Beachside Financial Services
Ph: 1300 794340
Fax: 1300 794350
Email: glenn@beachsidefinancial.com.au
Post: PO Box 1874 Dee Why NSW 2099

Should super funds borrow?

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In this white paper, we consider whether borrowing in a super fund is a financially viable strategy.

Following recent changes in legislation, super fund trustees can generally use borrowed monies to acquire any asset they would be permitted to invest in directly. Examples include managed funds, shares and direct property.

When deciding whether the fund should borrow to invest in these or other eligible assets, the trustees should consider a range of factors, including the expected investment returns and relevant borrowing costs, such as loan interest. As the case studies throughout this article show, the results are highly sensitive to the assumptions made.

Note: We are expecting the ATO and APRA to clarify a number of outstanding interpretive issues relating to the mechanics of borrowing in super. We will keep you informed of any further developments, including product solutions.

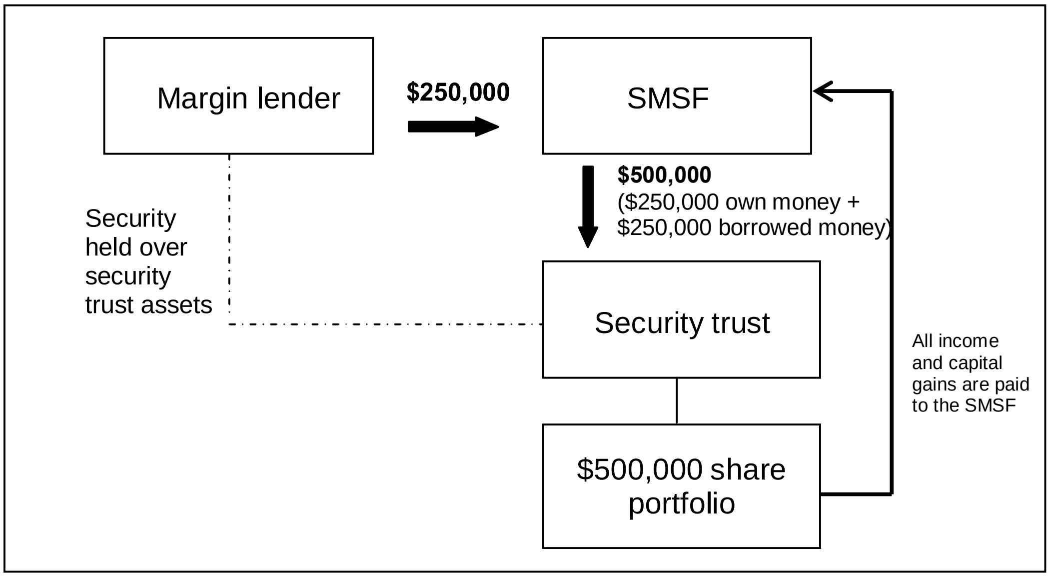
Case study 1 – Borrowing to invest in managed funds and shares

Bob (aged 40) wants to maximise his superannuation savings. He has recently contributed $250,000 in cash into his SMSF as a personal after-tax contribution and is considering two options:

1. Investing the $250,000 in a portfolio of Australian shares, or
2. Arranging for his SMSF to borrow $250,000 via a margin loan to boost the share portfolio to $500,000.

If Bob elects option 2, the entire share portfolio will be held on behalf of the SMSF in a security trust. The SMSF will make interest-only repayments to the margin lender and will acquire legal ownership of the share portfolio when the loan is repaid at the end of the investment period.

The following diagram summarises the relationship between the SMSF, the lender and the security trust, where gearing is used.



What are the results?

The table below summarises the results after 20 years, based on certain assumptions*. As you can see, by gearing the share portfolio in his SMSF, Bob will be $93,949 better off at the end of this period.

	Value of investment (after 20 years)
Option 1: Invest $250,000 in super (no gearing)	$1,408,736
Option 2: Invest $500,000 in super (50% geared)	$1,502,685
Value added by gearing	**$93,949**

* Assumptions: Investment return is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the margin loan is 9.3% (excluding adviser commission). These rates are assumed to remain constant over the investment period. Where investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested. Any income losses in the gearing option are carried forward and applied against future taxable income where possible. Figures are after repayment of loans. No CGT or lump sum tax is deducted on super benefits withdrawn at the end of the investment period.

Interpreting the results

While the results above favour gearing, the modelling outcomes are very sensitive to the assumptions used.

For example, a higher **investment return** or higher **franking level** could significantly increase the value added by the gearing strategy. However, advisers should be mindful of any licensee standards that govern return and franking assumptions used in client projections.

