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and Property Strategies.*

# *GUIDE TO SELF-MANAGED SUPER FUND BORROWING*



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## NO ADVICE WARNING

The information in this eBook is of a general nature only. This information was prepared without taking into account your personal circumstances and goals. You **should not** rely on or act on information provided in this eBook without seeking advice from a qualified financial planner. Frontier Wealth Group and related entities will not accept responsibility for any loss suffered as a result of reliance on information contained in this eBook. The information provided does not constitute a Statement of Advice.



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## Letter from us

Dear Reader,

We are delighted to provide you with a free copy of this eBook and hope that you will find it very useful.

At Frontier Wealth Group, we believe in empowering you with the information you require to make sound and reasonable decisions about your wealth and financial future.

As an investor, the structure you choose to own your investments affects the ongoing income generated by your investment as well as terminal taxes paid through the capital gains taxation system. As a result, superannuation ownership has become an effective way of holding valuable income and growth assets. The interest in superannuation asset ownership and borrowing has, broadly speaking, increased since changes to superannuation laws in September 2007 and subsequent amendment in 2010. This means that, as long as certain conditions are met, superannuation funds can borrow to invest in virtually all asset classes available to individual investors.

This complimentary eBook provides you a basic set of information that you will find helpful as a starting point in exploring this seemingly green and growing area of investment. The guide provides general information about a superannuation fund; the purposes of it, Self-Managed Superannuation Fund (SMSF) and borrowing arrangements. It is not intended to substitute tailored and personalised advice. The reader is therefore strongly encouraged to seek professional advice tailored to their situation.

Should you require advice, please contact us. Our in-house Certified Financial Planners™ and Chartered Tax Advisers™ work as a team, to help you optimise your future financial outcomes.

Have a great day and we hope to talk to you soon.

Best regards,



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Private Wealth Adviser

Frontier Wealth Group



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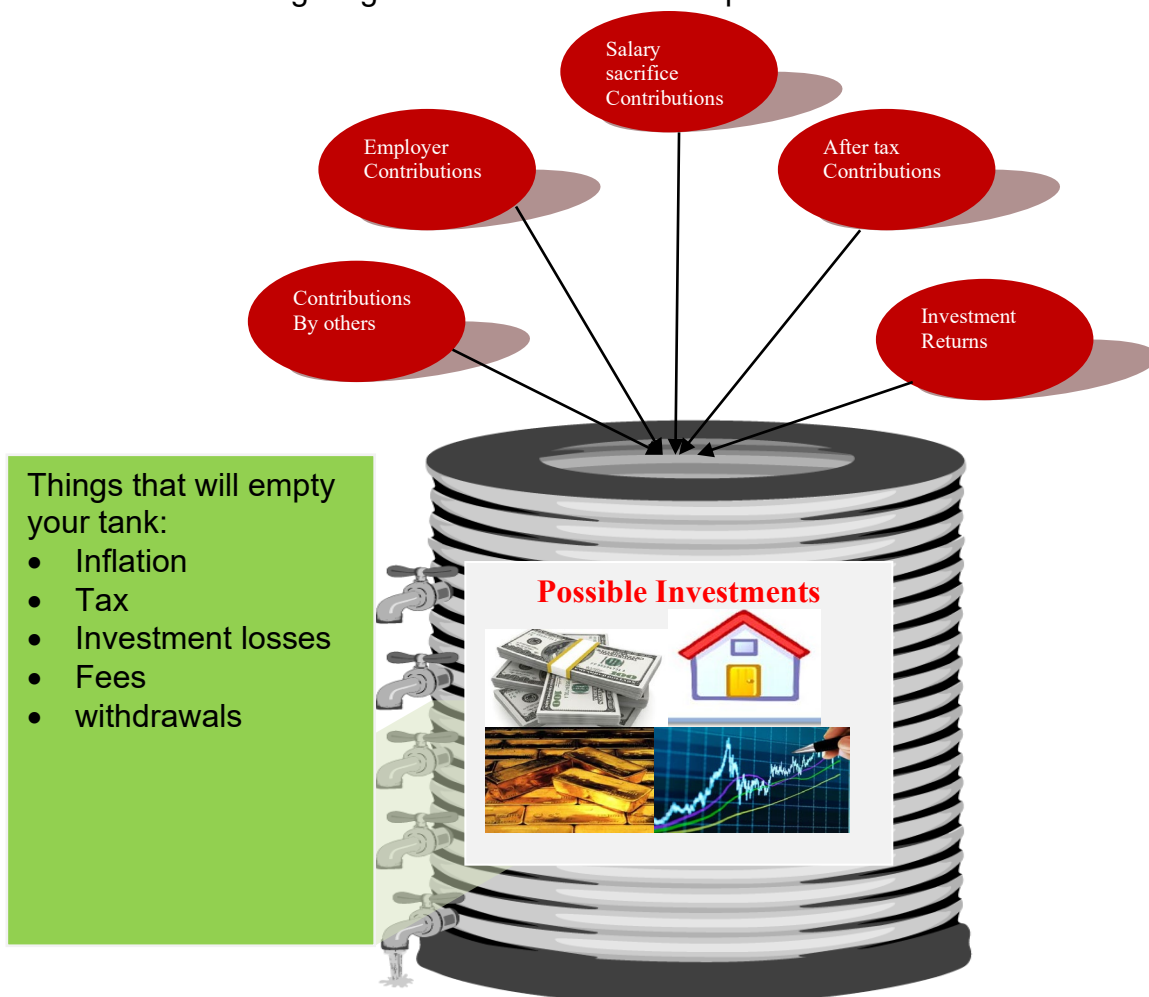
## What is a super fund?

