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Leverage and Self Managed Superannuation Funds

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The Cooper Review[1] did not make recommendations to limit use of leverage by SMSFs but recommended that recent proposals relaxing constraints on usage be reviewed in two years. There are several reasons which, on balance it is argued, support the view that SMSFs should not be able to leverage investments, and that policy should be changed accordingly.

Self Managed Superannuation Funds (SMSFs) have, for some years, been able to invest in levered products such as instalment warrants, despite a general legislative prohibition on borrowing by superannuation funds. Instalment warrants package together in a single financial product an investment in a listed stock with a no-recourse loan (of perhaps 50 per cent of the stock value) from the warrant provider. The warrant provider purchases the stock in trust for the investor, using the initial instalment contribution of the investor and the loan amount. Because the loan is no-recourse, the maximum loss to investors should they not make the required loan repayment (the "final" instalment) is the initial instalment amount. In that event, the warrant provider bears any loss due to the stock value being less than the final instalment amount, while otherwise the investor pays the final instalment and acquires ownership of the stock.

The attraction to investors of such products is the opportunity to leverage investments without risk to other wealth holdings (for which benefit a price is paid via the fees and interest paid to the warrant provider) and to exploit tax "arbitrage" opportunities. Some SMSFs have utilised investment structures which have enabled them to make instalment warrant type levered investments in property, by investing funds in a separate trust which purchases property using non-recourse loans. The Government's March 2010 proposals[2] for changes to tax treatment of instalment warrants would effectively remove some anomalies in the tax legislation regarding treatment of ownership and taxation for such products and make use of such products simpler. The Cooper Review recommends that this issue should be reviewed in two years time and that providers of such products should be required to provide improved data on usage to enable better understanding of this market segment.

There are a number of arguments as to why use of instalment warrant products by SMSFs is not socially optimal and thus should not be permitted.

[1] http://www.supersystemreview.gov.au/
[2] http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1724

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First, use of instalment warrants increases the risk being taken by the SMSF. While choice of a risk profile of investments is at the option of the SMSF trustees, it is not obvious that use of financial products which increase risk beyond some level is consistent with the policy objectives which justify concessional tax treatment of superannuation.

Second, because companies whose stocks are incorporated into instalment warrants borrow to finance their assets, those stocks are already levered investments on the underlying assets. Investment via an instalment warrant thus involves a doubling up of leverage.

Third, the tax deductibility of interest is permitted when a loan is taken out for investment in an asset which is expected to produce taxable income. One attraction of leverage, such as via instalment warrants, is the opportunity for "tax arbitrage" when some part of investment returns takes the form of capital gains which are subject to a lower tax rate.[3] In the case of SMSFs, the investment is made to generate income which is already concessionally taxed (in addition to any advantageous treatment of capital gains in general). Whether tax deductibility of interest on loans taken out to generate concessionally taxed income is a socially appropriate or optimal policy is open to debate.

Fourth, one consequence of allowing SMSFs to invest in such products is to give incentives for financial services firms to create such products to market to SMSFs. And in general, complexity of product structure can become substantial. It is arguable whether trustees of SMSFs are able to adequately assess the risks and expected returns of such products, such that any tax benefits ultimately end up accruing to the providers of such products via excessive fee levels.

Fifth, it should be recognised that some proportion of the population will attempt to "rort" the system, while many others will be unable to understand its complexities. The former can be seen through attempts by SMSF trustees to structure property investments with a limited recourse loan from a third party – but where the trustee provides a personal guarantee to the lender. The latter is observable from the stream of requests to financial advisers about whether particular investment structures are feasible. Providing opportunities for leveraged investments contributes to both problems, and an optimal policy may be to simply ban such products rather than trying to police non-compliance with the requirements.

Finally, policy settings such as maximum contribution limits (and the now removed *reasonable benefit limits)* indicate a policy view that some upper limit on tax concessions provided through the superannuation system to individuals should apply. Allowing SMSFs to leverage up their concessionally taxed investments is at variance with that view.

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[3] There is also a more subtle tax arbitrage effect arising from the inappropriate legislative treatment of some part of fees paid (which are essentially an option fee payment) as loan interest. See Christine Brown and Kevin Davis "Taxing Capital Protected Equity Products" Agenda, 12, 3, 2005, 239-252