There are a number of other variables that can also impact the results. These include:

- **Interest rates**. In the above example, we assumed a margin loan interest rate of 9.3% pa. If this was to increase by 0.5% to 9.8% pa, the value added by gearing drops to only $34,834.

- **Advice fees**. If an advice fee of 1% pa of the asset value was charged in both options, the gearing strategy would underperform no-gearing by $34,112.

- **Fees payable to the trustee of the security trust**. If a trustee fee of 1% pa of the value of the assets in the security trust was payable, gearing would underperform no-gearing by $253,017. To minimise the impact of trustee fees, Bob may be able to act (or arrange for a related entity to act) as trustee of the security trust.

The following table summarises the results and the value added (or detracted) by gearing, using the base case scenario and each of the variations outlined above.

Scenario	**Option 1: Invest $250,000 in super (no gearing)**	**Option 2: Invest $500,000 in super (50% geared)**	**Value added or (detracted) by gearing**
Base case	$1,408,736	$1,502,685	$93,949
Base case plus interest rate rise of 0.5% pa to 9.8% pa	$1,408,736	$1,443,570	$34,834
Base case plus 1% pa advice fee	$1,187,564	$1,153,452	($34,112)
Base case plus 1% pa security trustee fee	$1,408,736	$1,155,719	($253,017)

Note: If all the variations to the base case above were to apply simultaneously, the gearing strategy would underperform no-gearing by $414,919. For gearing to come out ahead, the shares would need to generate an investment return over the 20-year period exceeding 13% pa (split 3% income and 10% growth).

Case study 2 – Borrowing to invest in direct property

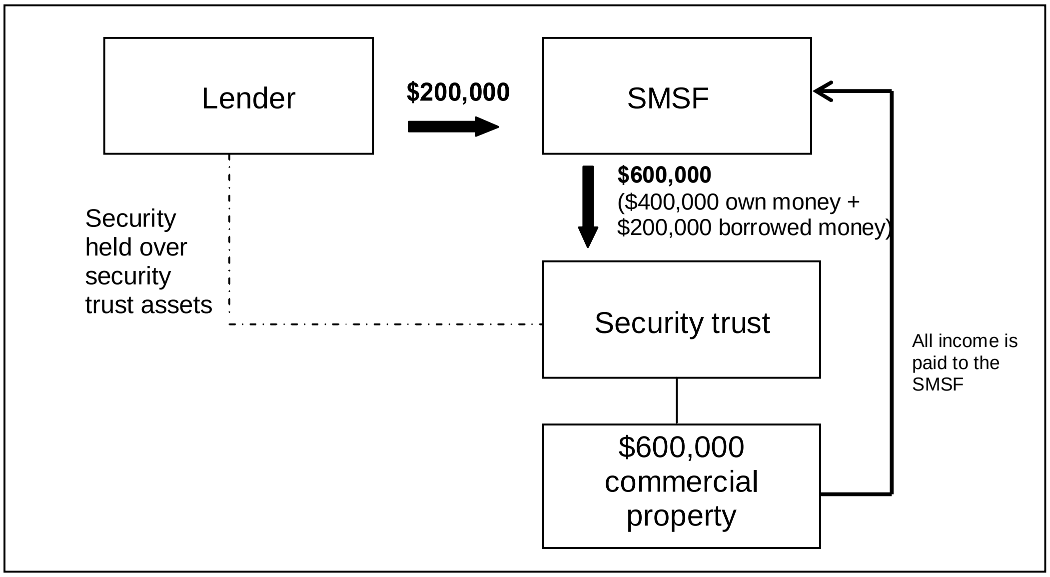
Kate (aged 45) wants to buy a $600,000 commercial property from which she will run her business. She currently has $400,000 in cash and will need to borrow $200,000 to complete the purchase. She is therefore considering the following options:

1. Borrowing $200,000 in her own name and purchasing the property outside super, or

2. Contributing the $400,000 into super (as a personal after-tax contribution) and arranging for her SMSF to borrow the $200,000.

If Kate chooses the second option, like the previous case study, the commercial property will be held on behalf of the SMSF in a security trust. The SMSF will make interest-only repayments to the lender and will acquire legal ownership of the property when the loan is repaid at the end of the investment period.

The following diagram summarises the relationship between the SMSF, the lender and the security trust, where the geared property is purchased in super.



What are the results?

The table below summarises the results after 20 years, based on certain assumptions*. As you can see, Kate is over $400,000 better off borrowing to purchase the property within super rather than outside super.

