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How to borrow using a self-managed superannuation fund to acquire farmland

PHOTO: iSTOCK

Background

The superannuation system provides several benefits when it comes to a self-managed superannuation fund (SMSF) owning farmland. These include asset protection and the management of estate planning risk. However the overriding advantage is that it provides a tax-effective environment to help build wealth. In most circumstances a superannuation fund will be taxed at a maximum rate of 15% and in certain instances its income will be tax free.

In circumstances where a SMSF has borrowed to acquire an asset, theoretically there could be 85%–100% of income (after tax) available to pay back the debt. This potentially allows debt to be paid off faster when compared to a 'non-superannuation' environment, thereby generating wealth at a superior rate. The downside of such tax-effective conditions are the strict regulations and compliance rules a SMSF faces. The 'sole purpose test' is the fundamental doctrine that all superannuation fund trustees must legally comply with.

The sole purpose test imposes a requirement on the trustee to maintain the fund for the primary purpose of providing

Key points

- A SMSF can use a limited recourse borrowing arrangement (LRBA) to acquire farmland
- Problems may arise if buying land which is spread across multiple titles
- Funding can come from a related party

SUMMARY OF ACRONYMS

LRBA – Limited recourse borrowing arrangement

Non-divisible property – property the trustee cannot take from a bankrupt

SAA – single acquirable asset

NCC – non-concessional contributions: amounts paid into a superannuation fund from after-tax income

RBA – Reserve Bank of Australia

LVR – Loan to value ratio

Installment warrants – lending arrangements that enable a super fund to acquire an asset through a series of installment payments.

its members with retirement benefits. The test is the underlying rationale behind the four key SMSF investment restrictions that relate to how the investment is transacted and with whom, rather than the type of asset being acquired. The restriction relating to the ability of a SMSF to borrow money has had several significant changes since 2007.

Prior to September 2007 a SMSF basically had no capacity to borrow money to acquire an asset (e.g. real property), due to the strict adherence to the sole purpose test. However, in September 2007, amendments to the superannuation legislation enabled SMSF trustees to borrow or gear their investment acquisitions, initially using instalment warrants (up until July 2010) and currently via a limited recourse borrowing arrangement (LRBA – from July 2010). This fact sheet focuses on a SMSF using a LRBA to acquire farmland.

What is a LRBA and how does it work?

A LRBA involves a SMSF taking out a loan from a third-party lender or from a related party (e.g. fund member). The SMSF then uses the borrowed money and any of its own available funds (e.g. a deposit) to purchase a single asset (real property) that is to be held in a separate custodian or 'bare' trust.

The trustee of the bare trust is the legal owner of the asset, whilst the SMSF has only a beneficial interest in the asset, up until the loan has been extinguished. During the LRBA any income received from the asset, such as a farm lease, is paid directly to the SMSF. The loan repayments, including interest, are to be made by the SMSF. Once the loan is paid out the SMSF's trustee has a right to acquire legal ownership of the asset.

If the SMSF defaults on the loan, under a LRBA, the lender's right to recourse is limited to the asset (under finance) held in the related bare trust. All other fund assets are not exposed to any claim from that lender. Therefore, the retirement benefits of the fund's members are protected and the sole purpose test is met.

Benefits of utilising a LRBA

Growing fund assets through borrowing – A LRBA provides the ability to acquire farmland in the superannuation system when a SMSF has not enough cash to purchase it outright. Initially the fund only has a beneficial interest in the property, however it is entitled to receive all derived lease income and/or any capital gain proceeds from the sale of the land. Legal ownership of the land will pass to the SMSF on loan payout.

