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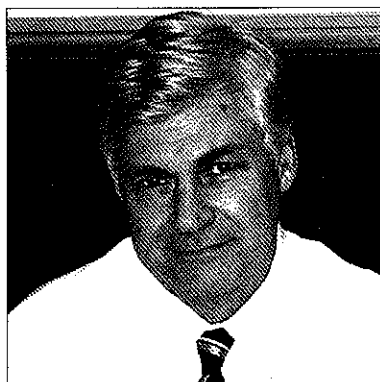
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Borrowing by super funds – a new era of advice



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By **Tim Pepper**
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Gearing a superannuation investment offers investors new opportunities and threats. Financial planners and accountants are well placed to help their clients navigate through these new laws.

The new superannuation rules are drafted broadly. The changes introduced last year in Sec 67(4A) of the *Superannuation Industry Supervision Act 1993* (SIS Act) allow a super fund to borrow to invest in an “acceptable” asset.

Instalment warrants are a way to purchase an asset by making an initial part-payment and a subsequent payment at a later date and to use a related trust to hold the asset.

Any new asset that a self managed super fund can buy, it can gear. This includes residential real-estate, business real property (even if owned by a member or relatives and others deemed by the super laws to be related to the fund’s members provided the property is exclusively a business real property), managed investments, shares, art work and exotics.

But note that this is a once only opportunity as once the asset reaches the superannuation environment then the chance for gearing the asset is lost. Considering the opportunity to gear an investment is an appropriate matter for review before any asset is acquired by or transferred into the SMSF.

Let’s take you through the instalment warrant process. We show the roles of each adviser. There are opportunities for accountants and advisers to work with real-estate agents, finance brokers and bankers.

Using the SIS Act terminology, we identify the *Instalment Warrant Trust* rules – as employed as a security trust in the loan and property acquisition.

FORTUNE FAVOURS FRED – CASE STUDY

Fred, a lawyer, has a family of five and a large house and mortgage. In 10 years time he intends to retire and sell his practice. He and his wife dream of a smaller retirement home with views directly over the ocean, tennis court, outdoor pavilion and space in which to garden.

Fred's estate agent may have found the dream retirement property – the only problem is financial.

His children are either entering university or still at school. He is still paying off the existing mortgage on his family home.

Fred earns a lot and (in his view) "loses" 9 per cent of his salary to super. What is left is not enough to fund the deposit on his retirement home.

He has no chance of saving the deposit given his current financial obligations. Fred has been heard whining about the fact that in Singapore superannuation can be used to buy the family home and live in that house. No such "luck" in Australia he bemoans.

Then fortune favours Fred. Fred's adviser tells him that since September 2007 thanks to section 67(4A) of the SIS Act, he can now borrow money to fund superannuation investments. His adviser says:

1. Go ahead and buy the retirement home in your self managed super fund.
2. Use some of the SMSF funds to pay the deposit.
3. Borrow money (from yourself or a bank) to fund the rest of the purchase price.
4. Pay the loan off over the next 10 years in three ways:
 - a. Rent
 - b. Tax friendly compulsory super guarantee contributions and
 - c. Salary sacrifice superannuation contributions.

FRED'S QUESTIONS:

Residential property in member's name.

Can I transfer an existing beach shack that my wife owns to the warrant trust and refinance?

Sadly, no. A SMSF cannot accept a residential property from a member (or in this case a related party of the member) – not even if it was a gift. Residential property that a member owns can never be sold or gifted into super. Because you can't put that asset into your SMSF, you can't gear it. You can only gear assets that you can normally put into your SMSF. If a non-related third party owned the beach shack, then yes, you could buy it for your SMSF and borrow on it. However, in this instance, your wife owns it. Therefore, it can't become part of your Super.

Instalment Warrant Trust Deed

Isn't the Instalment Warrant Trust simply a standard Declaration of Trust (bare trust) for my Super Fund?

