Super-leveraged property investment has arrived in Australia

Eagle Funding Pty Ltd

Phone: 1300 552 471 Fax: 1300 552 476

Email: info@eaglefunding.com.au

Web: www.eaglefunding.com.au/SMSFloans.htm

1 Structure Information for Advisors

Superannuation funds can now borrow money to purchase real estate. An investor can have just as much choice and control over investment properties inside as outside a superannuation fund.

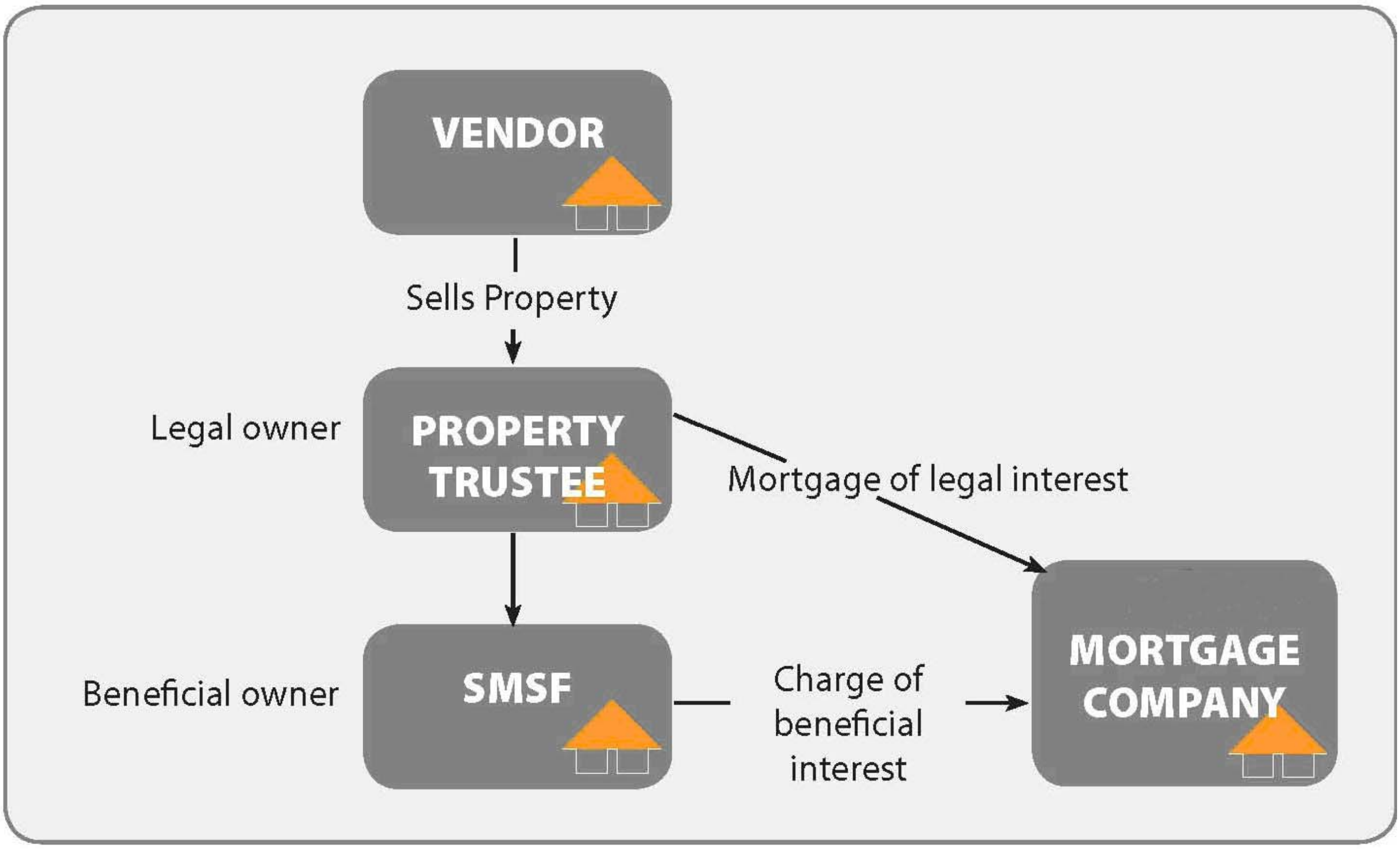
Many Australians have significant money in superannuation, and more and more are establishing their own self managed super funds (SMSFs). Many people would like to be able to include direct investments in real estate in their super fund's investment portfolio.