Many people think that superannuation (super) is in itself an investment. This is not the case, super is an account into which money can be contributed, and invested on your behalf to fund your retirement and/or provide death and disability benefits to you and your loved ones when you reach retirement age or suffer the unfortunate event of death or disability.

Contributions into a superannuation account can come from one of three sources:

- You, the investor,
- Your employer,
- The Australian Taxation Office (e.g super co-contribution), and
- Someone else (e.g your spouse)

The following diagram illustrates the concept.



As an investor, the best way is to imagine your super as a rain tank. Your challenge is to fill up the tank as much as possible for a “rainy day”; your retirement. Contributions and returns made on them help to fill up your super tank. On the other hand, losses, fees and withdrawals detract from the tank.



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How your super is invested entirely depends on you, the account owner. Where you fail to make an investment election, the trustee of the fund will decide on your behalf by investing your capital in the fund's default investment strategy, usually a premixed portfolio depending on your age.

It is also important to note that superannuation funds are set up as trusts, wherein someone called the trustee, holds your benefits in trust until you meet a condition of release. With very limited exceptions, you do not meet a condition of release until you retire at your preservation age.

## Taxation of superannuation

Taxation laws apply to superannuation funds in as much the same way as they apply to individuals or companies, but at concessional rates. This means that the fund pays tax on its net income after expenses just like individuals. The income of a superannuation fund includes interest income; dividends; distributions from managed investments and rental income if the fund invests in property. However, the definition of the income for super funds is extended to include contributions made to the fund. These contributions, broadly speaking, can come either from a pre-tax source, like those paid by your employer, or an after tax source, like those paid by you from your bank account. If the contributions are funded by pre-tax money, they are referred to as "Concessional Contributions". On the other hand, if funded by after tax money, they are called "Non Concessional Contributions".

Concessional contributions pay tax at a maximum rate of 15%. Non concessional contributions by their nature are paid into a super fund after paying a marginal rate of tax at the individual level. Therefore, upon contribution to the fund, they are not subject to the super contributions tax.

## What is Self-Managed Superannuation Fund (SMSF)?

In a nutshell, Self-Managed Superannuation Fund (SMSF) is a superannuation fund run by members for their own benefit. As such, it provides members greater control over their retirement savings than any other superannuation fund. A SMSF has the ability to invest in assets like bank deposits, fixed interests, direct shares, managed funds, property trusts, direct property and more. Their ability to pay retirement benefits, such as pensions and annuities directly from the fund means that the SMSF can be retained well into your retirement. This then provides the flexibility to determine the timing of disposal of growth assets during the pension phase when they are generally **exempt** from CGT provisions - a strong tax planning proposition.

Like any other superannuation funds, SMSFs must be established for the sole purpose of providing benefits to fund members on retirement. They must adhere to strict provisions regarding the contributions, taxation, benefit payments, annual reporting, compliance regime, etc. Our advisers at Frontier Wealth Advisers are well experienced in all aspects of superannuation including setting up SMSFs and recommending an investment strategy to suite your financial circumstances.



