tenant's interest if the property is residential.

A tenant in common arrangement needs to be distinguished to a joint tenancy arrangement where no one party owns a clearly identified proportion of the property. Owning property with an SMSF as joint tenants is not considered appropriate, primarily due to the right of survivorship on the death of one party, which creates a complex set of issues on how to treat the SMSF's increased share in the property.

Private (unrelated) unit trust

A private unit trust provides a flexible structure to pool superannuation and non-superannuation resources to own real property.

The key factor here is that where any of the unitholders are SMSFs, the parties to the arrangement must not be related parties for superannuation purposes. It is important that any SMSF unitholder and related parties together do not have actual (more than 50%) control or effective control of the unit trust which would cause the SMSF investment in the unit trust to be treated as an in-house asset subject to the 5% market value in-house asset limit.

Advantages

Some of the advantages of the SMSF owning the property via an unrelated private unit trust include:

- Divisibility of the asset – SMSF can buy/sell parts of the asset (i.e.units in the trust). Also easier to accommodate multiple investors.
- Flexible borrowing arrangements – The unit trust itself can borrow and use the property as security, without having to comply with the LRBA rules in the SIS Act.
- Property activity unrestricted – The trust is not limited in any way in dealing with the property purchased in terms of development, modification or improvement, even if the activities of the trust amount to the carrying on a business. The trust can also acquire multiple properties.
- LRBA – SMSF can borrow to buy units in the trust. Likely to need a related party loan given the security for the loan cannot be the underlying property owned by the unit trust.
- Related party transactions permitted – Provided all transactions are at arm's length, the unit trust can enter into arm's length arrangements with related parties, including loans and leases.

Disadvantages

Some of the primary risks or practical problems faced by SMSFs investing in an unrelated private unit trust include:

- In-house asset limits – Care is required when changing unit holdings between existing or new unitholders to ensure the unit trust is not converted into a related trust and treated as an in-house asset of the SMSF.
- Lack of control – The SMSF and its 'group' of related parties cannot have actual control or effective control of the unit trust.
- Gearing risk – Borrowing by the unit trust does not have to be limited recourse and assets of the trust can be used as security.
- Adverse tax considerations – Unit trust losses cannot be distributed to unitholders and underperforming trust assets may raise sole purpose test issues for the SMSF.
- Unpaid trust distributions – Where the SMSF has unpaid distributions for a significant amount or has not sought payment within a reasonable period, the sole purpose test, the in-house asset rules and non-arm's length provisions are at risk of being breached.
- LRBA – Increased risk of non-arm's length income as external lenders are generally reluctant to lend to SMSFs, using the private trust units as security alone.
- Exiting parties – The SMSF is prohibited from acquiring units in the trust, owned by related parties.

Related (ungeared) unit trust

Provided an interposed unit trust is structured correctly, related party investors can pool their money together with an SMSF to acquire the property, without being treated as an in-house asset or creating circumstances of financial assistance to members or relatives.

As the trust would be a related trust of the SMSF, only where it meets all the requirements of SIS Regs 13.22C and SIS Reg 13.22D at all times, will it be excluded from being treated as an 'in-house' asset. One such requirement is the prohibition against borrowing which is why SIS Reg 13.22C unit trusts are commonly referred to as non-geared unit trusts (NGUT).

In accordance with the SIS Reg 13.22C and 13.22D requirements, the NGUT must not:

- hold an interest in another entity including units in another trust
- lease property to a related party of the fund or enter into a lease arrangement with a related party of the fund unless it relates to BRP
- make a loan to another entity
- borrow money or allow a charge over an asset of the trust
- acquire an asset from a related party of the fund or an asset that has been owned by a related party of the fund within the previous three years (unless the asset is BRP)
- conduct a business
- conduct any transactions on a non-arm's length basis

Advantages

Some of the advantages of the SMSF owning property via a NGUT include:

- Control – The SMSF and related parties have absolute control of the NGUT.
- Flexible and affordable funding option – All parties can disproportionately contribute to buy units in the NGUT to indirectly own the property and subscribe to new units to inject capital to fund improvements to the property.
- Property improvements permitted – The trust can acquire multiple properties which it can develop, modify or improve, provided it is not carrying on a business.
- LRBA – The SMSF can borrow to buy units in the trust. Likely to need a related party loan given the security for the loan cannot be the underlying property owned by the unit trust.
- Related party acquisitions – The SMSF can acquire units held by related parties to allow for a "staged" purchase of a property over time. May be used as an alternative to the SMSF borrowing.
- Unwinding NGUT – In the event that the NGUT needs to be wound up, the SMSF can retain an interest in the property if it is BRP, as it can acquire it direct from the NGUT.

Disadvantages

Some of the primary risks or practical problems faced by SMSFs investing in a NGUT include:

- Restricted activity – The NGUT is limited in what activity it can undertake (cannot run a business, cannot borrow, cannot invest in listed shares, cannot lend monies etc)

- In-house asset trap – A breach of any of the conditions in the regulations is considered ‘fatal’ and cannot be rectified. The NGUT is forever tainted and can never be exempt from the in-house asset rules, requiring the trust to be wound up or restructured.
- Unpaid trust distributions – The NGUT is not permitted to borrow which could include any unpaid entitlements which are deemed to be a loan or the provision of credit/financial accommodation to the trust by the SMSF.

Pre-1999 (related) unit trusts

Where an SMSF acquired units in a unit trust on or before 11 August 1999, or under the transitional period operating from that date to 30 June 2009, these units will never be in-house assets. The exemption from the in-house asset rules applies indefinitely and any units an SMSF holds in a pre-1999 unit trust will not be in-house assets regardless of what activities the unit trust undertakes.

Advantages

Some of the advantages of the SMSF owning property via a pre-1999 unit trust include:

- Flexible borrowing arrangements – The unit trust can borrow without having to comply with the LRBA rules. The unit trust can even borrow from a related party other than the SMSF.
- Unrestricted trust activities - The trust can use the property purchased as security, it can develop or improve the asset as well as carry on a business without triggering the in-house asset rules.
- Can convert into a NGUT – Provided no event in SIS Reg 13.22D has occurred since 28 June 2000 a pre-1999 trust can be converted into a NGUT. This is the only way an SMSF can make additional investments into the trust.

Disadvantages

Some of the primary risks or practical problems faced by SMSFs investing in pre-1999 unit trusts include:

- Cash flow concerns –There is limited ability to inject capital into pre-1999 unit trusts as any additional investment by the SMSF, post the end of the transitional period, will be an in-house asset. Most problematic if the pre-1999 unit trust has a debt to service.
- In-house asset Trap – Unpaid trust distributions can be deemed a loan and caught as an in-house asset and limited to 5% of the market value of the fund’s assets.

Summary

Gearing in an SMSF using the LRBA rules can be beneficial for certain trustees, however alternatives should also be considered in order to determine the most appropriate strategy for any one particular set of circumstances. This is particularly the case for large lumpy assets, such as real property, where the SMSF is not in a position to purchase the property outright.

While there are benefits in owning real property (directly or indirectly) with related parties, at all times, the SMSF trustee must implement and maintain its investment at arm's length and in accordance with the sole purpose test.

The ATO is interested in how trustees arrived at the decisions they made and what considerations motivated them when deciding to make a particular investment. Trustees must be able to objectively demonstrate a genuine belief at the time of making an investment that it was for a retirement purpose. Poor and underperforming investments that represent a significant proportion of fund assets will also readily cause the regulator to question the retirement purpose of the trustees. When structuring the way investments are held, trustees must ensure that sufficient income and/or capital growth is passed onto the SMSF from the interposed trust to satisfy the ATO's broad and extended application of the sole purpose test.

It is also important that SMSF trustees ensure that all transactions are undertaken on an arm's-length basis. The general test is whether a prudent person acting with due regard to their own commercial interests would have made such an investment.

This paper has considered the option of gearing alongside common alternatives when structuring the purchase of real property and highlighted the various issues that trustees need to consider.