

STRUCTURING FOR THE FUTURE WITH COMPANIES AND TRUSTS

How do you borrow funds for an investment property through a trust or company? story **STUART WEMYSS**

More and more investors are starting to think about the legal structures that they have in place when investing in property, or any other assets for that matter. It's important to maintain perspective when considering legal structures, because you not only need to think about what is the best structure for you now, but also what is the best structure for the investing term (which may be 20 or 30 years).

It's critical that you obtain quality professional advice when setting up your structure. After all, once property is owned by a certain entity, it can be very costly to change the ownership structure later on. For example, there would be stamp duty and capital gains tax consequences.

Many investors opt to invest through a discretionary trust. In my experience this is the most common structure.

A trust is not a separate legal entity. A trust is an agreement that certain people (called beneficiaries) may be entitled to certain property as determined by the trust deed.

The trustee is a person or company that is responsible for holding property on behalf of the trust, because you need a legal entity to actually own the property. The trustee is usually a proprietary company, for tax and legal reasons.

There are many benefits of investing through a trust, including improved tax planning opportunities (i.e. income streaming), asset protection and estate planning. However, I will leave the pros and cons of investing through company and trust structures for another day.

A SIMPLE STRUCTURE

When investing in property via a trust, the trustee will hold

the property on behalf of the trust. Therefore, the name on the property's title will be the trustee, which is normally a company.

The trustee will normally borrow the money on behalf of the trust. Therefore, the loan will be in the trustee's name. In some circumstances, the loan might be in the individual investor's name, where the investor uses a hybrid discretionary trust. In this case, the investor borrows money to purchase income units in the hybrid discretionary trust. I'll discuss this in more detail later on.

Perhaps the best way to demonstrate how to structure your lending is to go through a simple example.

Assume an investor owns their home, in their own name, and it's worth approximately \$500,000. They have a home loan for \$100,000. They have decided that they would like to invest in property and have been advised to set up a trust for this purpose. They would like to purchase an investment property for \$500,000.

STEP 1

The first thing they need to do is set up a new lending facility so that they can access the equity in their existing home to use as a deposit.

They will need enough funds to pay for a 20 per cent deposit plus costs, such as stamp duties. The reason will be obvious later.

In NSW, the costs associated with a \$500,000 purchase amount to approximately \$20,000. Therefore, they will need to set up a loan for \$120,000 – being \$100,000 (20 per cent) plus \$20,000. The investor's loan structure will look like this.

LOAN	AMOUNT	SECURED BY
Home Loan	\$100,000	Home
Investment loan	\$120,000	Home

It's possible that a lender would allow the new \$120,000 facility to be in the name of the trustee company. It would depend on the structure of the trust (i.e. who is a director and/or beneficiary).

STEP 2

The investor will then need to seek a pre-approval for \$400,000 (that is, the remaining 80 per cent of the property's purchase price) from a lender.

The loan will be in the trustee's name. However, since the trust/trustee is a newly formed entity and earns no income in its own right, the lender will more than likely require a personal guarantee from all the directors of the trustee company. Therefore, the loan structure will be:

LOAN AMOUNT	\$400,000
APPLICANT	Trustee company (on behalf of the trust)
GUARANTOR	Directors of trustee company

STEP 3

Once an investment property is selected the investor will pay for the 10 per cent deposit from the \$120,000 loan facility. On settlement, the investor will pay for another 10 per cent plus costs from this facility. The bank will then set up the new facility in the name for the trustee company for the remaining funds. Therefore, the loan structure will be as follows:

The key benefit of this structure is that there is no cross securitisation, which means there is a good separation between the investor's personal use assets (the home) and investments. A simple definition of cross securitisation is where a loan is reliant upon more than one property as security. In addition, all loan-to-value ratios (LVRs) are 80 per cent or less, therefore there is no requirement for lenders mortgage insurance.

Alternatively, a less attractive structure would be to have one single loan in the name of the trustee company, for 100 per cent of the property's purchase price plus costs. This would be structured as follows:

LOAN AMOUNT	\$520,000 (purchase price plus costs)
APPLICANT	Trustee company (on behalf of the trust)
GUARANTOR	Directors of trustee company
SECURITY	Investment property and home

I don't like this structure much, because it commits one of the biggest loan structuring sins – cross securitisation. This also blurs the separation of investment and personal use assets. Some people like to use a different lender for investment loans and home loans. They cannot do this if they use this alternative structure.

REGISTERED MORTGAGE DEBENTURES

A Registered Mortgage Debenture is an instrument that lenders can use to take a fixed and/or floating charge over a company's assets. It's most common with business finance, where a trading company borrows money for business purposes.

In this instance, a company may own a number of different assets including cash, plant and equipment, debtors, etc. The lender may take a registered first mortgage over real estate property and an RMD as secondary security.

In this circumstance, if the bank sells the real estate security for less than they are owed (for example, if the borrower defaulted on the loan), then the lender can seek the repayment of the shortfall through the sale of the company's other assets such as stock, debtors, etc. This would take place through company administration/winding-up processes.

