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FINANCIAL SERVICES



**Property
Instalment Warrants in
Self Managed Super**

Property Instalment Warrants



Property Instalment Warrants

A powerful new tool for the accumulation of wealth through superannuation was introduced late last year. Amendments made to the rules governing superannuation opened up the ability for self managed super funds to borrow money to invest. Whilst the ability to borrow to invest is open to any asset a superannuation fund is presently able to invest in directly, most of the interest lies in a fund's new found ability to borrow money to invest into direct property.

The power of negative gearing has long been a popular tool for individuals looking to create wealth for their retirement. Accumulating a personal property portfolio has been the asset of choice for many negative gearing strategies. The comfort of bricks and mortar plus the substantial deductions available to offset income has made this a popular and widely accepted investment strategy.

The excitement for trustees and members of self managed superannuation funds is that many more will now be able to invest directly into property and potentially take advantage of investments previously out of their reach.

So how does it work?

Whilst many product promoters are likely to advocate the ease with which such investments are possible, there are a number of important regulatory issues that need to be satisfied. Satisfying these regulatory requirements will allow a self managed super fund to establish and maintain an instalment warrant structure capable of investing in direct property.

1. The structure of the property instalment warrant

The Regulations prescribe the structure of the instalment warrant as well as the terms and conditions of the financing mechanism that will assist in the purchase of the underlying investment asset. The diagram in Figure 1, below, illustrates the structure required to satisfy the appropriate regulations.

You will see from Figure 1 that the superannuation fund must purchase the underlying investment asset through a trust. This trust must not take part in the purchase, ongoing maintenance, eventual sale or transfer of the asset. You will also see that all expenses incurred in maintaining the investment asset are paid directly from the super fund as are all loan repayments. Any income generated by the investment asset must pass directly to the super fund. In this way no money is streamed through the trust and apart from holding the investment asset, the security trust has no other role to play.

2. Financing Options

As an instalment warrant strategy is based on the premise of partially purchasing an asset with the outstanding amount being financed, this strategy requires a financier. The fund will have two options to source finance. One option is to source the required funds from a financial institution. The fund may also seek a 'friendly' financier i.e. a member with the financial resources to loan the super fund the required amount to complete the purchase. The latter financing option will need to be

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done at arm's length i.e. rates and terms must be similar to those offered by other financial institutions and comply with the appropriate regulations.

