



A 'SUPER' NEW LENDING OPPORTUNITY

By DERRICK TOH



As of 24 September 2007, amendments to the Superannuation Industry (Supervision) Act 1993 (SIS Act) mean that self-managed superannuation funds (SMSF) are now able to borrow funds to invest in certain situations.

BACKGROUND

Prior to the recent amendment, the Australian Taxation Office took the view that investment in instalment warrants was a breach of the SIS Act, which prohibits superannuation funds from borrowing.

This caused widespread consternation within the industry, as there were a significant number of SMSFs that were in the practice of investing in listed securities by way of instalment warrants at the time.

The Government considered the matter for some time and eventually announced new laws which eased the restrictions on SMSFs.

CRITERIA

In order to satisfy the provisions under the new law, the following criteria must be satisfied:

1. The borrower must apply the borrowed funds towards a newly acquired asset (i.e. an asset not previously held by the super fund);
2. The asset must be a 'complying' asset, which is one that the trustee of the fund is not prohibited from investing indirectly by the SIS Act or any other law (see further details below);
3. The asset must be held on trust for the SMSF, through a separate trust structure, so that the SMSF acquires a beneficial interest in the underlying asset;
4. The trustee of the SMSF must have a right (but not an obligation) to acquire legal ownership of the underlying asset by making one or more payments after acquiring the beneficial interest;
5. The rights of the lender against the trustee of the SMSF must be limited to rights relating to the asset only, and cannot attach to any other asset of the SMSF (i.e. a limited recourse loan). However there is no restriction on a third party providing other security to support the loan (e.g. a personal guarantee from a member of the SMSF fund)

BASIC RULES FOR DETERMINING WHAT IS A 'COMPLYING' ASSET

1. Sole purpose test - any investment (especially one where related entities are involved) must be assessed carefully to ensure that it is being made for the purpose of the provision of member benefits, and not for some other purpose
2. In-house asset rules - All superannuation funds are subject to limits on in-house assets. Generally, the limit is 5% of the market value of

the fund's assets. For example, the trustee would not be able to borrow to acquire units in a related trust.

3. Arm's length test - the terms and conditions of all contractual and borrowing arrangements must effectively be negotiated at arm's length
4. Cashflow - the SMSF must have sufficient cashflow to meet the interest payments. If the income received from the asset itself will be insufficient, there must be adequate income from other assets.

** NB: Some advisors take the view that a trustee may not rely on a third party or a SMSF member's undertaking to the making of further contributions to meet interest payments when entering into a borrowing arrangement.*

5. Related party acquisition rule - SMSFs are generally prohibited from acquiring assets from members and related parties. Acquisitions of business real property and listed securities are exceptions to this rule, if acquired at market value.
6. Commercial issues - the investment must be assessed by the trustee of the SMSF to be advantageous from a commercial viewpoint. If on analysis the investment does not provide commercially acceptable returns, this may raise both investment strategy and sole purpose test concerns.

HOW DOES IT WORK?

- The SMSF decides to buy a 'complying' asset ("property").
- A service trust is created which is commonly known as an "Instalment Trust". There are already several non-bank lenders who have come up with investment products whereby an Instalment Trust is established for the SMSF.
- The trustee of the Instalment Trust purchases the property on behalf of the SMSF and holds the legal title to the property on trust for the SMSF. The deposit is paid for the complying asset using funds from the SMSF.

** NB: it is important that the Instalment Trust has been created prior to signing the contract, to avoid any risk of incurring double stamp duty.*

** NB: it is also important that finance pre-approval is obtained prior to signing the contract, or alternatively, to ensure that the contract is subject to finance.*

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- Assuming that finance is obtained (see further details below), the Instalment Trust uses the borrowed funds to complete the settlement together with equity from the SMSF.
- The Instalment Trust will now hold the property on trust for the SMSF and the SMSF will pay the interest on the loan. The Instalment Trust passes on any income to the SMSF, after deducting expenses associated with the property.
- Eventually, if all goes well, the loan to the Bank / Lender is paid out and the SMSF can call on the Instalment Trust to transfer the property to the SMSF or leave it in the Instalment Trust.

