

Instalment Warrants

Borrow to invest through your self-managed super fund

Commonly Asked Questions

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Borrowing and Your SMSF – Commonly Asked Questions

We set out below a range of commonly asked questions on borrowing by SMSFs:

What are the new borrowing requirements for superannuation funds?

From 24 September 2007, the new borrowing requirements, which are also referred to as instalment warrants, permit a superannuation fund to borrow in limited circumstances:

The amount borrowed by the fund must be used towards the purchase of an investment which the fund would be permitted to acquire under the superannuation law.

The legal title to the investment acquired is held on trust for the fund and once the loan has been paid off it is transferred to the fund.

It is possible to exchange the investment held on trust for another.

If there is a default on the loan then the lender is limited in recourse to recover the amount of the loan outstanding from the sale of investment and not from other investments of the superannuation fund.

Are self-managed superannuation funds able to use the new borrowing rules?

Yes, the new borrowing rules apply to all superannuation funds including self-managed superannuation funds, whether established before or after 24 September 2007.

If my self-managed superannuation wishes to borrow is it required to invest in a publicly marketed borrowing (instalment warrant) product?

No, the new borrowing requirements do not limit trustees to traditional tradable instalment warrant arrangements. It is possible for the superannuation fund to obtain a loan privately from many sources and to use it to purchase an investment which is held in a privately established trust. The trust is referred to as a bare trust.

Are there any restrictions on the investment that can be acquired as part of the borrowing arrangement?

The investment must be one that the superannuation fund could acquire under the superannuation law. As a general rule there is no restriction on the type of investment that can be acquired such as property or listed shares and other securities. However, the investment subject to the loan cannot be an investment the fund already owns. In addition, the superannuation law places restrictions on investments that can be acquired

from related parties such as fund trustees, members, relatives or members or trustees and any entity they control either individually or as a group. You should obtain independent advice in this regard as these rules can be complex.

Who chooses the investment?

The trustees of the SMSF choose the investment as part of the fund's overall investment strategy.

What rules apply to the loan?

Any loan that the SMSF obtains for purchases of the borrowing rules must satisfy the following conditions:

The loan must be acquired for purposes of acquiring an investment permitted under the superannuation laws.

The investment, or its replacement, is held on trust so that the fund receives the beneficial interest in the investment. The beneficial interest includes the right to income earned by the investment.

The superannuation fund acquires the right to legal ownership of the investment after one or more payments have been made.

The lender is limited to recover any outstanding amount relating to the loan only from the sale of the relevant asset. The lender does not have the right to recover any of the outstanding loan from the other investments of the superannuation fund.

If the SMSF used the borrowing to acquire shares in a company or unit trust that is an 'in-house' asset for purposes of the Superannuation Industry (Supervision) Act 1993, what are the consequences?

If the SMSF borrows for the purposes of acquiring an in-house asset then the market value of the in-house asset is included in the value of the fund's in-house assets to determine whether the fund has satisfied the in-house asset rule.

Can the SMSF acquire the investment subject to borrowing from a related party?

It is possible for the loan to be used to acquire an investment from a related party. However, there are restrictions placed on the type of investment that can be acquired. Types of investments that can be acquired include commercial property, primary

production properties, listed shares and securities, certain insurance policies and in-house assets, providing the fund remains within the in-house asset restrictions.

What happens when the loan is repaid?

When the loan is repaid the legal ownership of the investment held by the bare trust is transferred to the SMSF. Of course, prior to the transfer of the investment to the SMSF it is possible for investment to be sold. Any profit made on the sale of the investment will be transferred to the SMSF. However, any loss that is made will become the responsibility of the lender as the terms of the loan are on a limited recourse basis. This means that the lender is only able to recover the amounts outstanding on the loan from the sale of the investment subject to the loan.

Does the loan have to be secured?

No, the legislation does not require the loan to be secured. However, it would be expected that any unsecured loan would bare a higher interest rate than a secured loan in the same circumstances.

Is it possible for the trust that holds the investment on behalf of the fund to be a unit trust?

No, for legal reasons the investment must be held as a bare trust. It cannot be held in a unit trust or a discretionary trust.

Can the SMSF transfer an existing investment it owns into the borrowing arrangement?