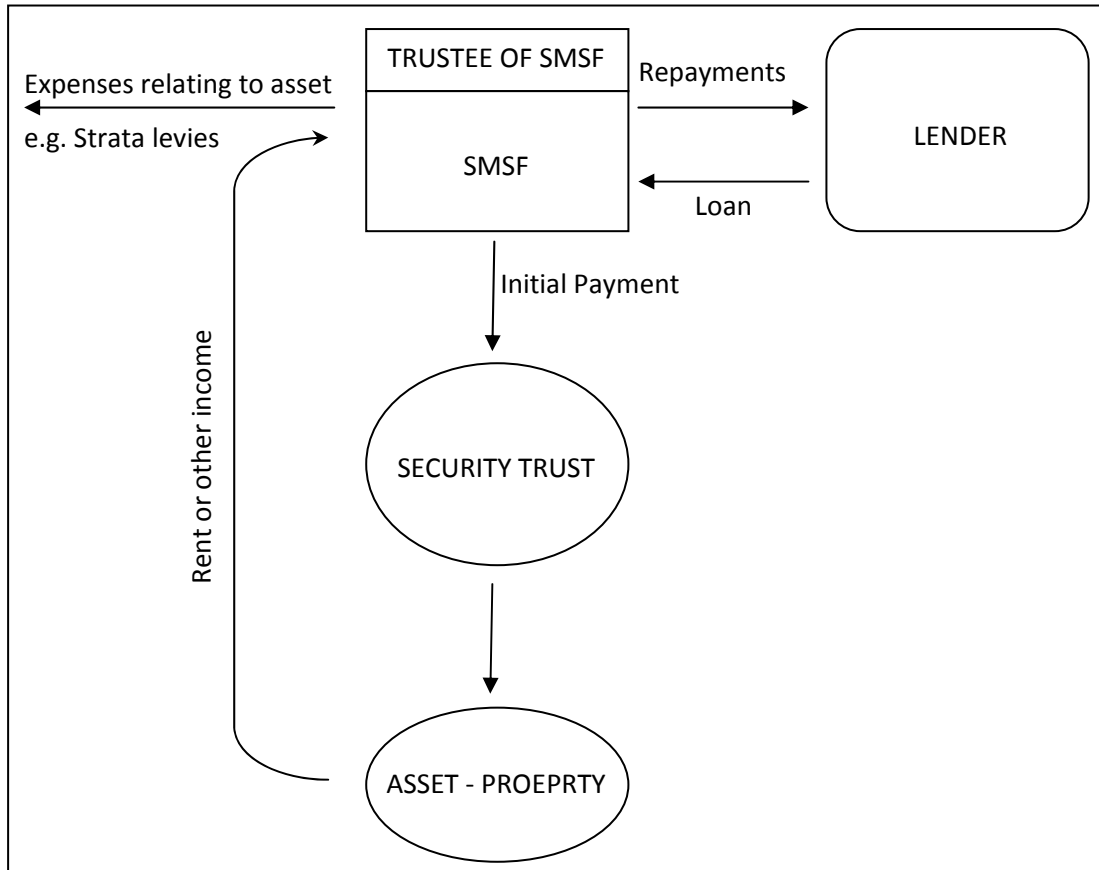


Figure 1. Instalment Warrant Proposed Structure

3. Documentation

Apart from getting the structure right and sourcing the necessary finance, one of the most critical aspects will be the documentation supporting the strategy. The super fund will need to prepare appropriate documentation setting out its relationship with the security trust and enter into agreements with the vendor, financiers and property managers. Other documentation will also need to be formalised to ensure that the strategy complies with the necessary regulations i.e. an updating of the super fund's investment strategy and possibly the Trust Deed as well.

The importance of these documents cannot be overstated as challenges to the validity and compliance of the investment, its structure and operation will best be defended through the documentation prepared. Any issues with the documentation may significantly impact the ability to mount a defence of the structure and the strategy.

It should be quite clear that this is a sophisticated strategy and one with many complexities. It will be important to employ an adviser that can ensure the structure is established correctly and the documentation prepared appropriately. It will only be through the employment of such a capable

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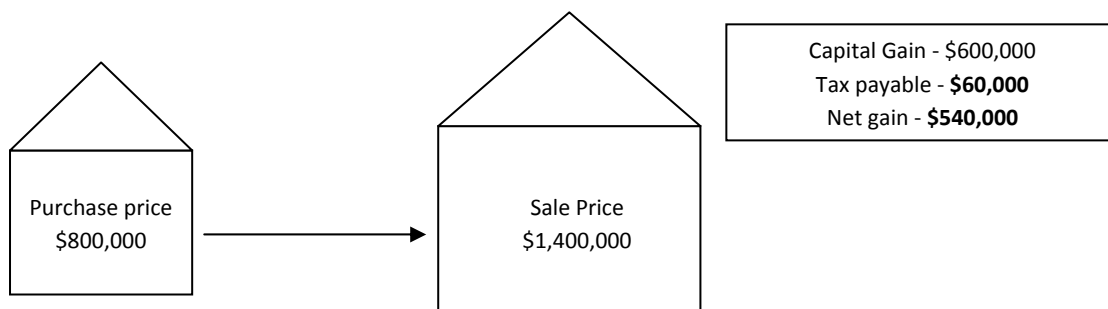
adviser that the super fund and its members will be able to enjoy the significant benefits this strategy can provide.

So what are the benefits?

