

Paul Bolstad

Paul Bolstad is an AMP Financial Planner and director at boutique financial planning firm AGS Financial Group. The business focuses on providing an integrated financial advice model to its clients. AGS Financial Group offers advice on self-managed superannuation (SMSF), corporate superannuation, mortgage broking and accounting services.

SMART STRATEGY FOR SMSF SUCCESS

Deciding to take control over their own impending retirement, Mike and Sara Jones*, 51 and 45 respectively, established a corporate fund for themselves in March 2011.

In the following months they sought the guidance of AGS Financial Group to discuss their self-managed super funds (SMSF), the legal implications of being trustees for this fund and how to maximise their assets.

"Both Mike and Sara intend to retire at age 60, and with their good health and income, we determined they were both of a moderately aggressive risk profile," said Paul Bolstad, financial adviser and director at AGS.

New to the world of SMSF, Mike and Sara had to be made aware that as trustees of the Jones Family SMSF they were obliged to prepare and adopt an investment strategy for the fund, of which there was currently none, as part of the trustee covenants and operating standards.

"During our meetings we have discussed the fund's current position, the gaps between where the fund is and wants to be, and our recommended strategy."

Mike and Sara were fairly clear on their investment goals and objectives from the outset, with urgent needs for a strategy, insurance cover and a better management of their fund.

On their first meeting, Mike and Sara outlined their specific investment aims of the fund, including a superannuation rollover of $299,391 for Mike and superannuation rollover of $14,524 for Sara and the understanding of ongoing regular contributions.

"The Jones' were clear on their objectives and what they needed from this fund to ensure they retired by age 60. Along with an investment strategy, they also wanted advice about how best to acquire a $200,000 parcel of Australian shares."

"Based on the fund's investment strategy, needs and investment objectives, and circumstances of the fund, we recommended they take a moderately aggressive (85% Growth) approach to investing."

The moderately aggressive (85% Growth) asset allocation is structured to invest across all asset sectors, but will mainly consist of more aggressive investments. As the fund's trustees under a moderately aggressive investment approach, Bolstad told the Jones' must be prepared to accept higher volatility in the short to medium-term, with the primary focus being to accumulate growth assets over the long term.

The minimum investment term for this investment approach was six years.

Overall Bolstad and the Jones' decided to invest around 85% of the fund's assets in growth assets to achieve these goals.

"Our recommended strategies will give the Jones' much needed exposure to different types of asset classes which will provide the fund with diversification and smoother returns over the member's investment horizons."

Bolstad and the Jones' agreed that an annual review of investment recommendations would be ideal to allow for changing circumstances of the fund.

SMSF borrowing strategy

One of the goals of the Jones' fund was to acquire a $200,000 parcel of Australian shares in December 2011.

"When we first met, the fund did not have sufficient assets to undertake such an investment," said Bolstad.

"We recommended that the Jones Family SMSF borrow $200,000. The fund can then use these borrowed funds to purchase the shares. Superannuation fund trustees are able to borrow monies in order to purchase an investment asset provided the borrowing meets certain strict conditions."

Where an SMSF borrows under these rules, the borrowing needs to meet the requirements outlined under superannuation law. This includes the trustees entering into a loan arrangement and uses the borrowed funds to purchase an acquirable asset, the asset must be held by a custodian on trust for the SMSF, the fund must have a right to acquire the legal title to the asset from the custodian following the repayment of the loan and finally the rights of the lenders, or any other party, against the SMSF must be limited to the rights relating to the underlying asset.

Bolstad discussed the benefits, risks, considerations and costs involved in such a strategy and the issues that need to be addressed when borrowing through a superannuation fund.

"We made clear to Mike and Sara that third parties would need to be consulted, such as legal and tax professionals, who are familiar with this area."

Four steps were outlined to the Jones' on how to implement the borrowing strategy:

The Jones Family SMSF organises to borrow money

A related individual advised that she is able to lend the amount required to the Jones Family SMSF.

Bolstad recommended the move to allow the fund to purchase the $200,000 share parcel.

"However, while the ATO will allow this, before implementing this recommendation it is important for Mike and Sara to ensure that the loan terms and conditions are established on a commercial arms length basis. This will also require that a commercial rate of interest be paid. This will require the services of a solicitor to ensure that the loan agreement is properly drafted and that the terms of the loan are properly documented."

Use the $200,000 of borrowed monies to purchase shares

This asset will need to be held on trust for the fund. Once a trust arrangement has been established, the fund will become the beneficial owner of the asset held within the trust and receive a right to acquire the asset from the trust at a later date, once the loan has been repaid.

"Again, the need for legal advice is paramount here as failure to follow proper legal processes may potentially result in superannuation rules being breached, excessive stamp duty costs, and an increased potential for Capital Gains Tax (CGT)."

Generated investment income

Income generated from the $200,000 share parcel will be treated as income of the Jones Family SMSF and taxed within the fund. Any costs and expenses related to the holding of this asset will also be payable by the fund.

Ownership change

Once the outstanding loan amount is repaid, the ownership of the shares can pass from the trust into the Jones Family SMSF.

"We found that in order to be able to make the required loan repayments on time, the fund needed to have sufficient cash flows to meet these loan repayments," said Bolstad.

Loan repayments for an interest only loan at 8% pa will be $1,333.33 per month ($16,000 pa).

The shares will generate an estimated income of $7,000 pa, so additional funds of $9,000 pa will be required from the SMSF bank account to meet the regular loan repayments.

