Another step closer to self-funded retirement

If you're a property investor looking to increase the value of your super, new laws could allow you to reach your retirement goals faster. **Pat Mannix**

THE availability of property warrants since September 2007 has enabled active investors saving for their retirement to have direct property as part of their portfolio. A property warrant is borrowing by self-managed superannuation funds (SMSFs) on a limited recourse basis. Previously a property had to be purchased for cash to be included in your SMSF.

In December's API I pointed out the advantages of property warrants and some of the issues with them. They remain an excellent way to increase your property portfolio but in a tax effective manner that can't be matched outside of superannuation.

The ability to save up to 31.5 per cent income tax while paying off loan principal and to have your super fund assets free of capital gains tax (CGT) on retirement provide real cash power to property warrant holders.

This new law may not just be good for individual investors but the population in general.

Both major political parties are mindful of the ageing Australian population and the fact that many won't have enough private super when they reach retirement age. This will become a major national funding issue in the next 10 to 20 years, as the government will have to subsidise baby boomer retirees.

I believe this is the main reason why the current Labor Government hasn't intimated that it will scrap this new law. Property warrants will help investors self fund their retirement – just what the country needs as it gradually turns grey.

This is all good news for property investors and presents opportunities for retirement savings that haven't previously existed, but sorting out the structure of these products and what's allowed and not allowed has taken product offerers and their legal advisors months to decipher.

How it works

The two sections of the *Superannuation Industry Supervision (SIS) Act* that were inserted to enable property warrants, S.67(4A) and S 71.(8), were drafted in a manner that has allowed a number of structures to be established. These structures vary based on how the property is to be funded.

Funds can be accessed for property warrants via a third party bank, an on-lent loan from a bank secured against other assets or a direct loan from a related party.

Because of the different ways of structuring there have been early adopters releasing products that don't comply with these new sections of the *SIS Act*.

In response to this early non-compliance or lack of understanding of property warrants, the Australian Tax Office (ATO) has released *Taxpayer Alert* 2008/5. This is a positive response which alerts both taxpayers and product suppliers that the law has been drafted with flexibility but structures must remain commercial and not contravene areas of the *SIS Act* or *Tax Act*.

With regards to related party advances to an SMSF the arrangement requires monies to be lent at a commercial interest rate. Any other rate used will contravene sections of the *Tax Act* and the *SIS Act*. Clearly a commercial interest rate must be used for related party borrowings to adhere to the law. There's nothing new here.

Capitalisation of interest is a risky financing strategy at the best of times, however in the *Taxpayer Alert* the ATO could deem such practice as contravening the new section 67(4A)(a), which requires the acquisition of an asset. This won't be relevant to many investors looking to further their quest for a large nest egg on retirement because the SMSF's investment strategy will likely view this as too risky a strategy.

Purchasing assets (apart from shares or business real property) from a related party has also been flagged in the alert. Again there's nothing new here for superannuation fund trustees who are aware of their obligations.

So the above potential contraventions of the new laws are only relevant for a minority of trustees and advisors who lack knowledge of the basic tax and superannuation laws.

The final feature that concerns the ATO, and isn't solved by the *Taxpayer Alert*, is the giving of personal guarantees by SMSF members or related parties. The ATO is concerned by personal guarantees that may result in action taken against other SMSF assets apart from the property being financed. For example, if the SMSF has $300,000 worth of assets and $150,000 was used for a 30 per cent deposit plus costs on a residential property then there's

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$150,000 invested in other asset classes. If the fund can't meet its repayment obligations on the property and the financier is forced to sell to recover the debt then the legislation provides that the remaining $150,000 invested in other asset classes is protected.

Clearly the ATO has already found financiers who have drafted their documents so that this $150,000 in other asset classes can be used to make up any shortfall that the financier has after sale of the property. This contravenes section 67(4A) of the *SIS Act* and is clearly in breach.

Most banks offering property warrant financing have drafted their documents to disallow recourse to the other assets of the fund, however this hasn't stopped them from requiring personal guarantees from the members of the fund that bring in the members' other assets outside superannuation.

The big question

This is where we finally come to the question that sent legal advisors delving back into their books – and that property investors are waiting for… does a personal guarantee by a trustee or member contravene the new law?

As previously mentioned, unrelated parties can't have recourse to super fund assets outside of the warranted property, so a personal guarantee must have this exclusion. However it's vitally important that the loan documentation is drafted so that the guarantor doesn't have a right to take legal action against the trustee of the SMSF. If the financiers have covered off on these issues with their loan documentation then indications coming from the ATO are that this will comply.

There are some financiers who don't require guarantees and these institutions offer 100 per cent asset protection and are the trailblazers, however they're charging a higher interest rate and lower loan-to-value ratios.

The doomsayers predict that *Taxpayer Alert 2008/5* is a precursor to the scrapping of the new law. On the contrary, I believe it's the intention of the ATO and the Federal Superannuation Minister that this law is marketed, structured and administered correctly.

The onus will also fall on SMSF auditors to get it right and so higher compliance, education, training and independence may be required for this vital group in protecting SMSF nest eggs.

If the laws are handled correctly by participants it will help with the shorter-term issue of a slowing economy and longer-term issue of providing for baby boomer retirement income. ■

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