STRAT X ADVISORY

Explaining a Limited Recourse Loan Arrangement (LRBA)

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Introduction to a LBRA

The following paper is designed to provide a general overview of the components of a LRBA and what is involved.

WARNING:

It is most important is to seek specialist advice to ensure an appropriate level of knowledge is obtained before entering into an LRBA.

A common mistake made in the past is SMSF Trustees purchased the leveraged property in the Trustees name and not the Trustee of the Security Trust. This can be a costly mistake as double stamp duty could apply.

Also as stamp duty is a state matter, each state has different ways of providing either an exemption or concession on the eventual transfer of the title of the property when the LRBA terminates and the lender then passes title to the SMSF trustee. Using a specialist aims to avoid this type of situation does not happen.

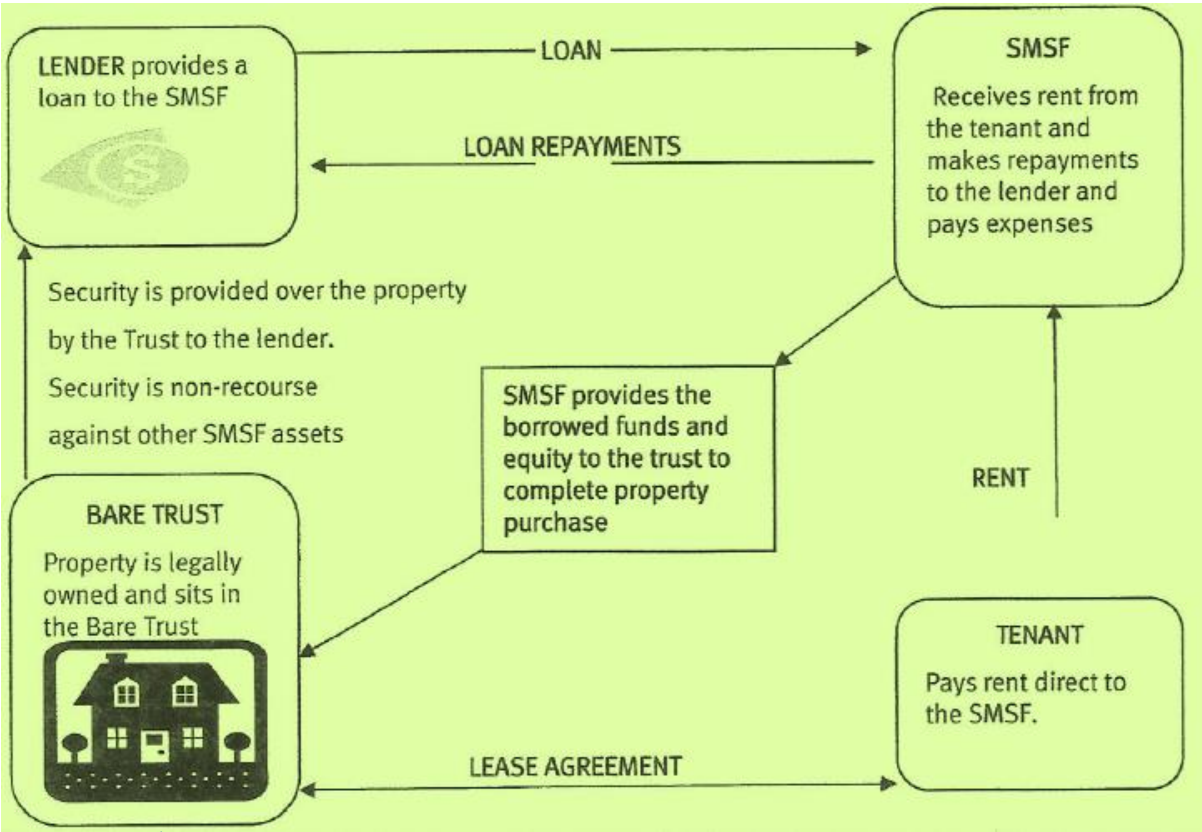
Many lenders now require Financial Planner Certification before approving a LRBA.

