



Wealth & Estate Planning update

by Peter McCrohon and Dung Lam

Borrowing to increase wealth in your SMSF. How to use the instalment warrant strategy

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1

SMSF borrowing to buy investments

Generally, a self managed superannuation fund (“SMSF”) is prohibited from borrowing funds.¹

In late 2007, the superannuation law was changed to allow a SMSF to gear² any type of approved investment. This is commonly referred to as the instalment warrant product which is an approved exception to the general rule that a SMSF cannot borrow.³ Instalment warrants are designed to allow a SMSF to borrow against the value of the asset being acquired.

Under the instalment warrant exception, a SMSF may borrow to invest in an asset **where all the following are met:**

- (a) the borrowed money is used to acquire the asset;
- (b) the asset is held on trust by another entity (security trustee) for the sole benefit of the SMSF;
- (c) the SMSF has the right to acquire the legal ownership of the asset by making one or more payments after acquiring a beneficial interest in the asset; and

¹ Subject to the exceptions in s67 of the *Superannuation Industry (Supervision) Act 1993* (‘SIS Act’).

² Borrow funds for the purpose of acquiring the approved investment

³ Being an investment asset that is permitted under the SIS Act. A reference to an investment or asset in this article is a reference to an investment or asset that is permitted under the SIS Act.



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- (d) the rights of the lender against the SMSF are limited to the asset held on trust by the security trustee for the benefit of the SMSF.

Prior to the introduction of the instalment warrant exception, the ability of SMSFs to make investments was limited because funding deficiencies could only be met with further contributions by members to the SMSF. This option is, however, limited⁴ by the annual contribution caps on members (discussed below). The instalment warrant exception provides a way for a SMSF to legitimately access more funding.

2

Labor government changes to contribution caps

In the 2009 Federal Budget, the annual cap for concessional contributions (i.e. tax deductible contributions)⁵ was reduced by 50%.

For persons aged 50 years and over, this reduced the annual concessional contributions cap from \$100,000 per annum to \$50,000 per annum per person.

For persons under 50 years of age, this reduced the annual concessional contributions cap from \$50,000 per annum to \$25,000 per annum per person.⁶

The annual cap for non-concessional contributions (i.e. non-deductible contributions) remains the same at \$150,000 per annum per person, and for persons aged under 65 years at \$450,000 per person (in every three consecutive years).

The reduction in the annual concessional contribution caps reduces by 50% the ability of SMSF members to wealth build within the SMSF on a tax deductible contribution basis. It also limits the tax effectiveness of using salary sacrifice to build wealth.

As such, smaller SMSFs are currently limited in their ability to fund the acquisition of substantial wealth creation assets by straight contribution funding alone.

Using instalment warrants to gear such acquisitions is therefore a viable strategy provided that the income derived by the geared asset and future contributions paid into the SMSF are sufficient to service the interest cost of such funding.

If a 2 person SMSF is annually funded by only one income earner aged over 50 years, the maximum deductible contribution that can be made per annum is \$50,000 and the net funding received by the fund (after contributions tax of 15% is deducted) is $\$50,000 * 85\% = \$42,500$.

If both members are working and over 50 years, then the maximum deductible contribution per annum is \$100,000 and the net funding received by the fund (after contributions tax of 15% is deducted) is $\$100,000 * 85\% = \$85,500$.

It is important that a person stay within their contribution cap, since contributions which exceed these limits are effectively taxed at a penalty rate of 46.5%.

3

Typical instalment warrant structure

The following diagram illustrates a typical instalment warrant structure where the SMSF acquires commercial premises which results in the receipt of rental income.

