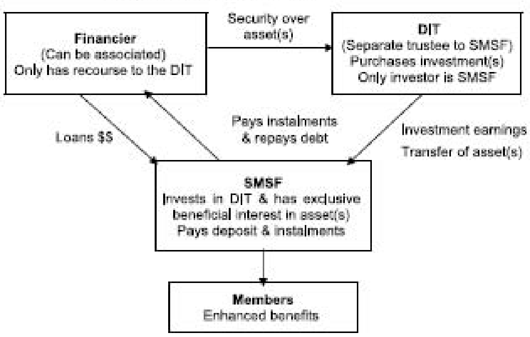
Gearing your superannuation fund

In September 2007 the Government passed new laws that, in effect, allow superannuation funds to use gearing to purchase investments. A superannuation fund (including an SMSF) can now borrow to make investments.

THROUGH THE USE of a special purpose bare trust, which is broadly referred to as a Debt Instalment Trust (DIT), a superannuation fund is now able to use its own cash plus borrowed funds to purchase investments via the DIT. The following diagram illustrates how the DIT would work in conjunction with an SMSF:



Any investment can be made through the DIT that the superannuation fund could have purchased in its own right under Superannuation Law, providing the following conditions are met:

- The trustee of the superannuation fund and the DIT are different entities.
- Any borrowings the superannuation fund makes must be used to acquire an asset in the DIT (or a replacement asset). Borrowings cannot be used for any other purpose.
- The superannuation fund can only deposit cash into the DIT. Existing fund assets (e.g. existing shares and property) cannot be used.
- The superannuation fund must have sole beneficial ownership in the asset(s) of the DIT and the right to acquire the asset(s) outright through the payment of instalments.
- The underlying investments in the DIT must be allowable investments under Superannuation Law e.g. you cannot have 'in-house' assets of greater than 5% of the value of the fund, residential property cannot be let to members

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and/or their relatives and the fund cannot acquire assets from related parties unless they are listed securities, business real property or widely held trusts (managed funds).

- The payment of (and the security over) any liability must be limited to the assets of the DIT and there must be no obligation on the superannuation fund to make any future payments i.e. the financier cannot take security over other superannuation fund assets (the ATO has even suggested that they would not be comfortable with a personal guarantee provided by a trustee).
- If the fund borrows from a related party then it must be on commercial terms e.g. a commercial rate of interest must be charged.

If you do not adhere to these conditions (and any others that may apply) then: interest concessions from related parties could count towards annual contributions' caps and result in penalty taxes, or could be treated as an early release of benefits which could be considered a compliance breach; you could pay capital gains tax (and potentially GST and stamp duty on property transactions) on the transfer of the asset from the DIT to the superannuation fund; or worse still, your superannuation fund could be deemed non-complying by the ATO and taxed at 45% on its income and most of its capital.

It cannot be emphasised too highly how important it is to get professional advice in this area and ensure that your arrangements are set up correctly and you adhere to all the regulations.

Given that superannuation generally cannot be withdrawn, there will be guaranteed cash flow (SGC and other contributions) and relatively low loan to valuation ratios (ratios of around 50% to 60% are being seen from current finance providers in the market) – all responsible gearing practices – DITs can provide some extremely valuable benefits to trustees and members of SMSFs for whom gearing is appropriate.

Examples are provided below of how: 1. An SMSF could purchase a commercial property (potentially a related business could even lease the property from the SMSF) and through the utilisation of gearing (via the DIT) conduct the purchase in a tax-effective manner; and 2. An SMSF could enhance the return it achieves from a portfolio of blue chip shares by utilising gearing.

1. Purchase of a commercial property

Assumptions:

1. You and your spouse are both employees/directors in your family business, and members of your family's SMSF.
2. You would like to purchase a property for $500,000 for use by your business.
3. The property yields 8%.
4. You have a $200,000 deposit and you borrow $300,000.
5. 10% interest is payable on the loan.
6. Your other income places you in the 41.5% tax bracket (including Medicare Levy)

Gearing personally		Gearing through SMSF & DIT	
Income:	$100,000	Contributions:	$100,000
Rent:	$40,000	Rent:	$40,000
Interest expense:	($30,000)	Interest expense:	($30,000)
Tax payable @ 41.5%	($45,650)	Tax payable @ 15.0%	($16,500)
Net funds to pay off loan principal	**$64,350**	Net funds to pay off loan principal	**$93,500**

As you can see in this example, by running the gearing and purchasing this property through their SMSF as opposed to gearing up and purchasing in their own names, these clients have saved themselves $29,150 p.a. or an improvement of 45% over what they could have achieved personally.

You should also note: by gearing personally, this couple will almost certainly pay capital gains tax (CGT) on the eventual sale of the property whereas there may be no CGT payable on the property purchased through the SMSF & DIT, if both members are retired and taking full pensions when the property is eventually sold.

2. Enhancing the return of a portfolio

Assumptions:

1. Dividends yield 4% and are fully franked.
2. 4% capital gains (unrealised).
3. $200,000 current fund balance and $300,000 borrowings.
4. 8% interest is payable on the loan.

Superannuation fund – no gearing		Superannuation fund – geared DIT	
Fund balance:	$200,000	Fund balance:	$500,000
Gearing:	$0	Gearing:	($300,000)
Capital gain:	$8,000	Capital gain:	$20,000
Dividends:	$8,000	Dividends:	$20,000
Interest expense:	$0	Interest expense:	($24,000)
Imputation gross up:	$3,429	Imputation gross up:	$8,571
Gross tax payable:	($1,715)	Gross tax payable:	($686)
Franking credit:	$3,429	Franking credit:	$8,571
Net tax (payable)/refund:	$1,714	Net tax (payable)/refund:	$7,885
Net return:	**$17,714**	Net return:	**$23,885**
Rate of after tax return:	**8.86%**	Rate of after tax return:	**11.94%**

Notes:
a) In this example, the fund's annual return has been improved by $6,171 or 3.08% p.a. compound.
b) The costs to establish a DIT will be in the order of $3,000 or more.

As has been seen in recent months, gearing can compound an investor's losses. However, past experience shows that gearing used prudently within a sound blue-chip portfolio (shares or property), and as part of a properly constituted investment strategy (and reviewed on a regular basis), can enhance performance and provide a vastly superior return to investors (now including superannuation funds). ●