Generally the Financial Planner Certification is part of a Statement of Advice and involves stress testing the financial viability of the proposed leveraged property purchase and states the SMSF trustees are aware of their responsibilities. Lastly an appropriate investment strategy tailored to the SMSF is a mandatory part of the process.

Components of a LBRA

Central to understanding how an LRBA works is knowledge of the components and relationship of the legal entities involved and who owns what and where cash goes to.

Below is a diagram showing the components and legal relationships of an LBRA:



In summary:

- the residential investment property will be held beneficially in the name of the Security Trust Trustee (Bare Trust) XYZ Pty Ltd, not the SMSF Fund Trustee

- The SMSF Trustee has invested (30???%) equity/deposit in the property, and has borrowed (70????%) of the purchase price-(depends on lender and type of property)

- Under the LRBA, the lender has limited recourse, meaning the only asset for security under the LBRA is the purchased property and no other Fund asset. This means if for some reason the property was sold and there was a loan shortfall (and the Fund lost its initial capital investment) the loss would be borne by the lender and not from the Fund's other assets.

- The SMSF Trustee (not the Security Trust Trustee) is responsible for paying the loan and will receive rent from the property

- Any lease is between XYZ Pty Ltd Bare Trust Trustee and tenant (not the SMSF Trustee)

- The lender may require a Director's personal guarantee in respect to ongoing super contributions to ensure money is available in the Fund to pay the loan repayments and any shortfall in the event the sale of the property was insufficient to repay the loan on full
- The Fund Trustee (not the Security Trust Trustee) is responsible for paying all expenses related to the Investment property

The risks of direct property investment and gearing

Assumed investment property knowledge

To qualify you need to demonstrate some experienced as a Direct Property investor and may have had leveraged investment properties and are very aware of the risks of leveraged investments.

If rent is not forthcoming during the first year, the Fund's capital or other income will be required to pay the loan amount.

The amount owed by the SMSF in relation to the LBRA must be repaid before legal title to the secured property can be transferred to the SMSF Trustee

The SMSF is not the legal "owner" of the investment property and this will be the case until the LBRA is finalised.

This means if the property is to be sold beforehand, the Lender as mortgagor must approve any sale and the Security Trust must settle the outstanding loan before any surplus monies can be paid to the SMSF Trustee.

The acquisition of the property using the LBRA by the Fund Trustee, is permitted by the fund trust deed, and within the Fund's Investment Strategy parameters

The Fund's investment Strategy provides explicitly for leveraged Direct Property investments and needs to be within the specified asset allocation range for the Fund.

The costs and benefits of the LBRA

The costs of the LBRA, include the set-up cost for the Security Trust Trust Deed, Stamp Duty Exemption Statutory Declarations (tailored for each state) and the corporate Trustee for the Security Trust and Financial Planner Certification. There is an ongoing annual ASIC fee of around $240 for the company to lodge an annual statement but no accounts or tax return is required. The other "cost" is the Director's guarantee for ongoing contributions to this Fund.

The benefits of the LBRA include, but not limited to:

- Significant leverage on the initial capital invested due to the 80% LVR
- Significant Depreciation Allowance on the new property
- Reduced taxation liability on contributions due to Depreciation Allowance
- Property could be cash flow positive within 3-5 years
- Limited Recourse against other Fund Assets in the event of default

The costs of running a self-managed super fund

The annual cost of running the Fund will be in the order of $2,200 which covers compliance, accounting and the annual audit.

Risks and consequences

The risks and consequences includes but is not limited to:

Market Risk

If the property market drops dramatically and remained so for an extended period the Fund could lose part or all of the capital if the lender decided to call the loan

Interest Rate Risk

If interest rates rise dramatically the property may remain negatively geared and cause the Fund to liquidate other assets to pay for the loan repayments

Income (Rental) Risk

As mentioned above if the property occupancy rate is high and or rent at appraised rate does not eventuate the Fund will have to provide liquidity to make the loan repayments

Diversification Risk

As the majority of the Fund assets are in 1 asset class there needs to be an awareness to invest ongoing contributions into other assets over time, if the Trustee wishes to mitigate reliance and concentration in only one major asset class in an effort to diversify investment performance risk and include non-correlated investments.