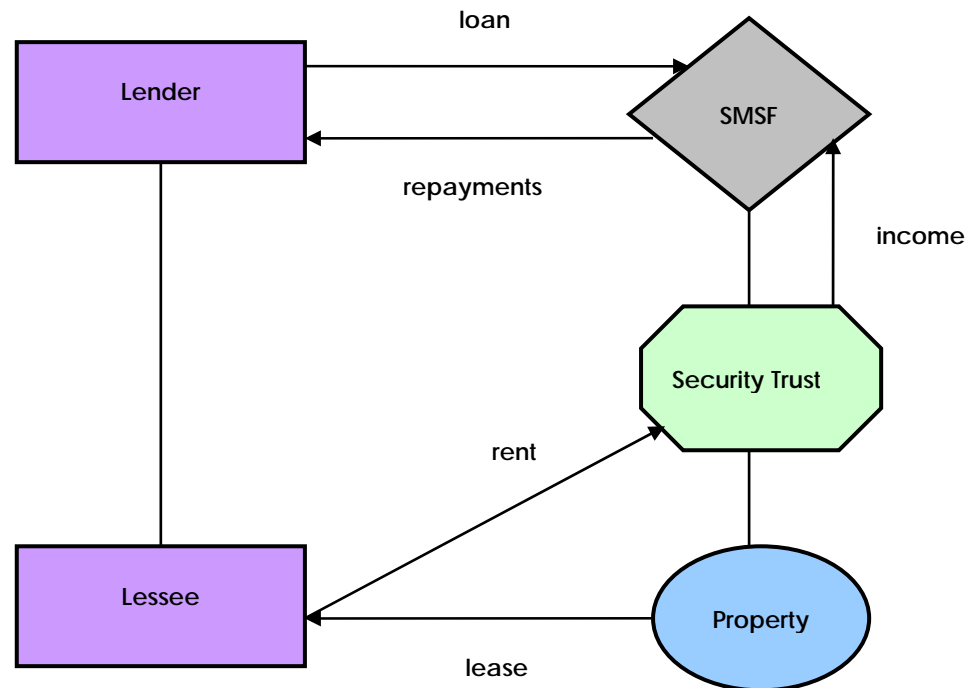
⁴ The Rudd Government changes in the May 2009 Budget whereby they reduced the concessional contributions has only made it harder for high net worth individuals to build assets in their SMSF to fund a comfortable retirement.

⁵ Concessional contributions include superannuation guarantee contributions and salary sacrificed contributions.

⁶ This \$50,000 cap is transitional and only lasts up to the 2011/2012 income year at which time persons aged 50 years or over are pegged back to the lower \$25,000 cap currently applicable to persons aged below 50 years.



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By way of further explanation, a security trust (the instalment warrant trust) must be created. This security trust will have a corporate trustee. The sole absolute beneficiary of this security trust must be the SMSF.

The lender is typically an external financier (e.g. a bank) but related parties can lend money to the SMSF on an arm's length basis. The loan is made directly to the SMSF – it is not made to the trustee of the security trust. The loan must be made on a limited recourse basis – that is, the lender's rights to recover the loan is limited to the commercial property bought under the instalment warrant structure.

The commercial property is owned directly by the trustee of the security trust. The trustee of the security trust would grant a mortgage in favour of the lender over the commercial property, to secure the lender's right to repayment of the loan.

The SMSF, as the sole beneficiary of the security trust, has rights to the property. However, its right to obtain the legal ownership of the property is subject to the lender's right to have its loan repaid under the mortgage.

The trustee of the security trust would then enter into an arms length and market value lease agreement to lease the property – often to a tenant who is a related party to the SMSF. The SMSF is entitled to the rental income derived from the lease and would use it to fund repayments to the lender.

4

The benefit of instalment warrants

Acquiring and holding income producing assets in a SMSF is financially beneficial for both tax and asset protection purposes.

Instalment warrant borrowings allow a SMSF to acquire income producing property which it would not otherwise have funds to acquire. Currently, accumulating assets in superannuation is one of the most tax effective strategies an individual may employ. The tax rates applicable to superannuation investments are:



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- (a) during the accumulation stage⁷ investment and contribution income derived by a complying SMSF is generally taxed at a concessional 15% tax rate and the tax on any capital gain made by the SMSF on a capital asset may be reduced to 10%;⁸ and
- (b) where the SMSF has converted to pension mode, the income derived by the SMSF which is used to fund the payment of a complying superannuation pension is generally tax free and any capital gain made by the fund on asset disposal may be reduced to nil.

These tax rates compare favourably to the 46.5%⁹ tax rate which may otherwise apply where an individual invests outside the superannuation environment.

