HUNT STRATEGIC Advisors

ACCOUNTANTS & TAX ADVISORS

GEARING WITHIN SUPERANNUATION

WHAT YOU MUST KNOW BEFORE USING BORROWING IN YOUR SUPER FUND

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1. Introduction

Used correctly, gearing or leveraging and the use of borrowing can significantly boost the returns from investments in super funds.

However, for many years, the authorities discouraged the use of leverage in super funds which was only allowed in highly restricted circumstances.

This all changed in September 2007 when borrowing by super funds was explicitly permitted in a change to the SIS Act.

However, a number of issues arose in the operation of the new provisions and there was a further change to the legislation in July 2010.

This special report takes a look at the new legislation and the opportunities it offers to super fund investors the new legislation provides greater clarity for investors BUT there are a number of potential traps that could cause problems and investors MUST be aware of these issues before entering in to any borrowing arrangements through a super fund.

This Special Report covers:

- The case for using leverage and borrowing by super funds
- The different ways super funds have been able to take advantage of leverage
- The background and history of the use of limited recourse borrowing by super funds
- The new law and its application
- Practical considerations

Armed with the information in this report and with the appropriate professional advice, investors will be able to make informed decisions about the use of leverage in their own superannuation funds.

2. The Case for Super Funds to Use Borrowing and Leverage

The basic principle behind the use of leverage (or gearing) to boost investment returns is simple.

Provided the total return on the assets purchased exceeds the cost of borrowing (taking into account costs and tax effects), then an investor will gain by borrowing funds to use for investment.

On the other hand, if the cost of borrowing exceeds the return achieved on the assets, then the investor who uses borrowed funds will end up worse off.

Leverage therefore magnifies both gains and losses in investment returns.

2.1 The best assets to use with leverage

For an investor to benefit from the use of leverage, it’s essential that the total return on assets exceeds the cost of borrowing. The investments that are most suited to leverage are those with the highest expected returns. Historically those investments are equities and property.

Now investments that have higher returns, such as equities and property, are usually the most volatile over the short term. However, many financial studies have shown that over the long term the volatility of these asset classes is reduced significantly.

As a result the ideal situation in which to use leverage is:

(i) With assets expected to deliver high returns

(ii) Where those assets are held for the long term

2.2 Why using leverage for superannuation investment makes sense

Superannuation is perhaps the classic case of a long term investment situation and hence is well suited for the use of leverage and borrowing to boost investment returns.

Firstly, superannuation preservation rules mean that for most investors, superannuation is a long term investment. The length of investment period is a function of the member’s age and the period before which benefits can be withdrawn.

In practice, even members who have commenced receiving their benefits by way of pension, will have a relatively long investment time horizon. For example, a member who commences receiving a pension at the age of 60 has a life expectancy of 21.66 years for a male and 25.44 years for a female.

So, it may be appropriate for these investors to consider leveraging part of their portfolio so long as their risk appetite can withstand the additional volatility created by leverage and they have considered cash flow in a variety of market conditions.

One other point to bear in mind is that because of the preservation rules (which mean that superannuation investments cannot be accessed until retirement, except in extreme circumstances), investors are obliged to adopt a long term investment horizon and so are much better able to handle short term volatility.

In contrast, if an investor holds leveraged investments outside of superannuation, adverse short term volatility may force them to abandon the strategy and sell assets at a loss.
So, there is a strong case for the strategic use of gearing within superannuation.

Of course, due consideration needs to be given to factors such as:

- Cash Flow - Ensuring sufficient cash flow to meet interest and principal payments, income tax liabilities and pension payments.
- Fluctuating investment returns caused by factors such as tenants leaving a rental property or investment markets in general.
- Meeting the prudential and taxation regulation requirements.
- The age of the member and time to retirement.
- The risk profile of the investor and their ability to withstand large fluctuations in their investments and remain focused on a long term outcome.

3. The Different Ways to Take Advantage of Leverage in Superannuation

There are a number of ways to leverage investments in superannuation funds under current legislation.

(1) The first method is by investing in publicly listed companies which borrow to finance their investments and operations. By investing in these companies a superannuation fund accesses the power of leverage.

(2) The second method is by investing in widely held unit trusts which in turn borrow to invest. Some managed funds and property trusts borrow to invest in a variety of assets.

