Pen of Paul

Changes in the Laws Governing SMSFs

If you have a Self-Managed Superannuation Fund (SMSF) changes in the governing legislation may be of interest to you.

There has generally been a prohibition on a SMSF acquiring assets from a related party. One major exception was that it was permissible for a fund to purchase business real property from related parties. Many smart operators have taken advantage of this feature: They were able to utilize their retirement savings so as to inject capital into their business operation, at the same time as moving one of their business's main capital assets into the milder tax regime of superannuation. It also meant the business received a deduction for rent, whilst the Fund had to declare rental income. This effectively shifted an amount equal to the rent out of the company tax regime – currently 30% – into the superannuation tax regime of just 15%.

Of course, the amount of cash which could be injected into the business using this strategy was limited to the Fund's resources.

Changes to the supervisory legislation means a SMSF is now permitted to borrow to acquire investment properties – residential or commercial. A Fund can still not acquire residential property from a related party, but these changes mean it can now borrow in order to purchase business real property from a related party. There are a number of constraints, including the requirement for the Fund to have a corporate Trustee, the requirement for the transactions (including subsequent rent paid to the Fund) being at arm's-length market rates, a cap on the level of gearing (63% of lender's valuation) and the requirement for the strategy to have been approved by a licensed financial advisor. There are various other technical requirements, but I won't bore you with these. I really don't think any of these requirements are onerous – rather, they are in keeping with the general notion that we should be prudent with our retirement savings.

There are higher borrowing costs than for other borrowing entities, but this can be mitigated if the Trustee ensures the Fund attends to all regulatory requirements before lodging a finance application.

So how can this change to legislation help the small business entrepreneur? Let's say the owners of a small business have a fundamentally sound business, but are somewhat under-capitalized. This is an all too common situation, and the consequent lack of working capital can severely hamper the business's performance. Let's also say the business is operating out of premises with a bank valuation of $700,000. If the existing gearing is too high, it may be very difficult to find further finance. Now let's also say our business owners have accumulated around $300,000 in their superannuation fund. The Fund could borrow up to around $440,000 secured against this property, thus enabling it to acquire the property.

Hey presto! The business is now no longer under-capitalized. The owners haven't been forced to sell the business, nor to secure their house against it. The business can realize its potential, and thus ensure maximized growth in the value of goodwill when the business is eventually sold. Rent is moved to the more benign superannuation tax regime, as is the appreciating asset of land and building.

Is this strategy for everybody? No. I would suggest this strategy is most suited for a Fund whose fund members (the business owners) are relatively young – say no older than 55. It would only be appropriate in a situation in which there is a fundamentally sound business. (A very good indicator of this is the 'Balanced Scorecard' shown in your Resurg Group Benchmark report.) It would also only be appropriate if there was a very high probability of obtaining a reasonably good capital growth on the property. Finally, if you are not fiscally self-disciplined, the strategy is not for you – in fact, if you fit into this category it is probably not wise to have a SMSF!

The above scenario has been presented for illustrative purposes only, and should not be construed as advice. If you are contemplating employing such a strategy, you should contact a licensed financial advisor and your accountant.