	Value of investment (after 20 years)
Option 1: Purchase geared property outside super	$1,525,038
Option 2: Purchase geared property in super	$1,968,425
Value added by purchasing geared property in super	**$443,387**

* Assumptions: Investment return is 8.5% pa (split 3% income and 5.5% growth). Interest on the loan is 8.5% pa. A $600 loan application fee and a $375 annual loan fee is payable in both options. These rates are assumed to remain constant over the investment period. Kate has a salary of $100,000 pa. Where investment income and tax benefits are insufficient to meet interest payments, the value of the property is reduced to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested. Any income losses are carried forward and applied against future taxable income where possible. Figures are after repayment of loans. No CGT or lump sum tax is deducted on super benefits withdrawn at the end of the investment period.

Interpreting the results

Like case study 1, the modelling results are very sensitive to assumptions such as interest rates and fees for advice and trusteeship (as shown in the table below). These results highlight why itûs important to consider a range of variables before deciding whether to gear within or outside super.

Scenario	**Option 1: Purchase geared property outside super**	**Option 2: Purchase geared property in super**	**Value added by purchasing geared property in super**
Base case	$1,525,038	$1,968,425	$443,387
Base case plus interest rate rise of 0.5% pa to 9% pa	$1,502,079	$1,926,963	$424,884

Base case plus 1% pa advice fee	$1,307,897	$1,579,560	$271,663
Base case plus 1% pa security trustee fee*	$1,525,038	$1,582,413	$57,375

* Super only.
Note: If all the variations to the base case above were to apply simultaneously, gearing in super would underperform gearing outside super by $111,844. For gearing in super to come out ahead, the property would need to generate an investment return over the 20-year period exceeding 11.1% pa (split 3% income and 8.1% growth).

Making principal repayments

When borrowing to buy a property within and outside super, making principal and interest (rather than interest-only) repayments will help negatively geared investments to become positively geared sooner. This outcome will generally favour borrowing in super because of the lower tax rate payable on taxable income.

The tax savings from making principal repayments are potentially even greater in situations such as Kate's, where the investment is positively geared from the outset. For example:

- If Kate makes an **after-tax super contribution** of $1,000 per month and her SMSF uses the money to make principal repayments, she would be $580,191 better off than using the same amount of after-tax salary to reduce the principal in the non-super loan.
- If Kate makes a **pre-tax super contribution** of $1,709* per month and her SMSF uses the money to make principal repayments, she would be $837,541 better off than using $1,000 in after-tax salary to reduce the principal in the non-super loan. The reason the value added is even greater in this situation is because the pre-tax repayments in super exceed the after-tax repayments outside super (after allowing for the 15% contributions tax).

Scenario	**Option 1: Purchase geared property outside super**	**Option 2: Purchase geared property in super**	**Value added by purchasing geared property in super**
Base case	$1,525,038	$1,968,425	$443,387
Base case plus principal repayments with after-tax contributions of $1,000 per month	$1,946,618	$2,526,809	$580,191
Base case plus principal repayments with pre-tax contributions of $1,709* per month	$1,946,618	$2,784,159	$837,541

* $1,709 is the pre-tax equivalent of $1,000 in after-tax salary, after allowing for Kate's marginal tax rate of 41.5%
(ie $1,000 / (1 – 41.5%) = $1,709).

Other issues

Some other issues to consider when deciding whether to borrow to buy an asset within or outside super include:

- **The clients marginal tax rate (MTR)**. A higher MTR favours gearing outside super while the investment is negatively geared, and favours gearing within super while the investment is positively geared. A higher MTR can also benefit gearing in super if pre-tax contributions are made to fund the loan repayments (see above).
- **The loan-to-valuation ratio (LVR)**. Assets purchased with a higher LVR will generally be negatively geared for longer. This outcome typically doesn’t favour gearing in super because of the inability to use the income losses (which must be carried forward). For example, if Kate from the case study above, wanted to purchase the same $600,000 property, but needed to borrow $400,000 (ie the arrangement was 67% geared), gearing in super would only beat gearing outside super by $55,341. This assumes all the other base case assumptions are left unchanged.
- **The super funds tax position**. In situations where a superannuation investment is negatively geared, the results could be enhanced if the fund has other taxable income to utilise the income losses.

Conclusion

Gearing in super can be a viable strategy, particularly when borrowing to invest in direct property. But regardless of the assets purchased, care needs to be taken with asset allocations especially where access to funds will be needed in coming years.

The direct property asset class remains relatively illiquid and timing of eventual sale must be considered as part of the overall investment decision, especially if superannuation based income streams are also being considered.

Brought to you by:

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Beachside