These investments meet the prudential regulations found in the Superannuation Industry Supervision Act 1993 (“SIS”) as long as they meet the sole purpose test found in the SIS and are in accordance with the trustees investment strategy.

(3) The final method is where a superannuation fund borrows money directly from a lender for investment purposes. This method was introduced in the SIS Act in 2007 but was changed as of July 2010 and is discussed in detail over the remainder of the paper.

4. Limited Recourse Borrowing Arrangements and Superannuation

4.1 The situation prior to September 2007

Until 24 September 2007, Section 67 of the SIS Act provided a prohibition on borrowing by superannuation funds except in specific circumstances.

These circumstances include:

- Borrowing for the purpose of meeting benefit payments or surcharge liabilities. In this case, the maximum value of the borrowing is 10% of the fund's assets and the maximum term is 90 days.

- Borrowing for the purpose of settling securities transactions. The amount of the borrowing can again be 10% of the value of the fund's assets however the terms of the borrowing can only be for a maximum of 7 days.

Additionally, both the Australian Prudential Regulation Authority ("APRA") and the Australian Taxation Office ("ATO"), as regulators of the superannuation industry, had previously formed the view that instalment receipts, for example to purchase Telstra shares, did not involve a borrowing by superannuation funds.

They did this via the guidelines found in *Superannuation Circular No.11.D*4 and in their *Guidelines on Instalment Warrants for Trustees*. Essentially they found that where endowment warrants or instalment receipts did not require the payment of the remaining instalments, the warrant or receipt did not constitute a borrowing.

However the situation changed in November 2006 when the Government announced that instalment warrants did contain an element of borrowing and were therefore prohibited.

4.2 Borrowing allowed by super funds from September 2007

In order to rectify this situation, the Government sought to amend the legislation to ensure that instalment warrants do not breach the prohibition against borrowing and introduced subsection 67(4A) of the SIS Act.

Following is a summary of the key features of subsection 67(4A) of the SIS Act:

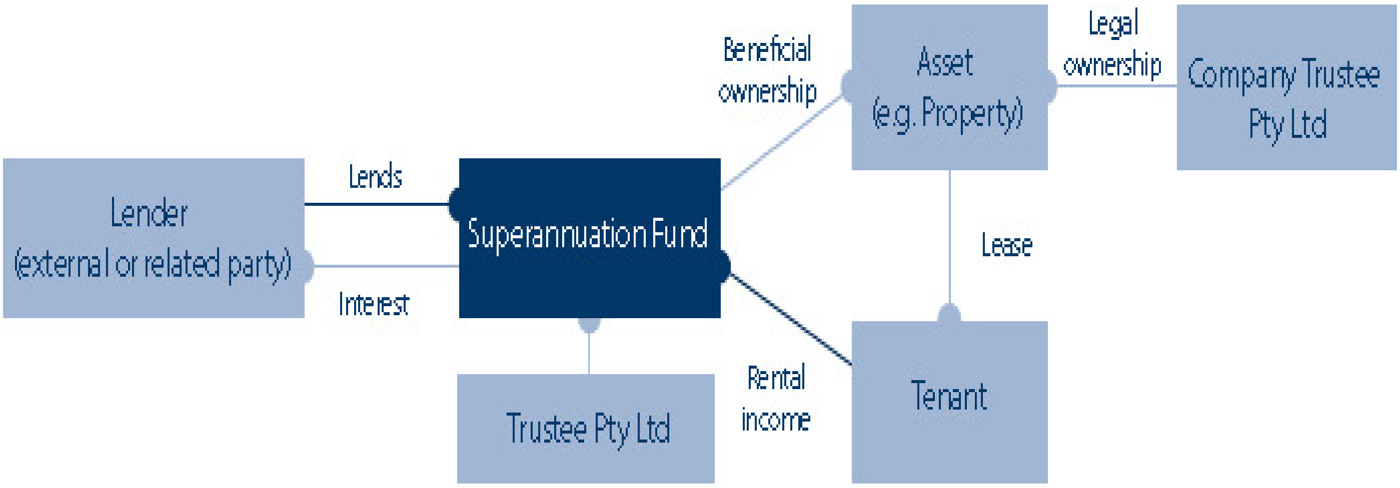
'An exception to the prohibition on borrowing in section 67 of the Superannuation Industry (Supervision) Act 1993 will allow a superannuation fund trustee to borrow money in accordance with an arrangement that has the following features:

