Gearing up your super fund: As safe as houses?

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In the May/June 2008 edition of *Australasian Dental Practice*, I outlined changes allowing your self managed superannuation fund (super fund) to borrow. Notwithstanding that I heralded this as exciting news, I also cautioned that you should carefully consider whether implementing a superannuation gearing structure is the appropriate wealth creation vehicle for you, what level of gearing you should apply and what investments you decide to make.

In simple terms

In simple terms, as set out in Figure 1, I went on to highlight how your super fund could borrow to purchase either listed shares or rental property. At the risk of repeating myself, the borrowing will not be prohibited if:

- Legal ownership is held by a custodian/installment 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.

Uptake of property investments

So essentially we have seen the borrowing door re-opened for super funds. That door had been closed in 1999 with changes to the "in-house" asset rules and the outlawing of geared unit trust structures from 11 August 1999.

So what has been the practical uptake of a seemingly generous legislative concession which was effectively re-introduced in 24 September 2007?

Interestingly, but perhaps not surprisingly given the state of play in the stock market, the geared superannuation structures we have seen implemented over the past year have almost predominantly involved residential property. Initially there were strong long-term positions of up to 10 years taken on major blue chip equities via self funding installment warrants as well as various commercial properties but residential real property has increasingly emerged as the geared super fund investment of choice.

Based upon this observation, this article seeks to outline some of the issues specific to making a geared superannuation investment into residential property.

What borrowing terms?

Given the average cost of residential investment property, your super fund normally cannot fund the full purchase price. If your super fund has sufficient funds to satisfy the lending bank's loan to value ratio

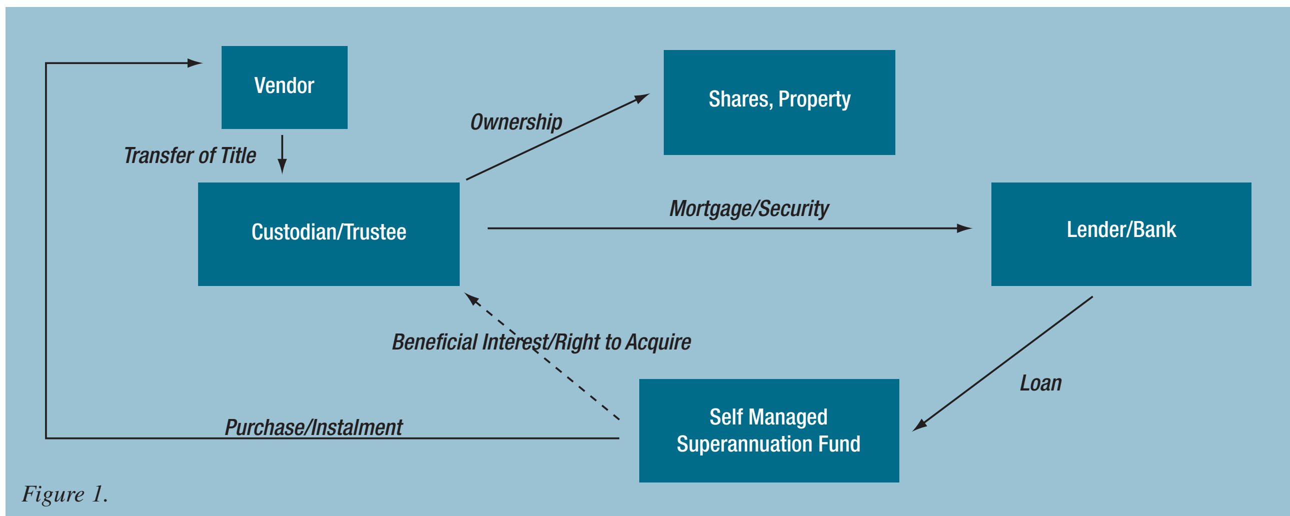

Figure 1.

requirements, your super fund can make partial payment and borrow the remainder of the purchase price under an installment arrangement. Note however that your super fund must pay all other relevant fees and borrowing costs such as stamp duty. It cannot borrow any of the acquisition costs to complete the purchase.

The parties lending money have usually been banking institutions. However the Tax Office has expressed the view that if the borrowing otherwise satisfies the installment warrant arrangements, the custodian/lender can be a related party of the super fund. The interest payable under the loan must however be an arms length interest rate that would be reasonably expected to apply if the borrower and lender were dealing with each other at arms length. If in doubt, determine the rate with specific reference to one bank's published market rates.