SMSFs want to gear their real estate investments in order to diversify risk, increase the yield on the investment, and because many funds do not have sufficient money to purchase real estate outright.

Until recently, this has not been possible for most SMSFs because of restrictions on superannuation funds borrowing and charging their assets. However, the Superannuation Industry Supervision Act (SIS ACT) was amended in September 2007 to allow super funds to borrow and charge their assets so long as a special structure is used.

Features of the structure

- Choose any kind of property including residential, commercial, retail, and holiday units.
- A super fund can purchase real estate let for business purposes from a member or a related entity (ie this does not breach the "in house asset" rule under the SIS Act). Investments in property other than "business real property" are permitted provided the purchase is from an arms-length vendor.
- The legal owner of the real estate will be the Property Trustee. The beneficial owner of the real estate will be the SMSF.
- The lender has no recourse to the other assets of the SMSF, providing the SMSF with absolute protection for its other assets.
- The loans are personally guaranteed by the member/s of the SMSF (subject to credit approval).
- SMSFs can deal with the property however and whenever they like, in the same way as investors can deal with "normal" investment properties (eg: lease, renovate, repair, or sell), (subject to the terms of the relevant loan and mortgage).
- All rents are paid direct to the SMSF. Loan repayments are made in the ordinary way from the SMSF.
- The SMSF can pay out or reduce the mortgage at any time (subject to the terms of the relevant loan).
- When the mortgage is paid out in full, title to the property can be transferred to the SMSF or the Property Trustee can continue as registered proprietor.



2 Q & A

Q1 How does my SMSF purchase a property?

- The SMSF chooses the property it wishes to invest in, in the ordinary way. Residential property must be purchased from an arm's length vendor. Non residential property can be purchased for full value from related parties so long as the property is let for business purposes.
- The SMSF obtains a loan approval.
- The SMSF's own lawyer/conveyancer acts on the purchase in the ordinary way. The purchase MUST be in the name of the Property Trustee. .
- The SMSF pays the deposit, the balance purchase money (less the amount borrowed), the legal costs, and stamp duty in the ordinary way.
- On completion of the purchase the Property Trustee mortgages the property to the lender.
- SMSF then manages the asset in the same way as you would with any other real estate investment.

Q 2 Can I occupy the property?

No. If a member of the SMSF occupies the property the "in-house asset rule" would be breached.
However, the SMSF can buy a property that the investor intends to live in after retirement. This is possible if you transfer the property from your super fund to yourself after you retire.

Q 3 I thought super funds could not borrow or charge their assets. Is this correct?

That was correct, until amendments to the Superannuation Industry (Supervision) Act 1993 (SIS Act) made in September 2007. Under the new section 67 (4A) of the SIS Act, SMSFs can borrow providing the following conditions are satisfied.

- The borrowed funds are used to purchase an asset (e.g. real estate)
- The asset is held on trust for the SMSF by another entity (ie the Property Trustee).
- The SMSF must have the right to acquire legal ownership of the asset by making payment.
- The lender's recourse against the SMSF must be limited to the underlying asset (ie the purchased property). The lender must not have a right of recourse against other assets of the fund.

Q 4 What other restrictions apply?

SMSFs must comply with all regulations applying to superannuation funds.
SMSFs may acquire up to 100% of the fund's total assets in the form of real property. SMSFs must ensure that the level of investment in real property is in line with the fund's investment strategy, including diversification of assets, liquidity, and maximisation of member returns in the fund.
Where a fund invests 100% of its assets real property, trustees must ensure that the fund continues to meet these requirements, for instance they must ensure the fund has sufficient liquidity to meet its liabilities (such as pension payments).
The government has also made it clear that super funds investing in these types of investments must have appropriate risk management measures in place and must understand the risks of investment.

Q 5 Who pays what and when?

As the beneficial owner of the property and the borrower of the loan, the SMSF is responsible to pay all the usual amounts that you would expect to if you had bought an investment property and borrowed money on it in your own name rather than your super fund. For example, your SMSF will be required to pay:

- council rates, water rates, and land tax (if any);
- interest and other loan repayments;
- lender's fees; repairs;
- property management costs; and
- any insurance premiums / management fees imposed by the Property Trustee.

Q 6 What about land tax?

As the SMSF is the beneficial owner of the property, land tax is payable by the SMSF. The SMSF will only have to pay land tax if the total land values exceed the proscribed amount.

Q 7 What happens when the loan is fully repaid? Can legal title be transferred to the SMSF? Would any stamp duty or GST be payable with respect to the transfer?