- *the borrowing is used to acquire an asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right to acquire legal ownership of the asset (or any replacement) through the payment of instalments;*

- *the lender's recourse against the superannuation fund trustee in the event of default on the borrowing and related fees, or the exercise of rights by the fund trustee, is limited to rights relating to the asset; and*

- *the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly.'*

Diagrammatically these legal relationships are set out below:



In terms of the assets which may be acquired under the SIS legislation, generally this includes assets such as:

- Commercial / Industrial Property
- Residential Property
- Listed and unlisted shares
- Managed Funds
- Some Exotic Assets
- Cash

4.3 Borrowing in practice 2007-2010

Following the introduction of Section 67(4A) many super funds took advantage of the new flexibility and ability to borrow and use leverage.

The authorities kept a close eye on how super funds used leverage and a number of issues and concerns emerged.

Firstly, the Government acted to clarify the tax treatment of instalment warrants, a popular investment choice for many individual super funds.

In March 2010 they released a paper called *Income Tax Treatment of Instalment Warrants – Proposal Paper*. The proposals put forward made it clear that the investor, that is the superannuation fund, would be assessed on a "look through basis" and income and gains would not be taxed to the trustee.

This announcement provided clarity to superannuation investors although at the time this Special Report was written (November 2010) no proposed legislation had been drafted.

There were also a number of other concerns:

- The use of personal guarantees to underwrite the lender's risk and the potential for other assets of the fund to be available to the guarantors in the event of default.
- Borrowing arrangements over multiple assets which can potentially allow lenders to choose which assets are sold in the event of default.
- Arrangements where the asset subject to borrowing can be replaced at the discretion of a superannuation fund trustee or lender.

As a result of these concerns, the government repealed Section 67(4A) on 6 July 2010 and replaced it with Section 67A and 67B.

5. The Situation Today - New Law: Sections 67A and 67B

5.1 Pre-existing arrangements

Importantly, any borrowing arrangements put in place before 7 July 2010 will be subject to the former rules unless on or after 7 July 2010:

- The debt is refinanced;
- The borrowing arrangement is substantially changed;
- The borrowing is inconsistent with the original (pre 7 July 2010) arrangement. For example, to buy assets not envisaged under the original agreement, or
- The structure is effectively sold so that there are new beneficiaries.

5.2 Acquirable asset

As with the previous provision, any asset acquired with borrowed funds must be an asset which is permitted to be owned by superannuation law.

This means that:

- assets cannot be acquired from members or related parties (except for business real property and listed securities for example);
- must not fail the in-house asset rules;
- must meet the sole purpose test;
- be in accordance with the investment strategy; and
- on an arm's length basis.

As before, this means the following types of assets can be purchased by super funds:

- Commercial / Industrial Property
- Residential Property
- Listed and unlisted shares
- Managed Funds
- Some Exotic Assets
- Cash

It is important to note that the funds must be used to acquire an asset. Therefore, it is not acceptable to merely borrow funds in order to free up cash.

Once these requirements are met it is possible that the asset could be leased to a related party, assuming it is business real property, and it could be owned as tenants in common with another party.

5.3 Assets must be held on trust

The requirement for the asset to be held on trust remains and there is no change from the previous legislation.

The effect of this requirement is that the asset is effectively quarantined from the other assets held by the trustee of the superannuation fund. This structure is important in limiting the lenders recourse in the event that the fund defaults on the loan.

5.4 Single acquirable asset

This new rule creates additional restrictions on the "asset" that may be purchased with borrowed funds.

The new rules stipulate that the borrowed funds can only be used to acquire a single asset or a collection of identical assets. Examples of a single acquirable asset include:

- Title to a specific property, however, acquiring related rights to a storage facility or car parks under separate title would not be permitted to be funded by the same borrowing;
- A collection of economically equal and identical commodities, for example, gold bars;
- A number of identical units in a single unit trust. Each unit must have the same rights and belong to the same class;
- A number of identical shares in a single company. The shares would also need to have the same rights attached and be of the same class.

This concept has important implications for the structuring of the borrowing and investments as it means that each stock line (for example) would need to be under a separate arrangement. This is a departure from the previous position where it was considered that a portfolio of shares in different companies, several properties or combinations of assets could be held under a single borrowing arrangement.

