Count

SMSF Strategy

Borrowing to invest with your SMSF

what you need to know

Many investors borrow to invest. But did you know that Self Managed Super Funds (SMSFs) are also able to borrow for investment purposes? This means that your SMSF can borrow to acquire assets that it may not otherwise be able to afford, such as commercial and residential property. This handy guide gives you the information you need to know about borrowing to invest with your SMSF.

What are the advantages of borrowing to invest with your SMSF?

- Provides the ability to invest in high cost assets such as commercial and residential property.
- Increases the amount you are able to invest which in turn maximises your potential investment return. However you should remember that borrowing also increases any potential losses and may not be appropriate depending on your circumstances and risk profile. Speak to your adviser for more information on whether a borrowing to invest strategy is appropriate for you.
- If a commercial property is purchased the property can be leased back to members of the SMSF (at market rate) to use in their business.
- You may have the ability to pay back the loan sooner as pre-tax superannuation contributions (which are used to pay off the loan) generally have a lower rate of tax than the tax paid on your income. However, annual limits apply to superannuation contributions.
- Any income or capital gains earned from the asset will be taxed at the SMSF's concessional tax rate. If the asset is used to pay a retirement phase income stream, any income or capital gains will be tax-free.

Are there any disadvantages?

Lower tax rates inside super means an SMSF will generally get less value for its interest deductions than if the members borrow personally.

Due to additional legal structures required, the cost of setting up a loan in your SMSF is generally more than the cost of establishing a loan in your own name. The cost to establish a super borrowing arrangement can vary depending on your circumstances, the asset's characteristics and the amount of advice required.

These additional costs should be factored in when assessing whether it is better to borrow in your SMSF or in your own name. You should also consider the usual transaction costs such as legal fees and state government stamp duty.

Let's look at how it works – a case study

Martin and Ruth are married and together they have an SMSF. They run a successful small business and would like to use their SMSF to buy the commercial premises by borrowing to invest. They then plan to lease the property at commercial rates from the SMSF to use in their business.

Property purchase cost	$650,000
Loan required	$200,000
Annual employer contributions (paid from their company)	$25,000 (combined)

How the strategy works

Martin and Ruth arrange for their SMSF to borrow the required $200,000 from their bank through a special limited recourse borrowing arrangement. The property is purchased and held on trust for the SMSF through a separate holding trust. The SMSF is then entitled to all of the rental income generated from the property and any interest payable on the loan is tax deductible to the SMSF.

Outcomes

	Year 1	Year 2	Year 3
Loan outstanding	$200,000	$171,780	$140,762
Rent received	$26,000	$26,780	$27,583
Employer Contributions	$25,000	$25,000	$25,000
Interest payable	$17,800	$15,288	$12,528
Tax payable	$4,980	$5,474	$6,008
Principal repayments[1]	$28,220	$31,018	$34,047
Loan balance	$171,780	$140,762	$106,715

- Martin and Ruth have been able to use their super to acquire a commercial property that they can lease back to themselves to use in their business.
- Concessional superannuation tax rates means their SMSF has excess cash flow in Year 1 of $28,220 which can be used to repay the loan.
- By using their SMSF, they can afford to pay off the loan in less than six years.
- The rent Martin and Ruth pay to their SMSF plus any future capital appreciation of the property will go towards their retirement.
- Once the loan has been repaid the legal ownership of the property can be transferred from the trust back to the SMSF at market value. Capital gains tax and stamp duty concessions generally apply to this transfer. Please speak to your adviser for more information.

Case study assumptions: Interest rate of 8.9% secured on commercial property, rental yield 4% in year 1 indexed by 3% each year, superannuation tax rate of 15% applied net of interest deductions.

1 Principal repayments = surplus cash flow after taking into account tax of 15% on net rent and employer contributions.

What you need to know before you get started

Criteria for borrowing within an SMSF	For the trustee of an SMSF to be permitted to borrow for investment purposes the borrowing must be set up under an arrangement that satisfies certain criteria. These include that: • the loan is used to purchase an allowable asset under the super investment rules • the loan is set up on a limited recourse basis so that the lender's recourse is limited to the asset acquired with the borrowing • the legal title of the asset is held on trust for the SMSF until the loan is repaid • the SMSF is the beneficial owner of the asset and can request legal ownership of the asset be transferred back to the fund once the loan has been repaid. Under this type of arrangement the SMSF is generally entitled to any income generated by the asset, which could then be used to help repay the loan. The SMSF will also get the benefit of any change in value of the asset.
What assets can be purchased?	In general, borrowing can be used to acquire any single asset that a trustee is not otherwise prohibited from purchasing. The only requirement is that the asset must be a single asset, such as: • a block of land on a single title • a collection of shares of the same class in the same company • a collection of units in a unit trust. Where the asset consists of multiple assets, such as a portfolio of different shares or a number of properties on multiple titles, a separate borrowing arrangement will generally be required for each separate asset. For more information on what assets can be purchased with a borrowing arrangement, please speak to your financial adviser.
Key risks of a borrowing strategy	**Investment risk** Borrowing to invest increases potential losses as well as gains. There is a risk that you are not able to service the loan which would result in the strategy having to be reversed and you losing money. Trustees should therefore ensure that a borrowing to invest strategy is appropriate given the fund's circumstances and risk profile. **Legislative risk** The Government has committed to review the use and take up of superannuation borrowing rules. Therefore, there is always the risk that the Government could amend the rules to restrict the ability of trustees to undertake certain borrowing activities in the future.

How your financial adviser can help

If you're interested in borrowing to invest within your SMSF, speak to your financial adviser. They can help in a number of ways including:

- Providing advice on the suitability of setting up a borrowing arrangement in an SMSF and the types of assets that can be acquired under a borrowing arrangement.
- Reviewing and updating the SMSF's existing investment strategy.
- Facilitating the review of the SMSF's trust deed and establishment of the required trust structures and arrangements.
- Reviewing the SMSF's insurance needs, given that it now has outstanding liabilities that may need to be insured to protect against loss in the event of the death or disablement of a member.

Speak to us for more information

If you would like to know more about self managed super funds and their borrowing arrangements, talk to your Count Financial Adviser. They can give you more detailed information on the best approach for your situation.

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