

SMSF Instalment Warrants – Was it all just a storm in a tea cup?

When the Instalment Warrant provisions were added into the SIS legislation back in September '07, the borrowing principles for Self Managed Super Funds were turned upside down. There was a frenzy of activity amongst financial advisers who had all too often heard the words in the past “the problem with super is we can’t borrow to invest”.

Most thought that there would be a mass of SMSF Trustees lining up to let the gearing commence. Financial providers were racing against the clock to release products. Within weeks there were websites dedicated to this strategy. Investor seminars were being held across the nation and the media soaked it all up. It was quite a storm.

Nine months have passed, and what have we seen? The product providers aren’t going to let on too much about the take up rate, but we get the feeling that the numbers at the moment might amount to more like the rustling of a few autumn leaves.

So why are people not using this strategy? Obviously the bottom line is the key, but first let’s consider some of the other factors:

Investment market confidence has been hit fairly hard in the past 9 months with volatility in the global stock market as well as flattening in property markets. Investors may be sitting back to ride out this volatility before making long term investment decisions.

Market interest rates have been on the rise ever since the legislative change was made. This impacts on investor confidence as the cost of the Instalment Warrant facility appears expensive.

Product offerings started coming out a few months after the legislation was released. The first offerings were un-attractive with high establishment fees, interest rates a couple of percent above standard home loan rates and Loan to Value Ratio’s (LVR’s) around 55%. Product offerings have since improved with interest rates around 0.5% to 1% above standard variable

and LVR’s varying between 55-70%. Some offerings require Member Guarantees which the ATO is not comfortable with (TA 2008/5).

Complexity and set-up costs are a clear barrier to entry. The arrangements require a separate legal custodian (Instalment Trust / Security Trust) to maintain legal ownership over the asset, whilst the SMSF retains beneficial ownership. Legal ownership transfers to the SMSF on payment of the final instalment.

Some of the product offerings provide custodianship within the package and establishment fees are around \$2,500 - \$4,000. Alternatively, if a private arrangement is being contemplated legal assistance would be required at similar costs.

It is generally agreed that the Instalment Trust does not need to prepare financial statements and lodge income tax returns and business activity statements. However, it is critical to ensure that the Instalment Trust is formed prior to entering into a purchase contract and that the execution of the purchase contract shows that the Instalment Trust holds legal title.

The political objective has also been in question. This was one of the last legislative changes passed by the outgoing Liberal Government and many thought that it was rushed through and was far broader than the Government had intended.

Most prudent advisers cautioned investors that they really only intended to legitimise Instalment Warrants for listed securities and the new ALP Government were likely to make changes. There was also a fair amount of Industry lobbying against the new legislation from outside of the SMSF sector.

Many expected to see an announcement on Instalment Warrants as part of the recent Budget but there was nothing forthcoming. The Government is about to undertake a large scale tax review which is likely to include taxation within the SMSF sector. If they remove the tax exemption on income and capital gains on assets used to fund a pension it would seriously impede any financial benefits of this gearing strategy.

Rumours of retrospective legislative change have circulated and they can play a significant part on Trustees' confidence. It is one thing to say that the Government may change the legislation from a date, however retrospective changes which cause SMSF's to reverse borrowings might turn out to be a very costly exercise.

Uncertainty about the scope and the ATO's interpretation of the legislation. The ATO does not make the legislation, they interpret it. Given that the Government's Explanatory Memorandum was focused on Instalment Warrants for listed securities, many believe the ATO will ultimately form a narrow view.

The ATO's National Tax Liaison Group has been reviewing submissions and talking with industry groups. Last month they released on their web site an ATO Question and Answer sheet on Instalment Warrants as well as Taxpayer Alert 2008/5. They accept that the legislative provisions do not restrict investment in any form of asset or the borrowing itself could be from a related party so long as the arrangement:

- is not at less than commercial rates (ATO considers this as a form of contribution);
- is not at more than commercial rates (ATO considers this a breach of the sole purpose test (SIS s62) and/or giving financial assistance (SIS s65.1));
- doesn't allow for capitalisation of interest.
- precludes personal guarantees from SMSF members (ATO wishes to ensure no re-course other than to the asset being financed);
- complies with all other SIS regulations including prohibition from Acquisition of Asset and In-House Asset rules.

Whilst this gives greater comfort, some questions remain unanswered including:

- Vacant land and future property developments - Borrowing to fund vacant land is acceptable but additional borrowing for the future development may not be because it is connected to the land and is therefore not the acquisition of a new asset;
- Loan re-financing - The re-financing is not to purchase a new asset and is therefore questionable if it complies with the legislation.