Additionally, the "single acquirable asset concept" is used in the new rules to require a collection of identical assets to be dealt with as a single block. The legislation provides the following example:

"A collection of shares must be acquired and disposed of as a collection and could not, for example, be sold down over time."

The rationale behind these changes is:

"Borrowing arrangements over multiple differentiated assets could expose superannuation funds to greater risk than if a trustee took out a number of discrete loans, each relating to, and only enforceable against, a single asset."

The legislation doesn't take into account that shares are not always purchased or sold in one lot and may be acquired and sold down throughout a day or over a number of days depending on the liquidity of the stock.

Hopefully the legislation will be administered in a practical way which would allow a reasonable period for acquisition and sale of one "collection". However, further clarification by government is required.

5.5 Associated costs

The new rules confirm that the borrowed funds may be used to finance costs associated with:

- The borrowing – e.g. bank fees, stamp duty;
- The acquisition – e.g. conveyancing fees, stamp duty, brokerage;
- Maintaining and repairing the asset (but not improving it).

One of the important changes under the new rules is that improvements to an asset, for example a property, cannot be made out of borrowed funds. The legislation does not, however, prevent improvements being made to the property out of the fund's other cash reserves.

5.6 Replacement assets

Section 67B permits the replacement of one asset for another in limited circumstances:

- Mergers, takeovers and acquisitions – for example, where shares in one company are replaced by shares in another company;
- Restructures – for example, where shares in one company are converted to new shares.

The only assets which are capable of being replaced in accordance with this provision are:

- Shares;
- Units in trusts;
- Instalment receipts.

Other assets, such as property, are not able to be replaced with a similar asset under the borrowing arrangement. Further, the legislation provides examples of circumstances which are not permitted under the replacement asset rules. These include:

- *Securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy;*
- *Money or cash is not eligible as a replacement asset under any circumstances: -Includes circumstances where the original asset would otherwise be replaced with an eligible replacement asset plus cash for example shares in X Ltd replaced by shares in Y Ltd and a pool of cash as a result of a takeover of X Ltd by Y Ltd;*

- *Replacement asset arising from an insurance claim covering the loss to the original asset;*
- *The replacement by way of improvement of real property;*
- *A series of titles over land replacing a single title over land that has been subdivided; and*
- *A replacement of a title over real property as a result of Government action such as the resumption of all or part of a property or re-zoning.*

These restrictions are likely to cause great difficulty to trustees because it is difficult if not impossible to predict future circumstances and what may happen with particular assets.

For example, if a fund purchased shares in Rio Tinto and it was the subject of a takeover offer from BHP which included an offer of both scrip and cash, the trustees could not accept such an offer under the borrowing arrangement and would need to either sell the shares in the market or pay out the loan with other available funds. This would be very unsatisfactory from a portfolio management point of view.

Also, the inability to use insurance proceeds to fund a replacement asset is likely to cause problems.

This imitation would cover the loss of assets such as shares or units (as a result of fraud, for example) and their replacement being purchased from insurance proceeds received.

It would also mean that if a property was damaged by fire and the building was “improved” by using better materials with the insurance proceeds, this would not be allowable under the borrowing arrangement.

These areas require further clarification and perhaps changes by the government in order to provide trustees with greater clarity and the ability to make such investments.

5.7 Limited recourse for lenders

The title of Section 67A is Limited Recourse Borrowing Arrangements. This clearly identifies one of the main conditions for a superannuation fund to borrow money.

Both the new and old provisions limit the lender’s recourse to the asset acquired under the borrowing arrangement. However, the new rules specify that any third party guarantors must limit their rights by agreeing to only pursue the asset which is the security for the borrowing. This means that the other assets of the fund will not be available to the guarantor.

5.8 Refinancing

Borrowings may be refinanced, however, any borrowing set up under the former provision, Section 67 (4A), will fall under the new provisions after refinancing.

5.9 Borrowing from related parties

Related party lenders are permitted under both the former provision and the new provisions, however, it is important that the borrowing is maintained on an arm's length basis.
In order to satisfy this test the terms and conditions of the loan must be similar to that found in the market or that would be negotiated between arm's length parties. It may be difficult to find a direct comparison.

However, it is important to ensure that the terms are not more generous to the lender and risk the fund providing financial assistance to members or relatives.

Commercial or arm's length arrangements would often take into account:

- Interest rates – set after considering the limited recourse nature of the loan;
- Timing and regularity of interest and principal payments;
- Termination or default conditions.