When the loan is fully repaid, the SMSF is entitled to have the legal title transferred to it. Depending on how the trust structure is set up and administered, this transfer should be possible without incurring tax, GST, or stamp duty liabilities (other than nominal) as the SMSF will already be the beneficial owner. Of course, this position may change because of future changes in the law.

Q 8 How can I transfer the property?

The SMSF can direct the Property Trustee to sell to any third party (subject to paying out the mortgage loan and any other amounts which might be outstanding).

Q 9 Who can be the Property Trustee?

The Property Trustee should be an arms length trustee from the SMSF Trustee and the members of the SMSF. This is to ensure that the transaction is not a sham, and the related party and in house asset rules are complied with. Eagle Funding can introduce you to a service which provides an arms length trustee.

Q 10 Is there an ATO product ruling for this loan?

No, there never will be because each individual's circumstances are different. Eagle Funding has obtained its own legal advice (available for perusal by interested parties) but each borrower and/or adviser should seek their own expert tax opinion, based on their individual circumstances.

3 The Product

Effectively Eagle's new SMSF loan falls within existing credit policies and procedures. The main difference is that we require interest payments quarterly in advance.

An important feature of our product is that it allows individuals to find their own properties. This is an important point as it differentiates Eagle Funding from many other lenders who link up with developers to sell residual stock (which may be overvalued) using warrants. Thus the decision to invest is entirely that of the SMSF. Like our other loans, all properties are required to be independently valued by 3rd party valuers.

Credit Requirements

Eagle's credit requires all members of the SMSF to provide personal guarantees for the loan to the SMSF. This is akin to Eagle's requirements for standard products offered to investors who invest via company or trust structures.

All applications must meet Eagle's standard credit criteria.

The features of Eagle's loans to SMSFs are as follows.

- Residential securities:
  - 85% LVR for Full Doc Loans;
  - 83% LVR (excluding any further advances for credit fees and charges payable on or before settlement) for Lo Doc Loans.
- Commercial securities:
  - 78% LVR for Full Doc Loans (including any further advances for credit fees and charges payable on or before settlement);
  - 75% for Lo Doc Loans (inclusive of any further advances for fees and charges payable on or before settlement).
- Maximum loan size - $2m for Residential securities, $5m for Commercial securities;
- Maximum exposure to any one guarantor - $6m in total;
- Post codes - Metropolitan areas only;
- Purchases only - except certain commercial properties which fall within the exemption to the "related party" prohibitions in the SIS Act;
- Loans are Principal & Interest Amortising Loans with interest payable quarterly in advance. Interest only periods may be available;
- Loan term:
  - Residential - 30 years (max 5 years interest only);
  - Commercial - 25 years (max 5 years interest only);
- Due to SIS Act restrictions, no top ups or redraws allowed.

CASE STUDY

Sandra is a 47 year old partner in a firm of architects who was looking at purchasing a unit for $500,000 as an investment. Her financial planner recommended she weigh up the alternative strategies of a "normal" negatively-geared investment or setting up a Self Managed Super Fund (SMSF) to purchase the investment. Sandra was astonished to find that, by repaying her loan using deductible super contributions, the total projected advantage to her by age 60 would amount to approximately $150,000, including CGT savings.

Assumptions: Loan of $400,000 repaid by salary sacrifice of $2500 pm; Marginal income tax rate 46.5%; Rent received = $600 pw increasing by 3% pa; Property value increases by 5% pa; Loan interest rates average 9% pa over term.

The Process

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1. Establish/review SMSF

(a) The Trust Deed establishing the SMSF must give the Superannuation Fund Trustee power to:

1. purchase real estate,
2. borrow money, and
3. mortgage property to secure repayment of that borrowing.

(b) The proposed investment must comply with the requirements of the SIS Act (including the "sole purpose test - see section 62 of the SIS Act which requires that regulated superannuation funds are obtained solely for the provision of retirement benefits to members).

(c) Ensure that the investment in real property is in line with the SMSF's overall investment strategy (note that superannuation funds must have a written investment strategy), and the proposed purchase complies with all other requirements of the S1S Act (including but not limited to the "in-house asset rules" and the restrictions on acquiring assets from "related parties”

2. Establish the Property Trust Deed

It is desirable that the trustee company is not associated with the investor/SMSF. This is to ensure that the arrangement is not a "sham”. "Sham "arrangements are likely to be viewed by the ATO "form over substance" arrangement and may therefore be considered to be non-compliant with the intention of the SIS Act amendments.

