

Gearing Property In A SMSF

Legislative changes introduced in September 2007 allow self-managed superannuation funds (SMSFs) to borrow under what is commonly known as an instalment warrant or limited-recourse arrangement.

In light of the halving of the concessional superannuation contributions caps from 1 July 2009, it is likely that gearing in super will become more popular as people seek ways to improve their retirement savings.

An instalment warrant allows an SMSF trustee to pay a small part of the cost to purchase an asset upfront, and borrow the rest. The asset is then held in trust for the life of the loan but the SMSF has the "beneficial interest" in the asset.

The asset must still be treated as if it was held by the fund, that is, it must meet SMSF rules such as the sole-purpose test. When the loan has been repaid, full ownership of the asset passes to the SMSF.

A major advantage of instalment warrants is that they are "non-recourse", meaning that the lender can only take back ownership of the specific asset if the borrower defaults on repayments, not any other assets held by the SMSF.

Before instalment warrants are used, areas that should be considered include:

- 1 Ensuring both the SMSF Trust Deed and the stated investment strategy allow for this type of investment.
- 2 Reviewing costs such as CGT, stamp duty, land tax and GST, and operation of custodian trustee, as well as legal costs of advice and documentation.
- 3 Agreeing the security for the loan, and who will provide that security.
- 4 If the lender is a related party:
 - Agreeing the interest that will apply to the loan.
 - Considering the company loan restrictions in Division 7A of the Tax Act.
 - Researching whether a product disclosure statement is required.
- 5 Deciding who will be the custodian trustee, who will establish this and what fees will apply.
- 6 Properly documenting the loan arrangements (i.e. the instalment warrant contract) and the instalment warrant trust deed. For any investment, trustees must consider the cash flows, potential capital growth of the investment and the exit plan before making a commitment.

Related party lending

As well as banks and lending institutions, related parties may provide finance to their SMSF.

This means that if members have surplus cash, but cannot contribute any more money into superannuation due to the contribution caps, they can provide a limited-recourse loan to their SMSF as a way of funding the acquisition of further growth assets in the concessional superannuation environment.

However members must ensure that the loan is strictly on normal commercial terms, including having a loan agreement, charging a commercial rate of interest, and having policies in place to deal with defaults on the loan.

Compliance

If the arrangement does not satisfy all of the required conditions, a breach of superannuation law will arise, which may have civil or criminal consequences.

Depending on the circumstances, the ATO may also suspend or remove a trustee, freeze fund assets or declare the fund non-complying.

A superannuation gearing strategy will not be suitable for everyone and the merits of the strategy should be examined on a case by case basis.

It is most effective over the long term with a minimum recommended investment term of at least seven years.