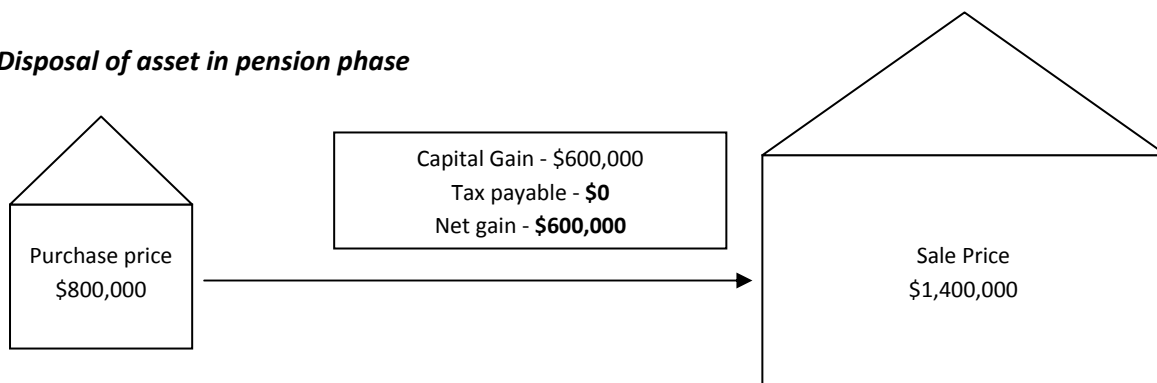
Capital Gains

There can be some substantial benefits for those taking advantage of property instalment warrants. The most significant of these is the potential to maximise the fund's ability to accumulate wealth for retirement. Consider for a moment the taxation rates for superannuation. Whilst you are accumulating benefits i.e. working, the tax rate inside super is 15% with a 10% tax rate applying to any capital gains arising from the disposal of assets held for more than 12 months. Once a member decides to start drawing a pension, the tax rate applicable to the income and capital gains of the assets supporting that pension is 0%. Therefore, purchasing a property in the accumulation phase and not selling this property until after a pension has commenced will mean that the fund will be able to enjoy the full benefit of the capital gain. The following diagram and the case study at the end of the article demonstrate the effectiveness of this benefit.

Disposal of asset whilst in accumulation phase



Disposal of asset in pension phase



You will see from this simple example the significant benefits available in simply disposing of assets in the different phases of superannuation.

Greater benefit accumulation

The ability of business owners to potentially purchase their own business premises will promote greater benefit accumulation. Particularly as their businesses rental can be redirected into their own fund. This rental payment will be in addition to any superannuation contributions their business

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must already make on their behalf. This increase in contributions will assist the fund with funding the instalment strategy and further growing the member's superannuation benefits. This strategy may also give the business greater location security as well as ensuring the business is not exposed to over inflated rental increases.

Non-recourse loan

As part of the legislative requirements, the loan provided to the fund to complete the property purchase must be a non-recourse loan. This means that the Trustee/s is able to walk away from the investment without being required to pay back any outstanding mortgage amount. This essentially limits the loses to the fund of its initial purchase payment plus the total of all mortgage repayments made to that time.

Negative gearing benefits

Whilst most property investments are done to generate income and capital gains, the use of a loan to complete the initial purchase can mean that the costs in maintaining the investments i.e. the interest costs and other property maintenance costs, can outweigh the income generated by the property. Such a situation is generally referred to as negative gearing. Any income deductions not able to be offset against the income of the property, can then go towards offsetting other income of the fund.

This may be useful in that contributions made to the fund by members is considered income of the fund and can be taxed at 15% (contributions tax). Excess income deductions may then assist in reducing this liability and possibly even negating it completely.

It is important to note that the fund must maintain sufficient income inflows to meet the interest and other ongoing expenses of the investment. There will also be other regular expenses specific to the fund that will need to be met. Therefore, the cash flow of the investment and the other income of the fund must be able to meet all ongoing liabilities. This is potentially one of the greatest risks of this instalment strategy.

Other benefits

The other benefits include the very comfort individuals derive from investing in property over say shares and managed funds. This benefit is one that cannot be overlooked particularly in times when share markets are under pressure. This strategy may allow the fund to diversify into another investment which may provide greater comfort for the members and some stability to the value of the fund itself.

The case study at the end of the article demonstrates some of the above benefits.

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So what are the risks?

Legislation and compliance

One of the biggest risks in using a property instalment warrant in super is the legislative and compliance risk. This means that the purchase needs to be structured correctly with all the appropriate documentation conforming to the requirements under the regulations. The ongoing management and eventual sale will continue to be subject to the regulations.

Most of us will agree that the superannuation regulations are always changing. It is possible that the opportunity which presently exists may be closed or significantly restricted in the future. Whilst this is unlikely to mean that the property purchase will need to be reversed, the possibility exists.