The Instalment Warrant Trust deed is not a regulated trust as is the case with the SMSF trust deed. It must be specifically drafted for each instalment warrant. In the drafting, there must be no liabilities that encumber the beneficiary of the trust (the SMSF) if there is a default. The term "bare trust" has a more generalised meaning.

The Instalment Warrant Trust is a fixed trust with a named beneficiary – that being the SMSF. The Instalment Warrant Trust's object or beneficiary (which is the SMSF) has a present entitlement to all income and proceeds.

There is a fine line between a lender's heavy handed demands and the limited recourse security demanded by the SIS Act. It is a delicate balance.

The Instalment Warrant Trust must also be drafted bearing in mind State and Federal taxation to comply with various rulings and provisions to reduce the chance of the Warrant Trust paying GST or at worst double tax, that is paying tax in the trust as well as in the SMSF. Careful drafting of the trust deed is required.

Business real estate Fred personally owns

Can I transfer business real property that I own to a warrant trust and then gear it?

Yes. It is permissible (unlike residential property unless a business is being conducted) to sell or gift business real property from yourself into your SMSF therefore as a new asset it can be transferred directly into the instalment warrant trust and geared through the SMSF.

Gearing assets already in the SMSF

I have listed shares in my SMSF. Can I use them as security for the Instalment Warrant and borrow some more money to buy more shares?

You can only gear new assets. In the above question, your business real property (while an existing asset for you) was a new asset for the SMSF. In this question, you already own the shares in your SMSF. The legislation requires fresh assets. You can certainly borrow to acquire new shares; but, you can't borrow using the existing shares already in your SMSF.

Property development

Once purchased and geared, can I further develop the retirement home? I am considering another unit subdivision, or perhaps a granny flat for my mother.

A word of caution. There is debate about whether the SMSF can redevelop a property through borrowings i.e. to change the nature of the asset initially acquired. It is preferable to err on the side of caution at this stage and not redevelop a property to the extent that will change the asset from that initially purchased.

Build on a block

Can I purchase vacant land and borrow with the view to build on the block?

Probably not. Rather than acquiring an asset which is the land, you will be creating another asset that is the house and land. This may fall outside the ambit permitted by the gearing rules because the loan is not used entirely in the purchase of the asset ie the land.

Moving into a residential property

When can I actually physically move into the superannuation owned property? I am happy to pay market rent. In fact, I am happy to pay well above market rent.

Your superannuation is for your retirement. You can't enjoy any of your superannuation until you are retired and the property is transferred out of the superannuation environment. Let me be blunt, you can't enjoy or live in the property while it remains in the SMSF. You can only move in after the property is distributed *in specie*. "*In specie*" means that you get the actual asset. The opposite of *in specie* is to sell an asset and take the cash instead. Depending upon your age there may be lump sum superannuation tax to pay.

It is not relevant whether you pay under, actual or over the market rent. It makes no difference whether or not you pay rent. You just can't live in (or personally use) the residential property under any circumstances while it remains part of your superannuation.

This rule also applies to any of your relatives.

Renting the business real property to a member

I want to buy business real property, gear it, and immediately start leasing it from my SMSF. I am not going to wait until retirement before I can personally rent the business real property – that would be silly.

The government agrees with you. The SIS Act has a special exemption for business real property. A member can rent out business real property owned by the superannuation fund to a member or member associate. Obviously, this has to be for the full market value. The exemption continues to apply even if the business real property is geared.

I see from a previous question that you may want to rent the property at other than a fair market rent. Don't. If you rent the property for less than market rent, then you are deriving an illegal gain from your super. If you rent it for above market rent, then in effect, you are contributing into your super. Just get your accountant (or valuer) to work out the market rent then have your superannuation lawyer prepare a legally binding complying lease.

HOW DOES THE ADVISER AND ACCOUNTANT PROJECT MANAGE?

Fred needs professional advice regarding all aspects of the investment through instalment warrant trusts. Fred is acting as a trustee of his self managed superannuation fund. There is a huge responsibility to act – not in his personal best interest – but the best interests of his SMSF. Fred is not his superannuation fund.

