



Loans the lifeblood of self-managed funds

The loophole that allows such funds to borrow in order to buy property may soon close

LONG-TERM borrowing has been a feature of the Australian economy for many years. Many people have purchased residential investment properties using finance and it's reasonable to assume a lot of those borrowers intended to use some or all the wealth they created for their retirement.

Before the late 1980s it was possible for superannuation funds to borrow to invest. Back then superannuation was really run by employers and the fund was often used to provide capital to run the business.

As superannuation became available to more and more pre-retirees the government stopped super funds from borrowing and also stopped super funds investing the majority of their assets in sponsoring employers.

The platitude for these prohibitions against borrowings, which are still sometimes trotted out, are that superannuation is a long-term investment designed to provide retirement income and because investment borrowing is too dangerous super tax concessions should not be given it.

In reality, we have the strange inconsistency that you can borrow in your own name or in the name of a family trust or even company to build your retirement wealth, but you can't carry out the same transaction in your super fund.

During the '90s investment banks began offering products that allowed investors to borrow in order to invest in the share market.

The most popular of these products were called instalment warrants. These effectively gave investors the ability to buy shares (or pre-defined parcels of shares) on lay-by and also provided the investor with downside protection: if the value of the underlying share fell then the investor could walk away and



Tony Negline

the bank could not seek to have the outstanding loan repaid.

For more than 10 years many super funds, particularly self-managed funds, were happily using these products because they were deemed to fall outside the rules.

In 2006 the Australian Tax Office dropped a bombshell on this practice. The ATO had received legal advice saying that instalment warrants were not allowed because they breached the borrowing prohibitions. The Howard government announced it would legislate to provide legal certainty because the use of instalment warrants "is long-standing and widespread and superannuation fund investment comprises a significant proportion of the instalment warrant market", Peter Dutton, the minister at the time, said.

In time the government did legislate to allow these products but did so in an interesting way. In practice, the rules did allow these investment bank products to continue to be used. But the rules are reasonably flexible, although not without their complexities, and this flexibility is creating an interesting phenomenon.

The new rules demand that while the loan is outstanding it must be held in a security or bare trust.

The wording of this trust deed is crucial to the proper operation of the arrangement.

Small super funds are now beginning to use these structures to invest in residential property.

Vince Scully, technical adviser at SMSF Finance Specialists, believes that investors with at least \$200,000 in super, who thus far have elected not to run their own self-managed fund, are beginning to show an interest in this structure because they can borrow using the instalment warrant structure and buy property.

Peter Townsend of Townsends Business and Corporate Lawyers says that most of the interest is coming from people who "have enormous faith in Australian real estate".

Townsend says that 98 per cent of the arrangements he has set up involve the purchase of property.

The reason these investors will be looking to set up a self-managed fund is that retail super funds will not be able to provide the instalment warrant structure to their investors.

Already many retail super funds are facing reasonable outflows into self-managed funds by their higher account balance clients. If Scully is right and large numbers of retail super fund investors would be interested in using this structure then inflows into self-managed funds might become even more significant.

It's no surprise that some large super fund lobbyists are making louder and louder statements against the instalment warrant structure. So will the Government change the rules? It's difficult to know.

A spokeswoman for Minister for Superannuation and Corporate Law Nick Sherry said that the Government is "closely monitoring" the gearing situation.

We will discuss more issues about this structure next week.

Disclosure: Tony Negline provides services to SUPERCentral, of which Peter Townsend is the managing director.

Tony Negline may be contacted at www.atcbiz.com.au.



Old favourite: Peter Townsend says people still have enormous faith in Australian real estate

MATTER OF TRUST

Issues to consider before using a trust to borrow within a super fund

Does a super fund's trust deed allow the fund to invest in the bare trust that will hold the asset? Is the super fund allowed to borrow?

Macquarie Group Services managing director Chris Batten says that if the arrangement is not set up

properly, penalty super fund taxes may apply to the income and capital distributed by the trust.

Batten also says that if the trust deed for the trust that holds the asset is poorly drafted then capital gains tax may apply when the asset is transferred to the fund.

If the initial purchase of the property or the transfer of the

property to the super fund once the loan is repaid are not done properly, then ad valorem stamp duty may apply.

All the main banks are offering loan products in this area. Each one has slightly different requirements. Some are allowing up to 70 per cent loan-to-value ratio. Others seem to be permitting only up to 50 per cent