

The Government has recently amended the superannuation legislation to ensure instalment warrant arrangements that meet specific conditions do not contravene the borrowing or in-house asset restrictions. This legislative change has created a number of opportunities for super fund trustees.

Background

Generally, trustees of superannuation funds were not permitted to borrow under superannuation legislation (except in very limited circumstances). In recent times, both APRA and the ATO considered that instalment warrants constituted a borrowing and therefore contravened section 67 of SIS. The ATO also determined an investment by a self managed superannuation fund (SMSF) in an instalment warrant was an in-house asset of the fund under section 71 of the SIS Act.

Following industry consultation, the Government recently amended SIS to ensure that a borrowing by a SMSF trustee will not contravene the borrowing prohibition (section s67(4A)) and the in-house prohibition (section 71(8)) if the following conditions are met:

1. the borrowing is used to acquire an asset held on trust, so that the superannuation fund trustee receives a beneficial interest and a right (but not an obligation) to acquire the legal ownership of the asset (or any replacement) through one or more payments;
2. the lender's recourse against the superannuation fund trustee in the event of default on the borrowing (and related fees) is limited to rights relating to the asset at the time of the action. These rights may include taking possession of, or disposing of, the asset; and
3. the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly. The existing investment restrictions, such as those on in-house assets and acquiring certain assets from a related party of the fund, continue to apply.

An arrangement that meets these conditions will only be an in-house asset where the underlying asset would itself be an in-house asset if it were held directly (i.e. a loan to, lease with or an investment in a related party).

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Strategy opportunities

The conditions set out in the legislation for instalment warrant arrangements to be exempt from the borrowing or in-house asset prohibitions are surprisingly broad and the concessions extend beyond 'traditional' instalment warrant arrangements.

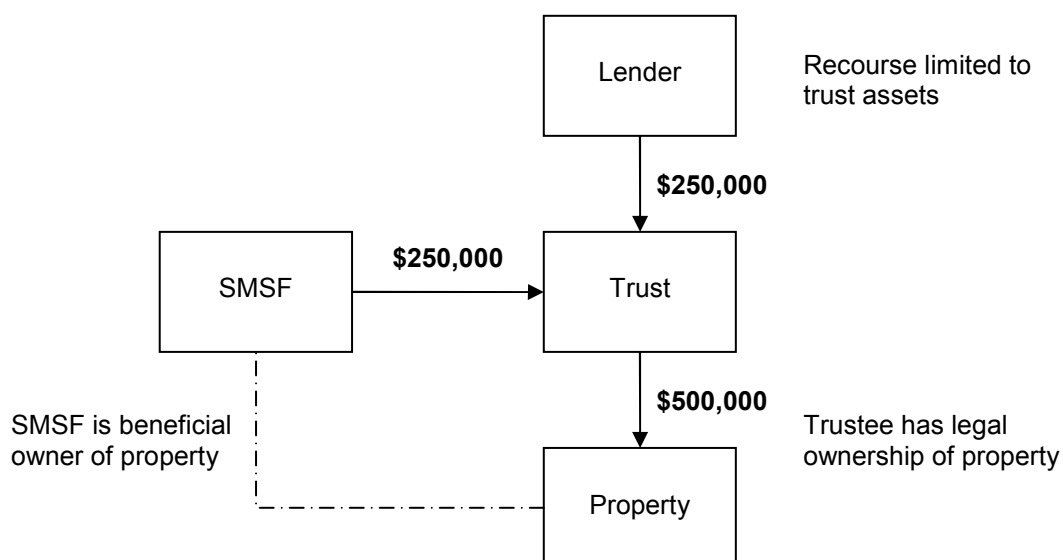
Given the underlying investment can be any asset the fund would be permitted to invest in directly, it is now possible to expand these arrangements to other assets such as direct property. Whilst this opportunity is not limited to SMSFs, it is expected SMSF trustees will be particularly interested in it due to the broader investment opportunities.

Trustees do, however, need to ensure any investment in an instalment warrant arrangement complies with SIS investment duties. For example, it must be in line with the fund's investment strategy and any acquisitions from related parties are specifically permitted by legislation.

These changes are particularly attractive to clients, as they provide new opportunities for them to 'gear' their superannuation savings. They also provide the potential to acquire large lumpy assets such as direct property in super that might not otherwise be possible due to insufficient cash in the fund and the contributions caps.

