

Technical Update



'Back to the Future' – Borrowing By Self Managed Super Funds

With the new tax year underway Super Fund investors are now turning their attention to investment options in a difficult investment environment and many are excited about the possibilities of investing in real estate opened up by relaxation of the prohibition on borrowing. Are you ready to address your clients' questions and are you aware of the wide ranging implications of these legislative changes on your advice in relation to asset ownership structures, business finance and succession planning?

This series of papers is designed to help identify the issues to be considered when responding to clients in relation to these changes.

What has changed?

Despite the media hype, the prohibition on borrowing contained in s67 of the Superannuation Industry (Supervision) Act 1993 (SISA) has not been removed, nor has the prohibition on giving a charge over fund assets in SIS Reg 13.14 been removed. Rather, the introduction of SISA s67(4A) introduces the concept of a permitted borrowing, being one that satisfies the five tests detailed in the section. These tests broadly encapsulate the essence of a traditional installment warrant.

These five tests are in summary:

1. The borrowing must be by the SMSF to fund the acquisition of an asset that it would otherwise be permitted to buy
2. The asset must be held on trust for the SMSF
3. The SMSF must acquire a beneficial interest in the asset from the outset
4. The SMSF has the right to acquire legal title to the asset on the making of one or more payments; and
5. The rights of the lender to recover from the SMSF in the event of default are limited to the asset acquired.

This legislation was passed in September 2007, with bipartisan support in the Parliament including a speech in favour by the current Minister for Superannuation, Senator Nick Sherry in which he said

"Labor believes that this proposal assists superannuation funds to grow their assets to support Australians in their retirement, and as a result supports the measure".

The changes were designed to clear up the uncertainty around traditional installment warrants and to remove the former legislative bias which favoured investment in shares or managed funds over other asset classes.

What does this mean in practice for myself and for my clients?

The prohibition on use of geared unit trusts by SMSFs in 1999, meant that the SMSF ceased to be a practical solution for ownership of real estate for many clients. These recent changes restore the SMSF to its former place as a practical asset ownership vehicle for business or other real estate and other assets and have opened up a range of opportunities for you and your clients. Whilst an SMSF will not be the best solution for all clients, it must at least be considered when preparing any advice in relation to asset ownership structures.

In the nine months since the legislation was passed, the market has matured rapidly with a number of providers, two broad structures and settled transactions now numbered in the hundreds. Much of the demand is client driven, rather than being generated by advisers.





Back to the Future

We have titled this paper "Back to the Future" – as many of the opportunities available pre-1999 have been reinstated but with added prudential safeguards for your clients. The Government now has placed the onus on the lender to ensure the borrowing is sensible. The SMSF borrows without placing its other assets at risk as any loan must be limited in recourse to the asset being acquired only. It is clear that a prudent level of borrowing is an essential element of any long term wealth creation plan – and superannuation is the longest term investment any of us will have. The past 8 years (from 1999 to 2007) have been unusual in that it is the only period in the 30+ year history of SMSFs and their predecessor s23F or excluded funds) where access to gearing (either direct or indirect via controlled entities) has not been available.

Practical Solutions

Most solutions available can be grouped into two broad categories:

- Traditional warrant products; and
- Trust and Loan arrangements.

Warrants

Traditional warrant products use the same basic structure used for share gearing for over a decade. These use a professional trustee to hold the property for the life of the loan and are generally shorter term (usually 10 years). Use of a professional trustee increases costs, reduces flexibility and in most cases requires the client to give up day to day control over the property including choice of tenant and property manager and sometimes choice of property. This is likely to be a negative for the client given that all of the research on SMSFs suggests that control is the major motivator for choosing an SMSF. On the other hand, they could suit a client who seeks a "set and forget" solution with no day to day responsibility. These products are regulated as financial products (some are categorised as derivatives) and so require an adviser to hold an appropriate AFSL and provide a complete statement of advice at the client's cost.

Trusts and Loans

This approach delivers greater flexibility, control, choice and transparency and in most cases a lower overall cost to the client which explains why the vast bulk of transactions are trust and loan arrangements. As a credit product, a loan is regulated under State Law and no AFSL is required to provide advice.

In this case the transaction is unbundled, with the SMSF entering into a loan agreement with a lender and obtaining the required trust deed either from the lender or from an unrelated document provider. The loan is limited recourse to the property and the SMSF is the beneficiary under the trust deed. The trustee is selected by the SMSF, but cannot be the same as the SMSF trustee. The lender can either be a commercial lender or a related party of the client may provide the funding.

These structures differ in only three respects to pre 1999 geared unit trusts, with which most accountants are familiar.