There is no prescribed period of repayment of such loans so that period can reflect maximum bank loan periods of up to 20 or 30 years. If you decide the initial loan period is to be significantly shorter, ensure any option to extend the term of the original borrowing are specifically provided for in the original limited recourse loan agreement.

Finally, you will note that most arrangements promoted by commercial lending institutions have significant disclaimers on the superannuation and taxation law. Notwithstanding how high a regard you have for your bank, you should seek independent accounting or legal advice in this regard. It is important that you carefully consider the particular circumstances of your case as well as the methods by which the lender claims to satisfy the super fund borrowing concessions as not every warrant offering is the same, nor is every offering legislatively compliant.

What super fund documentation?

It is important that your super fund deed allows this form of borrowing arrangement. Amendments must be effected before any arrangements are entered - not afterwards.

Your super fund's investment strategy must permit the proposed investment under the installment warrant arrangement. If an existing investment strategy does not exist, or does not reflect such arrangements, then one needs to be prepared, reviewed and adopted.

Accounting records for your residential property investment need to be kept by the super fund itself. Whilst the asset is legally held by the custodian as bare trustee, until finally transferred to the super fund, the super fund trustee must account for all related rental property transactions.

Notwithstanding that I presently outline that there are no significant adverse tax consequences if things are done properly, you should, however, ensure you archive and hold the original executed installment warrant/borrowing agreement, settlement statement setting out purchase price details as well as copies of bank statements showing the movement of funds from the super fund to the custodian to pay the purchase price.

What about Capital Gains Tax?

Provided that the arrangements are put in place properly, then the arrangements will not attract the usual discretionary or fixed trust tax treatment which most of you would be familiar with in terms of your own service and family trust arrangements.

As such, all adverse capital gains tax consequences can be avoided. It is however fundamental that only a bare trust is created meaning that the deed does not contemplate that any positive trust duties are to be carried out by the custodian/trustee. This also means that no active management duties should be carried out either. Therefore all rental property management should be carried out by an appointed property agent or someone other than the custodian/trustee.

Under a bare trust, the super fund is absolutely entitled to the residential property from day one so that no capital gains tax disposal is triggered when the property is eventually transferred to the super fund trustee.

What about GST?

GST does not need to be taken into account when purchasing and/or during the holding of the residential investment property.

When the custodian transfers the residential property to the super fund trustee, there is not considered to be a taxable supply for GST purposes as no enterprise has been carried out in relation to the trust property.

What about Land Tax?

Given that even residential unit apartments reflect some underlying land value, land tax may well apply.

In NSW, whilst both the custodian and the super fund trustee will technically be liable for land tax, the super fund trustee is entitled to a credit for land tax paid by custodian. As only a bare trust is in existence, the adverse land tax rules that normally apply to special trusts, such as discretionary trusts, etc will have no application. Therefore the custodian should also be entitled to the benefit of the existing land tax free thresholds (i.e. rather than paying land tax from the first dollar), subject of course to what other land holdings it may have.

What about Stamp Duty?

Whilst stamp duty is not payable on the purchase of listed securities, ad valorem duty is normally payable on the purchase of land. This is an upfront cost that should not however recur on the eventual subsequent transfer from the custodian to the super fund trustee. Each State differs but specific concessions, such as the "apparent purchaser" provisions in NSW, operate to achieve the same end result. In NSW, when the residential property is ultimately transferred from the custodian to the super fund trustee, only nominal duty is payable provided the super fund establishes that it has paid the purchase price in full from its own funds.

Only nominal stamp duty is payable on the installment warrant/borrowing agreement in respect of the underlying loan arrangements. However, stamp duty is normally payable in NSW and Queensland in respect of the charge/mortgage granted over the residential property in favour of the lending bank.

What property advice should I get?

Each of you are experts within your own specialist areas. Many of you have also accumulated significant business acumen across both your own practice business model and financial investments. However you should not be reticent about acknowledging the expertise of others in different fields. I certainly know where I go when I have a toothache. Same when I need my car serviced. We have a second partner review policy on most major client matters and consequently I highly value one of my partner's reviewing the positions I take from time to time in respect of my own personal tax affairs.

