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HOW TO GEAR YOUR SMSF

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Recent amendments to the SIS Act regarding instalment warrants also permit many other borrowing arrangements by a SMSF. It is now possible to gear your super to invest in any permissible asset class, including real estate. Jeffrey Chang, Special Counsel with Riordans Lawyers, examines the practical applications of this investment strategy.

Disclaimer: *This article contains a general discussion of the law regarding borrowing by SMSFs and does not contain specific legal advice. Whether a particular borrowing by the trustee of a super fund is permitted under the SIS Act depends entirely upon the specific circumstances of that borrowing. The consequences of non-compliance with the SIS Act are severe. Any trustee of a super fund contemplating a borrowing arrangement should only proceed once it has obtained specific legal advice.*

INTRODUCTION

With effect from 24 September 2007, amendments to the *Superannuation Industry (Supervision) Act 1993* (“**SIS Act**”) have permitted super funds to borrow. The amendments take the form of a new exception to the general prohibition against borrowing in s67(1) of the SIS Act.

To qualify for the exception, the borrowing must adhere to a prescribed form (which I will refer to as a “**Complying Loan**”). However, the statutory requirements enable significant flexibility. It is therefore possible to structure a Complying Loan in many different ways.

In this article I will discuss the following with a focus on self-managed superannuation funds (“**SMSF**”):

- the background to the new exception to s67(1);
- the requirements for a Complying Loan;
- why you might want to gear your SMSF; and

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- how to implement a Complying Loan.

INSTALMENT WARRANTS

The amendments to the SIS Act have arisen because of problems associated with super funds investing in instalment warrants.

An instalment warrant has typically been understood to be a type of derivative financial instrument whereby:

- the warrant holder acquires beneficial ownership of a share via the payment of two or more instalments;
- pending payment of the final instalment the share is held on trust for the warrant holder, who benefits from any dividends paid on the share and growth in its capital value;
- the deferred instalments are effectively a loan by the warrant issuer (typically an investment bank) to the holder;
- if the warrant holder defaults on the loan, the issuer's recourse is limited to the share; and
- upon payment of the final instalment the warrant holder is entitled to receive a transfer of the share.

THE PROBLEM

Instalment warrants have long been marketed as an allowable means for SMSFs to gear their exposure to the stockmarket.

However, in December 2002 the ATO and APRA expressed the view that an investment in an instalment warrant by a super fund may constitute a borrowing by the fund. Such a borrowing would have resulted in a breach of s67(1).

THE SOLUTION

In order to avoid disruption to financial markets, the Government announced on 3 November 2006 that it would:

“... act to allow superannuation funds to continue to invest in instalment warrants, consistent with longstanding administrative practice ...”

The announcement noted that s67(1) was designed to limit risk in super fund investments. This decision by the Government effectively acknowledged that instalment warrants represented an acceptable super fund investment due to their particular risk features (in particular, the limited recourse nature of the loan).

The announcement also noted that industry consultation would take place to determine the scope of amendments to the SIS Act.

PERMISSIBLE ASSETS

Following industry consultation, the Government announced on 22 May 2007 that it would:

“... legislate to allow superannuation funds to invest in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly.”

This represented a significant departure from the previous announcement. Previously instalment warrants had been understood to relate to listed securities only. Of immediate interest was the prospect of an instalment warrant in relation to real estate.

In the context of s67(1) as a risk management provision, the extension of the instalment warrant exception to all permissible asset classes is understandable. The reason why instalment warrants are considered to be an acceptable super fund investment is because of the limited risk they pose to a super fund.

In particular, the limited recourse nature of the loan means that if a super fund defaults on the loan, the other assets of the fund will not be at risk. This analysis is not affected by the type of underlying asset involved.

DEFINING THE EXCEPTION

The Government's policy was subsequently implemented by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (“**Amending Act**”) which received the royal assent on 24 September 2007. Schedule 3 of the Amending Act is entitled “Investment by Super Funds in Instalment Warrants”.

