E: advice@barrettwalker.com.au
www.barrettwalker.com.au

BARRETT WALKER

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A: Suite 8, 150 Chestnut Street, Cremorne
P: (03) 9428 1033

What if you are forced to unwind your LRBA? Best to have a contingency plan

Limited recourse borrowing arrangements (LRBAs) were once all the rage in SMSF land. However, with the tightening of banking rules this frenzy has begun to abate somewhat over the last few years.

LRBAs are great in a growing market as they allow an SMSF to grow the value of assets it holds in the expectation of greater retirement income.

For all LRBAs, there does come a time when the trustees must unwind the LRBA – hopefully when the loan has been paid off and the asset can be transferred to the SMSF proper. However, there are times when the choice to unwind an LRBA may not be fully in the hands of the trustees, but rather forced upon them by events outside of their control.

What events are we talking about? There are four main occurrences that may force the unwinding of an LRBA, and they are:

- forced sale by the lender
- divorce
- death/disability, and
- the member entering pension phase.

Forced sale by lender

The whole point of an LRBA is to generate capital growth and investment earnings for the SMSF, but as with all investments this is not guaranteed. We have seen property prices in the major cities rise spectacularly but that is now starting to taper off, with falling prices in some regions and market collapse in others. The share market has also fluctuated significantly over the last few years. What happens when you bet on black but it lands on red?

The great thing for an SMSF with an LRBA is that, should the value of the asset be less than the value of the debt and a sale is forced, the lender does not have recourse to other assets of the fund. However, the problem is that any money made from the sale must be put towards repaying the debt. Also, given that most banks only lend on the basis of a 60% loan-to-value ratio these days, the fund will lose any amounts initially contributed. Worse for the trustees is that while the lender may not have access to other assets in the fund, if they were prudent they would get the trustees to sign agreements to give access to other assets of the trustees outside of superannuation.

The reality is that if we see a bursting of a property bubble with significant falls in the value of property — as happened in the US and other countries during the GFC — this could cause the calling in of loans set up as LRBAs. The trustees may have no option other than to liquidate the asset in a falling market. Be prepared for the possibility.

Construction costs

It is possible to claim certain building costs, including extensions, alterations and structural improvements, as capital works deductions. Generally, you can claim a capital works deduction at 2.5% of the construction cost each year for 40 years from the date of completion.

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If the previous owner claimed a capital works deduction, they should give the current owner the relevant information to calculate costs, so it always pays to ask for this. If they didn't use the property to produce assessable income, an estimate can be obtained from a professional. However, the ATO requires that this professional is qualified, uses a reasonable basis for their valuation and excludes the cost of the land when working out construction costs.

Divorce

Unfortunately, one in three marriages will end in divorce (down from one in two). The hardest part of any divorce, other than custody issues involving children, is the division of property. This becomes even messier when the divorcing couple has an SMSF that holds an LRBA.

In this circumstance, one or more of the members of the SMSF are likely to leave. There needs to be sufficient assets to transfer the value of the leaving members' benefits to alternative funds. In SMSFs with an LRBA, the LRBA asset tends to be the major asset, and there are unlikely to be sufficient alternative assets to pay out the leaving members. This will force the fund to prematurely unwind the LRBA and sell the asset. If the asset is a business asset used by one of the members, this becomes even more of an issue in terms of how the trustees arrange for the sale and who to sell to.

Getting agreement on what to do, while also going through a divorce, will be tricky and add to the complexity, time and expense of the divorce. Given the one-in-three divorce odds, the best thing to do is to get agreement between the trustees as to how to deal with fund assets on divorce while things are good. This may seem like a strange thing to do, but having a prior agreement in place could save a lot of costs and hassles down the line.

Death/disability

Another situation that can lead to the forced sale of an asset subject to an LRBA is the death or disability of a member of the SMSF. In such a situation, either a death benefit must be paid out or a disability pension may be paid. Because these are paid out of the assets of the fund, an SMSF whose main asset is a property subject to an LRBA may have liquidity problems that may force the sale of the property to pay the benefits.

To avoid this problem, one answer may be to have death and disability insurance outside superannuation that covers the amount of the outstanding loan. Therefore, upon the death or disability of a member, the amount of the loan can be repaid out of the insurance benefits, allowing the loan to be paid off and the asset freed from incumbrancers.

In reality, however, even where insurance is sufficient to pay off the loan, the ongoing costs of a death benefits pension or disability pension may be more than the income that can be generated from the assets. This would, therefore, require the sale of assets, including potentially the asset that previously underpinned the LRBA.

Pension phase by a member

The final main reason an LRBA could be forced to unwind early is the retirement of a member and the starting of a pension. If the LRBA asset is delivering positive income streams that can help to fund the pension, a sale may not be required. However, if there is not enough income to pay for the pension, this may require a sale. Again, the best way to deal with this is to have a written agreement between the trustees as to what will happen to the LRBA in the event of the retirement of one member and the need to liquidate assets.

Conclusion

In most cases, SMSF trustees will make their own decision as to when and how to unwind their LRBA. However, there are potential circumstances that may arise that take this decision out of the hands of the trustees. The best defence against such scenarios is to plan for their possibility (while hoping they don't occur) by having agreements in place with the trustees as to what is to occur should one of these events happen. It also highlights the importance of having insurance outside of superannuation.