Furthermore, there are also aspects to this strategy i.e. the future application of stamp duty, which cannot be answered today, these risks are unknown and the financial implications undeterminable. Entering into such a transaction will mean that you will need to be fully informed of these risks and decide yourself whether or not you would like to proceed.

Cash flow

In addition to the legislative risks, there are also monetary risks. Some of these monetary risks include the following:

- A significant deficit between the rental income and mortgage repayments;
- Cash flow short falls in times when the property is vacant;
- An increase in mortgage repayments due to rising interest rates; and
- Issues with un/expected expenses.

Other monetary risks may include reduced income streams from other investments assisting with the repayment of the instalment warrant mortgage and reductions in member contributions which will reduce the fund's ability to meet any mortgage repayment deficit.

You will see that from the above paragraphs the very importance of the cash flow of the fund and thus its ability to maintain the instalment warrant strategy. Whilst ensuring that all the compliance requirements have been met, it will be crucial to ensure that the fund has planned for most cash flow eventualities.

Higher interest rates

As the loan to fund the property purchase is a non-recourse loan with no requirement to be paid back if the Trustee/s decides to walk away from the investment, the interest rates charged are generally higher than normal home loan rates. Currently, non-recourse interest rates are around 10% - 11% per annum. This can make the strategy quite expensive and provide an onerous repayment liability on the fund.

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Other Expenses

In addition to the standard costs of buying property, a fund will also need to meet the costs of the advisers required to assist in establishing this strategy. Trustees and members alike must also understand that significant costs may also be incurred in unwinding this strategy.

Further risks are likely to arise specific to the property purchase and fund circumstance, these will need to be investigated and understood before any action is taken to commit to this strategy.

So is it for me?

Whilst it is clear, that even in the face of the risks, property instalment warrants offer a unique and powerful opportunity to maximise the wealth accumulation in super. It is imperative that any Trustees and members considering such a purchase should ensure that they fully investigate the benefits and the risks before committing themselves to this investment strategy.

As with any gearing strategy, the use of property instalment warrants will be better suited to younger member's in the accumulation phase as they are better able to take advantage of the long term growth potential of property. These members will also need to be comfortable with the risks inherent in any gearing strategy i.e. rising interest rates and maintaining an ability to meet the costs of the strategy.

Business owners looking to hold their business premises through their superannuation fund may also find this strategy of interest.

This strategy will essentially suit any fund that has the cash flow to support the proposed financing arrangement and the belief that the property or investment asset has the capital growth potential to more than absorb the initial and ongoing costs of the strategy in the time horizon of its members.

Getting the right advice

It is imperative that any Trustee or member considering the use of an instalment warrant to purchase an asset through their superannuation fund get thorough financial and legal advice. The superannuation environment is a complex legal structure with significant monetary implications for those not abiding by the Regulations.

Aspley Jandera Superannuation Specialists is able to provide comprehensive financial and strategic advice on this strategy and has the professional network to ensure that the appropriate legal documentation is also prepared. Our services in this area can:

- Assist you in deciding whether or not the strategy is for you;
- Consider alternate direct property strategies in super;
- Establish the appropriate structures and ensure that the correct documentation is in place;
- Assist with maintaining and reviewing the strategy;
- Keep you informed of any legislative changes; and
- Adjust the strategy to maintain its compliance with the Regulations.

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Why use our services

Our advisers have an extensive background in superannuation, specialising in complex superannuation, estate and investment strategies particularly with regard to self managed superannuation funds. Our advisers have presented at numerous National professional association conferences on the topic of superannuation, including The Financial Planning Association of Australia, The Self Manages Super Fund Professional Association and The Family Law National conference to name a few. With professional backgrounds spanning Chartered Accountancy and Financial Planning, together with over 15 years experience, they provide the perfect professional base from which to develop superannuation strategies.

For more information regarding the above strategy or to book a place at an upcoming seminar please phone 1300 79 10 69, or visit www.ajsuper.com.au.

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Case Study

John and Mary are both employed earning \$100,000 and \$60,000 respectively. John is 45 years old and employed as a sales manager, while Mary is 43 and works in a diagnostic laboratory. A number of years ago they both established a self managed super fund. Their fund has accumulated assets of \$600,000 and their employers both make the mandatory superannuation guarantee contributions to their fund. They presently, do not make any other contributions to superannuation.