- The borrower is the (trustee of the) SMSF rather than the (trustee of the) unit trust;
- The loan must be limited recourse; and
- The nature of the trust being a fixed, non unitised trust rather than a unit trust.



Are you prepared for your Clients' questions?

What type of property can I fund?

The legislation requires that the money be used to fund the acquisition of an asset – this means that if the SMSF already owns the asset directly, it cannot be geared up. This mirrors the previous prohibition on shareholder applications for warrants.

The new legislation does not further limit the type of assets that can be acquired beyond the existing limitations contained in the SISA. These restrictions are few and relate mostly to related party transactions. If the asset is to be acquired from an unrelated party, the important restrictions are the "sole purpose test" (SISA s62), the "prudent person test" (SISA s52 (2) (b)), the funds investment strategy (SISA s52 (2) (f)) and the trust deed.

SISA s66 prohibits acquisitions of assets by SMSFs from a related party (which is quite broadly defined) other than listed shares, widely held trusts and "Business Real Property". Importantly, this excludes residential property whether or not used to earn rental income. Assets which are leased to related parties are categorized as "in-house assets" and these may not comprise more than 5% of the assets of the fund. Again there is an exemption for Business Real Property.

Each lender will also have their own credit criteria as to what they will fund in addition to the legal requirements.

What are the costs?

Given the limited recourse nature of the loan (which increases the risk to the lender and reduces the risk to the borrower) and the additional legal documentation required, these loans are a little more expensive than traditional loans.

As well as the standard costs of acquiring property (conveyancing fees, stamp duty and search and other Government charges) there are the costs of the borrowing and structure. Where the loan and the trust deed are acquired from separate providers some of these costs may not be clear at the outset. When comparing products, it is important to consider all of the related costs as well as the benefits. Clients should expect the following costs:

Trust Costs

- Establishment of the special trust;
- Stamp duty on the trust deed;
- Obtaining a TFN/ABN for the trust;
- Cost of establishing a corporate trustee for the special trust (if required);

Loan Costs

- Establishment Fee
- Valuation
- Lender's legal fees (an additional fee may be payable for the lender's lawyer to review the trust deed)
- Mortgage duty (in some states)
- Application or commitment fees

Other fees

Some lenders require that the borrower/members obtain separate legal or accounting advice, fund auditor signoff or a statement of advice from a licenced financial planner. These can add significant costs and can create liability and potential conflict issues for accountants and auditors.

Ongoing fees

- Interest (check whether it is in advance or arrears and the compounding period)
- Line, administration or account keeping fees
- Periodic valuation fees
- Requirements to use specified property managers
- Early termination fees

"The SMSF sector is an important part of the superannuation architecture in Australia and I strongly support the ongoing role it plays."

Hon. Senator Nick Sherry

Vince Scully
Chief Executive Officer



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Renewal fees (if the loan is for less than the period you expect to need, can you be sure you will be able to roll or refinance and what fees will be payable).

Capital gains and stamp duty need to be considered if the client is considering transferring existing property to the SMSF. In many cases the small business CGT exemptions may be available to reduce or eliminate the CGT liability. In some states there are stamp duty exemptions available, but in most cases the benefits of having the property in super will outweigh the stamp duty liability over a very short period.

Overall you should expect to pay up to 2% of the loan amount upfront and an interest rate of 1% above the outside super equivalent loan. For residential property this means 1% over the standard variable home loan rate of 9.6% giving 10.6%. For commercial property this will mean a rate of 10.7%-11.5%. Over time these additional outlays are more than offset by the tax savings, so clients should consider this (as should any property transaction) be considered a long term investment (7 years or more).

In future issues

In future issues of the Calliva Technical Update, we will provide you with more tools for dealing with your clients' questions in relation to SMSF borrowing including:

- What to look for when comparing products
- Practical strategies to boost your clients' retirement income
- What do I need to do about grandfathered pre-1999 geared unit trusts on July 1, 2009?
- How to use these structures to solve some Div 7A loan problems;
- When is a super loan not a super loan? and
- Personal guarantees and why they are problematic

Where to from here?

Calliva are committed to best practice and providing transparency in the SMSF property lending field.

- A comprehensive 'SMSF Commercial Lender Comparison Matrix' will be made available in the coming weeks. To request your copy, please reply to this email (or email Amber at Amber.Holliday@calliva.com) with 'Lender Matrix' in the Subject Line.
- If you have any specific questions about SMSF lending you would like to discuss, please contact a Calliva representative on 1300 177 000 or invest@calliva.com

About the author

Vince Scully is CEO of Calliva Group, the pioneer in SMSF gearing products for direct real estate. He is a chartered accountant with particular expertise in tax and superannuation.