Case study

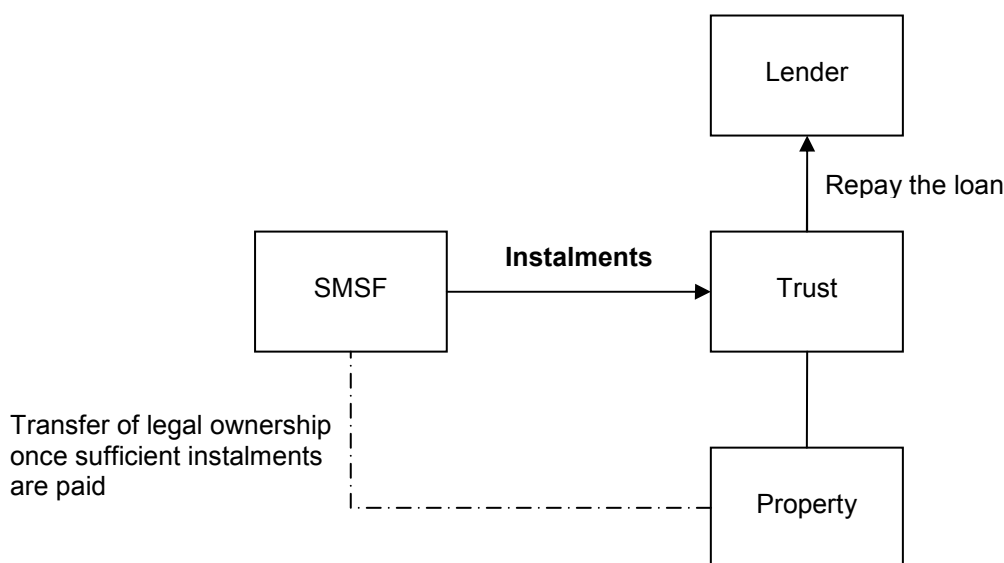
John would like to acquire a \$500,000 property in his SMSF from an unrelated party. After making non-concessional contributions, he will have \$250,000 in cash in his accumulation account. In order to acquire the property, the SMSF invests the \$250,000 contributed by John into a trust ("the borrowing trust"). The trustee of the borrowing trust then borrows an additional \$250,000 from a lender to acquire the \$500,000 property.



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Under the arrangement between the SMSF trustees and the trustee of the borrowing trust, the SMSF trustees have the right to acquire legal ownership of the property through the payment of one or more instalments to the trustee of the trust. The instalment amount and frequency will depend on the agreement between the trustee of the borrowing trust and the SMSF trustee. The instalments would normally need to be sufficient to allow the trustee of the trust to meet their liabilities to the lender.



If structured correctly this arrangement would not breach the SIS borrowing or in-house asset restrictions.

Other considerations

- There are a number of options when it comes to the structure of the trust arrangement. For example, it could be a simple trust arrangement controlled by the lender who holds legal title to the underlying assets with the SMSF trustee having the right to acquire legal ownership when the required payments under the agreement are made. It is also possible to have a more formal trust structure with an independent or related trustee.
- The transfer of legal ownership of the underlying assets from the borrowing trust to the SMSF trustees would generally not be a CGT event, since the SMSF trustees continue to hold beneficial ownership of these assets.
- The stamp duty implications for such a transfer will depend on the type of asset and the State of registration. No duty is payable on the transfer of listed securities while a nominal amount may be payable on the transfer of most public offer managed funds. Most States have exemptions from ad valorem stamp duty for the transfer of direct property to an investor from a trustee who acquired it on their behalf.
- Trustees need to carefully consider the risks associated with these arrangements (e.g. a rise in interest rates or a fall in the value of the underlying investments) when deciding what exposure (if any) is appropriate for the fund.

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Summary

These changes provide an exciting opportunity for clients to use borrowed money to leverage their superannuation savings. However, there are many issues to consider before implementing these arrangements and we strongly recommend that fund trustees seek professional legal and tax advice.

We expect that many product providers will in due course develop products that make it easier for super fund trustees to take advantage of this opportunity. We will endeavour to keep you updated on any further developments in this area.

Reference: s67(4A) & s71(8) of the Superannuation Industry (Supervision) Act 1993
MLC Technical Update: 26 November 2007

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