Without labouring the point further or unintentionally insulting anyone's intelligence, I also know where I go when I wish to discuss the timing and the nature of my property investments. Many of us have sufficient knowledge to make good investments but I want the experts to help me make timely investments that are good value on acquisition and that will outperform the rest of the property market during its subsequent growth cycles.

Clients are often very passionate about their property investments. In terms of many of the residential property investments made by clients over the past year, I share greater comfort with them when I know their property investment choice has been made after consultation with property brokers who have taken considered positions in respect of the following macro- and micro-economic matters.

Macro-economics?

There are many conflicting views in the media. Many economists are forecasting a property led recovery for the economy whilst others are predicting a slow down. Should you be waiting or is now the right time to invest in property? Whilst I will not profess to personally knowing what is going on, I am very happy to share some of the salient points that have been shared with me by many clients and advisors over the past year.

Note that when reading on, remember that often economic indicators appear "bad news" from the perspective of the Australian economy on the whole (e.g. low construction levels), but the consequential effects of supply and demand give rise to "good news" in respect of making a good quality individual property investment from the property investor's perspective.

On the supply side, the conditions for developers have continued to be unfavourable, with inflation in the costs of both wages and building materials keeping construction activity at 50-year lows. Following on from the dreadful fall in building approvals, housing finance commitments for construction of new homes was measured to be down 20% year on year just before Christmas. For example, notwithstanding the sizeable reduction in NSW developer levies, announced in December, policymakers still have a lot more work to do if they are to boost the construction sector in 2009 and will therefore be struggling to boost supply within the construction sector in the short to medium term.

Policymakers will also need to continue to create demand in the property sector in 2009, being cognisant that a sharp rebound in property markets will be pivotal to the short-term outlook for the Australian economy. An example is the trebling of the first home owners grant (FHOG) for new homes. This appears to be encouraging new home buyers into the market with finance commitments for the purchase of new homes increasing 9.8% month on month just prior to Christmas as well as the highest proportion of first home buyer financing since 2002. Whether the short term economic outlook improves by stimulating the demand side with an incentive to try and address a supply side issue is debatable. Traditionally, the introduction of demand side incentives such as FHOG's has helped early adopters only. Namely, only those who get in on the act quickly to take advantage of the FHOG actually derive any benefit from it. Over time, the amount of the grant effectively gets added onto the price of properties sold. Of course, those who already hold property will stand to benefit from ensuing price increases.

The Reserve Bank of Australia (RBA) has slashed official interest rates by 300 basis points since September 2008, reversing all of the 12 rate rises imposed between mid-2002 and March 2008. Property buyers, whether home-buyers or investors, are set to enjoy the improvements in housing affordability due to this massive monetary policy easing, flowing through into lower standard variable mortgage rates. Interestingly the above-mentioned rises in finance commitments occurred before a further 100bps of RBA rate cuts were provided in early December. Thus, further improvements should become evident in the months ahead, particularly if the RBA continues

to lower interest rates aggressively in 2009. Indeed, the importance of a quick and large improvement in this sector would intimate that the RBA will continue to lower rates until signs of a sustained turnaround in activity is evident. The expectation is that the RBA will cut rates by a further 75bps when they meet in February. Many commentators predict that the cash rate will probably fall to around 3% by around April this year and perhaps 2.5% later in 2009.

Of course, it is not possible to ignore the issue of credit availability. Availability of credit has driven the property market over the last 40 years. Without this, no matter how intense the demand is, it can never be actualised as increased price movements. However with interest rates dropping (lowering the debt servicing burden), Australian interbank credit spreads narrowing (indicating that Australian credit is becoming less crunched) as well as strong competition in our lending sector to increase the volume of loans, credit availability in Australia is likely to be better than what is commonly perceived by the general public. The continuing weakness of the Australian dollar is stabilizing the economy by making our exports more attractive, whilst deterring our imports. This is going a long way towards closing our trade deficit gap and improving our capital-asset ratio, which ensures that Australia will (in the medium term) continue to get funding from institutional lenders. Therefore the medium term prospects for credit availability of funding should allow property prices to continue to appreciate.

