



Background

For some time it was believed that a super fund could invest in an instalment warrant. Then the ATO came out with a host of clarifications and finally decided that a warrant did indeed constitute a borrowing and an encumbrance of an asset owned by the super fund i.e. an instalment warrant was not an allowable investment for a super fund.

Across Australia the practice of investing in warrants was so common place (by industry and government super funds as well as SMSFs) that the ATO sought to have the legislation amended to reflect the practice.

An Act was passed in late October which effectively allows a super fund to borrow money on a "Limited Recourse" basis to invest in any asset that is not an in-house asset.

It is important to note that this does not mean that a super fund can simply go out and borrow money at will and invest in anything. The prohibition on borrowing in a super fund was NOT changed, an exception was made for Instalment Warrants.

As a result of the changes:

- a new sub-section was included in Section 67 (the bit that says a fund cannot borrow) to allow the investment through a very specific type of trust commonly known as a Debt Instrument Trust (DIT), that facilitates the Instalment Warrant.
- Section 71 (covering in house asset rules) was amended to allow a fund to invest in a trust of this nature. Otherwise the borrowing could not be made.

What is an Instalment Warrant?

In its simplest form they work like this:

- The fund provides \$1 and you borrow \$1. The \$2 is put into a DIT and the investment is made from the DIT.
- The super fund gets 100% of any income return and capital gain.
- The super fund (or the trust in some situations) pays the interest.

The super fund can ONLY offer the investment within the DIT as security. If the lender requires additional security you must arrange additional security from sources outside the fund. The fund CANNOT offer any of its other assets as additional security.

What can the DIT invest in?

Basically any investment that the super fund could hold itself can be purchased by the DIT i.e. Residential Property, Business Real Property, Shares, Cash, Managed Funds even Collectables.

The usual rules apply:

- Must be purchased at arm's length basis.
- Restrictions apply for assets purchased from a related party in the normal way (ie can't buy residential property or Collectables from the member or a related party of the member).

Who can the lender be?

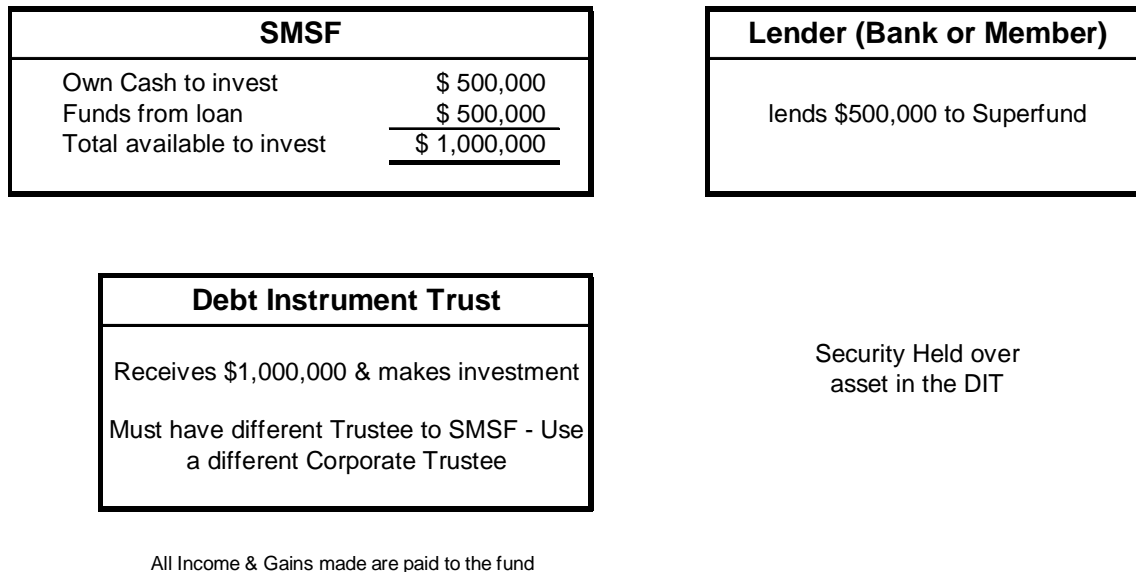
- A Bank.
- A Margin Lender.
- Yourself or a Related Party (ie you can be your own lender either as an individual or a trust).

Please note that if you want to use funds from a company you should seek advice before doing so as the loan may have Division 7A consequences.

How does it Work?

Example:

A SMSF has a balance in members' accounts of say \$1,500,000. The fund wants to use \$500,000 of its own funds and borrow \$500,000 to invest in an investment valued at \$1,000,000.



PLEASE NOTE: This is a simplified diagrammatic representation of the structure only. There are a number of required steps which must be followed in a specific order and a lot of paperwork and documentation which must be put in place.

If this process is not followed correctly, the investment may fail the exception rule and be deemed a "Non-Excepted Borrowing" thus making the fund Non-Complying. Additionally the loan may be treated as a contribution which, if outside allowable contribution limits could be taxed as an excess amount.

Who can use this?

The normal approach should be taken with this as for any borrowing or gearing. Remember if you borrow money you have to pay it back.

Borrowing is not for everyone and each person should seek advice on the appropriateness of a gearing strategy for their risk profile.

As the borrowing is not treated as a contribution there is no age restriction on who can use this strategy.

- An 80 year old could utilise this strategy
- A 40 year may also use it

Simple example for a younger person

They could borrow utilising the DIT asset (perhaps in conjunction with security over their home) whereby the 40 year old borrows money from the bank then (after going through the appropriate process) lends the money to the super fund which invests it into a DIT that then purchases the investment.

The super fund must pay an arm's length interest rate return to the lender (ie the 40 year old) hence repaying the interest to the bank.

A loan agreement is entered into between the fund and the borrower (the 40 year old) stating how and when that loan can/must be repaid.

Simple! Yes, but you must follow the correct process or it will all fall apart.

The information contained in this document is of a general nature only and is not intended to be personal advice. No person should act solely on the basis of the information contained herein but only after discussing their individual circumstances with their Financial Adviser.