

Gearing self-managed super



BY BRETT DAVIES

Every single asset a self-managed super fund (SMSF) can buy, it can gear. However, once the asset is acquired, the opportunity to borrow on it is lost forever. Are you ready to give advice on SMSF gearing strategies? If not, then get out of SMSF advice. Permitted assets include shares and business and residential real estate.

The old section 67(4A) of the Superannuation Industry (Supervision) (SIS) Act has gone. It has been replaced with brand new sections 67A and 67B.

Change of name

The old section 67(4A) called these loans 'instalment warrants'. They are, of course, nothing to do with 'instalment warrants'. Thankfully, the name has changed to 'limited recourse borrowing arrangements'. A mouthful, yes, but the name more correctly describes the purpose.

If an SMSF wishes to borrow, it sets up a separate bare trust. The bare trust generally has its own trustee (often a new company). The bare trust buys the asset for the SMSF, and the money comes from the SMSF and the lender. The loan is paid back by the asset earning some income. The SMSF is also free (but not required) to help with the repayments. If something goes terribly wrong, then the SMSF can just walk away. The SMSF only loses the asset and the money it put into the asset. The lender can't get its hands on any of the SMSF's other assets. The lender only gets whatever it can

from selling the asset in the bare trust. Unless there is a guarantor (by someone other than the SMSF, of course), then the lender has no further recourse and wears the loss.

Common sense is that the bare trust has no separate tax file number. This is because the bare trust asset belongs to the SMSF. (Of course, the SMSF can't get its hands on the bare trust asset until the loan is fully repaid.) Therefore, the losses and gains are taxed in the hands of the SMSF. Similarly, up to now, most bare trusts use the SMSF's GST registration: GSTR 2008/3.

However, recently, the Australian Taxation Office (ATO) changed its view. It states that the bare trust (for property) can never actually be a 'bare trust'. Now, if the income is above the GST limit (\$75,000), the trust may have to have its own GST registration. Ridiculous. If you work this argument through, then:

→ There is a risk of capital gains tax (CGT) and stamp duty when you eventually transfer the bare trust asset to the SMSF. This is in direct contradiction to the ATO's current position on CGT.

→ You may breach the in-house asset rule if you keep the property in the bare trust after the loan is fully repaid.

Let's now look at some of the other recent changes.

Churning the banker

Upon taking out the loan, is the SMSF stuck with the same bank? This is not the case. Moving to another bank is not deemed a new loan. Refinancing is expressly permitted. This means that the SMSF can move the loan around to get the best rates and deals. Given that these are early days and the bank loans are so conservative in structure, there will be plenty of churning over the next few years.

Guarantees

Can a 'friend' (like a member) guarantee the loan? Until recently, no one knew for sure. The loan had to be "limited recourse" but only as against the SMSF's assets. This was to protect the superannuation. There is nothing in the legislation or its intent to protect the members' own assets. All was resolved when ATO Taxpayer Alert TA 2008/5 gave the green light to guarantees – with a

minor concern. (See also ATO ID 2010/170.)

The ATO's concern was if the member personally paid money to the bank under the guarantee. In effect, the member is paying off the SMSF's debt. The SMSF then got the asset for 'free' – as the debt is now fully paid. This is compliments of the member (as guarantor). The honouring of the guarantee is, in this instance, a contribution into the fund. To avoid the contribution, sell the asset first to pay down the debt. Only then is the remaining money paid by the member (as guarantor). This way there is no contribution, as the SMSF gets no asset or value.

Replacement assets

Sure, you can replace assets, but only with identical assets. So shares and units in a unit trust can be replaced – but only with the same type of share in the same company.

It is common for a SMSF to buy land for subdivision. The ATO states that the land cannot be carved up until the limited recourse loan is extinguished. The Explanatory Memorandum specifically stated that subdividing land is a 'replacement asset'. Unlike 'repairs' for example, 'replacement assets' of real estate are not allowed in bare trusts.

Repairs vs improvements: major fault one

An SMSF can borrow money to pay for repairs and maintenance – but not for improvements. That is silly. Let's say that the fund buys a commercial property. The property is falling apart. The borrowings are useable to repair the property.

Now, let's say that the commercial property could be 'improved' by adding toilets. However, the fund can't borrow money for this as it is not a repair and not maintenance. If you inadvertently break this rule, the fund is non-compliant. It then loses up to half the assets to tax.

Currently, on my desk, I have a client that wants to borrow to buy some land. The property needs sewerage and road works. Is that maintenance or an improvement? Further, as you see below, are the sewerage, road works and extra toilet separate assets? This then requires three additional bare trusts if the client wants to borrow to acquire these assets.

funds: key changes

One asset or many?: major fault two

The fund can't use loans to buy more than one asset. A single asset includes a collection of assets that are 1) identical and 2) have the same value. For example, if the SMSF wanted to buy 50,000 shares in the publicly listed Integrated Legal Holdings (ASX: IAW), then it can buy all 50,000 shares in the same bare trust. Each share has the same value and are equal in rights to each other. However, these shares could not be mixed in with shares in Wesfarmers. The fund needs two bare trusts.

I have a client that wants to buy and gear two strata properties. Sadly, two 'identical' properties even under the same strata plan are not allowed. This is not a permissible collection of assets. The

client needs two bare trusts. While I don't necessarily read this into the legislation, the Explanatory Memorandum gives the example of a collection of buildings all under the same strata plan, all-identical and all having the same purchase price. It states it is not allowed under the same bare trust.