6. Practical Aspects of Borrowing by Super Funds

The following are some of the practical considerations to take into account when considering the use of borrowing and leverage in a superannuation fund:

1. Check that the superannuation fund deed allows the borrowing and have it upgraded where necessary;

2. The trustee, which has legal title to the property, can be any legal person but must be different to the trustee of the fund. An individual could be a trustee for these purposes;

3. The trustee must be shown on all documents as the legal owner, for example, property title, lease documents;

4. There is no need for a separate TFN or ABN for the trustee as it is treated as a bare trust for tax purposes;

5. There needs to be a trust deed governing the arrangement. These cost anywhere between $500 and $1,000;

6. Be careful not to reinvest dividends under the one borrowing arrangement;

7. Keep records sufficient to detail the assets acquired in one collection;

8. Many of the major banks have tailored products available for these loans;

9. Draft a new investment strategy to include the investments made and the borrowing;

10. Shares and business real property may be purchased from members under such a borrowing arrangement although arm's length prices and conditions must be used;

11. If purchasing property ensure that all properties are on one title and do not acquire other assets such as furniture under the same borrowing arrangements;

12. Careful consideration of the current and future cash flows is required taking into account factors such as the loss of tenants, non-payment of dividends, higher interest rates and the stopping of contributions;

13. The Cooper review recommended the Government review the borrowing rules after two years and therefore there may be further changes.

7. Potential Traps and Problems for Super Funds Using Borrowing

As highlighted in previous sections, the main areas where problems are likely to arise when super funds use borrowings are:

1. The single acquirable asset concept

The consequence of this is that when borrowing to invest in shares, for example, the loan for each line of stock needs to be under a separate arrangement. It's no longer possible to use a single loan to fund a portfolio of shares (or other assets).

2. Restriction on the use of insurance

This means that insurance proceeds cannot be used to fund replacement assets and that any related borrowing arrangements may need to be unwound.

3. Limitation on improvements to real property

One of the most likely uses of borrowing by super funds is to purchase real estate. Often, the owner of real estate will wish to protect and enhance the value of the investment through improvements to the property.

The use of borrowed funds for improvements is not permitted under the current legislation.

4. Restrictions on replacement assets

The only assets capable of being replaced by other assets under the same borrowing arrangement are shares, units, trusts and instalment receipts.

Note that these problems are not insurmountable. However, they are cumbersome to deal with and may have adverse tax consequences as well as involving additional expense and time to deal with.

8. Summary and Conclusions

Leverage within superannuation can be a powerful strategy to provide greater retirement benefits over the long term. As with any form of borrowing, the investor must be sufficiently sophisticated to manage the additional volatility caused by investing with borrowed funds.

As discussed, there are a number of methods available to gain access to leverage which include simpler methods, such as purchasing public company shares, or the more complex method of the fund borrowing directly. If the fund is to borrow directly, careful planning and experienced professional advice is required to ensure the new rules within Section 67A and 67B are complied with.

'To find out more about how Hunt Strategic Advisors can help you use leverage in superannuation the right way, simply call 1300 347 952 and ask for David Hunt.

About David Hunt

David Hunt is a Chartered Accountant and Fellow of the Taxation Institute of Australia. He has a Bachelor of Business degree majoring in accounting and a Master of Taxation degree from Sydney University where he obtained a distinction average.

David commenced his career at Industrial Equity Limited (IEL) in the 1980s and worked in the accounting division of Chase Manhattan Securities in London before completing his undergraduate degree and commencing with Peter H Hunt & Associates (renamed Hunt Professional Group) in December 1992. He became a partner of the firm on 1 July 2000 and acquired majority share of the firm by 2007. David has since gone on to form Hunt Strategic Advisors.

David’s significant experience and expertise are in the following areas:

- Tax effective business structures
- Capital gains tax
- Employee share schemes
- International taxation
- Family business advising
- Self-managed super fund gearing
- Superannuation and retirement planning
- Estate planning

Often sought after for press commentary on current taxation matters, David has spoken on numerous occasions as the key note speaker to audiences as private bankers, lawyer associations and member based organisations.

David is advisor and confidante to some of the most senior executives in Australia and is highly regarded by many institutions and small to medium enterprises and associations.

David is happily married with three children. His interests include all sport, particularly rugby, rugby league, golf and tennis.