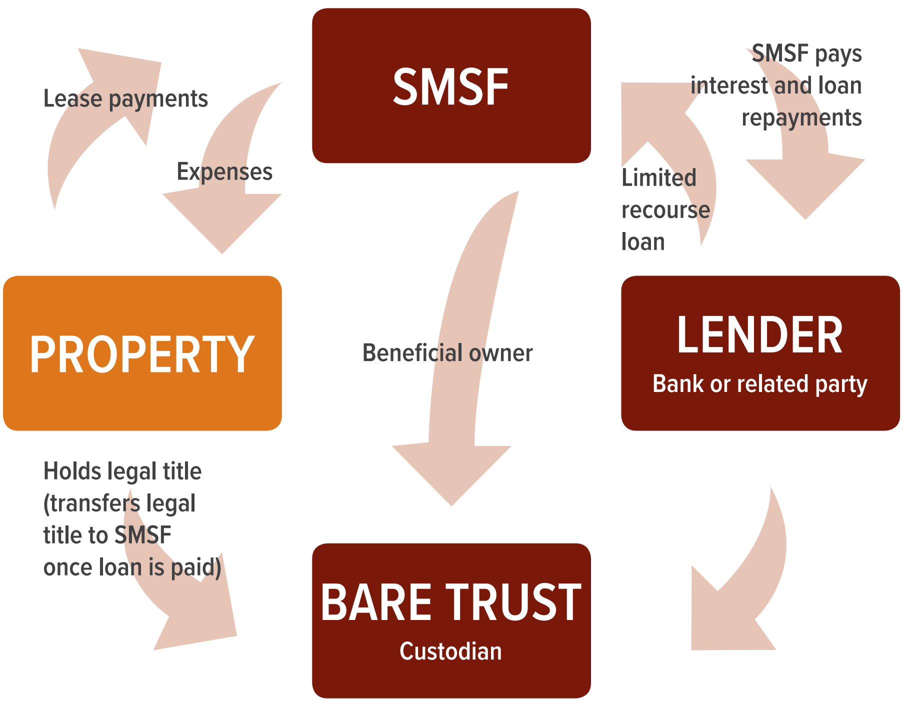
Concessional tax rates – Lease income derived from farmland owned by a SMSF will only be subject to a maximum tax rate of 15% during 'accumulation' phase. This rate would also apply to any capital gain realised on the disposal of the land. When compared to the marginal (individual) and company tax rates applicable outside the superannuation environment, there is potential for any income received from farmland to be taxed substantially less when owned by a SMSF.

Furthermore, if the SMSF is in the 'retirement' phase, and the farmland forms part of the asset base supporting the payment of a pension stream, any income (including capital gains) derived from the land will be tax free.

Asset protection – By the SMSF owning farmland separate from the farming business operations, the land is basically shielded from exposure to financial and legal risk. Also, assets in a SMSF are usually treated as non-divisible property, and protected against creditor claims in the event of bankruptcy.

Estate planning – Assets held in superannuation will not form part of a deceased individual's estate. By having

FIGURE 1: The structure of a limited recourse borrowing arrangement



SOURCE: ORM PTY LTD

in place a superannuation binding death benefit nomination, a member(s) of a SMSF can ensure farmland (inside the fund) is transferred on their death to a specified individual. This can be used to provide certainty and security to the next farming generation as the listed land will not form part of the estate or any contested Will action.

Disadvantages of a LRBA

A SMSF cannot acquire an asset from a related party – One exception to this rule is business real property acquired at market value. Business real property generally means land and buildings used wholly and exclusively in a business.

'Single acquirable asset' (SAA) – This concept is relevant where a LRBA is used to acquire farmland comprising multiple titles. Refer to the case study opposite for a detailed example.

Property improvement costs cannot be funded – Alterations or improvements to the farmland, such as new sheds, fencing, yards, bores etc. cannot be paid for by the LRBA loan funds. However, repairs and maintenance associated with purchased farmland (e.g. fence repairs) can be funded by the LRBA borrowings.

Additional costs and complexity – Extra costs relating to the set-up and administration of the bare trust, including potentially a corporate trustee, are a direct impost when acquiring an asset using a LRBA. Financial institutions may also charge for additional costs of vetting the SMSF's deed to confirm the trustees are able to maintain a borrowing arrangement. A LRBA loan will attract a higher interest rate to compensate financiers for their limited recourse capabilities.

When new entities are added to a business structure, as is the case with a LRBA, it is inherent that administrative complexities also increase.

Farmland security unavailable – A major disadvantage of farmland being owned by a SMSF is that the asset cannot be used as security for further borrowing (e.g. to buy more land). Any such asset exposure is in direct contravention of the Superannuation Industry (Supervision) Act.

There are benefits of utilising a LRBA including asset protection and estate planning, however careful scrutiny of the detail is required.

PHOTO: iSTOCK

The devil is in the detail – If a LRBA has not been structured correctly, this may require the arrangement to be unwound, potentially requiring the farmland to be sold. The SMSF deed's governing rules must also specifically permit entering a LRBA. The asset investment should also be consistent with the fund's investment strategy. If not, there could be action to recover loss and damages by an aggrieved member.

Single acquirable asset and implications for farmland acquisitions

The key concept of a 'single acquirable asset' (SAA) applies to LRBAs put in place on or after 7 July 2010 and only permits a SMSF trustee to borrow to acquire a single asset or a collection of identical assets (e.g. 1,000 BHP shares).

