

SMSF BORROWING:

Complying with personal guarantee law makes clients richer — significantly richer!

By Bryce Figot

Introduction

An interesting quirk in super law means that by complying with the law, clients can become significantly richer. This is a welcome change: compliance is often seen as a necessary evil and certainly not as a profit centre. The quirk arises out of a combination of the super law itself, personal guarantees, banking practice and recent ATO materials. The quirk does *not* arise out of any tax benefit.

Background: Super fund borrowings

The new ability of regulated super fund trustees to borrow has been a revolution for the super industry.

Naturally, some were initially sceptical. But since the ATO's recent releases on SMSF borrowings (FN1), most are now fairly comfortable with the idea of trustees borrowing. Of course, trustees can not just borrow as easily as individuals might borrow. There are various requirements that trustee must meet. Ensuring these requirements are met is vital to ensure the super fund remains a complying super fund.

Background: Limited recourse loans

One such requirement is that a loan be a limited recourse loan. In other words, 'the rights of the lender against the [super fund trustee] for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, [should be] limited to rights relating to the [asset being acquired by the borrowing].' (FN2) To use a simple example, consider a trustee that has 20 properties and wishes to borrow to buy a 21st property. In order to comply with this requirement, the borrowing arrangement must ensure that if trustee defaults, the only fund asset the lender can pursue is the 21st property.

Naturally, this is quite a change for banks. Traditionally, banks require recourse over all of the borrower's assets. However, if banks want to have a 'super fund-friendly' loan product, their loans must be limited recourse.

Background: Higher interest rates and risk premium

An important implication of the limited recourse nature of the loans is that the lenders bear more risk than usual. Lenders have several techniques to help defray the extra risk. One such technique is to charge higher than normal interest rates. In other words, trustees pay a risk premium on borrowings. Typically, trustees pay an interest rate that is 1–3% higher. As a simple example, if an individual can obtain a full recourse loan at an interest rate of 9%, an SMSF might expect to obtain a limited recourse loan at an interest rate of 11%.

The problem: related party guarantees

It is usual bank practice to require related parties to give personal guarantees for borrowings. SMSF borrowings are no exception. Many banks have been asking members of SMSFs to give personal guarantees.

However, the ATO has flagged related party guarantees as a cause for concern. The ATO states that related party guarantees 'may result in recourse being made to the assets of the SMSF other than the asset acquired (or any replacement) in the event that the guarantee is enforced against the trustee as the principal debtor, contrary to the intent that the [borrowing exception] only applies to limited recourse borrowings...' (FN3) Accordingly, the ATO warn that a borrowing arrangement that 'may give rise to taxation and superannuation regulatory issues' (FN4).

The solution: related party lending

Luckily there are solutions. One solution is to try to negotiate with banks so that no personal guarantees are required. However, often banks can not or will not alter their standard lending terms. Even if a client is successful in such negotiations, the bank typically require a lower loan-to-value-ratio and an even higher risk premium on interest rates.

Often the best solution involves the following steps:

- The clients borrow personally, giving personal guarantees. This loan is not subject to any superannuation borrowing restrictions. The interest on this loan is the normal interest rate.
- The clients then on lend the money to their SMSF. The interest on this loan is the normal interest rate *plus the risk premium*. Because the client controls the loan, they can choose not to require related party guarantees.
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- If related parties lend to their SMSF, the interest rate *must* be at 'commercial rate of interest' (FN5). Money advanced by a related party at less than a commercial rate of interest could be characterised as a contribution (FN6) which in turn could trigger a hefty liability for excess contributions tax (FN7). Money advanced by a related party at greater than a commercial interest rate of interest may result in a breach of:
 - the sole purpose test (FN8) and
 - the prohibition on giving financial assistance to a member of the SMSF or their relative (FN9).

Complying with these requirements results in an important arbitrage opportunity. Clients can borrow at say 9% and on lend to the SMSF at say 10.5%. By using related party lending, the risk premium stays within the family group. It is this risk premium that adds tremendous value.

Case study

Mr and Mrs Smith are the directors of Prudent Super Pty Ltd, which acts as trustee of the Prudent Super Fund. The fund has \$700,000 cash and wishes to buy business real property worth \$1.5 million. The Smiths resolve for the trustee to borrow to obtain the balance of money to acquire the asset. Naturally, the fund's investment strategy and governing rules (contained in the trust deed) expressly allow for such an arrangement. They have two options:

Scenario 1: the fund borrows directly from a bank. The fund will pay an effective interest rate of 10.90% pa and the Smiths would be required to give personal guarantees.

Scenario 2: the fund borrows from the Smiths. The fund will pay an effective interest rate of 10.90% pa. The Smiths in turn borrow from the bank and they personally pay an effective interest rate of 9.26% pa.

Now consider a comparison of the two scenarios after 10 years (FN10):

	Scenario 1	Scenario 2
Increase in fund's net value	\$2,243,653	\$2,243,653
Increase in Smiths' net value	\$0	\$91,729
Personal guarantees risking fund assets?	Yes	No
Compliance risk	Higher	Lower

The fact that the risk premium has stayed in the Smith family group has significantly increased the Smiths' personal wealth. They are over \$90,000 personally richer. Naturally, the fund itself is indifferent to where the money is funded — this is of course because the related party borrowings are at arm's length. The main difference to the fund is that its compliance risk is minimised in scenario 2 because there are no personal guarantees indirectly jeopardising other fund assets.

It is important to note that the interest that the fund pays to the Smiths will be included in the Smiths' personal income tax return. However, generally speaking, the interest expense on the loan from the bank should be deductible to the Smiths (FN11). Accordingly, the Smiths do not receive any tax benefit (FN12) — in fact the Smith family group pays more tax under scenario 2, but this is a happy result of the Smith family group receiving more net income.

Conclusion

Before entering in borrowing arrangements, clients should consider whether related party borrowings are appropriate for their circumstances. Certainly, from a legal perspective they can minimise risk.

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Footnotes

1 See Taxpayer Alert TA 2008/5 and *Instalment Warrants And Super Funds - Questions And Answers* (2008) ATO <<http://www.ato.gov.au/super/content.asp?doc=/content/00132054.htm>> at 1 June 2008.

2 *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA') s 67(4A)(d).

3 Taxpayer Alert TA 2008/5.

4 Ibid.

5 Ibid.

6 Ibid.

7 See *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') div 292 which can result in an effective tax rate of 93% on contributions.

8 Taxpayer Alert TA 2008/5 and SISA s 62.

9 Taxpayer Alert TA 2008/5 and SISA s 65.

10 Naturally several other assumptions have been made regarding the arrangement in order to arrive at the outcome (eg, net cash yield of asset, capital gain in asset, etc). Full calculations can be obtained by emailing the author at bfigot@dbabutler.com.au

11 See ITAA 1997 s 8-1. Clients would also be well advised to read cases such as *Fletcher v Federal Commissioner of Taxation* (1991) CLR 1.

12 *Income Tax Assessment Act 1936* (Cth) s 177C(1).