

SMSF AND INSTALMENT WARRANTS

Overview

In November 2006 the Australian Taxation Office (ATO) and the Australian Prudential Regulation Authority (APRA) declared that the use of instalment warrants constituted a breach of the super borrowing restrictions. This was a reversal of previously held positions on instalment warrants published in policy advisory circulars.

In order to avoid widespread chaos on financial markets the federal Government announced that they would amend the existing legislation to allow borrowing under instalment warrant arrangements. The amending legislation was passed in September 2007 and surprised the superannuation industry by allowing super funds to borrow for investments in all permitted assets as long as a strict set of criteria are satisfied.

Key Changes

The Superannuation Industry (Supervision) Act contains a section that prohibits a super fund from borrowing money with exceptions made in limited circumstances.

In September 2007 the amending legislation introduced a new exception to the borrowing restrictions. The exception is titled *Exception –instalment warrants* and outlines the conditions under which instalment warrants can be used to purchase any permitted asset.

The conditions imposed on the arrangement are:

1. The money borrowed is applied to purchase an asset;
2. The asset that is purchased is held in trust for the super fund and the super fund holds a beneficial interest in the asset purchased;
3. The asset purchased is one that the super fund is permitted to purchase under the legislation;
4. The super fund has a right, but not an obligation, to acquire the asset after making one or more instalment payments; and
5. The loan style is of limited recourse, where the rights of the lender to recover the loan in the event of a default are limited to the asset purchased.

It is noteworthy that the loan to the fund is not required to be from an approved lender or an issuer of instalment warrants such as a bank. This is an important point as it allows a SMSF to put in place its own instalment warrant based on the legislative criteria.

In House Assets

Another section of the legislation was also amended to alter the meaning of an in house asset for super purposes. This was necessary as the instalment warrant arrangement imposes a relationship with a related trust.

This part of the legislation restricts a SMSF from investing in a related trust over a prescribed amount. The amending legislation now allows this type of investment where the related trust meets the criteria mentioned above.

What Is An Instalment Warrant?

Instalment warrants are unique to Australia. They are a means to gain exposure to a share (or any type of asset) by only paying a portion of its price. However, the full benefits of ownership, such as dividend income, are received by the instalment warrant holder. The sale of Commonwealth Bank and Telstra shares when they were issued are the most highly visible style of this type of arrangement.

Banks issue instalment warrants over the top 50 shares on the Australian Stock Exchange. To invest in an instalment warrant an amount of money, the first instalment, is made to the issuer. This could be somewhere between 40% and 60% of the share's current price. The first instalment will vary between issuers and the underlying share being purchased.

The issuer of the warrant purchases the share and holds it in trust for the warrant holder. The warrant holder has a beneficial interest in the share and as such is entitled to dividends and the franking credits that the share may receive. Depending on the contractual terms of the warrant, the dividends may be paid to the warrant holder or be used to reduce the outstanding loan.

The second instalment is made up of the difference between the first instalment and the final strike price of the warrant plus interest and borrowing costs. The amounts that comprise the second instalment are the loan that is made by the issuing institution to the purchaser of the warrant. The payment of the second instalment is optional.

At the end of the contractual term of the warrant the holder may choose one of two options:

1. Exercise the warrant by paying the second instalment and the full ownership of the share is transferred from the trust to the warrant holder; or
2. If the share price has dropped significantly, let the warrant expire.

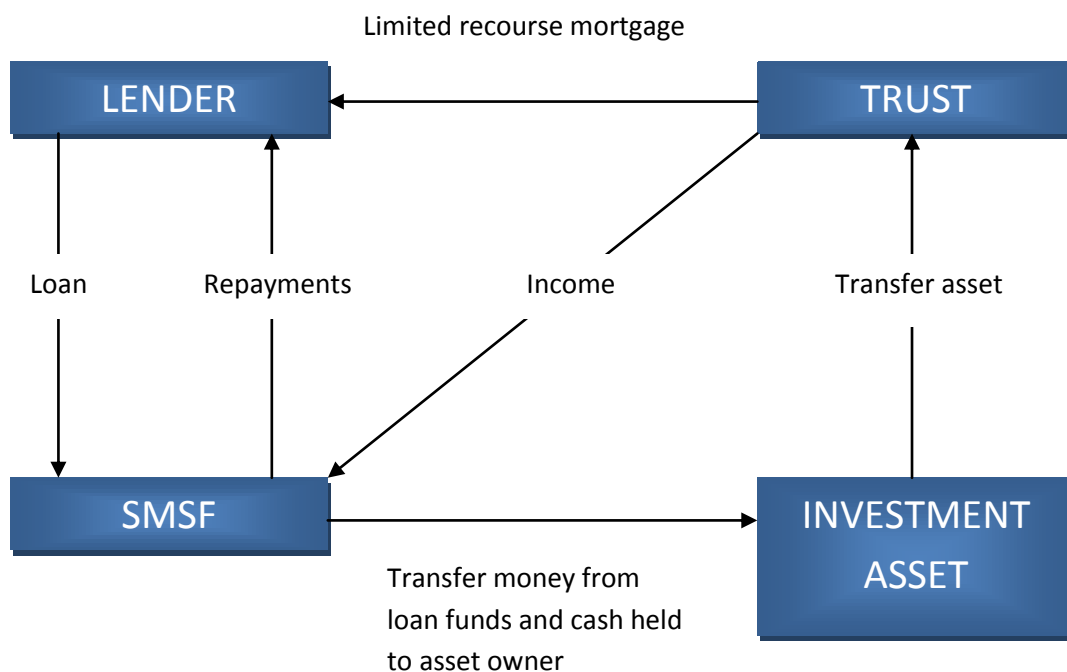
In the event that the second option is taken the issuer sells the share on the market to repay the loan outstanding on the warrant. If there is any residual then this is returned to the warrant holder. It is important to note that if there is any shortfall then the issuer does not have any recourse against the warrant holder to recoup this loss. (In practice the issuer has a put option over the share to cover this contingency).