The Government's press releases describe the purpose of the amendments as being to allow super funds to invest in instalment warrants. The mechanism adopted to achieve this was to insert a specific exemption into s67 to deal with instalment warrants. That exemption is set out in s67(4A).

The draftsman tasked with wording s67(4A) would have been immediately confronted with the question of “what is an instalment warrant?” There is no definition of instalment warrant in any Commonwealth legislation.

The solution to this definitional problem was not to define an instalment warrant, but rather to define the features of a borrowing arrangement that qualifies for the exemption (i.e. a Complying Loan). In fact, s67(4A) does not use the term “instalment warrant” except in the heading to the subsection.

As a result, any borrowing arrangement by a super fund that satisfies the requirements set out in s67(4A) will qualify for the exception, even if it does not constitute an instalment warrant as traditionally understood. In a way the heading to s67(4A) is somewhat misleading – a more apt description might be “Limited Recourse Borrowing by Super Funds”.

COMPLYING LOAN REQUIREMENTS

The result is that s67(4A) provides that a borrowing by the trustee of a super fund (“**Fund Trustee**”) is not prohibited by s67(1) (i.e. it is a Complying Loan) where:

1. the borrowed money is applied to the acquisition of an asset. I will refer to the person from whom the asset is acquired as the “**Vendor**”;
2. the asset is of a type which the Fund Trustee is permitted to acquire. For example, it could not be an asset that the Fund Trustee is prohibited from acquiring from a related party under s66, or an in-house asset that would result in the fund exceeding the allowable limit for in-house assets under s71;
3. the Fund Trustee is not the legal owner of the asset. Instead the asset must be held on trust so that the Fund Trustee acquires a beneficial interest in it. I will refer to the legal owner of the asset as the “**Custodian**”;
4. the Fund Trustee has the right to acquire legal ownership of the asset by making one or more payments after acquiring the beneficial interest. Note that this refers to a right, not obligation, to acquire; and
5. the lender’s rights against the Fund Trustee for default under the loan are limited to rights in respect of the asset (i.e. the borrowing is limited recourse).

There is also scope within s67(4A) for the original asset to be disposed of and substituted for a replacement asset.

WHAT IS NOT SPECIFIED

The requirements of s67(4A) are drafted so that existing instalment warrants issued by investment banks in respect of listed shares will fall within them. However they are sufficiently broad that many borrowing arrangements that would not ordinarily be described as instalment warrants will also comply.

In particular, s67(4A) is silent with regard to the following:

- the identity of the lender – this could be a bank, or equally a member or other related party of the fund. It could be the Vendor;
- the identity of the Custodian – this could be a person controlled by the lender, or equally a member or other related party of the fund. Again it could be the Vendor, or the lender itself;
- the amount of the payment(s) that the Fund Trustee must make in order to exercise its right to acquire the asset;
- whether the Fund Trustee may have an obligation, not just a right, to acquire legal title to the asset from the Custodian;
- the term of the loan;
- the interest rate;
- whether the loan is principal and interest or interest-only;
- whether the loan is secured;
- whether the loan is personally guaranteed by a third party, for example by a member of the fund or other related party; and
- whether the lender has any third party security, such as a mortgage over real estate owned by a member of the fund or other related party.

The above features of a particular borrowing arrangement will still be relevant in the overall analysis of whether the arrangement is permissible under the SIS Act. In particular, consideration must always be given to other provisions of the SIS Act including:

- the sole purpose test (s62);

- the investment strategy requirement (s62(2)(f));
- the related party acquisition rule (s66);
- the in-house asset rule (s71); and
- the arm's length dealing requirement (s109).

However, subject to their impact on the various other requirements of the SIS Act, things that are not specifically mentioned in s67(4A) will have no bearing on whether a borrowing arrangement satisfies the exception to s67(1).

ACQUISITION OF AN ASSET

The requirement that the borrowed money be applied to the acquisition of an asset presumably means that interest on the loan cannot be capitalised. This is because the capitalisation of interest would constitute a borrowing by the fund to pay interest, not to acquire an asset.