The accountant/financial planner

The most important person is the accountant or financial planner. You need to review:

- The investment recommendation – the investment has to be sound given the fund's investment strategy. Does the investment stack up in its own right? The sole purpose is Fred's retirement – not the fact that Fred has a swanky retirement home. Is it a viable investment if:
 - The deposit funds available in the SMSF are insufficient?
 - All the fund income is being used to pay retirement pensions?
 - The asset will not yield sufficient net rent to meet the repayments?
- The fund investment strategy and asset fit – there are opportunity costs. Fred has limited wealth to invest.
- The risk management strategies of the fund – gearing allows for greater returns. But that is only on the way up.
- The appropriate gearing levels – especially given the short time frame to his desired retirement age.
- The SMSF members' risk tolerance – the gearing magnifies the effect of rate changes. Is Fred up to the increased risk?
- Contributions limits.
- Asset sale and reallocation.
- Ongoing review.

Real estate agent

You need to help Fred consult with the real estate agents regarding the property selection. The real estate can be residential commercial or industrial property. But if acquired from a member or associate then it must be business real property. The accountant or financial planner monitors the real estate agents leasing of the property.

Valuer

The accountant needs to value the property or engage a valuer. The real estate agent generally acts for the vendor (not the purchaser). The accountant and planner need to work out expected returns based on the valuation of the property and the expected rental returns. That needs documenting for the auditor.

Auditor

You need to work with the auditor of the SMSF. These are early days in this area of law and the auditor wants full documentation, minutes and deeds.

Superannuation lawyer

Before the property is purchased a superannuation lawyer, under your direction prepares or reviews the SMSF documents:

- **Investment strategy** – review and update the options to include borrowing and acquisition of an interest in an instalment warrant trust.
- **Product disclosure document** – update and explain the risks.
- **Self managed super deed** – update the SMSF trust deed to ensure there is power:
 - To borrow.
 - To invest in an instalment warrant trust.
 - To acquire residential real estate, business real estate (even if owned by a member), managed investments, shares, art work and exotics.
 - To pay a benefit in specie.
- **Instalment warrant trust** – careful drafting is required to prepare the trust deed. For the duration of the investment, the asset is held in trust with the warrant trustee for the benefit of the SMSF absolutely. The SMSF has an immediate absolute beneficial interest to receive the income, rental payments or capital gains from the asset and pays all expenses rates and taxes on the asset including land tax, goods and services tax and stamp duty.
- **Incorporate a new special purpose company** – to act as trustee of the Instalment Warrant Trust.
- **Caveat** – lodge a caveat at the titles office to show the world that the true owner of the property is the SMSF, not only the warrant trustee. Upon final payment, the SMSF, as the absolute beneficiary, is entitled to the asset.
- **Mortgage** – where the money is coming from a member, (rather than a bank) the specific mortgage documentation must be prepared as well.
- **Tax advice** – stamp duty, CGT and GST issues on in specie transfer to the members.
- **Lease** – a legally binding lease at a commercial rent is required.

Finance broker and banker

On Fred's behalf, the accountant or adviser arranges finance with a lending institution.

Alternatively, Fred can act as lender. To provide the self-funding monies, Fred could borrow against the equity in his home. Fred then loans the money to the SMSF at a commercial interest rate and on arms length terms. There must be a loan and not merely a debtor/creditor relationship.

Also in line with views expressed by the ATO if the interest rate is higher or lower than what an arm's length lender will lend, or capitalising the loan interest or obtaining member personal guarantees exposing a risk their benefits in the SMSF could lead to regulatory problems.

What if Fred and his wife, as the SMSF trustees, default on the loan? Wherever the money comes from, the essential condition in the loan agreement is that the loan is "limited or non-recourse". The bank or lender only gets the property offered as security. The lender can take no other SMSF fund assets. The lender suffers any shortfall, not the super fund.

The accountant or planner must review the various features of the loan product to ensure the investment stacks up including:

- The non recourse terms.
- Establishment fees, term, interest rates and ongoing fees.
- Maximum loan-to-valuation ratio.
- Personal guarantee from members.