No, the loan acquired by the fund must be applied to acquire an investment or replace the investment. As the fund already owns that asset it is not possible for it to acquire it via the new borrowing arrangements.

Can the fund borrow from a related party?

Yes, the fund can borrow from a related party. However, it must be ensured that the transaction complies with the superannuation law. For example, the fund is required to meet the sole purpose test and meet the investment restrictions such as ensuring the whole transaction is made on an arm's length basis.

Who pays the deposit for the purchase of the investment?

The deposit is paid by the SMSF. The deposit may come from the resources of the superannuation fund or may come from the loan that has been obtained by the trustees for the purposes of acquiring the investment.

Is it possible for part of the purchase price to be paid by an *in specie* transfer of some of the fund's investments? For example, is it possible for the fund to transfer some of the listed shares it owns to the vendor in part of satisfaction of the purchase price?

Yes, this is possible, however, the value of the SMSF's investments that are given in exchange as part of the purchase price must be on an arm's length basis.

In the case of the purchase of real estate, who pays the deposit and the final amount on settlement of the purchase?

It is the SMSF which pays the deposit for the property. On settlement, the lender would provide a cheque to the value of the loan and the superannuation fund may provide additional funds to make up the whole of the purchase price.

Once the contract for purchase of the property has settled the legal title for the property will be in the name of the trustees of the bare trust.

If the borrowing arrangement includes ownership of real estate by the bare trust, who collects the rent and pays expenses?

The rent is collected and accounted for by the trustee of the SMSF. Any expenses related to the upkeep of the property, renting the property or paying interest on the loan is the responsibility of the trustee of the SMSF.

Who is responsible for insuring the property?

As expenses relating to the property are the responsibility of the trustee of the SMSF, then they are also liable for insuring the property.

Who pays the legal expenses relating to the purchase of the investment?

The trustee of the SMSF would be responsible for paying the legal expenses for purchase of the investment.

Who is able to manage the property?

Management of the property depends on the arrangement that is put in place. It may be the trustee of the SMSF or could be an agent employed by the trustee of the SMSF.

Which entity is responsible for the accounting for the borrowing arrangement?

The SMSF is the entity which will account for the income and expenses of the borrowing arrangement. It is understood that the fund will also pay tax on any net income it receives from the investment. Also, any net loss that is made by the SMSF on the borrowing arrangement will be deductible against the other income of the fund. This should be confirmed with the tax adviser for the SMSF.

Who is able to act as trustee of the bare trust?

The trustee of the bare trust can be a company or individual. However, the trustee of the bare trust should not be identical to the trustee of the SMSF.

Is it a requirement that the bare trust is established and in place before the property is purchased?

Yes, it is preferable that the bare trust is established prior to purchase of the property as the bare trust will be the legal owner of the property on settlement.

Will the borrowing arrangements be treated as a derivative for purposes of the Corporations Act 2001 and therefore would amount to a financial product?

No, the borrowing arrangement that will be implemented is not considered to be a derivative for purposes of the Corporations Act 2001 and therefore is not a financial product.

Does the loan need to be on commercial terms?

Yes, the superannuation laws require that any transaction entered into by the SMSF is on a full arm's length commercial basis. For example, if the interest rate on the loan was zero or less than a commercial rate the Regulator would be concerned that the money received by the SMSF may not be a loan at all but rather a contribution to the fund. If the interest on the loan was greater than a commercial rate then there may be concerns that the SMSF is not being maintained solely for superannuation purposes.

If maximum superannuation contributions have been to the fund for the year is it possible for any loan that the fund acquires for the purposes of the borrowing requirements be treated as an excess contribution?

Providing the borrowing arrangements are in accordance with the legislation, are properly documented and on an arm's length commercial basis it is unlikely they would be treated by the regulator as contributions to the SMSF. It should be ensured therefore that any borrowing requirements the fund enters into are strictly in accordance with the legislation.

If the trust deed of the SMSF prohibits the fund from borrowing, can it borrow for purposes of the new legislation?

No, if the trust deed of the SMSF places more stringent restrictions than the superannuation law, then it is not possible for the fund to borrow. A SMSF trust deed should permit the trustee to borrow for purposes of the new borrowing rules.

