Self Managed Super – Costs and risks of borrowing by self managed superannuation funds (SMSF)

A SMSF may borrow to acquire assets as part of the fund's investment strategy.

Although gearing can deliver benefits, the risks associated with gearing may mean it is unsuitable for you. It is essential to carefully consider these risks before proceeding with a gearing strategy.

Risks

The risks associated with borrowing to invest within a superannuation fund may mean it is unsuitable for some SMSFs and its members. It is essential to carefully consider these risks and to seek professional advice before proceeding with this strategy.

The specific risks associated with borrowing to invest within superannuation include:

- **Reduction in capital value**. Although there are potential wealth creation benefits to be gained from borrowing, these benefits are achieved at the expense of higher risk.

It is important to note that although borrowing funds has the potential to increase capital gains in a rising market, it can also compound a capital loss in a falling market. The following table provides an example.

Starting Values	Geared	Non-Geared
Investor Equity	$40,000	$40,000
Amount borrowed	$60,000	$0
Total Investment	$100,000	$40,000
Market Rises 10%		
Value of Investment	$110,000	$44,000
Loan outstanding	-$60,000	$0
Investor's Equity	$50,000	$44,000
***GAIN* in Investor's Equity**	**25%**	**10%**
Market Falls 10%		
Value of Investment	$90,000	$36,000
Loan outstanding	-$60,000	$0
Investor's Equity	$30,000	$36,000
***LOSS* in Investor's Equity**	**-25%**	**-10%**

- **Interest mismatch**. The success of the strategy hinges on the earnings (income and capital growth) of the proposed investment being greater than the borrowing costs. There is a risk that investment earnings are lower than borrowing costs. You should consider this carefully before borrowing within superannuation. The taxation benefits of this strategy should not be considered in isolation.
- **Deductibility of borrowing costs**. There will be assessable income and interest tax deductions generated within the SMSF. This will not provide any personal assessable income, or personal tax deductions. Within accumulation phase, assessable income less allowable deductions is taxed at a maximum rate of 15%. However, income derived in retirement phase is taxed at 0%.
- **Loss of immediate access to your funds**. If further funds are contributed to superannuation to cover the interest costs and instalment payments, these funds will generally be preserved until you meet a condition of release.

- **Capital gains tax (CGT)**. Within accumulation phase, capital gains are taxed within the fund at a maximum rate of 15%. When sold, if the asset has been owned for at least 12 months, capital gains are taxed at a rate of 10% (one third discount applies). If the asset is sold at a loss the capital loss may only be offset against assessable capital gains. There are no CGT consequences if the asset is sold in pension phase.
- **Liquidity risk**. The nature of some assets (e.g. property) is illiquid, meaning that it takes a longer time sell the investment in order to repay the loan in the case of an unforeseen event.
- **Market timing risk**. The asset may need to be sold at a time when the sale price is at a low-point, for example if the SMSF cannot meet the loan repayments due to cash flow problems.
- **Investment restrictions**. Superannuation funds have restrictions on acquiring certain assets, such as in-house assets and the acquisition of certain assets from related parties.
- **Existing SMSF assets**. Existing SMSF assets cannot be placed into a limited recourse borrowing arrangement. The giving of a charge over an existing asset of the SMSF (as would generally occur under such arrangements), would result in a contravention of the operating standards that apply to the trustees of superannuation funds.
- **Total super balance**. The outstanding balance of the LRBA entered into from 1 July 2018 is included in your total super balance if:
    - you satisfy a condition of release that allows you full access to your superannuation, or
    - if the loan is provided by an associate.

  Conditions of release for this purpose are retirement, terminal illness, permanent incapacity and reaching age 65. Associate includes members of the SMSFs, relatives and related entities (such as companies and trusts).

  The amount included in your total super balance is on a proportional basis to recognise the amount supporting your interest in the fund. If applicable, this is tested at the time of SMSF entering into a loan arrangement and on an ongoing basis. The inclusion of this amount in your total super balance may impact your ability to make certain contributions to superannuation. LRBA arrangements entered into before 1 July 2018 are not assessed under this rule. This exemption also extends to pre-1 July 2018 loan arrangements that are refinanced after that date.
- **Fluctuations in interest rates**. If interest rates on borrowed funds increase, then you will incur additional costs that will need to be covered. This may affect the attainment of some of your goals and objectives.
- **Arm's-length**. If the lender is a superannuation fund member or a related party it is essential that the borrowing, as well as any approved acquisition of an asset from a related party, is conducted at arm's-length. The Australian Taxation Office as issued guidance on the features of loans from a related party to an SMSF. That is, market rates of interest, terms and conditions including the value applied to the asset being transferred, are commercial. Penalties apply for non-compliance.
- **Defaulting on the loan**. If the superannuation fund defaults on the loan (i.e. does not pay the loan or interest repayments when they are due), the lender may impose a penalty payment or ask for the loan to be repaid in full immediately. You should ensure you read your loan documentation thoroughly and seek legal advice if you have any queries or do not understand the documents. Under the legislation, it is a requirement for the loan to be 'limited recourse' whereby the lender is only able to recover monies where there is a default on the borrowing by repossessing or disposing of the asset acquired, but cannot recover such monies through recourse to the SMSF's other assets.
- **Loan costs**. An application fee may be payable when you apply for the loan, the details of which can be found in the Loan Application. Other fees may include a monthly service fee and, if applicable a facility fee. In addition, government fees may also apply. These may include stamp duty on the loan and State Government charges which differ from state to state. Some lenders may require adequate personal insurance to be put in place in order to pay off the loan should the death or incapacity of a SMSF member occur.
- **Trust costs**. There will be a cost for setting up the Security (or bare) Trust needed to implement this borrowing strategy, plus ongoing costs for maintaining the trust. You will need to seek professional legal advice about setting up a trust.

- **Ending your loan**. If you decide to end or terminate the loan facility, it may be necessary to sell the underlying investment in order to do so. This means you could be selling the investment at a lower price than what you paid for it, or too early for the borrowing strategy to have provided significant benefits. The recommended minimum investment term for this strategy is 7 years.
- **Legal documentation**. Appropriate legal documentation is crucial as incorrect drafting could potentially lead to a breach of the super or tax legislation, or additional cost such as CGT and stamp duty. Logistical issues such as the pricing of the limited recourse borrowing arrangement, whether actuarial advice is required, potential investment strategy and trust deed amendments must be considered.
  Appropriate documentation must show the SMSF trustee(s) has made a genuine borrowing to acquire an asset, particularly when the amount borrowed is from a member or related party. If documentation is inadequate, the amount borrowed may be treated as a superannuation contribution received by the SMSF, which could lead to significant tax consequences if any superannuation contribution limits are exceeded.
- **Divorce**. In the case of divorce, it is important that the members and/or parties involved seek independent professional legal advice as superannuation assets are taken into consideration in relation to property settlements.
- **Bankruptcy**. Superannuation could potentially provide a degree of asset protection in the case of bankruptcy. Again, we recommend that all parties seek professional legal advice.
- **Transaction costs**. The higher the transaction costs the greater the investment must perform to avoid loss. Please refer to the financial projections attached to this advice for a list of estimated and anticipated costs to implement this strategy.
- **Legislative risk**. Legislation applying to SMSFs may change in the future. The Australian Taxation Office and/or courts may also change their interpretation and enforcement of the legislation. This may change the effectiveness of the borrowing strategy.

Version: 3.0
Issue date: 01 July 2021