Both John and Mary are interested in their ability to purchase a property through their self managed fund and would like to structure the property purchase as an instalment warrant investment. They have seen a commercial property they would like to purchase with the following details and transaction costs:

Purchase price:	\$800,000
Stamp duty:	\$31,490
Deposit:	\$431,490
Loan required:	\$480,000

John and Mary would like to know the effectiveness of owning this property through their super fund.

The following assumptions are made with regard to the property and the accompanying loan:

Expected property income return:	6.50%
Expected property capital return:	4%
Instalment warrant interest:	11% p.a.

Making the investment in the instalment warrant will mean that \$248,510 of assets will remain in the fund, the following assumptions around these investments are as follows:

Income Return:	6.50%
Franking:	0%
Capital return:	3%

To consider the effectiveness of the property instalment warrant strategy consideration needs to be given to the following:

1. Cash flow assessment
 - a. Where the super fund does or does not hold a property instalment warrant; and
 - b. Where John and Mary do or do not hold the property personally given consideration to the different loan amounts available personally.
2. Capital return assessment
 - a. Comparing the net capital return where the property is held through a superannuation instalment warrant or personally having regard to the different personal tax rates.

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Cash flow assessment

1. Superannuation annual income assessment comparison between John and Mary investing in a property instalment warrant and where they do not

	Purchase Property Instalment Warrant	No Property Instalment Warrant
Income		
Super guarantee contributions		
John	\$9,000	\$9,000
Mary	\$5,400	\$5,400
Income from property	\$52,000	
Income from other investments	\$12,426	\$39,000
Total income	\$78,826	\$53,400
Expenses		
Instalment interest	\$52,800	\$0
Taxable income	\$26,026	\$53,400
Tax payable @15%	\$3,904	\$8,010
Net income	\$22,122	\$45,390
Tax as a percentage of net income	17.65%	17.65%

Please note that in the above example no allowance has been made for accounting fees in both scenarios. Furthermore no allowance has been made for depreciation in the property instalment warrant scenario nor have any council rates, strata levies, insurance or other costs been factored into this scenario. Therefore the fund's taxable income under the property instalment warrant scenario may be reduced further than what the above scenario depicts. These expenses have not been included as they vary greatly.

You will note from the above table that where a property instalment warrant is used the tax payable by the fund is lower but the income received by the funds is also lower. Holding the property through an instalment warrant arrangement provides a tax saving of about \$2,700 and a reduction in income of almost \$15,000.

You will also note that the property instalment warrant has little effect on the true tax saving as there is no difference between the tax payable as a percentage of the total net income. Please note that a difference would be seen where depreciation of the property is taken into consideration. Including depreciation would lead see the tax as a percentage of net income fall slightly.

2. Holding the property personally to rather than through a superannuation property instalment warrant

Three scenarios will be compared, the first where John and Mary do not own any investment property and the second where they own the property jointly with a loan the same as that available through a property instalment warrant i.e. a loan of 60% of the purchase price of the property. The final scenario considers the prospect where John and Mary borrow up to 95% of the purchase price

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of the property which they may be able to do where they decide to own the property in their own name. The final scenario will be that of a superannuation property instalment warrant.

It should also be noted that the interest rate used where the property is owned personally will be the standard variable rate which is presently around 9.47% p.a.

	No Property		Held personally (Loan @ 60%)		Held personally (Loan @ 95%)	
	John	Mary	John	Mary	John	Mary
Loan amount	\$0		\$480,000		\$760,000	
Income						
Salary	\$100,000	\$60,000	\$100,000	\$60,000	\$100,000	\$60,000
Property income	\$0	\$0	\$26,000	\$26,000	\$26,000	\$26,000
Total Income	\$100,000	\$60,000	\$126,000	\$86,000	\$126,000	\$86,000
Expenses						
Interest	\$0	\$0	\$22,728	\$22,728	\$35,986	\$35,986
Taxable income	\$100,000	\$60,000	\$103,272	\$63,272	\$90,041	\$50,041
Tax payable	\$27,500	\$12,900	\$28,858	\$13,931	\$23,367	\$9,763
Net income	\$72,500	\$47,100	\$74,414	\$49,341	\$66,647	\$40,251
Total net income	\$119,600		\$123,755		\$106,898	
Tax as a percentage of net income	33.78%		34.58%		30.99%	

Please note that in the above example no allowance has been made for depreciation, council rates, strata levies, insurance or other costs. Therefore the above tax payable may be lower in the two scenarios where an investment property is owned, this would also result in a lower net total net income in these two scenarios.