Neither is it possible to ignore the decline in house values in some parts of major capital cities and regional areas. However, will that mean corrections of the magnitude seen in the US? In December, Reserve Bank of Australia Governor Glenn Stevens said, in response to such a question, that Australian house prices were unlikely to decline by 30 to 40%, like the US, because of the undersupply of housing. Recent estimates suggest that Sydney's population will increase from around 4.5 million residents to over 6 million over the next 30 years. This increase of 40% is projected to be faster than the population growth of NSW overall (which is projected to increase to 9 million or 33%).Unlike coastal regions that are expected to grow mostly from migration, of the 1.7 million rise in Sydney's population, 69 per cent will be driven by births and only 31 per cent by net migration. Three years ago the strategy estimated Sydney would need an extra 640,000 dwellings by 2031 but a co-author of the report, Patrick Fensham, claimed up to 876,640 would be needed because of soaring immigration. Besides traffic and decentralisation, when we combine this with the trend for falling household sizes (a trend that has unwaveringly progressed since around 1911) it begs the question where will everyone live?

There are of course a large range of variables that will affect the property price/growth cycle, including real wage increases (productivity improvements), inflation, investment demand (which is typically twice as sensitive to interest rates), population growth, building completion levels, credit availability and the investing population's expectation of getting a better return in an asset class competing against equities. But, all things being equal, decreasing interest rates remove the cap on property prices. For example, for the typical first home buyer, every 0.25% decrease in interest rates allows property prices to grow by another 2% for the same cost of controlling the asset. More so when we have a typical investor who also obtains a tax deduction for the gearing loss, predominantly generated by the interest rate expense. But when decreased interest rates are combined with relatively low current acquisition prices, under supply of housing, rising rental yields and a slow but steady improvement in the availability of credit, then we see the ongoing set up of solid buying conditions for investors. Measurable change in property prices almost invariably happens late in the rate cutting cycle but upwards momentum in property prices will come. The age old supply - demand equation demands it.

Micro-economics?

Over time, the specific micro economics of the suburb or area and the features of the specific residential investment are almost more significant than general market conditions. Macro economics helps your timing into the market but micro economics determines how well you do during your time in the market.

The demographics of the suburb itself are so fundamentally important. It is difficult to sum up all the major demographic factors but the following seem to have been common to some very successful investments:

- Solid upper-middle class suburbs dominated by families with older children or households consisting of younger children; over-represented in one of the key household formation age groups of 18-24 year olds (Generation Y's); or by those aged 55 and over (baby boomers) who are preparing to downsize to apartments and townhouses close to amenities and their existing social networks;
- The average household income is significantly higher than the State average of the top, second and middle income brackets being very highly over-represented. This is very likely to result in property price and rent increases that are less restricted by income levels;
- In line with the above, a significantly higher proportion of professionals, associate professionals or persons working in management and administration in the suburb; or well-educated with significant over-representation in those who are qualified with a degree or higher form of education as well as those that have lower diplomas;
- The area is dominated by owner occupiers with those owning or paying off their property significantly higher than the State average; or the proportion of owner occupiers have less debt on their house compared to the State average;
- Whether the total return for houses in the suburb has outperformed the State average over the last ten years (for example, this has measured 13.6% for houses for Sydney). Similarly, whether the total return for units in the suburb measures up favourably against the State average (for example, in Sydney this measured 12.8% over the same time period).

Again, individual properties are so diverse it is difficult to sum the major factors of a good quality residential investment. However the following factors are common to most of the good ones:

- Short distance from the centre of major cities ensuring location is close to transport, leisure and work as ultimately the scarcity of inner city land supply underpins its value;
- Expected rental return is within 10%-20% of the median price for the local area to ensure rental affordability by approximately 80% of the local population;
- Purchase price accords with the median price for that area, such as an apartment in Sydney or Melbourne but a house in South Australia or Western Australia;
- Enjoying numerous points of differentiation in terms of unique location, accentuated views, water features, landscaped terraces, privacy, architectural design harmonising with surrounds, high level of finish and superior quality fixtures and fittings, plenty of sunlight, facilities such as solar heated lap pool, gymnasium and/or steam room for residents.

Is this right for me?

Notwithstanding all the various economic, commercial and technical factors I have outlined, three main areas of assessment exist:

- Is my superannuation investment plan still within a long term investment phase of 10 years or more?
- Am I comfortable with my current levels of geared investment inside and/or outside of superannuation?
- Will the income yields and capital growth on my specific residential property acquisition make it a good investment?

If one or two residential property growth cycles accords with your retirement strategy and your current gearing levels are conservative, then now is definitely the time to make the effort to determine what is really going on in the Australian property market and consider using your super fund to gear that investment.

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 and 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.