It is evident then that the benefits of warrants are similar to a gearing strategy in that the purchase of the asset is leveraged while the full benefits of the income and tax deductibility of the interest and borrowing costs are received by the warrant holder.

There are no margin calls on instalment warrants and the limited recourse nature of the loan means that the investor can only lose the amount of the first instalment.

Instalment Warrant Arrangement

As mentioned a SMSF could arrange its own instalment warrant as the legislation does not stipulate that the loan must come from an approved provider. An instalment warrant arrangement would have the following characteristics to comply with the criteria.



1. The SMSF trustee organises a loan from a lender. The lender could be a bank or it could be a member of the fund. As the legislation does not stipulate who the lender has to be it could be any lender or related party.
2. The loan money in addition to money the fund holds are used to purchase the asset which is held in a trust specifically created to hold the asset the SMSF wishes to purchase. The SMSF has a beneficial interest in any asset purchased by the trust as well as the right but not the obligation to take full ownership of the asset by making one or more instalment payments.
3. This asset may be a share, real property, a managed fund or another type of permissible asset.
4. As the beneficial owner of the asset, the SMSF receives any income derived by the asset.
5. Once the final instalment (repayment) is paid full title of the asset passes to the SMSF as the loan has been extinguished.

Practical Applications

Leveraging Superannuation's Low Tax Rate

Super is extremely tax effective as the tax rate is only 15%. Gearing can magnify the benefits by taking advantage of the low tax rate as follows:

Assume Frank has his own SMSF with a cash balance of \$500,000 available to invest and his employer contributes \$100,000 to his fund. Frank has been considering investing the \$500,000 into an Australian share portfolio and now is considering investing the \$500,000 into an instalment warrant geared to a level of 50%. Assuming the same shares are purchased, only the proportion changes, and a yield of 4% fully franked is obtained and the instalment warrant interest rate is 8% the SMSF's tax outcome is very favourable.

	Instalment Warrant	Direct Share Investment
Assessable Income of SMSF	\$157,142.86*	\$128,571.43*
Interest Deduction	\$40,000 (8% of \$500,000)	\$0
Taxable Income	\$117,142.86	\$128,571.43
Tax on Taxable Income	\$17,571.43	\$19,285.71
Less: Franking Credits	\$17,142.86	\$8,571.43
Total Tax Payable	\$428.57	\$10,714.28

*The fund's assessable income includes the \$100,000 employer contribution

The benefits of this strategy are that the fund has effectively doubled the amount invested in the share portfolio to \$1,000,000 and increased its dividend income and franking credits available to decrease the fund's contribution tax liability.

Small Business Owners

A small business owner could potentially take advantage of the changes to the legislation in the circumstances where they would like to own their own business premises. A SMSF may be a tax efficient means of holding the property asset to enable a business owner to leverage off superannuation savings and not locking up non-superannuation capital in a property asset, provided they have enough money accumulated in the fund.

Examples

Daniel and Alana own a small business and they are currently leasing premises from a third party. They have found some premises that are better suited to their business and would like to purchase them in their SMSF. Their fund has available \$500,000 and the premises that they are interested in costs \$900,000. Daniel and Alana could purchase the property under an instalment warrant arrangement using the \$500,000 in the fund and borrowing the remaining \$400,000. The advantages of this method of purchase to them are:

- By accessing the capital available in their SMSF they have effectively reduced the amount they had to borrow by \$500,000
- The rent they pay on the premises goes directly to their SMSF increasing their retirement savings while the rent is still deductible to their business
- The interest on the instalment warrant is deductible to the SMSF
- The rent is income and not a contribution meaning that Daniel and Alana can contribute up to their concessional contributions cap on top of the rent that they are paying
- Any capital gain arising on the sale of the premises is capped at 10% if the premises are held for over 12 months and may be 0% if the premises are sold in the pension phase

This strategy is quite advantageous to business owners especially when one considers that the business premises that they would otherwise have purchased in some other structure would tie up large amounts of capital and have large repayments associated with the borrowings. Also, the business owner will generally benefit from the protection afforded under the bankruptcy rules.

Additional Information

Use of Existing Assets

There are retail instalment warrant providers that take existing shares owned by a SMSF and transfer them into instalment warrants. This is called either cash extraction or shareholder application style warrants. The ATO and APRA have ruled that this type of transaction is prohibited as they deem it creates a charge over an existing asset of the fund.

Dealings With Related Parties

The amending legislation has not changed the rules relating to dealing with assets acquired from a related party. The exemptions in the legislation to acquire listed shares and business real property from a related party still exist but it has not exempted the purchase of a residential property from a related party.

Arms Length Transactions

This means that any transactions with a related party must be conducted on commercial terms as if the party were at arms length.

GST and Stamp Duty Issues

The structure and wording of the instalment warrant arrangement is critical to ensure that CGT and stamp duty do not apply on the subsequent transfer of the asset from the trust to the fund once the final instalment payment is made. This is on the basis that the SMSF is absolutely entitled to the asset being held via the related trust.

In particular, when dealing with real property each state has different stamp duty rules and it is essential to seek specialist advice.

Duration of Warrants

The duration of the instalment warrant is at the discretion of the trustee.

Investment Strategy

The investment made by the SMSF must be made having considered the investment strategy of the fund, its suitability and the risk profile of the fund's members.

An instalment warrant is a derivative product and as such the trust deed and investment strategy must allow this type of investment. In addition, a derivatives risk statement is required and consideration of the use of derivatives within superannuation as advised by APRA should be considered.