"On the chance that loan interest rates would rise then Mike and Sara would need to allocate a larger portion of regular member contributions to the SMSF bank account so that cash is available to meet the higher loan repayments."

If the borrowing arrangements, and the associated trust structure is established correctly from the start, there should not be any CGT nor stamp duty implications when the loan is repaid and the asset is transferred to the fund. However, appropriate tax and legal advice should be sought in this regard.

Borrowing benefits and pitfalls

As with any investment strategy there were benefits and potential dangers with the borrowing strategy Bolstad had recommended, but with the right third party advice and with a well executed set up, he felt certain it would reap high rewards for the Jones.

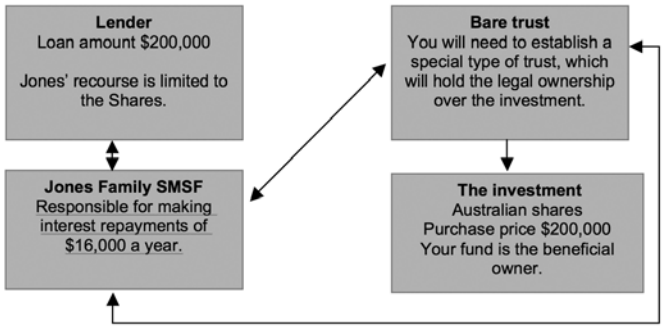
"By borrowing $200,000 and purchasing the shares, the fund is now able to gain a valuable asset through a manner that should result in a tax deduction for the Jones Family SMSF that should improve the funds after tax returns."

Bolstad also felt the potential for accelerated wealth accumulation and that due to limited recourse nature of the borrowed monies, only those assets would be vulnerable to creditors in the event of a default.

However, using such a strategy would require the establishment and ongoing management of additional trust structures and possibly other entities, along with additional costs for legal advice, SMSF administration, accounting and tax advice, establishment of entities.

"There are some disadvantages to a borrowing strategy of course, such as impacts from market conditions on repayments and the complexities associated with establishing and maintaining borrowing arrangements such as high penalties for poor documentation, but overall I felt this strategy will produce strong results for the Jones'."

Figure 1: How the fund's borrowing strategy will work



Exit strategy

"Whilst we do not expect anything to go wrong, things can and often do. In a borrowing arrangement, it is important that we have a plan of action in place should something go wrong, therefore we recommended that the shares be sold and the loan repaid if needs/circumstances change. If the shares are sold at a loss, then the loss will be born by the Jones Family SMSF," said Bolstad.

Insurance analysis

Following requests received from members of the Jones Family SMSF, as part of their overall risk planning solution, Bolstad determined the required levels and types of insurance cover needed for Mike and Sara.

When first meeting with Bolstad, no insurance policies were owned by the fund that could provide benefits to the beneficiaries of these fund members in the event of death, disability, or serious illness.

"I recommended that Mike get Term Life cover for $1,310,000 and TPD for $765,000, while Sara was suited for $450,000 of Term Life cover and $450,000 of TPD. These policies will be owned by the Jones Family SMSF," said Bolstad.

"We have conducted an assessment of the fund's cashflow position and found that there is sufficient cashflow to ensure that the premium payments can be paid out of the fund's cash flow. These insurance premiums can generally be claimed by the fund as a tax deduction when completing its tax return each year.

"This recommendation is appropriate as it meets the fund's goals of establishing appropriate levels and types of insurance cover for the benefit of fund members as well as improving the tax position of the fund."

Fee structure

During the first meeting, Bolstad and the Jones' agreed the scope of the initial and ongoing services including the Statement of Advice, annual reviews, performance reports, asset allocation reviews and any reviews as a result of changed circumstances.

"We should regularly review the fund's financial situation to ensure it remains on track and in line with the stated investment strategy. The circumstances of the fund and its members can change over time and this can have a significant impact on the suitability of our advice and recommendations," said Bolstad.

Bolstad provided a detailed table of costs associated with the provision of advice and recommended products to the Jones', with the option of ongoing fees for advice being charged as a fixed dollar amount or as a percentage of the investment balance

The agreed advice fee was $3,485 with an ongoing annual cost of $3,960. The recommended product costs for all listed products was around $5,000 while annual insurance premiums were $5,130.72

"This figure is the standard premium for the first year of cover in the quoted policies at the standard rates for the insurer. The actual premium payable and premiums for subsequent years may vary after the application for cover has been processed," said Bolstad.

*Note: * Names changed to protect identity*

Table 1: Bolstad's recommended investment strategy

Sector	Benchmark (%)
Defensive Asset Sub-Classes	
Cash	0.00%
Australian Fixed Interest	8.00%
International Fixed Interest	7.00%
Total Defensive Assets	15.00%
Growth Asset Sub-Classes	
Australian Shares	34.00%
International Shares	31.00%
Listed Property	5.00%
Direct Property	3.00%
Other*	12.00%
Total Growth Assets	85.00%

Table 2: investment strategy adopted by the Jones' after receiving advice

Sector	Range (%)
Defensive Asset Sub-Classes	
Cash	0% - 25%
Australian Fixed Interest	0% - 25%
International Fixed Interest	0% - 25%
Growth Asset Sub-Classes	
Australian Shares	24% - 44%
International Shares	21% - 41%
Listed Property	0% - 15%
Direct Property	0% - 13%
Other*	2% - 22%

**'Other' includes alternative assets which refer to any non-traditional assets that would not generally be found in a standard investment portfolio. Examples of alternative assets include hedge funds, private equity, infrastructure and 'real' assets such as commodities and agribusiness schemes.*