Do I save my way to retirement or do I gear up my super fund, effectively borrowing?

By Garry Pammer, CA, BEc, LLB

"The changes allowing self managed super funds to borrow are exciting news. However it is critical that you first carefully consider which individual/entity should invest, what level of gearing to apply and what investments you make. Gearing your super fund is not necessarily always the best decision..."

In the May/June 2007 edition of *Australasian Dental Practice*, I outlined the opportunities that Simplified Super presented. At the risk of repeating myself, I also emphasised that it was important to keep your financial future in perspective. To do so, I suggested that you should ensure your superannuation strategy dovetails within a wholistic investment plan that includes:

- Investments;
- Asset allocations;
- Effective structures;
- Taxation;
- Estate planning;
- Risk management;
- Cash flow management; and
- Social security and aged care.

The above checklist continues to apply today but you should be sure to work through it again if you are being swept up in the excitement surrounding the new rules that are paving the way for super funds to borrow to invest in either shares or property.

So what has changed now?

Superannuation funds have always operated under strict regulations. No doubt your advisors have heightened your awareness of many of the following:

- Self managed superannuation funds: membership structures;
- Sole purpose test: to provide retirement or death benefits;
- Trust deeds: trustee covenants;
- Lending to members: prohibitions;
- Acquisitions from members: exceptions;
- In-house assets: fund asset ratios; and
- Borrowing: prohibitions.

It is the last item on the list which has changed. Before September 2007, section 67(1) of the *Superannuation Industry (Supervision) Act, 1993* ("the SIS Act") prohibited the trustee of a superannuation fund borrowing money or maintaining a borrowing except in certain limited circumstances (i.e. "temporary" borrowings of no more than 10% of the fund value and for less than 90 days in respect of benefit payments or 7 days for asset purchase completion).

In September 2007 the insertion of a new section 67(4A) in *the SIS Act* received Royal Assent. Whilst section 67 (1) provides the trustee must not borrow money, section 67(4A) provides a new exception. Essentially, the borrowing will not be prohibited if:

- The borrowed money is *used to acquire* an asset;
- The asset acquired is *not one that is otherwise prohibited* (e.g. member or related party acquisition rules breached);
- The asset is *only held on trust* for the super fund (i.e. a beneficial interest is acquired, not full legal ownership);
- The fund has a right to acquire the legal ownership of the asset *by making one or more additional payments* (i.e. optional payments as opposed to the imposition of an obligation to do so); and
- The *recourse of any lender is limited* to the acquired asset.

Notwithstanding my legal paraphrase, the above summary may still be difficult to digest. If so, it is perhaps easier to think of the concepts that surrounded the Telstra float, T3, where the instalment receipt received a lot of publicity and discussion. The concept being legislated here is similar. Your super fund is allowed to make an initial upfront payment to acquire, for example, shares. Your fund is entitled to

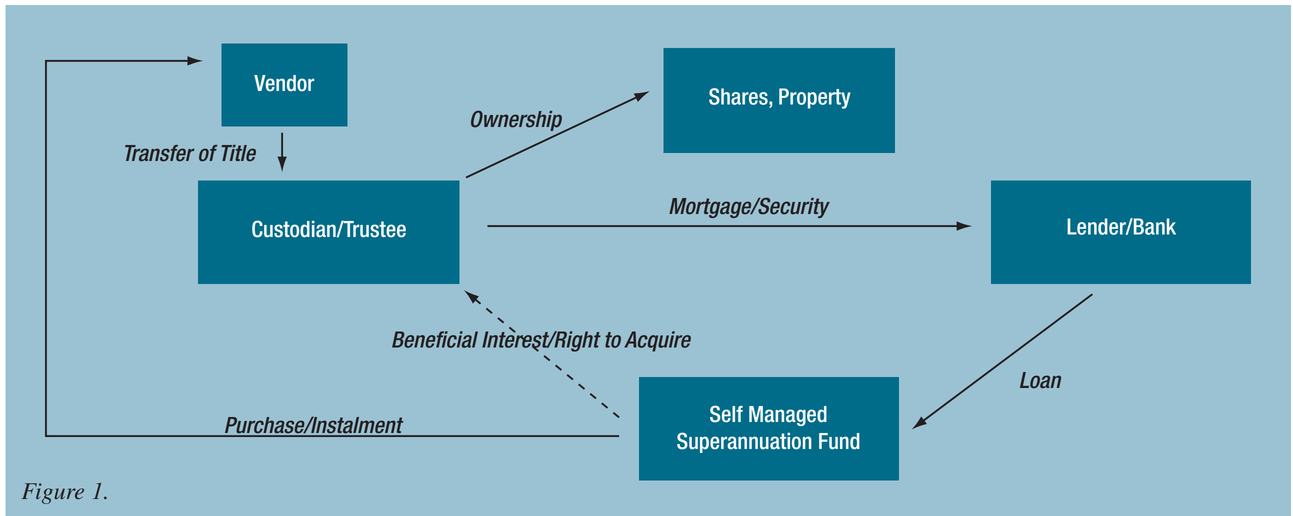

Figure 1.

receive any dividends paid in full from that point in time onwards. A final payment (or second instalment) is paid at a later date. However, this is where the T3 instalment receipt analogy ceases. In the case of T3 there was a mandatory payment due in May 2008. *The SIS Act* stipulates that any further payment would be optional. So, for example, your super fund would elect not to make the second payment where the combined cost of the first and second payments would be greater than the underlying share price. This is why the loan is referred to as limited recourse in nature.

So why did this exception arise? How well is it supported?