Also, a question arises as to whether a Fund Trustee would be permitted to borrow to improve an asset, such as the carrying out of repairs or improvements to land. On one interpretation, the materials used to construct the repairs or improvements are assets that are acquired by the fund and which then merge with the underlying land. However the repair or construction arguably also involves the acquisition of services, which would not be permissible.

WAYS IN WHICH A FUND MIGHT BE GEARED

Given the flexibility inherent in s67(4A), there are many different ways in which a super fund might be geared. All include the basic premise of leveraging the existing assets in the fund to acquire a more valuable asset than would otherwise be possible. But beyond this there are many possibilities.

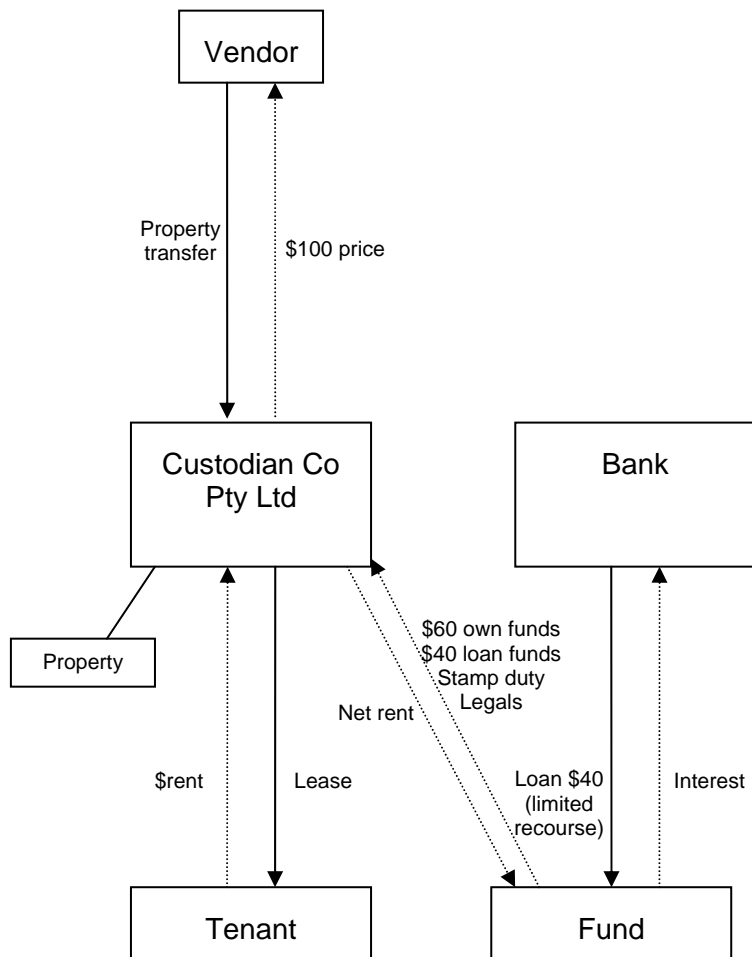
Direct loan from bank

The most straightforward arrangement is where the Fund Trustee borrows from a bank to acquire an asset on-market from an unrelated Vendor.

This arrangement involves the fund borrowing externally to acquire a more valuable asset that it otherwise could. This might be because the fund's available cash is limited by the size of the fund, its liquidity and the ability of members to make additional contributions.

The difficulty in implementing this arrangement will be finding a bank that is willing to lend on the required limited-recourse basis. Over time, it might be expected that banks will offer lending products specifically designed to satisfy the requirements of a Complying Loan.