Business owners and other individuals whose main source of income is not from employment as an employee (i.e. substantially self-employed persons¹⁰) may find an instalment warrant structure of particular interest. This is because they may be able to link the instalment warrant with a deductible personal superannuation contribution strategy. Where this is possible then such a person can make tax deductible contributions to their SMSF which are then applied by the SMSF to pay off interest and loan principal under the instalment warrant.¹¹

Other taxpayers can use salary sacrifice to reduce their tax and increase contributions to superannuation so as to fund an instalment warrant arrangement.

At the end of this article is a **simple worked example** which indicates how an instalment warrant strategy can operate to both reduce tax and to tax effectively build investments in your SMSF.

From an insolvency protection viewpoint,¹² assets owned by a SMSF are generally protected from creditors in a bankruptcy situation provided the assets were not transferred into superannuation with an intention to defeat creditors. Currently there is no monetary limit on the amount of superannuation assets which are protected.

5

Asset restrictions on using instalment warrants

Asset type is regulated

The type of asset which a SMSF may invest in under an instalment warrant arrangement is regulated by both:

- (a) the public trading trust rules in tax law;¹³ and
- (b) superannuation investment rules.¹⁴

Broadly, to ensure that the taxation of the security trust established under an instalment warrant is not adversely affected by the public trading trust rules, investments made by a SMSF using an instalment warrant should generally be limited to investments in:

- (a) real estate for the purpose of deriving rent;
- (b) shares;
- (c) units in unit trusts; and

⁷ This is the period prior to retirement when the SMSF accumulates assets and income to fund the retirement of member.

⁸ Where the asset has been held by the fund for more than 12 months prior to disposal.

⁹ This includes the 1.5% Medicare levy.

¹⁰ Broadly, a person is substantially self-employed for an income year if they satisfy the 10% rule. That is, less than 10% of the person's assessable income, total reportable fringe benefits and salary sacrificed superannuation contributions can be attributable to employment activities.

¹¹ Investment income derived by the SMSF from the asset which is the subject of the instalment warrant and from other investments of the SMSF can also be used to pay the loan interest and principal.

¹² This is a general statement and depends on the particular facts of a given situation including the intention of the subsequently bankrupt member at the time when contributions were made.

¹³ If the security trust is classed as a public trading trust then it will be taxed as a company and this may have serious tax and cash flow consequences for the SMSF's investment.

¹⁴ Contained in the SIS Act and the *Superannuation Industry (Supervision) Regulations 1994*.



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(d) bonds, debentures and certain similar financial instruments,

where such investments do not involve the SMSF being put in a position to control, directly or indirectly, the affairs or operations of another entity that carries on a trading business.¹⁵

Superannuation law contains a number of investment rules which a complying SMSF must adhere to. These rules include the requirement that an investment must be in line with the SMSF's investment strategy and be for superannuation purposes (and thus comply with the sole purpose test). Additionally, a SMSF cannot acquire an asset from a related party, nor can it enter into a lease with, lend to or invest more than 5% of its assets in a related party. There are exceptions from these related party rules for particular types of assets.

Business real property strategy

One important exception to the related party rules relates to business real property. Broadly, "business real property" is real estate which is used wholly and exclusively in one or more business. The business premises of a professional services business or the land on which a factory business operates are examples of business real property.

This exception for business real property when combined with the instalment warrant exception provides business owners with an opportunity to acquire business premises in a concessionary superannuation environment. As such, a business owner's SMSF may acquire business premises and then lease the premises to the business at market rent without breaching the superannuation investment or tax rules. The business can deduct the rent paid to the SMSF as an ordinary business expense and the SMSF would generally be taxed on the rent income at 15%.

Where a business owner already owns its business premises, the instalment warrant exception provides a business owner with an opportunity to unlock funds accrued in their SMSF. This may be of interest where cash flow is required. The business owner may sell the premises to the SMSF at market value without breaching the related party rules and the SMSF can use the instalment warrant exception to fund the purchase. The premises may then be leased back to the business at market rent. Provided certain conditions are met, the tax on the capital gain made on the disposal of the premises may be reduced under a number of tax concessions. Stamp duty and GST will be payable by the SMSF on the acquisition of the property, however, the GST generally can be claimed back as an input tax credit.

