

Super funds borrowing to buy real estate

In September 2007, S.67(4A) was inserted into the Superannuation Industry (Supervision) Act 1993 (SIS Act). Under this new section, Self Managed Super Funds (SMSFs) are allowed to borrow to acquire property as long as they comply with a number of provisos.

As many clients would like to be able to include real estate in their super fund's investment portfolio, this article sets out the basic parameters of two ways in which the arrangement may be structured to take advantage of this new opportunity.

The Legislation

The amendments to the law introducing new S.67(4A) have come about largely because of the popularity of funds investing in instalment warrants (e.g., Telstra 3 (T3)).

After receiving warnings from the ATO and APRA about difficulties with borrowings on certain instalment warrants, the government decided to remove the borrowing restriction where funds met certain other conditions.

Therefore, recent amendments to the SIS Act were introduced to allow SMSFs to borrow to acquire investment assets provided the borrowing is a non-recourse loan; i.e., there is no recourse for the borrowing against other assets of the fund.

A fund can borrow money under S.67(4A) if:

- the money is borrowed to buy an investment asset;
- the asset is held on trust so that the fund acquires a beneficial interest*;

(This basically means that the asset must be held on trust for the fund (i.e., in a security trust). Holding units in a trust owning the asset would not cut it.*
- the fund has the right to acquire legal ownership by making payment(s); and
- the rights of the lender against the fund for default are limited to the asset.

Although the changes were introduced mainly to allow funds to invest in instalment warrants such as T3, the provisions are drafted broadly enough to allow a fund to invest in an asset such as real property (provided the fund could otherwise acquire the property directly).

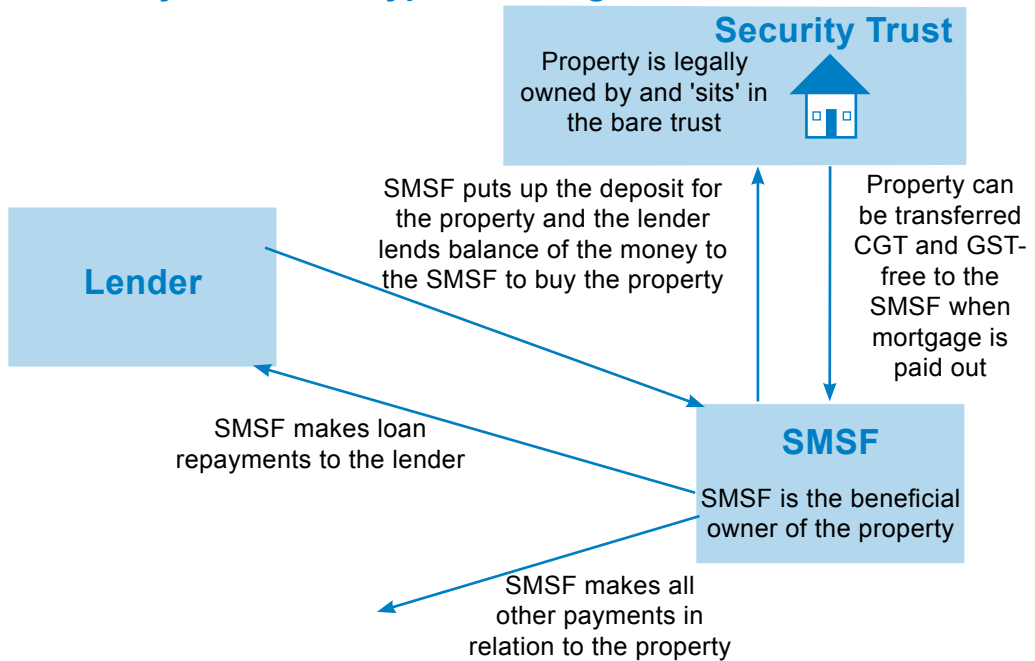
What are the basic features of the arrangement?

- ◆ The legal title to the property (e.g., real estate) is held by a security trust.
- ◆ The beneficial title to the property is held by the SMSF.
- ◆ In Scenario 1, normally where the SMSF is able to provide a 'decent' deposit, the lender lends money to the SMSF on a limited recourse basis (i.e., the lender's recourse is limited only to the property being acquired).
- ◆ In Scenario 2, where the deposit is not as high, the lender lends money on a limited recourse basis to the SMSF, but also requires personal guarantees from the members of the SMSF.
- ◆ The property is rented out, and rents are paid direct to the SMSF.
- ◆ The SMSF makes loan repayments to the lender and otherwise pays all other payments in relation to the property.
- ◆ When the mortgage is paid out, the property can be retained by the trust or transferred to the SMSF CGT and GST-free.

Note: Many clients will choose to acquire their own business premises. In that case, the premises are 'business real property' and may be purchased from a related party of the SMSF.

*However, residential property **cannot** be purchased from a member of the fund (or an associate), but must be purchased from a party unrelated to the fund, to avoid breaching the 'acquiring assets from related parties' rule.*

A Bird's Eye View of a typical arrangement



Editor: This diagram was kindly provided by InterPrac Ltd. which has sourced a panel of lenders who can provide finance to SMSFs for the above transactions. Information is available on their website at www.interprac.com.au. Technical queries should be directed to the NTAA's TaxTeam.