The following is a diagram of this arrangement in relation to real estate:



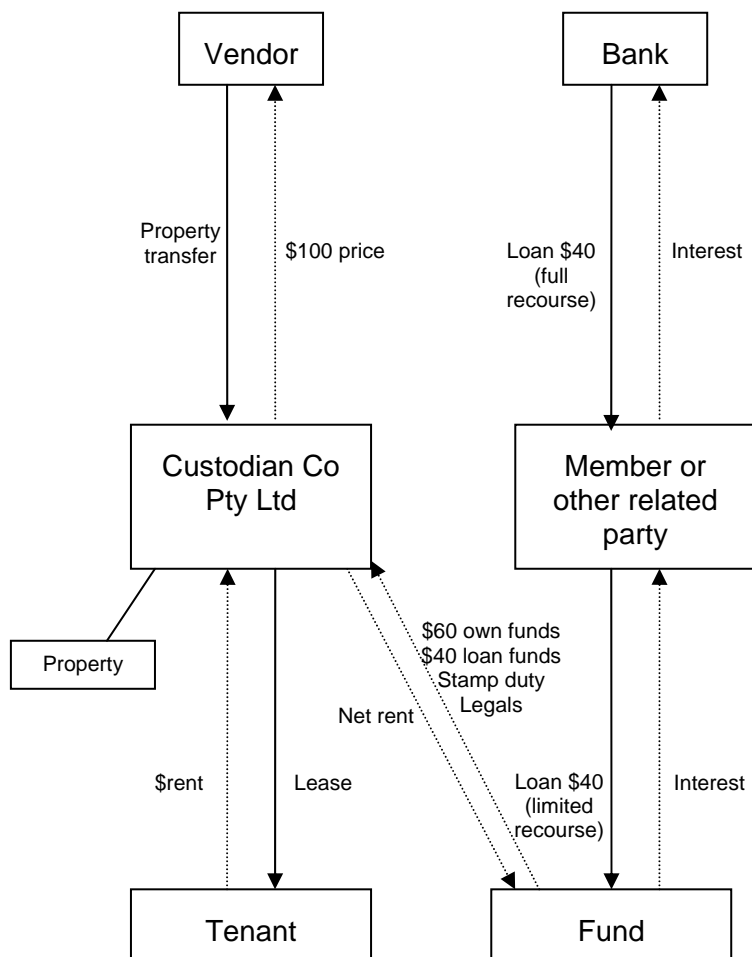
Indirect loan from bank

If it is desired for the fund to finance the acquisition externally (i.e. using money sourced on-market rather than from a related party) but a limited-recourse bank loan cannot be negotiated, an indirect loan structure may be used.

This involves a member of the fund (or other related party) borrowing from a bank on a full-recourse basis. The member would then make a limited-recourse Complying Loan to the Fund Trustee.

The advantage of this arrangement is that the full-recourse bank loan to the member will be much easier to arrange than a Complying Loan directly from the bank to the Fund Trustee.

The following is diagram of this arrangement in relation to real estate:



Direct loan from related party

Superannuation contributions in excess of the specified annual caps will result in a liability to the relevant member for excess contributions tax. This has the practical effect of limiting the rate at which contributions can be made to a fund. This in turn limits the gross value of assets that the fund can acquire without gearing.

A fund member may have existing monies outside super and desire to invest via a SMSF, but not be able to do so tax-effectively due to excess contributions tax. By the member making a Complying Loan to the fund, those monies can be invested within the super environment, notwithstanding the contribution caps.

Div 7A compliant Complying Loan from related private company

It may be that the existing non-super monies in question are currently in the form of retained profits of a private company controlled by a member of the SMSF. It would be possible for the private company to make a Complying Loan to the Fund Trustee on terms that also satisfy the requirements of s109N ITAA36, thereby ensuring that the Complying Loan is not treated as a deemed dividend of the fund.

Business real property acquired from related party

Of particular interest to many business owners will be the ability of their SMSF to acquire their business premises using a Complying Loan. Because the premises will be business real property, it may be acquired by a SMSF from a related party under an exception to s66.

The acquisition will often be made by way of an in-specie member contribution to save stamp duty. However such acquisitions are still subject to the annual contribution caps.

Where there is a willingness to pay stamp duty, the Fund Trustee may purchase the premises. However such purchases were previously subject to the amount of cash available within the fund.

Where the value of the premises significantly exceeds the contribution caps and purchasing power, the acquisition may be performed in stages over a number of years. But quite often in this situation the acquisition has been considered too difficult and not pursued.