6

Borrowing from a related party?

Related party lenders

There are no restrictions on who can lend to a SMSF under the instalment warrant exception. Loan funds may be sourced from a bank or a related party of a SMSF such as a member.

Arm's length requirements

Where a SMSF borrows from a related party then the limited recourse loan and any security over the investment property held by the trustee of the security trust must be on arm's length terms (including an arm's length interest rate) to comply with superannuation law.

Care and specific advice required

Complications can arise if a related party borrows to lend to the SMSF under the instalment warrant arrangement and seeks to claim an allowable deduction for interest paid to its bank for such funding. Provided care is taken it is always possible for the related party, if it is a member of the SMSF, to make

¹⁵ The public trading trust rules contain a detailed list of eligible and ineligible investments. The above discussion is a broad generalisation.
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concessional or non-concessional contributions to the SMSF by releasing on a tranche basis part of the loan used to fund the instalment warrant.

7

Supporting superfund borrowings with personal guarantees

Financiers may require personal guarantees

Since the instalment warrant exception requires the loan made to a SMSF to be limited recourse,¹⁶ a lender may require a personal guarantee from a related party of the fund (such as a member) to support the borrowing. A financier may also require a personal guarantee (sometimes a secured personal guarantee) where a SMSF has inadequate funds to satisfy the financier's loan to value ratio ('LVR') requirements.¹⁷

ATO position

The Australian Taxation Office ("ATO") is currently reviewing the use of guarantees in this context because it is concerned about a guarantor's ability to have recourse to the other assets of SMSF (apart from the asset the subject of the instalment warrant) should the SMSF default on its loan obligations under the instalment warrant. This is because the law operates to make the SMSF liable to pay the guarantor for money paid by the guarantor under the guarantee (that is, the guarantor obtains a right of indemnity for the guarantee payment as against the SMSF). Recourse to the asset which is the subject of the instalment warrant is expressly permitted by the law. It is recourse to the other assets of the SMSF which is the concern.

Our view

In our view, it is possible to overcome the ATO's concern through careful drafting of the guarantee so that the guarantor has no recourse to other assets of the SMSF.

This said, a SMSF should not enter into an instalment warrant arrangement where a guarantee is involved unless there is considerable confidence that the SMSF can meet its loan obligations.

This is because, should a guarantee be called upon by a financier (even if it is carefully drafted as suggested), then in certain circumstances the ATO may consider such a guarantee payment constitutes a further contribution made by the guarantor member to the SMSF.¹⁸ As noted above, contributions to superannuation are capped to set statutory limits in each financial year. If a member's guarantee payment exceeds these limits then the member may be liable to pay excess contributions tax.

It is currently uncertain when the ATO will consider that a guarantee payment constitutes a contribution for tax and superannuation purposes. The ATO has indicated that where a guarantor makes a guarantee payment for a SMSF and foregoes their right of indemnity, then it will consider that the guarantor has made a contribution to the SMSF. However, the ATO does not elaborate on when it considers a guarantor has foregone their right of indemnity. The ATO also has not indicated how it would view a situation where a guarantor makes a guarantee payment but does not insist on a payout of the right of indemnity immediately and instead allows the SMSF time to pay out the right.

In light of this uncertainty and until the ATO clarifies its position on guarantees, the more prudent course of action would be to ensure that the gearing of an instalment warrant arrangement be structured so that it is highly unlikely that a related guarantee is called upon by the financier.

Given the complexity of certain issues related to the provision of third party or member guarantees to support instalment warrant funding, it is recommended you seek expert legal advice from MBP Legal on

¹⁶ Meaning that the financier's legal right to recover its loan on default must be limited to the asset acquired under the instalment warrant – no other recourse may be made back to other assets of the SMSF.

¹⁷ Put simply – the fund may not have enough equity available to put towards the purchase price of the asset being acquired.