FINANCE:

One of the essential criteria is that the other assets of the SMSF are insulated from risk under the borrowing arrangement.

Therefore the Instalment Trust must obtain a limited recourse loan using the underlying asset as the only security.

Currently there are no restrictions in the legislation which prevent the Lender from taking other forms of security, such as a personal guarantee from a member of the SMSF.

Therefore, a Bank/ Lender may take the following security, in a typical scenario:

1. a first registered mortgage over the property;
2. a personal guarantee/ indemnity from members of the SMSF or other third parties; and
3. a fixed company charge over the trustee of the Instalment Trust if it is a corporate trustee.

STAMP DUTY AND CGT ISSUES:

- Care must be taken to avoid potential double stamp duty on the initial purchase of the asset by the trustee of the Instalment Trust and the subsequent transfer to the SMSF. Sections 36, 36A, 36B and 36C of the Duties Act 2000 (Vic) generally provide an exemption for stamp duty where property passes to a beneficiary of the trust.

Therefore, it is critical that the Instalment Trust is in existence before the contract is signed.

- Capital gains tax will apply upon the final distribution of the property or in the event that the Instalment Trust is dissolved. This form of investment, therefore, tends to favour pensioners or those who are close to retirement age, who can take advantage of the full CGT exemption, which applies when all members are pensioners at the time the asset is distributed.

BENEFITS OF THE NEW LAWS:

The major benefits of the new laws are that it:

1. applies to **real estate**, which is preferred by most lenders by way of security;
2. provides **asset protection** in an environment which has safeguards from the operations of the Bankruptcy Act, subject to anti-avoidance rules;

3. gives investors the opportunity to **grow the value of their super funds**, whereas in the past this was limited to the annual contribution caps;
4. is **income and CGT efficient** if structured properly; and
5. by using instalment warrants, an investor can **access the full benefits** of an investment asset for a smaller monetary outlay, which means that any capital growth in the underlying asset results in larger percentage values of the warrant.

HOW CAN A SMSF TAKE ADVANTAGE OF THE NEW LAWS?

All sorts of investors with a SMSF can take advantage of the new laws, but especially:

PENSIONERS:

In addition to acquiring assets through their SMSFs, pensioners can take advantage of the tax free and CGT-free rules if they are over 60 and retired. This is especially beneficial given the strong capital growth shown in the current property market.

BUSINESS OWNERS:

Business owners will now be able to tap into their SMSF to buy out their landlords.

Furthermore, because the freehold is considered business real property, it is exempt from the related party acquisition rule. This means that business owners who have title to their business premises can now create a complying loan structure, transfer the title to the SMSF and lease the business, therefore adding further value to their asset.

HOW CAN LENDERS TAKE ADVANTAGE OF THE NEW LAWS?

Lenders will now be able to create a product that will cater to the needs of those individuals who wish to invest in real estate, by using the funds locked away in their SMSF.

There is also an opportunity for Lenders to access investors (i.e. through financial advisors and investment planners) who have funds available in managed SMSFs and can afford to increase their gearing.

The size of the SMSF market has grown at a rapid rate, as reported in the The Australian on November 14, 2007:

"SMSFs are now collectively too big a juggernaut for anyone to stop or ignore. In June 1996, SMSFs had 12 per cent of all super assets. By June 2007, this had doubled to 25 per cent. Deloitte Touche Tohmatsu predicts this growth will decrease, but that by 2021 SMSFs will have 31 per cent of all super assets, the largest of any type of super fund."

It is not clear the Government has fully considered the interest generated as a result of its amendments to the SIS Act. It is possible that the new laws will be subject to further amendments, once the Government has considered its impact.

For further advice concerning any matter raised in this update, please contact Tony Rogers or Derrick Toh.

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