Property developers are concerned when they offer separate body corporate rights, such as a car park and storage room. SMSF gearing only allows you to put one asset in one bare trust. Do you need another limited recourse loan and bare trust for the car parking bay, as well? This is ridiculous. This is clearly all one asset. However, the ATO has only come out and said it "may" be one asset. [See <http://www.ato.gov.au/superfunds/content.asp?doc=/content/00132054.htm&page=38&H38>]

The ATO stated that it is probably only one asset where the "incident ancillary asset [is] of a very small value". Sadly, with schizophrenic glee it then states that "strata title with an accessory car park and commercial premises over more than one title" may not be one asset. The ATO needs to consider each acquisition on a case-by-case basis.

The ATO suggests in this case applying for a Specific Advice order. Clients should not sign up to any SMSF geared purchase of property until they check with their accountant and adviser.

Operation

The operation of the borrowing often works along these lines:

1. The SMSF finds an asset to buy (any asset that

Page 36 ►

a SMSF can acquire is fine). It can't be an asset that the SMSF already owns. It can be an asset that a member owns, if it is business real property or listed securities. (So residential property is fine, but not if the member or related party already owns the residential property.)

2. Review the super fund trust deed, product disclosure statement, risk analysis and strategy and investment strategy – they are all updated to comply.

3. Before an offer is made to purchase, the bare trust and the trustee.

4. The member goes to the bank and arranges the limited recourse loan (often you need 40 per cent deposit and must pay 1/15th of the capital every year plus interest). To avoid such draconian mortgages, the member can arrange an overdraft over a property outside of superannuation. The member then lend that money, themselves, to the SMSF.

5. The borrowed money is applied to acquire the asset.

6. The asset is held in the bare trust so that the SMSF acquires a beneficial interest in it (this is the very nature of a bare trust).

7. The SMSF can only acquire legal ownership of the asset when the loan is fully repaid.

8. The borrowing is limited recourse. Therefore, the fund's other assets are safe.

Must there be a loan?

Yes. The money borrowed is properly documented. The loan is used to purchase the geared asset, and is "limited recourse".

The ATO stresses that appropriate loan documents clearly reflect that the trustee of a super fund makes a genuine borrowing to acquire an asset. This is particularly the case where the monies provided are from a related party. What if you don't have adequate documentation to substantiate monies provided by a related party as being by way of a borrowing? It is likely that the monies are treated as a contribution received by the fund. This leads to tax consequences if the contribution cap is exceeded.

Who can be the lender?

Anyone can be a lender. This includes the bank, member or related party: ATO ID 2010/162.

However, the super fund must satisfy the sole purpose test that the investment is ultimately for retirement purposes. The fund must comply with existing investment restrictions and formulate an appropriate investment strategy.

Be careful if the member is borrowing the money originally from an asset outside of the super fund and then lending it to the bare trust. This is common (as the bank loans into bare trusts are draconian). For example, the member may have a spare loan facility lying around – perhaps from their own family home. They draw down and lend the money to the bare trust. What interest do they charge the bare trust? If they only charge what the bank is charging them, then there is no profit-making gain. Therefore, they can't claim back the interest that the bank charged them. Charge a higher than market interest rate (whatever that may be) and they are breaching the sole purpose test by 'stealing' money from their SMSF. A financial planner must assist here.

Conclusion: only financial planners can recommend these products

This is a 'one time only' opportunity as once

assets reach the super environment, the chance to gear the asset is lost forever. The opportunity to gear is an appropriate matter for review before any asset is acquired by SMSF. Each time you explore the acquisition for a client's SMSF, you can't ignore that it can be geared. If you recommend an asset for the SMSF and it shoots up in price, then the member can come back and ask why it wasn't geared. Gearing magnifies returns (yes, I know it magnifies losses as well). I have already seen an attack based on this argument. Be ready for that attack as only financial planners can recommend these products. Added problems that have not been fully worked out include:

→ Only derivative advisers provide advice on superannuation gearing.

→ Adviser knowledge and training requirements required on derivatives (I can't see why this is considered a derivative product).

→ Loans are regulated as a financial product. ❖

Brett Davies is a principal in national law firm Brett Davies Lawyers. As a private law firm, it only services clients referred by accountants, lawyers and advisers. The firm is listed on the ASX (IAW). Davies is also a co-author of *Australian Financial Planning Handbook 2010-11*, published by Thomson Reuters.

TO ANSWER QUESTIONS VISIT www.fpa.asn.au

1. Can you gear residential property?

- Yes, but only if the residential property is in Australia.
- Yes, provided it is owned by the member first (or a related person).
- Yes, provided the property is not owned by the member or a related person.
- No, residential property can't be owned by a SMSF.

2. What factors need to be considered before you gear?

- The sole purpose test (section 62) and commercial or arm's length dealing (section 109).
- Investment strategy (section 62(2)(f)) and related party rule (section 66).
- In-house asset rule (section 71).
- All of the above.

3. What are the risks in gearing a SMSF?

- Exposes the super fund to greater investment risk and impact of rising interest rates.

- Increased compliance risk and liquidity to support the loan.
- Makes lawyers and accountants even richer.
- a to c above.

4. Who can lend the money?

- Registered bank or building society.
- Any person, but not a member or related person.
- Both of the above.
- Any person can lend the money, including a member or a related party.