Example

The Black Superannuation Fund is an SMSF.

The trustees have always been keen on property as a class of investment but have been hamstrung by the inability of the fund to borrow to acquire such investments.

Further, any property acquired could not be mortgaged or given as security anyway.

Given the 'lumpy' nature of property investments, requiring relatively large amounts of money, the fund instead concentrated on share investments.

After the recent pounding the fund received on its share portfolio, the trustees of the fund decided to liquidate the fund's position and re-explore property investment opportunities.

This was especially so having heard of the recent changes affecting the fund's ability to borrow to acquire property.

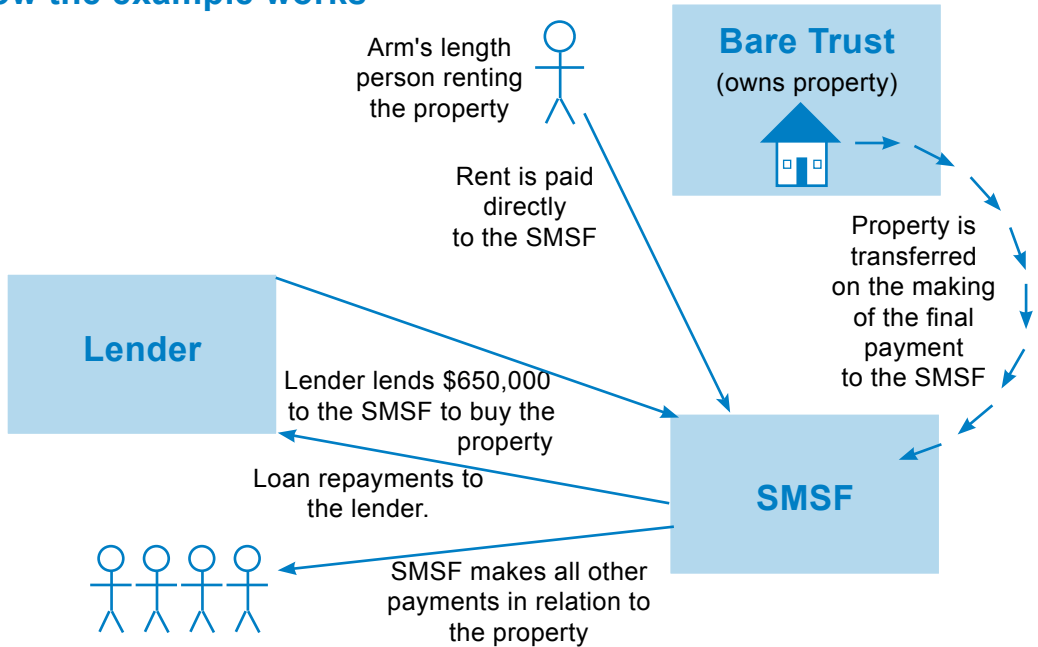
The fund generates \$400,000 from its share sales. It has found a suitable residential property to acquire from an unrelated party, but it will cost approximately \$1 million plus \$50,000 in incidentals (a total of \$1,050,000). It will rent the property to an unrelated person for its market rent.

The trustees enter into the following arrangement, which has been allowed by the super laws since September 2007, enabling the fund to borrow and acquire the property.

- An appropriate lender is found who understands the detailed requirements to satisfy the new laws.
- The property is purchased using \$400,000 of the fund's money and borrowing the balance of \$650,000 from the lender (i.e., a 65% LVR, being \$650,000 of the \$1 million purchase price in this case). The fund is the borrower of the \$650,000.

- ❑ The property must initially be held on trust for the fund by another entity (usually the lender will provide a trustee to hold the property on behalf of the fund).
- ❑ The fund has the right to acquire legal ownership of the property by making payments (the outstanding loan of \$650,000, plus interest). On the final payment, legal title is transferred to the fund.
- ❑ The fund receives the rent from the residential property directly.
- ❑ The fund directly pays the loan repayments to the lender.
- ❑ The lender's recourse against the fund is limited to the residential property.
- ❑ The lender has no right of recourse against other assets of the fund.
- ❑ To compensate or protect the lender for this limited recourse, the lender may:
 - ◆ charge a higher interest rate on the borrowing;
 - ◆ insist on a lower LVR; or
 - ◆ request a personal guarantee from the members of the fund.
- ❑ Some of these requests by the lender **may** cause the arrangement to fall foul of the investment laws in the SIS Act and Regulations. It is important to get proper advice.

How the example works



How to make the most of this great opportunity

The above example illustrates the basic structure of the new borrowing laws. If a client wants to take advantage of this potentially fantastic opportunity, the details become all important.

At the **Tax Hot Spots** seminars currently running around the country, we provide around 20 pages of comprehensive notes and examples to make sure you get it right. We look at borrowing products which have been set up to obtain a lower interest rate or provide a higher LVR, but do they work? We also look at strategies which attempt to 'turbo charge' the benefits that can be achieved. We give you the NTAA's take on these and more. Visit www.ntaa.com.au/seminars.