The Property Trust Deed is a key document. Care is required to ensure there are no adverse GST, taxation or stamp duty consequences.

3. Instructions to Solicitors/Conveyancers

Accountants should ensure that the lawyer / conveyancer acting for the SMSF on the purchase of the property understands that the property must be purchased in the name of the Property Trustee. This is an essential part of the structure - the SMSF cannot be the registered proprietor.

1. Obtain loan approval

Loan approval should be obtained from Eagle Funding in the ordinary way. Eagle Funding has a broad range of products specially designed to cater for SMSF borrowing arrangements.

The structure of the loan is:

a. Borrower: SMSF fund;
b. Security: a charge over the SMSF's beneficial interests in the property, with recourse for repayment of the loan limited to the property;

a mortgage over legal estate owned by the Property Trustee, again with recourse limited to the security;

a guarantee by all the fund's members and possibly a mortgage over other real estate owned by the guarantors outside the SMSF fund.

The SMSF fund cannot give collateral security.

The loan proceeds can only be used to purchase the property and there can be no subsequent advances.

2. Contracts exchanged

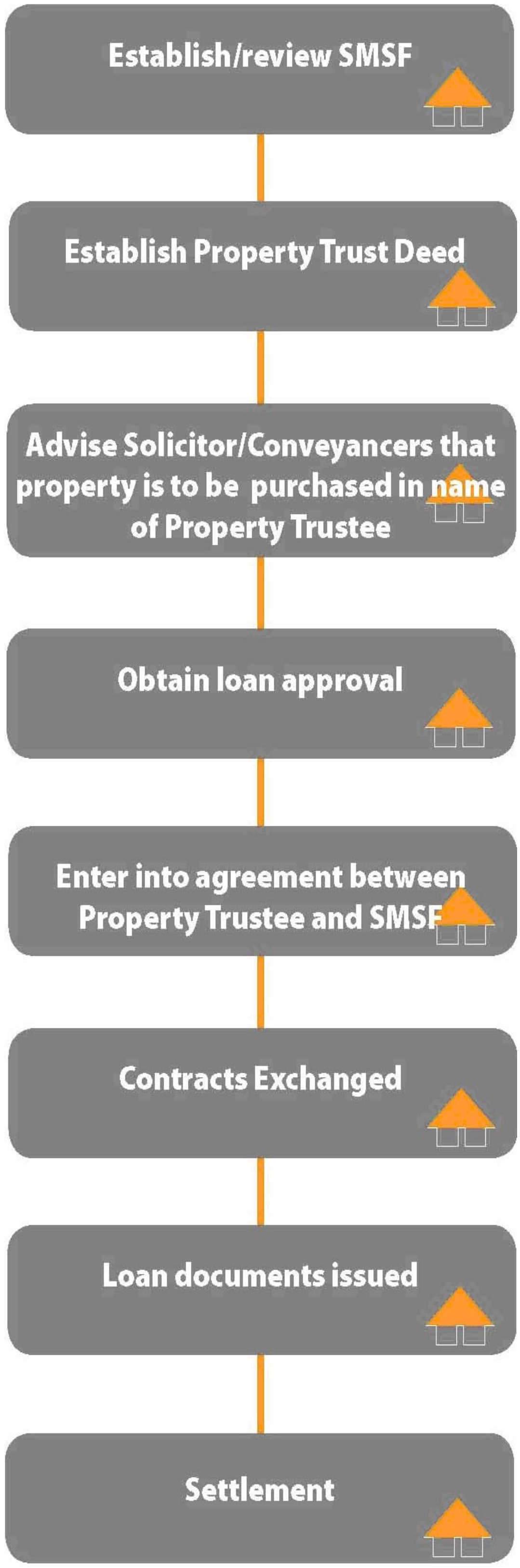
When contracts are exchanged between the seller as vendor and the Property Trustee as purchaser, the deposit will be paid by the SMSF. There is no need for the deposit to be paid through the Property Trustee, although this can occur if you wish.

3. Loan documents issued

Eagle’s lawyers will prepare the loan documents in the ordinary way and send them to the SMSF's lawyer/conveyancer for signing and return. The Eagle Funding SMSF borrowing structure uses normal loan and mortgage documents with special provisions to provide the limited recourse against the asset. Accordingly, the SMSF fund has its own discrete loan and provides its own discrete security.

4. Settlement

The purchase is completed. After registration of the transfer on the mortgage, the transaction/title documents will be held on behalf of Eagle Funding as lender.



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