It is now possible for the Fund Trustee to purchase the whole of the premises up-front, funded by way of a Complying Loan. The lender could be the existing owner of the premises, although examination of the relevant State's laws regarding terms sales of real estate would be required. Alternatively the lender could be another related party of the fund.

OTHER SIS ACT PROVISIONS

As mentioned above, any proposed Complying Loan strategy must also satisfy the other provisions of the SIS Act apart from s67(4A). Some key considerations in this regard will be as follows.

Investment strategy

Geared investments increase the borrower's exposure to the upside of the relevant investment, but they also increase downside exposure. The limited-recourse nature of a Complying Loan limits this downside to the amount invested in the underlying asset. However there will still be the possibility of the fund losing the amount so invested.

A properly conceived investment strategy will always limit the percentage of the fund's assets exposed to this downside risk to an appropriate amount based on the fund's circumstances. This may represent a significant limitation on the percentage of the fund that can appropriately be committed to a geared investment.

In-house asset rule

In addition to inserting s67(4A) into the SIS Act, the Amending Act modified s71 so that the interest of the Fund Trustee in the trust upon which the Custodian holds the asset is not an in-house asset of the fund. Consideration of the application of the in-house asset rule to a notional acquisition of the underlying asset by the Fund Trustee directly will however be required.

Arm's length dealings

Section 109(1) prohibits the Fund Trustee from making an investment unless:

- the trustee deals with the other party to the relevant transaction at arm's length in relation to the transaction; or
- if the dealing is not at arm's length, the terms and conditions of the transaction are no more favourable to the other party than they would have been had the dealing been at arm's length (s109(1)(b)).

Section 109(1A) also requires that in the management of its investments, the Fund Trustee must deal with non-arm's length parties as though they were at arm's length.

Section 109 and interest

The rate of interest paid by the Fund Trustee under a Complying Loan is an issue to which s109 is highly relevant. Whenever a Fund Trustee borrows from a related party, there will likely be a desire for the applicable interest rate to be as low as possible. This is because:

- the fund's effective tax rate will be somewhere between nil and 15%, thereby limiting the value of interest deductions to the fund;
- the lender (in this case a related party of the fund) will be taxed on the interest at its marginal rate, which will very likely be higher than the fund's tax rate;
- any interest that is paid therefore results in a shift of assessable income from a low-tax environment to a higher-tax environment; and
- the requirement to pay interest may also impact the liquidity of the fund and the ability of the Complying Loan to be justifiable under the fund's investment strategy.

Section s109 and in particular s109(1A) requires the Fund Trustee to deal with the lender on arm's length terms. This means that an arm's length rate of interest must be paid by the fund on the Complying Loan.

Section 109 and security

Perhaps more difficult to analyse is the question of s109 and security for a Complying Loan. In particular, if a third party such as a member of a fund gives a guarantee or security for a Complying Loan of the fund, can that person properly be described as "the other party to the relevant transaction"? If so, what is the effect of the arm's length dealing requirement?

In the majority of cases, the giving of a guarantee or security by the member or related third party will occur at the time the relevant investment is made. The benefit of the arrangement will flow to the fund. In those circumstances the better view is that the "no more favourable" test of s109(1)(b) will be satisfied.

CONCLUSION

The direct gearing of super funds via Complying Loans represents a bold new frontier in the evolution of super fund investments.

Whilst the exception in s67(4A) was initially conceived to address problems raised by instalment warrants, in execution it permits a much broader class of limited-recourse borrowing arrangements. When coupled with the expansion of gearing arrangements from listed securities into other asset classes including real estate, this represents a paradigm shift in the regulatory attitude towards the gearing of super funds.

Demand for Complying Loan products is expected to be high. However it is important that Fund Trustees understand that not just any borrowing is permissible, and that the correct procedures must be followed lest the fund be rendered non-complying.

The increased potential for loss of equity in an underlying asset must also be properly understood. However when implemented appropriately, direct gearing strategies have the potential to achieve a new range of desirable investment outcomes for SMSFs.

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