If you think your mortgage is high, look who's paying 8.85pc

DIY super fund borrowers are being slugged with a 65 per cent rate increase, which could force some to sell or refinance.

Duncan Hughes *Reporter*

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Self-managed super funds that borrowed from family or their own business face interest rates of nearly 9 per cent, triggering concerns they could be forced to sell assets or refinance.

The minimum rate for related party loans – provided by someone connected with the fund instead of a bank – has risen from 5.35 per cent to 8.85 per cent to catch up with 12 increases in the cash rate since May 2022. The higher rates apply from July 1.

It means related party loan rates – set by the Australian Taxation Office once a year to reflect movements in the cash rate and commercial rates – have jumped from the cheapest to potentially the most expensive for SMSF investors. They compare to an average rate of 6.5 per cent being paid by a property investor not using an SMSF.

SMSF loan providers' lowest variable rates

Lender	Rate (%)
Freedom Lend	6.94
Homestar Finance	6.74
La Trobe Financial	7.09
Liberty Financial	7.00
loans.com.au	6.74
Firstmac	6.99
Reduce Home Loans	6.89
Regional Australia Bank	8.94
WLTH	6.94
Yard Home Loans	7.00

Source: RateCity

Liam Shorte, a founder and financial adviser with SMSF specialist Sonas Wealth, says: "It's harsh but is based on a catch-up of cash rate increases set by the Reserve Bank of Australia. It could put some property investors' cash flows under pressure."

Paul Rafton, a partner at tax consultancy BDO, believes it could also accelerate the move from related party to commercial loans provided by banks and other lenders. "This seems to be the trend," he adds. "There is less audit scrutiny involved with a commercial loan. A related party loan requires a lot more work, such as document preparation and presentation."

Chris Foster-Ramsay, principal of Foster Ramsay Finance, adds: "There are already signs that refinancing of SMSFs has started and will continue over coming months as these higher rates begin to bite."

SMSFs, which have around 1.1 members and nearly $890 billion under management, are popular with property investors, particularly small business owners who use them to purchase their work premises, ranging from factories to medical practices.

The loans account for around 7 per cent of SMSF assets, with commercial and industrial property being twice as popular as residential. About 16 per cent of the funds borrow $500,000-$1 million, according to ATO data, which suggests there is also strong demand for residential.

SMSF specialists suggest the following strategies for borrowers affected by the rises in related party loan rate.

Find a new lender: The lowest commercial variable rates on offer range from 6.74 per cent to 8.94 per cent.

The structure of SMSF loans differs from traditional home loans. All SMSF loans must be set up through a limited recourse borrowing arrangement [https://www.afr.com/politics/ban-on-smsf-property-loans-rejected-20221013-p5bpj6] that minimises the risk to other assets in the fund if the borrower defaults.

Borrowers typically require a loan-to-value ratio (LVR) of 80 per cent, which means a 20 per cent deposit. Commercial property loans usually require a 70 per cent LVR. Major lenders, including CBA, have pulled out of these loans because they are so complex.

Peter Burgess, chief executive of the SMSF Association adds: "We have seen an increase in the number of SMSF loan products being offered by non-bank lenders. SMSF borrowing arrangements are complex, so we always recommend investors seek specialist advice."

Raise rents: Rafton's BDO says all transactions must be "arm's length", which means landlord and tenant have to act independently without one party influencing the other.

According to SQM Research, demand for residential property remains at record highs. Its analysis shows residential property rental listings fell by more than 7 per cent during the past 12 months, with most cities posting declines.

There is also robust demand for warehouses and other logistical property. Demand for office space and retail varies depending on location.

Rafton warns the ATO will be closely monitoring tax claims on rental income, including requiring lenders and other financial institutions to provide details of their clients' personal financial data to help corroborate use, income and expenses.

Play by the rules on related party loans: Peter Burgess, chief executive of the SMSF Association, says while related party lending rate rises are "discretionary", members must prove to the ATO that any loans are compliant with its guidelines on commercial rent.

Rafton says lower rents could make the ATO suspicious of "mates' rates" for the tenant, while excessively high rents could be boosting income into the fund.

"The ATO will want to see evidence of due diligence in granting of the loan, which includes the rate, term and borrowers capacity to pay," he says. "It must be not more or less favourable than a commercial loan."

That means a rate that might reasonably be expected if the parties were dealing at arm's length with one another. Breaches of the "arm's length" rule could result in taxes at the highest marginal rate of 45 per cent.

Alternatively, Rafton recommends selling the property [https://www.afr.com/wealth/superannuation/5-things-to-check-before-unwinding-an-smsf-property-loan-20190204-h1atst] or, where possible, pay off the loan sooner.

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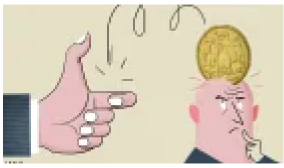

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Duncan Hughes is a Walkley award-winning personal finance reporter, based in our Melbourne newsroom. *Connect with Duncan on Twitter. Email Duncan at duhughes@afr.com.au*