Does the fund need to review the investment strategy of the fund?

It is worthwhile to review the investment strategy of the SMSF to make sure it is able to borrow to invest for purposes of the superannuation law.

If the investment of the fund does not permit the fund to borrow, can it borrow for purposes of the new legislation?

No, the investment strategy must permit the fund to borrow if the fund wishes to enter into one of the new borrowing requirements. Of course, it is always possible to adjust the current investment strategy of the fund to permit the fund to enter into the new borrowing arrangements. Professional advice should be obtained to confirm that any changes made to the investment strategy are correct.

Will the granting a right of limited recourse over the asset which is subject to the loan be treated as a breach of the rule which prohibits the fund to change its assets?

No, the regulators have indicated that if the loan is subject to limited recourse over the investment that it will not be considered as a charge over the fund assets.

If a particular investment held in the bare trust is subject to the borrowing arrangement is it able to be sold and another investment purchased in its place?

Yes, it is possible for a particular investment to be exchanged for another under the borrowing arrangement. This will depend on the terms of the borrowing arrangement and the lender.

Is the interest paid on the loan tax deductible to the SMSF?

Our understanding is that under the income tax law expenses that are incurred in gaining or producing assessable income are tax deductible. If the SMSF receives income from the renting of a property or dividends from share investments then any expenses, including interest on any loan used to purchase the investment, would be tax deductible. This should be confirmed by your tax adviser.

When the investment is transferred to the SMSF after the last payment has been made, is the transfer, the disposal and acquisition of an asset for purposes of the capital gains tax legislation?

Our understanding is that as there is no change in beneficial owners but merely a change in legal owners of the investment there is no capital gains tax event for purposes of the tax legislation. In the circumstances the SMSF will always be the beneficial owner of the investment. This should be confirmed by the fund's tax adviser.

If the investment is sold by the bare trust prior to transfer to the SMSF, is the sale a disposal of an asset for purposes of the capital gains tax legislation?

Our understanding is that as there is a change in the beneficial owner of the investment there is a capital gains tax event for purposes of the tax legislation. In the circumstances the SMSF as beneficial owner of the investment, has disposed of the investment. This should be confirmed by the SMSF tax adviser.

What are the stamp duty implications of the purchase of the property?

The laws relating to stamp duty vary from State to State. It is usual that on the purchase of a property that stamp duty is payable. However, it is understood that in some circumstances and in some States no stamp duty is payable. Further information on the stamp duty implications of the transaction should be obtained from a specialist tax adviser or solicitor.

Can the bare trust be used to acquire more than one investment?

The new borrowing legislation provides that only one investment, or its replacement or a replacement of the replacement, is held in the bare trust. If more than one investment is held our legal advisers have indicated that is advisable to have a trust declared over each individual investment.

Can the borrowing arrangement be used for purposes of property development or to improve a current property that is held subject to the bare trust?

Improvement of an existing investment creates a number of problems as the loan obtained by the fund is to be used to acquire a particular investment. If the particular investment, such as a block of land, already forms part of a borrowing arrangement then it is not possible to improve or develop the property as this will result in a material change to the investment that was acquired initially.

Is it possible to use the borrowing arrangements for purposes of acquiring a property as tenants in common (joint ownership) with another superannuation fund or third party?

A joint arrangement where two or more parties own an investment as tenants in common may be possible, however, it would require each party to hold their proportion of the investment in a separate bare trust.

While this arrangement may reduce the amount that is required to be borrowed the practical difficulty is whether a bank or other lending institution would be prepared to lend to the parties. Also, there may be difficulties in providing security for the loan where there was more than one borrower involved in the arrangement.

Are there any banks or other financial institutions providing loans for purposes of the new borrowing arrangements?

Yes, there are a number of organisations which are prepared to lend for purposes of the new borrowing arrangements. The arrangements that are available have a number of features. Some lenders are only prepared to provide a set percentage of the property valuation in the vicinity of 50 to 60% of the current property value. Others will only provide loans for particular types of investments and some lenders have a sliding interest rate depending on the property of the property that is subject to the loan.

What documentation and support is available the new borrowing arrangements?