¹⁸ Draft Taxation Ruling TR 2009/D3 at paragraph 137. A draft taxation ruling is not a publicly binding ruling, however, it does provide taxpayers with the ATO's current thinking on an issue.



any arrangement that involves the provision of such guarantees. There may be ways of structuring a member's superannuation contributions or the guarantee arrangement to keep within contribution limits which MBP Legal can advise on. Additionally, there are other investment strategies that a SMSF can pursue apart from an instalment warrant where a guarantee is not feasible. MBP Legal can advise on these other strategies if desired.

8

Can the SMSF capitalise interest on the borrowing?

Is it an issue

One requirement of the instalment warrant exception is that the borrowed funds be applied to acquire the asset the subject of the instalment warrant arrangement. Capitalisation of interest raises an issue as to whether this requirement is satisfied.

ATO position

The ATO indicates that it accepts capitalisation of interest in certain circumstances where, broadly:

- (a) the amounts capitalised are costs of the original borrowing (e.g. interest or other charges directly incurred under the borrowing) used to acquire the investment asset; and
- (b) the lender's rights against the fund in the event of a default in repaying the capitalised amounts remain limited to rights relating to the investment asset.

9

Steps to undertake in implement a SMSF instalment warrant structure

Step 1 – Can the SMSF invest in the asset?

If you wish your SMSF to enter into an instalment warrant arrangement then you should first seek advice as to whether superannuation law permits the SMSF to acquire the asset concerned and to enter into an instalment warrant arrangement.

This involves a review of the superannuation investment rules and also a review of your SMSF's trust deed and investment strategy. You should also seek advice that the investment will not cause the public trading trust rules to adversely apply to the security trust in the instalment warrant arrangement.

Step 2 – Documentation to implement instalment warrant

Documentation which needs to be obtained to implement the instalment warrant arrangement includes a security trust deed establishing the security trust, a loan agreement where related party funding is used and a Guarantor Access and Liability Deed between any guarantor, the security trust and the SMSF.

If third party funding is used then it would be necessary to review the loan documents and any guarantees which are required to ensure the loan taken out by the SMSF is limited recourse in nature.

Step 3 – Taxation consequences

The taxation consequences of the arrangement also need to be considered. This includes the capital gains tax consequences of the SMSF's acquisition of the asset under the instalment warrant arrangement (and disposal if a related party is disposing of the asset to the SMSF). Stamp duty on the transfer of the asset from the security trust to the SMSF may be minimised provided certain conditions are met.



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Where the investment asset is real estate then regard should be had to the land tax consequences of the SMSF holding the property and any GST that may arise where the real estate is commercial property and the SMSF leases it out.

Speak to MBP Legal

We can assist in providing advice in relation to superannuation law requirements and the taxation consequences of a SMSF entering into an instalment warrant arrangement. We are also able to provide the required documentation to implement the arrangement.

The instalment warrant exception is not the only way that a SMSF may seek to fund an investment. There are other alternatives including investing as tenants in common with another party or investing with another party using an ungeared entity. We are happy to discuss these other alternatives with you further if you wish. However, depending on the circumstances, the instalment warrant exception may provide the most appropriate investment strategy for a SMSF.