A major issue arises where a SMSF acquires farmland on a single contract of sale, consisting of multiple separate titles. Put simply, where land can potentially be sold in separate lots, the collective will not be classed as a SAA. Each individual title will be deemed a separate SAA, requiring their own respective bare trust and LRBA, which in turn means extra administrative costs and complexities.

The Australian Taxation Office (ATO) has taken a hard line on this in their tax ruling (SMSFR 2010/1), specifically noting that crops, fencing or irrigation systems spanning more than one title, is not sufficient to gain a SAA classification. However, if the farm being acquired conducts an intensive industry such as a piggery enterprise that has shedding and infrastructure constructed over multiple land titles, this may achieve a SAA status. This is on the proviso that the intensive industry's infrastructure value is a considerable component of the farm's purchase price. If this was the case, the farm would obtain a SAA classification and could be purchased under a single LRBA.

CASE STUDY
Single Acquirable Asset

- **Peter and Pauline are the only members of their SMSF**
- **Peter is interested in purchasing a parcel of land from a neighbour for $800,000 (including 'standing' crops). The farmland is split across three separate titles.**
- **All their current farmland holdings have either been transferred to or purchased by the SMSF. For succession planning purposes, they want all future land acquisitions within the SMSF.**
- **Their farming operations utilise a discretionary trust structure.**

FREQUENTLY ASKED QUESTIONS

Can a SMSF borrowing arrangement be refinanced?

Yes. The 2010 legislation clarifies that a SMSF trustee can refinance an existing LRBA. Refinancing may allow the SMSF trustee to minimise the risk of default on a borrowing resulting from a temporary inability to make a repayment, for example a SMSF facing solvency issues due to benefit payment obligations.

Can farmland in a LRBA be replaced with another parcel of land? No.

Who signs the contract of sale for a property purchased under a LRBA? The bare trust is the entity that holds the legal title to the property in trust for the SMSF. Therefore, the trustee of the bare trust should be noted as the purchaser of the property on the contract of sale. As each state or territory has different requirements regarding how the trustee (bare) is noted on the contract, it's recommended that you speak with your relevant revenue office or a property law expert to confirm contract notations.

What is the definition of a related party? Includes all members of the SMSF, their relatives, the business partners of each member, any spouse or child of those business partners, any trust or company controlled or influenced by a member, employers who contribute to the fund for a member and associates (business partners, companies and trusts controlled by the employer) of those employers.

ADDITIONAL RESOURCES

GRDC Farm Business Fact Sheet – National
The transfer of farmland into a self-managed superannuation fund
Link: https://grdc.com.au/the-transfer-of-farmland-into-a-self-managed-superannuation-fund

GRDC Farm Business Fact Sheet – National
Financing: Debt structuring and asset life cycles
Link: https://grdc.com.au/debt-structuring-and-asset-life-cycles

MORE INFORMATION

Contact your accountant or financial adviser

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ORM00015

- **They both have fully utilised their non-concessional contribution caps.**
- **The SMSF has $250,000 in cash available.**

WHAT ARE THE ISSUES TO BE DEALT WITH?

- The SMSF does not have the cash to buy the land outright and cannot be injected with additional funds via non-concessional contributions.
- With the parcel spread across three separate titles and if the sale is under one contract, the land will not be deemed a SAA, thus cannot be acquired using a LRBA.

POSSIBLE OPTIONS

1 Use the SMSF's cash ($250,000 or part of) to purchase one or two titles under one contract of sale, and any remaining title/s are acquired with a separate contract of sale and LRBA.

2 Each respective title is acquired with its own separate contract of sale and LRBA.

LRBA WITH A RELATED-PARTY LENDER

There are only a limited number of banks willing to lend to a SMSF. Those that do often place onerous obligations on the trustee and/or have an approval process that can be slow and expensive. An appealing alternative to using a third-party lending institution, is for the SMSF's trustee to arrange a LRBA with a related party (see definition in FAQs), provided arm's length terms are invoked. The ATO has issued new guidelines for a related-party loan to acquire real property, including farming land, as follows:

- An interest rate of 5.8% (2017-18). The interest rate must be updated every financial year (using May RBA lending rates). The trustees may choose to fix the rate at the commencement of the arrangement for a specified period, up to a maximum of five years.
- The term of the loan can be no more than 15 years, which includes any refinancing arrangement.
- Maximum loan-to-value ratio (LVR) cannot exceed 70 per cent. The market value of the asset is established when the loan is entered into.
- There must be a registered charge or mortgage over the property.
- Repayments are to be both principal and interest and to be made monthly.
- A written and executed loan agreement is required.

In practical terms, it means that any funding from a related party to a SMSF needs to be under the kind of loan terms offered by the commercial lenders.

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