We have a full range of documents for the new borrowing requirements. Documents and services include:

- Declaration of Trust
- Borrowing agreement
- Equitable mortgage documentation
- Information Memorandum
- Required Minutes
- Technical backup and support

These documents are eminently suitable where the loan is being obtained from a private source. However, if a bank or other financial institution is being used then they may wish to substitute some of the borrowing documents with their own.

What requirements might apply to the Trust Deed for my SMSF?

You should ensure that the trust deed you are currently using permits the superannuation fund to borrow for purposes of the new borrowing requirements. If the current fund deed doesn't permit the fund to borrow for purposes of the new requirements then it will need to be amended.

Who signs the relevant borrowing documents?

There are a number of parties who are required to sign the various documents. They are:

Document	Parties
Declaration of trust	Custodian – trustee of the bare trust which holds the investment in trust for the superannuation fund
Borrowing Arrangement Agreement	Lender – bank, financial institution or third party Custodian – trustee of the bare trust which holds the investment in trust for the superannuation fund Trustee – the trustee(s) of the superannuation fund Guarantor (optional) – party that provides collateral security for providing additional security over the loan
Equitable mortgage documentation	Mortgagor – trustee of the bare trust Mortgagee – bank, financial institution or third party
Information Memorandum	Custodian – the trustee of the bare trust which holds the investment in trust for the superannuation fund Trustee – the trustee(s) of the superannuation fund
Minutes	Lender – bank, financial institution or third party Custodian – trustee of the bare trust which holds the investment in trust for the superannuation fund Trustee – the trustee(s) of the superannuation fund

What is the likelihood that the government will change the new rules that permit a SMSF to borrow?

All legislation is open to change by any government. There is apparently a view that the borrowing legislation is not as intended by the government at the time. The minister responsible for superannuation at the moment is Senator Sherry who is undertaking a review of all aspects of superannuation. At this stage, there has been no suggestion from the government that there will be a change to borrowing arrangements currently being undertaken strictly in accordance with the legislation. Where there is a breach of these rules the regulators have clearly indicated they are prepared to take action.

What happens if the SMSF does not adhere to all new borrowing requirements?

If the SMSF fails to meet the new borrowing requirements then there will be a breach of the superannuation standards. Severe penalties can be imposed for the failure of the SMSF to meet all of the superannuation standards. The penalties can include civil and criminal penalties and may result in the fund being treated as a non-complying superannuation fund. In some circumstances the trustees may be disqualified from acting as a trustee of any superannuation fund.

What steps do trustees need to consider and complete prior to the purchase of an investment under the new borrowing arrangements?

Trustees of SMSF hold meetings to determine and approve use of borrowing exception under Section 67(4A), together with completion of necessary minutes.

Trustees should review the trust deed to be satisfied it allows for the borrowing arrangement. You may need to seek advice and if required arrange for a deed upgrade.

Trustees formulate and implement necessary changes to investment strategy, including risk management, and instalment warrant use.

A trust needs to be established to hold the investment including identifying who is going to be the trustee of that trust.

Note: The trustees of the bare trust should be different to the trustees of the SMSF.

The SMSF trustees need to determine how the investment is to be financed and by which lender. E.g. financial institution or related party etc.

Now the superannuation fund has the capacity to purchase the asset.

What are the steps to purchase a property via a SMSF using the borrowing rules?

SMSF trustees find a property to purchase in accordance with the Investment Strategy of the fund.

Trustees of the Bare Trust arrange for exchange of contract and sign the contract to purchase the property.

SMSF trustees arrange for payment of the property deposit.

SMSF trustee should take out a cover note to insure the property from the date of the contract.

SMSF trustees are responsible for ensuring all documentation is completed and ready for the property settlement.

Note: SMSF trustees would usually seek assistance from a solicitor or conveyancer in relation to the purchase of property.

SMSF trustee arranges financing from a lender. Where the lender is not a related party, and is a major financial institution then it is likely that they will have their own mortgage documentation for completion in addition to the documentation provided in respect of the bare trust structure.

Instalment Warrant Application Form is then completed in full by the authorising party and sent for preparation and forwarding of necessary documentation.

At settlement, the lender and SMSF trustee will provide their proportion of the purchase price amount.