Stamp Duty implications can be significant. Whilst Stamp Duty law differs from state to state there has been much debate about the implications of transferring the asset from the Instalment Trust to the SMSF on payment of the final instalment. Some propose that stamp duty does not need to

be paid if they never make the final instalment. That may be a short term solution however eventually the asset will be sold, perhaps on death of the members if not beforehand, and stamp duty might be a major financial impediment. Anyone

considering an Instalment Warrant arrangement for real estate investments should seek legal advice.

Existing SIS Legislation and regulations continue to restrict investors. The key ones in play are:

- The SMSF must satisfy the Sole Purpose Test. The purpose of the investment should be for commercial gain in order to provide for the retirement or death benefits of its members;
- The SMSF can't acquire assets from related parties other than listed securities or business real property. Existing residential investments can't be transferred into an SMSF;
- The SMSF can't operate In-House Assets if they exceed 5% of the total fund assets. That restricts these arrangements where the asset is to be rented or leased to a related party.

The Bottom Line – what is the likely after tax benefit?

Measuring the expected net benefit over the long term is a complex task and should be left to professionals with financial modelling experience. This is likely to be an expensive exercise which, in itself, may be the reason why the strategy has not yet been popular.

Let's consider the following case study:

- Jeff is 50 years old and has a personal income of \$100,000.
- He anticipates 4% p.a. salary growth.
- He is planning to buy a property for \$1,000,000 including stamp duty either in his personal name or in his SMSF.
- The lender's rate is 9.5% to Jeff personally or 10% to his SMSF and 55% LVR.
- The rental return in Yr1 is 4% with annual increases of CPI + 0.5%.
- He predicts 10% p.a. capital growth.

Jeff intends to sell the asset after 10 years whilst running a transition to retirement income stream (TRIS) and, therefore, the Capital Gain is tax free.

His comparative position over 10 years is:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Option 1: Do nothing										
Net After Tax Income	72,500	75,500	78,628	81,695	84,883	88,189	91,632	95,209	98,932	102,792
Present Value of After Tax Income	518,691									
Option 2: Invest in personal name										
Net Taxable Income Incl. Taxable Capital Gain	82,750	96,515	105,894	115,934	126,690	138,220	150,589	163,865	178,123	872,421
CGT Free Portion of Capital Gain (50%)										678,974
Tax Payable	(20,341)	(25,544)	(28,659)	(32,119)	(35,839)	(39,850)	(44,162)	(48,809)	(53,813)	(372,122)
Principal Payments on Instalment Warrant Loan	(10,162)	(11,128)	(12,185)	(13,342)	(14,610)	(15,998)	(17,517)	(19,182)	(21,004)	(414,873)
Net After Tax Cash Flow	52,247	59,844	65,050	70,473	76,242	82,373	88,910	95,874	103,307	764,400
Present Value of After Tax Cash Flow	716,671									
Option 3: Invest in SMSF										
SMSF										
Net Rental Income	40,000	43,800	47,961	52,517	57,506	62,970	68,952	75,502	82,675	90,529
Instalment Loan Interest	(64,000)	(54,040)	(52,983)	(51,821)	(50,543)	(49,137)	(47,591)	(45,890)	(44,018)	(41,960)
Capital Gain on Sale of asset										1,357,948
Tax payable (Tax free after TRIS commenced)	0	0	5,889	(104)	(1,044)	0	0	0	0	0
Principal Payments on Instalment Warrant Loan	(10,162)	(11,128)	(12,185)	(13,342)	(14,610)	(15,998)	(17,517)	(19,182)	(21,004)	(414,873)
Net Cash Flow in SMSF	(34,162)	(21,367)	(11,318)	(12,751)	(8,691)	(2,166)	3,843	10,431	17,653	991,644
Present Value of After Tax Cash Flow	324,100									
Jeff's personal position										
Net after Tax Income	72,500	75,500	78,628	81,695	84,883	88,189	91,632	95,209	98,932	102,792
Present Value of After Tax Income	518,691									
Present Value of Combined SMSF & Personal	842,790									

In this case study Jeff is better off making the investment in his SMSF by approx \$126,000 over the 10 year period in present value terms. The primary reason is due to the tax free status of the capital gain when the property is sold.

During the first six years his SMSF needs to fund the negative cash flows perhaps through contributions received. Using this strategy Jeff can maintain his personal after tax income whereas if he makes the investment in his own name he needs to personally fund the negative returns.

Conclusion

The Instalment Warrants strategy may be seen as too hard and risky for many, however for some there may be an advantage. Most of the factors listed above are confidence related and likely to dissipate over time. As industry professionals, we should be doing what we can to help Trustees comply with the legislation to lessen the chances of a turnaround in Government policy.

What we would like to see is well thought out strategic planning considering long term cash flow and tax implications from qualified professionals. On this basis we expect to see a steady growth in the use of this strategy.

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