

SMSF BORROWING AND PENSIONS - ARE THEY COMPATIBLE?

Borrowing in a SMSF takes on a different dimension when the fund is paying, or considering paying, a pension to a member.

This article enters the debate which has occurred in the superannuation profession around the topic:

Is a SMSF which is paying a pension to one or more members permitted to enter into a SMSF borrowing arrangement?

Is it Permitted?

It has been suggested that a SMSF in pension mode may not enter into a borrowing arrangement because of the provisions of reg. 1.06(9A)(d) of the SIS Regulations. In respect of Account Based Pensions, the Regulations read:

SIS Reg. 1.06(9A)(d)
the capital value of the pension and the income from it cannot be used as a security for a borrowing.

Does the regulation prohibit SMSF borrowing because the capital value of the pension cannot be used as security for a borrowing?

Although there is little legislative assistance upon which to base a response to the question, one factor to consider is the timing of both the prohibition on pledging capital value of pensions and their income as security for borrowing, and the 2007 introduction of legislation which permitted borrowing in SMSFs.

Although Account Based Pensions were introduced in 2007, the earlier forms of pensions available to be paid from SMSFs, such as Allocated Pensions and Market Linked

Pensions, contained a similar prohibition. In other words, the prohibition similar to the one in SIS Regulation 1.06(9A)(d) has been in existence well before the contemplation of permitting borrowing in SMSFs.

Also, the regulation applies not only to SMSFs but to all regulated superannuation funds. That lends credence to the suggestion that the SIS Regulation is member based and not fund based.

What that means, is that the regulation is designed to stop the pledging by a member of their interest in the capital and income of a superannuation income stream.

Example – pledging pension entitlement

Andrew, a sole member and director of the trustee of his SMSF, is currently receiving a pension in the form of a transition to retirement income stream from his SMSF.

Having drawn the maximum pension from his fund for the year, Andrew is short of money which he requires to meet specific urgent expenses.

He arranges with a short term lender for a loan to cover his expenses and provides security for the loan by pledging the pension and income from the SMSF.

In doing so, Andrew has acted contrary to the provisions of SIS Regulation 1.06(9A)(d).

If the regulation is member centric, then it would stand to reason that the trustee of the SMSF is not constrained from entering into a SMSF borrowing arrangement and pledging the acquired asset as security for the loan.

The ATO has confirmed that, in its view, the prohibition relates to the member and not the trustee when stipulating that the pension assets and income must not be used as security for a borrowing. However, that has not been confirmed in a binding ruling from the ATO, so some caution should be exercised.

There has also been a suggestion that if the assets of a SMSF are specifically identified as supporting the pension (segregated), those assets must not be used as security for any limited recourse borrowing.

This suggestion stems from the fact that the trustee of a SMSF, which is both paying a pension and has entered into a limited recourse borrowing arrangement, could be jeopardising the pension account of the member by pledging the asset as security for the loan.

Note:

The assets of a SMSF, in instances where the fund is only paying a pension and has no money in accumulation accounts, are considered to be segregated.

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However, there does not appear to be any legislative basis for that argument. When considering a borrowing in either pension or accumulation phase, the risk to member benefits remain the same.

Is it Viable?

Having ascertained that SMSFs paying a pension are not prohibited from entering into a SMSF borrowing arrangement, the question remains as to whether a fund which is paying a pension can **viable** enter into, or maintain, a SMSF borrowing arrangement.

Each scenario will be judged on its merits, as each will maintain different characteristics.

Considering the possibility of the impact different gearing levels will have on cash flow, those levels will to some extent determine the viability of such arrangements.

Despite borrowing to acquire an asset, some arrangements will be positively geared, meaning that the income generated from the investment outweighs the interest and other costs associated with holding the investment.

The two main considerations which should be judged by the trustee of the SMSF are:

- **cash flow** - the ability of the fund to meet both the loan payments and the minimum pension (at least, as the member may have higher pension expectations) requirements; and
- **taxation** - will the fact that at least a portion of the income

of the fund is not taxable, and that same portion of expenses is not deductible, mean that the usual taxation benefits from negative gearing will be lost?

Viability will not be a positive factor in all instances, and should therefore be determined on an individual basis, by taking into account the extent of the planned gearing, the ability to meet cash flow needs and whether the expenses of entering into a SMSF borrowing arrangement will be outweighed by the expected income and capital gains from the investment.

In Conclusion

A SMSF in pension mode **can** borrow to acquire a single acquirable asset. Whether it **should** do so is a matter for consideration of the trustee, depending on the specific circumstances of the particular fund.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

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