The exception was introduced due to the rising use of "instalment warrants" within super fund investment portfolios. Whilst there is some debate about how common instalment warrants were, the following time line quotes are worth noting in understanding their history.

Warrant type arrangements were considered by the Australian Prudential regulation Authority ("APRA") in a September 1998 circular. At the time APRA emphasised that you should "check the obligations that lie with the purchaser to meet instalment(s), as these determine whether the investment is a borrowing". APRA considered that endowment warrants or instalment receipts did not constitute a borrowing "*where the remaining instalment(s) is not 'compulsory' and the warrant/receipt holder receives the value of the warrant/receipt on 'default'*". As such, the products were considered eligible investments in self managed super funds.

The Government also acknowledged the investment trend back in November 2006 when it announced that it would amend *the SIS Act* to allow this form of super fund investment.

According to then Assistant Treasurer Peter Dutton: "The practice is long standing and widespread and superannuation fund investment comprises a significant proportion of the instalment warrant market. The Government will legislate to allow longstanding practice to continue, following consultation with the industry regarding the precise scope of the amendments to *the SIS Act*".

After consultation, a Government press release issued in May 2007 confirming that legislation would be introduced allowing investment "in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly".

In August 2007, the then Labor opposition supported passage of the legislation, stating in the House of Representatives that it would "assist super funds to grow their assets to support Australians in their retirement".

In October 2007, the Assistant Commissioner of the Australian Tax Office supported the new legislation as drafted on the basis that there would be no breach of the borrowing or in-house asset rules.

Of course, financial institutions have been offering such products prior to September 2007 on the basis that they were acceptable for superannuation funds. Considered retrospectively, many offerings do not fall foul of the prior borrowing constraints and clearly fall on all fours with the new legislation. This is because most products typically included:

- An acquisition of a warrant or contract to acquire an underlying security (or unit in a managed fund);
- A borrowing from the issuer of the security to fund the balance of the issue price; and
- The grant by the super fund of a charge over the underlying security.

Note that it is now even more likely that newly emerging product arrangements will go beyond the normal institutional instalment warrants marketed to date.

Not unexpectedly, Government regulators have already expressed concern over some products being aggressively marketed to self managed fund trustees and their stated intentions are to monitor instalment warrants closely, identifying issues and associated risks.

So in simple terms...

Expressed in simple terms (Figure 1), your self managed fund can borrow to purchase either listed shares or a rental property provided:

- Legal ownership is held by the custodian/instalment trustee under a bare trust;
- Your super fund has a beneficial interest in the asset receiving all dividends or net rental income;
- Your super fund has the right to acquire full legal ownership by making additional optional repayment(s);
- The only asset of the custodian trust is the underlying shares or rental property; and
- The rights of the lender or bank are limited to the shares or rental property.

Is this right for me?

There are numerous personal factors to consider, however, the two overriding issues that you should address up front are:

- At what stage of the income generation/capital growth cycle is my superannuation investment plan; and
- What level of geared investment do I currently have (or plan to have) outside of superannuation.

With regard to your superannuation investment cycle, never lose sight of the fact that superannuation is a long-term investment strategy as opposed to a short or medium term strategy. Injecting gearing into your super fund during the final phases of your super investment, particularly if you are a pre-retiree, may work against your retirement accumulation plan. Even if you are not contemplating further contributions but simply considering using existing funds, you must revisit and weigh up the basics of gearing. *Remember, geared investments have both the potential to produce magnified losses as well as magnified gains.*

Geared super funds are better suited for high-risk-tolerant investors with long-term investment timeframes of 10 years or more to retirement. The benefits that these investors derive from instalment warrants include:

- Increasing the pool of investment funds available;
- Increased exposure to any capital gain;
- Ability to invest more with your fund than the contribution caps allow;
- Entitlement to 100% of the income from day 1 on part paid assets;
- Borrowing is internal to the fund rather than a personal liability;
- Non recourse loans and no personal guarantees; and
- No margin calls.

Of course counter balancing these benefits are normal investment risks surrounding any gearing strategy including:

- Investment timeframe;
- Asset selection;
- Diversification;
- Interest rate volatility; and
- Further legislative change.

With regard to your existing (or planned) gearing strategy outside of superannuation, be careful to work through your tax savings before making any changes. Whilst tax is an important but not primary focus of any geared investment strategy, tax becomes a key part in determining the appropriateness of adopting a gearing strategy inside or outside the superannuation environment. The maximum marginal tax rate which is sheltered by gearing when undertaken by individuals (either directly or via trust structures) is 46.5%. Contrast that high personal rate with the low 15% concessional tax rate received by a complying super fund. *Any individual who is on an effective tax rate greater than 15% should examine their geared rates of return very carefully before opting to adopt or switch to gearing within superannuation.* Top marginal tax rate payers may well find the value of the deductible interest outside superannuation leading to higher wealth creation by:

- Maximizing their annual disposable net income during the term of the investment; and
- Capitalizing on the flexibility in their ex-super investment portfolio.

Conclusion

The changes allowing self managed super funds to borrow (as outlined above) are exciting news. We have entered the final stages of implementing a superannuation gearing structure for several clients. However it is critical that you first carefully consider which individual/entity should invest, what level of gearing to apply and what investments you make. Gearing your super fund is not necessarily always the best decision.

Disclaimer

This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

About the author

Garry Pammer is a Partner of Clark & Jacobs Accounting and Business Advisers, specialising in providing advice to dentists. Advice includes planning for your financial wellbeing, superannuation, insurance, practice management, computer software and the buying & selling of dental practices. For a free assessment of your financial position and to see how you can achieve your goals, please do not hesitate to call Garry on (02) 9264-1111.