Pitcher Partners

Superannuation borrowing

Borrowing to buy property in a super fund

Borrowing arrangements have the potential to increase your retirement benefits by offering 'gearing' in a tax advantaged structure. However, care must be taken to ensure that any borrowing arrangement represents a sound investment decision and that all legal and compliance requirements are met.

Concessional tax rates

As with other superannuation investment returns, rental income and gains on disposal will be taxed at concessional rates not exceeding 15%. If your super fund is entirely in pension phase, you will pay no tax.

Access existing equity

Direct property investments often impose a significant cash burden on the fund given the high cost of entering the market.

By using your super fund, you can use your existing balance as seed capital to finance the investment. Where available, future contributions may be used to pay down debt.

Size and diversification

Super funds are often limited in the range and size of investments they are able to hold. Contribution limits and the restrictions on member numbers effectively limits the speed with which super funds can grow.

Being able to borrow to acquire property means your super fund could buy an asset it otherwise wouldn't be able to afford. Similarly, borrowing to buy property may allow a level of diversification within your portfolio that you wouldn't otherwise be able to achieve.

Cash flow

One of the key considerations in structuring a geared property investment in a super fund is cash flow within the fund. There are limits on the amount you can contribute to your super fund each year.

As a result, it is crucial that your super fund has sufficient cash to meet repayment requirements and all costs associated with the investment as well as other ordinary outgoings (e.g minimum pension payments). Higher proportions of borrowing will increase the cash flow pressures in the super fund.

Borrowing limits

Cash flow considerations place an effective limit on the level of borrowing you can commit to and banks will ordinarily set their own lending criteria. Further, the ATO have recently stated that super fund borrowing terms should meet their stated safe harbours. The safe harbour terms provide a maximum loan to value ratio of 70% for super funds investing in property.

There is comparatively little value in negatively gearing within a super fund. Any loss from the investment would generate a tax deduction for the super fund but as a super fund only pays a maximum of 15% tax and possibly nothing, the tax break the fund obtains from negative gearing is small compared to other structures that might be available, such as investing personally or through a trust.

When it works best

Borrowing in a super fund works best when the investment is cash flow positive and profitable. This means the concessional rate of no more than 15% applies on the profit. From our experience, borrowing arrangements work best when a super fund borrows less than 60% of the property value.

Counting the cost

Costs associated with a borrowing arrangement are likely to be larger than you expect. There is a legal structure requiring the property to be held on trust. Putting in place a trust structure typically costs between $2,500 and $5,000.

Banks will charge their own establishment fees, typically in the order of 0.8% of the amount financed. Interest rates may also be higher than rates applying on standard property investment loans as the lender only has recourse against the property on default; although rates have become more competitive over time.

There is also other direct costs including stamp duty and government fees.

Fact sheet

Related party lending

If you have cash available in the family group, a related party can lend to the super fund provided the loan is on commercial terms. The advantage of related party lending is it may reduce costs by eliminating the fees charged by banks and by keeping interest payments in the family group.

Another popular structure is for a related party to borrow from a bank on standard property investment terms by giving security on existing assets and then on-lending to the super fund. This can avoid extra costs banks may look to charge.

It should be noted that related party borrowing is an area of focus for the ATO and borrowing terms should be in accordance with their safe harbour guidelines which, among other things, guide interest rates, repayment terms, and gearing ratios.

The structure

A special purpose 'custodian trust' holds the property for the super fund until the loan is repaid. This trust has no other role and there is no requirement to prepare accounts or returns for the trust. The super fund retains beneficial ownership of the property and all income and expenses related to the property go through the super fund. When the loan is repaid, legal title can pass to the super fund – usually without tax consequence.

The loan must be established on a limited recourse basis meaning the recourse in the event of default is limited to the property acquired with the borrowed funds and not to other super fund assets. Banks will generally require personal guarantees however.

Limitations

A super fund can borrow to buy commercial or residential property however a residential property generally cannot be acquired if already owned by the family group. You must be borrowing to acquire a single asset or group of identical assets. This rule causes complexity if the property may encompass more than one title. Any development plans will generally have to wait until the loan has been repaid.

Further information

Please ask your regular Pitcher Partners contact or any of the contacts below for further information.

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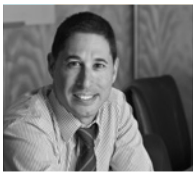

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