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## Why own an asset in super?

It is logical to suppose that every rational investor invests to increase:

- actual net income
- asset; or
- expected income and/or assets

Net income of a taxpayer and therefore, surpluses that can be converted into capital is affected by tax.

Because the tax rate we pay in Australia is affected by the choice of legal entity chosen to own the income generating asset, superannuation is very

attractive as it pays both income and capital gains tax at lower rates, being 15% and 10%, respectively. This is illustrated in the table below.

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Taxable Income	Marginal Tax Rate (includes Medicare levy)	Effective Tax Rate on Capital Gains (Medicare Levy Included)
\$18,201 - \$37,000	20.5%	10.25%
\$37,000 - \$80,000	34%	17%
\$80,001 - \$180,000	38.50%	19.25%
More than \$180,000	46.50%	23.25%
<b>Self-Managed Super Funds</b>		
Accumulation	15%	10%
Pension	Nil	Nil

As evident from the table above, individuals pay tax on income and capital gains at a rate of 46.50% and 23.25%, respectively, as compared to 15% and 10% for superannuation funds.

## Case Study

\$400,000 borrowed  
To buy \$600,000  
Property

### Super vs. Outside Super

If we assume the following:

- rental yield of 5% p.a
- interest rate of 6.50% p.a
- property management cost of \$6,000 per year
- marginal tax rate of 46.50% p.a



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## Outside Super

Rent		\$30,000
<i>Less:</i>		
Interest expenses	\$26,000	
Management cost	<u>\$6,000</u>	<u>(\$32,000)</u>
Income Loss		<u>(\$2,000)</u>

As the tax payer's marginal tax rate is 46.50%, they will get a tax refund of  $0.465 \times \$2,000 = \$930$ . This reduces the income loss to \$1,070 per year.

## Inside Super

Rent		\$30,000
<i>Less:</i>		
Interest expenses	\$26,000	
Management cost	<u>\$6,000</u>	<u>(\$32,000)</u>
Income Loss		<u>(\$2,000)</u>

As the tax rate is 15%, the super fund will get a tax refund of  $0.15 \times \$2,000 = \$300$ . This reduces the income loss to \$1,700 per year, which is 59% more than the loss if the property was held individually.

So on the basis of income tax alone, the investor might prefer to hold the property directly. However, this would not be the case if one or more of the followings apply:

- The property is likely to have a positive cash flow (e.g. because of decreases in balance or increases in rent as opposed to interest rates)
- Large capital gains are expected upon the sale of the property.

Now let's assume the property is held and sold after 5 years. Annual growth rate was 4%, over the same period; rent escalation was 3% and a loan balance of \$300,000 at 7% interest.

## Outside Super

Rent		\$34,800
<i>Less:</i>		
Interest expenses	\$19,500	
Management cost	<u>\$7,000</u>	<u>(\$26,500)</u>
Net Income		<u>8,300</u>

The tax payer will pay an additional tax of \$3,860 on this amount. If the property was held inside superannuation, the tax payable would be a maximum of \$1,245, resulting in tax savings of approximately \$2,615.

### Capital Gains Tax

Total assessable capital gains would be approximately \$130,000. As an individual, capital gains tax (CGT) would up maximum of \$30,225. If held in super, the CGT would be only \$13,000 and if sold whilst the fund is in the pension phase, the capital gains tax would be nil.



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We are a one-stop-shop financial services entity that can help you to:

- Establish an SMSF
- Source an SMSF loan
- Provide technical guidance over the borrowing process
- Help you source a property
- Deal with the auditing, accounting, and compliance of your SMSF.