10 Worked Example of a SMSF using instalment warrants

10.1 Assumptions:

- (a) A small to medium enterprise called "Just Surviving" is owned by the Entrepreneurially Cautious trading trust. The working directors of the trustee company are Mr Entrepreneur (53 years of age) and Mrs Cautious (51 years of age) who are also the main discretionary beneficiaries of the Entrepreneurially Cautious trading trust.
- (b) A few years previously, Mr Entrepreneur and Mrs Cautious established a self managed superannuation fund called the "Forging Ahead Superannuation Fund".
- (c) For the relevant year of income, the net business income of the Entrepreneurially Cautious trading trust is \$250K of which \$150K is paid to Mr Entrepreneur and \$100K is paid to Mrs Cautious.
- (d) As working directors Mr Entrepreneur receives an annual salary of \$100K and Mrs Cautious receives an annual salary of \$70K.
- (e) As such:
 - (1) Mr Entrepreneur has potential taxable income of \$250K and would pay 46.5% tax on his income over \$180K – i.e. \$90,550 in tax, and
 - (2) Mrs Cautious has potential taxable income of \$170K and she would pay 41.5% tax on her income over \$80K – i.e. \$55,350 in tax.
- (f) Mr Entrepreneur and Mrs Cautious decide to enter into an instalment warrant arrangement so as to boost their retirement savings. The instalment warrant will be funded through a combination of superannuation fund earnings and salary sacrifice.
- (g) In the 2009/2010 income year they each salary sacrifice such that their total concessional contributions for the year are \$50,000.¹⁹ For Mr Entrepreneur this involves reducing his salary down by \$41K to \$51,000.²⁰ For Mrs Cautious this involves reducing her salary down by \$43,700 to \$26,300.²¹
- (h) The salary sacrifices mean that in total, the Forging Ahead Superannuation Fund receives \$100K in concessional contributions.
- (i) MBP Legal establishes for them an instalment warrant structure including the Cash Cow Security Trust. The sole beneficiary of this security trust is the Forging Ahead Super Fund. The trustee of the Cash Cow Security Trust then acquires commercial real estate premises in Chatswood for \$1M. Under the instalment warrant structure, the Forging Ahead Super Fund borrows \$600K at 8% interest from the bank to fund the balance of the purchase price

¹⁹ Given that they are both over the age of 50 years the annual cap for concessional contributions for them is a transitional \$50k in each income year up to the 2011/2012 income year.

²⁰ This comes about because the 9% superannuation guarantee amount payable on a salary of \$100K is \$9K. This is subtracted from \$50,000 to get to the \$41K figure.

²¹ This comes about because the 9% superannuation guarantee payable on a salary of \$70K is \$6,300. This is subtracted from \$50,000 to get to the \$43,700 figure.



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for the Chatswood premises. The \$400K equity component of the purchase price was funded by cash on deposit that the Forging Ahead Super Fund already had. After funding the equity component the Forging Ahead Super Fund retained \$50K cash in bank.

- (j) This Chatswood premises returns a net rent of \$90K per annum.²² This net rent is assessable income derived by the Forging Ahead Super Fund under the instalment warrant structure. The Forging Ahead Super Fund uses the net rent to cover its interest payments to the bank and repay principal.
- (k) On receipt of the \$100K of concessional contributions from Mr Entrepreneur and Mrs Caution, the Forging Ahead Super Fund decides to repay bank debt in the sum of \$100K.

10.2 **The financial and tax outcomes are as follows**

- (a) A saving of \$19,065²³ personal income tax by Mr Entrepreneur and a saving of \$18,135.50²⁴ personal income tax payable by Mrs Cautious, being a total tax saving of \$37,200.50 for the year.
- (b) The Forging Ahead Super Fund pays 15% contributions tax on the \$100K received – namely contribution tax of \$15K.
- (c) The net tax saved Mr Entrepreneur and Mrs Caution is around \$22,200 (i.e. \$37,200 - \$15,000).
- (d) The contributions tax payable by the Forging Ahead Super Fund is paid from other funds available within the SMSF.
- (e) The principal debt of \$600K owed by Forging Ahead Super Fund is reduced by \$100K from \$600K to \$500K.
- (f) Interest payable by the Forging Ahead Super Fund is reduced by \$8K²⁵ and this allows for the further repayment of principal.
- (g) Essentially the net tax saved by Mr Entrepreneur and Mrs Caution is applied against the \$600K debt.

10.3 **Looking ahead**

- (a) On the assumption that Mr Entrepreneur and Mrs Cautious can afford to salary sacrifice the maximum concessional contribution cap for each of the next 3 years, then over a 3 year period,²⁶ **half of the Chatswood property would be paid off** and deriving a net rental exceeding \$90K per annum.
- (b) Total tax saved would be at least \$66K,²⁷ being a tax saving that has been used to repay the instalment warrant debt of \$600K.

²² The tenant pays all outgoings including land tax on a single holdings basis.

²³ \$41K x 46.5%

²⁴ \$43,700 x 41.5%

²⁵ 8% x \$100K.

²⁶ Note that the \$50k transitional cap for concessional contributions for persons 50 years and over ends in the 2011/2012 financial year.

²⁷ 3 x \$22,200.

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