You will see from the above table that by holding an investment property the net income stream and tax saving will depend on the loan amount. In comparing the above three scenarios, you will note that where the loan represents 60% of the purchase price, the investment property is positively geared and there is no tax saving in comparison to the first scenario where no investment property is purchased. However, the positively geared outcome means that the total net income is higher and therefore the total tax payable also represents a slightly higher amount as a percentage of net income.

Increasing the loan amount to 95% of the purchase price and you will see that John and Mary have a lower total net income and have also paid less tax. This level of gearing does however provide a small tax saving as the total tax payable represents less of the total net income. Again, taking into account any depreciation would further increase this benefit.

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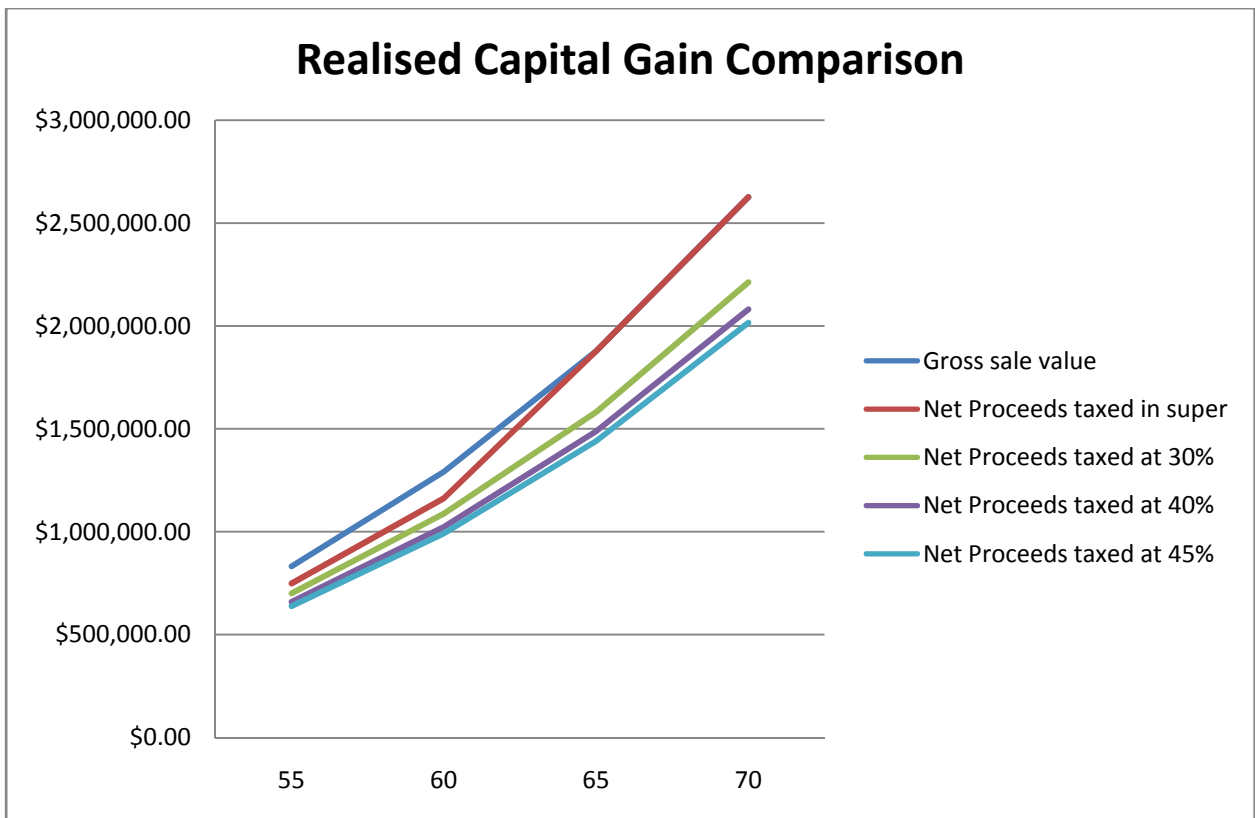