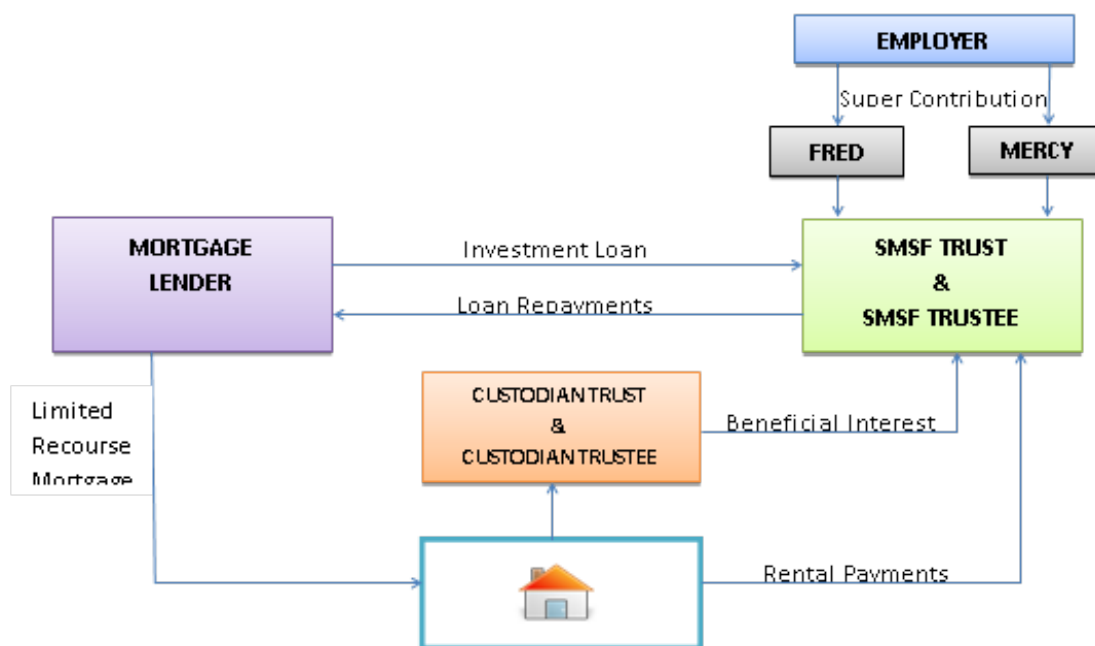
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From the above analysis, it is evident that superannuation ownership can be an attractive proposition depending on the tax payer's tax status. However, every individual is different. Thus personalised financial as well as tax advice is recommended before this sort of strategy is pursued. At Frontier Wealth Adviser, our resident Certified Financial Planners™ as well as our Chartered Tax Advisers™ are SMSF and taxation experts who can work with you to determine the most suitable strategy.

## Borrowing to invest in super?

You want to buy a residential property through your proposed SMSF but it will not have enough funds for an outright purchase. It will, however, have enough funds to make a deposit payment. The SMSF will make a deposit on the property and borrows funds to pay the balance plus

acquisition costs. The property can be used as security under a limited recourse loan. In the event of default, the lender will only have recourse to the property and cannot claim any other SMSF assets. The property is held in a custodian trust and the SMSF which is entitled to rental income. Your SMSF makes the loan repayments; after the loan is repaid, the legal ownership of the property can be transferred to the SMSF.



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### **THIS STRATEGY WORKS BEST IF:**

- You have a long term investment timeframe;
- The SMSF members are working or actively making contributions
- You want to invest in a residential property within superannuation;

### **THE BENEFITS OF THIS STRATEGY**

- You can pool together super assets of up to 4 members to increase deposit capital.
- Your SMSF can acquire property through instalments over the long-term.
- SMSF assets are secure as the lender does not have recourse to your SMSF's assets.
- Your SMSF receives all income and capital growth of the property during loan term.
- The SMSF will use rent from the property & super contributions to service the loan.
- Interest and other property expense may be claimed as tax deductions by the SMSF.
- You may eliminate CGT if property is sold in the retirement (income) phase

### **SERIOUS ISSUES TO CONSIDER**

- Your SMSF trust deed must allow borrowing under an instalment arrangement.
- You must purchase the property from an unrelated party. Arrangements must be at arm's-length and transacted at market rates.
- You should weigh the benefits of the strategy against the costs of setting up and maintaining the instalment arrangement.
- Investment in residential property must be consistent with your SMSF's investment strategy.
- You should consider risk, return, diversification issues as well as loan interest rates.
- The instalment arrangement must meet certain requirements to ensure that the SMSF remains complying.
- As trustee, you must be acting in the best interests of the SMSF beneficiaries and the ability of the SMSF to make the instalments over the term of the loan.
- Cash flow may be sourced from investment earnings or member contributions. Consider limits to contributions that are eligible for concessional tax treatment.



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## THE IMPORTANCE OF FINANCIAL PLANNING

There are a number of rules and regulations surrounding superannuation and planning for retirement. Your Frontier Wealth Adviser can provide advice on borrowing strategies for SMSFs that is personalized to your situation and goals. You should also consider seeking professional tax and legal advice.