Some lenders may apply the same policy where a non-trading trust is involved and request an RMD. Lenders do not apply this policy consistently. In addition, it doesn't reduce the risk of the loan in practice, because often a trust set up for property investment rarely owns any other assets apart from real property and a small amount of cash. The lender already has a registered mortgage over the property, which often makes up 99 per cent of the trusts assets.

The point I'm trying to make is that often there is no meaningful reason why the lender should request an RMD. In some cases however, agreeing to an RMD doesn't materially adversely affect the investor either, unless the trust is used for purposes other than property investing.

However, the main downside with agreeing to an RMD is that it may deter other lenders from lending your trust, or trustee, money for future purchases. The existence of an RMD may be enough to scare other lenders away. In some circumstances an investor will be required to seek the bank's permission (i.e. the lender that has the RMD) to allow another lender to register a first mortgage over future property.

For example, assume you have a loan with Bank A secured by one property and an RMD. You purchase another property and seek a loan from Bank B. Bank B may have to get permission from Bank A to register a mortgage over the new property. Obviously, this structure could significantly adversely affect your flexibility.

So what do you do if the lender requests an RMD? Sometimes you can argue with the lender and get them to waive the requirement. It doesn't always work. I have argued until I was blue in the face to no avail. Sometimes, lenders just dig their heels in.

If the lender insists on the RMD then my advice would be to go to another lender. This requirement isn't that common and I consider an RMD as superfluous, where the lender already has a first mortgage.

DIRECTOR, BENEFICIARY... WHO?

As discussed above, lenders will require personal guarantees from the director of the trustee company. This is required to ensure that the company will be able to service the debt.

Lenders can only take a guarantee from a party that is

involved with the trust, such as the director of the trustee company or a beneficiary. They cannot accept a guarantee from someone who is not party to the trust, because they would have no financial interest in guaranteeing the loan (which is a test lenders commonly use).

Consider this example. A wife is the sole income earner. Her husband is unemployed. The husband sets up a trust to invest in property. He is the sole director of the trustee company and sole beneficiary. In these circumstances, the lender would probably not accept a guarantee from the wife because she has no financial interest in the trust.

This restriction is probably not going to cause too many problems in a simple family trust, because normally both husband and wife are beneficiaries. However, if you start involving other family members or third parties in your trust structure, then you need to consider if the structure will limit serviceability.

For example, in a loan application for one of my clients the husband was sole director and beneficiary of an investment trust but the lender needed to rely on the wife's income, in addition to the husband's income, in order to qualify for the loan. Consequently, the wife had to be added as a beneficiary to the trust before the lender could accept a guarantee from the wife.

HYBRID TRUST

Some accountants will recommend people establish a hybrid trust so that the trustee will own the property but the loan will be in the individual's name (which is often useful if the individual is in the highest marginal income tax bracket).

In this circumstance, the loan structure will be:

APPLICANT	Individual
GUARANTOR	Trustee company (this guarantee actually provides security for the loan, i.e. the property)

Not all lenders will accept this structure because the security is provided by a third party (that is, the trustee). Normally the applicants will provide the security for a loan, which is usually property that the applicants themselves own.

Lenders' policies vary greatly on this issue. I've heard that some mortgage insurers will also not accept this structure. However, I have not yet come across this. The important point here is to get some advice from a mortgage broker that is experienced with these structures.

If you want the loan in your personal name, then it's important that the lender will still take into account the rental income from the investment property. Normally, lenders cannot accept serviceability (i.e. income) from a guarantor (i.e. the trustee company). That is, the applicants need to be able to service the loan in their own right. The reason for this is that the lender does not want to have to act upon the guarantee to ensure the loan repayments are made.

However, if the applicants and guarantors are essentially the same people (as is the case with most investment structures) then they will "look through" the structure and, dare I say it,

apply some common sense. However, if the parties on each side (the individuals and directors) are not the same, then this may create a situation where the lender will not take into account the investment property rental income (with a hybrid trust loan structure).

WHAT'S THE DIFFERENCE?

Normally there is no big difference when applying for a loan through a company or trust structure (other than mentioned above). Lenders tend to fall into three categories.

Some lenders will not accept company or trust applicants for residential loans. If a company or trust is involved, then they will classify it as commercial lending and you will have to deal with their business bankers. This normally means higher interest rates and fees, and less flexible products.

Some lenders will lend to companies and trusts but will charge extra fees for doing so. Some fees may include (but the list is not exhaustive):

- Preparation of guarantee documents
- Review of company or trust documents
- Higher ongoing fees

These extra charges can really add up, depending on the loan structure. Before you know it, you could be up for an extra \$300 to \$600, or more.

Some lenders will lend to companies and trusts and won't charge any extra fees or interest for doing so. Obviously, these are the most cost effective lenders to use.

As always, it's important to consider the costs with each option.

SETTING UP FOR THE FUTURE

This is the final article in my loan structuring series (see last month's issue for Part 2 and the Feb/March 2004 issue for Part 1).

These articles demonstrate that there are numerous issues to consider when borrowing to invest in property. However, hopefully they also demonstrate the importance of professional advice from all your trusted advisors including lawyers, accountants and mortgage brokers/lenders. Everyone's situation is different and this creates different issues.

As Gordon Gecko said, "The most valuable commodity in the world is information". ■

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