Capital return assessment

In assessing the potential future capital returns, consideration has been made of the net after tax values of the property if sold at various ages as follows:

Age of Mary	Value of property (\$)	Cost base (\$)	Net gain (\$)	Net after tax gain (\$)			
				In Super (pension) ¹	Personal tax rates ²		
					30%	40%	45%
55	1,246,374	831,490	414,884	373,396	349,540	328,796	318,423
60	1,444,888	831,490	613,399	552,059	516,789	486,119	470,784
65	1,675,022	831,490	843,532	843,532	710,676	668,499	647,411
70	1,941,810	831,490	1,110,320	1,110,320	935,445	879,929	852,171

Assuming that the super fund is entirely in the pension phase by the time Mary is 65 and is entirely in the accumulation phase when Mary is 55 and 60.



From the above table and graph you will note the significant savings that John and Mary may enjoy if the property is held in super rather than holding the property in their own name, particularly when the fund is entirely in the pension phase, up to almost \$200,000 by Mary's age 65. When the super fund is the pension phase no capital gains tax will be payable as the fund pays no tax on assets which support the payment of a pension to a member.

¹ The following calculations include the capital gains tax discount as it applies to assets in super.

² Note that the following calculations include the capital gains tax discount as it applies to personally held assets and includes the Medicare Levy.

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You will see age does not make any difference to the net gain outcome if the property is held personally as tax will be payable depending on the marginal tax rate that applies. Even with the 50% capital gains tax discount, the net capital gain is still significantly larger if the property is held in John and Mary's super fund.

Summary Outcomes

Cash flow assessment outcomes

1. There is no real tax saving in the super fund where the property is held as an instalment warrant because superannuation has a flat tax rate of 15%, although a small difference may exist where depreciation is considered;
2. The higher interest cost in superannuation is only offsetting a 15% tax rather than the 30% or 40% tax applicable to Mary and John when the property is held personally;
3. John and Mary may have access to a larger loan where the property is held personally resulting in a greater ability to further leverage their personal assets and which may also result in a larger tax saving;
4. With the higher interest cost of the property instalment warrant, the super fund is more reliant on income from the property investment as well as income from the fund's other investments and member contributions;
5. Property instalment warrant investments returning lower income streams, for example residential property, may cause significant income stress on the fund and thus require a more rigorous assessment of the expected cash flows;

Capital assessment

1. John and Mary stand to benefit significantly where the property is held in their super fund and not sold until their fund is entirely in the pension phase;
2. It should be remembered that the significant savings seen in the tables and graph are based on a 4% growth rate, should the property appreciate by a higher rate the savings would be even greater;

Overall summary

In assessing the effectiveness of the property instalment warrant strategy for John and Mary it is clear to see that they would not enjoy a significant year on year cash flow benefit and this may cause some concern in years where the property or the fund's other investments are not able to provide an income stream sufficient to cover the interest and other costs of the fund. It should be noted however that both John and Mary are able to increase their superannuation contributions up \$50,000 each. These additional contributions may assist in meeting the fund's expenses. Therefore it is crucial to assess the cash flows of the fund and the proposed property investment to identify any potential issues and put a plan in place to address these should they arise.

John and Mary would also see that by owning the property in their own name they would be able to borrow more and pay a lower rate of interest. The interest costs are also then offsetting a 40% and 30% tax rate rather than the flat 15% tax rate in superannuation. Again, the differences between holding the property in super and John and Mary's own name would need to be more fully assessed

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and include an additional assessment of other strategies that may be employed to achieve the same or similar outcome.

It is clear to see that the property instalment warrant would provide a more superior capital return, particularly where the property is sold when the fund is paying both John and Mary a pension. The property instalment warrant strategy is clearly a strategy which can maximise a couple's wealth however the issues raised above and the other issues raised in the article need to be considered before entering into this strategy.

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