## THINGS TO CONSIDER

- **Be careful:** Do not rollover your capital to the SMSF before you make adequate provisions to replace your current personal insurance policies.
- **Liquidity:** you should ensure sufficient amount of liquid cash (say \$10,000) is maintained in the fund to pay for ongoing fees, tax and rental shortfalls.
- **Deposit:** ensure the fund has enough money to fund deposit, set up costs, stamp duty and all other costs.

## The required documents

To implement a Limited Recourse Borrowing Arrangement, you need the following:

1. A financial plan that deals with suitability of the strategy to you as well as the affordability of the strategy from a cash flow perspective. Banks will ordinarily require your planner to sign a form to this effect.
2. A deed giving life to the Self-Managed Super Fund and Custodian/Bare Trust.
3. A trustee structure for your self-managed super fund. Whilst an SMSF can have individual trustees, the custodian trust must always have a corporate trustee.

This means that you will have to pay for the cost of deeds for the SMSF and custodian trust, as well as trustee structures.



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## The process

Steps	What does this entail
<b>Step 1:</b> <b>Pre-approval</b>	<p>This is basically where we contact a bank to find out if it can lend money based on facts provided. We believe this should be a first step as setting up SMSF costs money. If the purpose is to borrow and buy property, we do not want you to pay set up costs for the SMSF only to find out that you cannot get the loan.</p> <p>So the remainder of the steps are entirely voided and revisited if you cannot get a loan. For example, we might then look at an alternative strategy using traditional super funds.</p>
<b>Step 2:</b> <b>Get financial advice</b>	This will be a personalised financial plan outlining your strategy and how it benefits you.
<b>Step 3:</b> <b>Set up and execute SMSF</b>	<p>Establish SMSF and associated structures:</p> <ul style="list-style-type: none"> <li>• SMSF deed</li> <li>• Bare trust deed</li> <li>• Corporate trustee for SMSF, where applicable</li> <li>• Corporate trustee for custodian trust</li> </ul> <p>This is a very involving process which involves signing various pages of the SMSF deed as well as associated minutes, including the ATO's SMSF trustee declaration.</p> <p>We help you with the entire process and let you know where to sign.</p>
<b>Step 4:</b> <b>Apply for ABN and TFN for super fund</b>	This may take up to 28 days. We do all this in-house. So you do not have to worry.
<b>Step 5:</b> <b>Set up your SMSF Cash Account</b>	We do this for you at no additional cost. We use the Macquarie CMT for this purpose.
<b>Step 6:</b> <b>Rollover your super benefits</b>	This involves the rollover and consolidation of all your super benefits into your new SMSF.
<b>Step 7:</b> <b>Buy property</b>	<p>At this stage, you can engage Frontier Direct Property Pty Ltd to help you find an investment grade property.</p> <p>When a property is found, you will have to pay a holding deposit. All funds will be paid from the SMSF's account.</p>
<b>Step 8:</b> <b>Formal approval</b>	At this stage, you sign the loan offer documents and return them to the bank for final approval.
<b>Step 9:</b> <b>Loan settlement</b>	This involves liaising with your solicitor; we will support you on financial matters in this process.
<b>Step 10:</b> <b>Stamp Bare Trust</b>	Once you have settled on a property, you will need to arrange the stamping of the Security Custodian Trust with the State Revenue Office if required. Your solicitor will do this for you.
<b>Step 11:</b> <b>Finalise your SMSF admin</b>	<p>Throughout the process, we keep records of your SMSF transactions and give you an individual login where you can track your balances. However, individual balances are not likely to be fully completed until you have found a property.</p> <p>Once you have settled on a property, we provide you balances of each individual member and give you an online access code where you can monitor your individual super balances.</p>



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## How we can help?

### Our core compensation advice services

At Frontier Wealth Group, we can help to:	
• Explain the SMSF investment and borrowing process	✓
• Provide you full financial advice regarding an SMSF investment strategy	✓
• Set up your SMSF	✓
• Help you execute your SMSF deeds and minutes	✓
• Source a Limited Recourse Borrowing Loan	✓
• Help you source an investment grade investment property	✓
• Administer your SMSF	✓

## How do you contact us?

At any time where you would like to discuss your situation and how find out how we can help you, please contact us on the following:

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