

Your guide to SMSF in Property

Your future is our focus...



AssetZTM
WEALTH PTY LTD



Superannuation a great way for growing wealth

In simple terms Superannuation is the most tax-effective environment in which to accumulate and hold wealth in Australia. We won't discuss retirement here, but whilst you are accumulating wealth, the tax paid on your Superannuation is capped at 15% and in most cases the average tax rate of Superannuation funds is less than this (due to rebates and deductions). Therefore, building wealth in your own name outside of Super (potentially being taxed at 46.5%) versus inside the Superannuation environment (taxed at 15%) can make a significant difference.

In addition to the tax concessions on the earnings inside Superannuation, there are also some significant concessions for making additional contributions. Salary sacrifice is one common and effective way of not just growing wealth but also reducing the amount of personal tax you pay. Be careful though because there are limits, or caps, on the amount you are able to contribute to your Super before tax each year without incurring penalties, so if this is not managed properly you could end up in a worse position.

Of course, Superannuation for those under their preservation age, (between 55 and 60) can be restrictive as money contributed can't always be withdrawn. However, building wealth is a long-term proposition, (think of how long people hold shares, sometimes for 30+ years) so Superannuation will almost certainly play some part in your overall financial strategy.

There is no substitute for careful planning and consideration when it comes to wealth creation, so our advice is to take a long-term view and don't just think about tomorrow but also consider many years down the track. Think of what you want for yourself in 20 or 30 years and then think about the decisions you are making today which will help you reach your financial goals. With the right decisions, planning and taking advantage of the opportunities to build your wealth, the future can indeed look very rosy.

16 Questions about Property in SMSF

1. What type of property can my fund own?

A SMSF can own business property – offices, shops and factories – and residential investment property. But there are crucial differences between legal requirements for funds regarding business and residential properties.

Business real estate is among the few types of assets that SMSFs are permitted to acquire from their members and other related parties.

And business real estate is one of the few types of assets that funds can lease to related parties – including fund members and their businesses – without a restriction on its value.

Generally a SMSF is barred under the in-house asset rules in superannuation law from leasing or having investments with related parties involving assets that are worth more than five per cent of the fund's total market value. Business property is among the few exceptions to that rule.

SMSFs are prohibited from acquiring residential real estate from related parties – even if market value is paid.

Although self-managed funds are allowed to invest in business and residential property it is a different issue whether the assets are appropriate investments given the circumstances of the fund and its members.

A SMSF can be the sole owner of a property or hold a property with other investors, commonly using trust or partnership arrangements.

Some SMSFs enter arrangements to hold business property with their own members or with other SMSFs. That enables the funds to invest in otherwise unaffordable properties.

2. What are the tax benefits of owning property through my SMSF?

Income and capital gains from a property, as with other fund-held assets, are concessionally taxed.

Income is tax at 15% a year and capital gains are taxed at an effective 10% during a fund's so-called accumulation or saving phase if the property is held for more than 12 months.

Once the assets of the fund begin to back the payment of a superannuation pension fund income and capital gains are tax-free.

That means your SMSF can eventually sell a property in the pension phase without paying a cent in CGT – no matter how much the asset has risen in value over the years.

After members turn 60 superannuation pension payments are no longer taxable.

3. What are the asset protection advantages of owning property in a SMSF?

Assets held in a super fund are legally inaccessible to trustees in bankruptcy provided contributions or asset transfers were not made with the "main purpose" of avoiding creditors. That makes super a prized method of asset protection, particularly as there is no dollar limit on the protection.

Many small-medium business owners for instance place their business premises in a SMSF partly as an asset-protection strategy.

Take the example of husband-and-wife business partners who own business premises in their own names. Depending on the circumstances (including any professional advice received) the couple may decide to sell the property to their SMSF at market value or make an in-specie contribution of the property to the fund. (See the next point.)

4. What should fund trustees watch for when transferring a business property into their SMSFs?

Excess contributions tax will apply if the total value of the in-specie contribution of the premises exceeds the applicable annual concessional or non-concessional (after-tax) contribution caps.

Concessional contributions comprise compulsory and salary-sacrificed contributions as well as deductible contributions by self-employed members and eligible investors.

Under what is known as the bring-forward rule, a fund member under 65 can average the annual non-concessional contributions cap of \$150,000 over three years. In other words that enables a member to make non-concessional contributions up to \$450,000 in a single year, every three years.

Fund members should be aware that when a property changes ownership from a member to an SMSF, CGT is triggered on any capital profits. As already mentioned superannuation law prohibits self-managed funds from acquiring residential property from their member

5. Are there any disadvantages to owning a property through a SMSF?

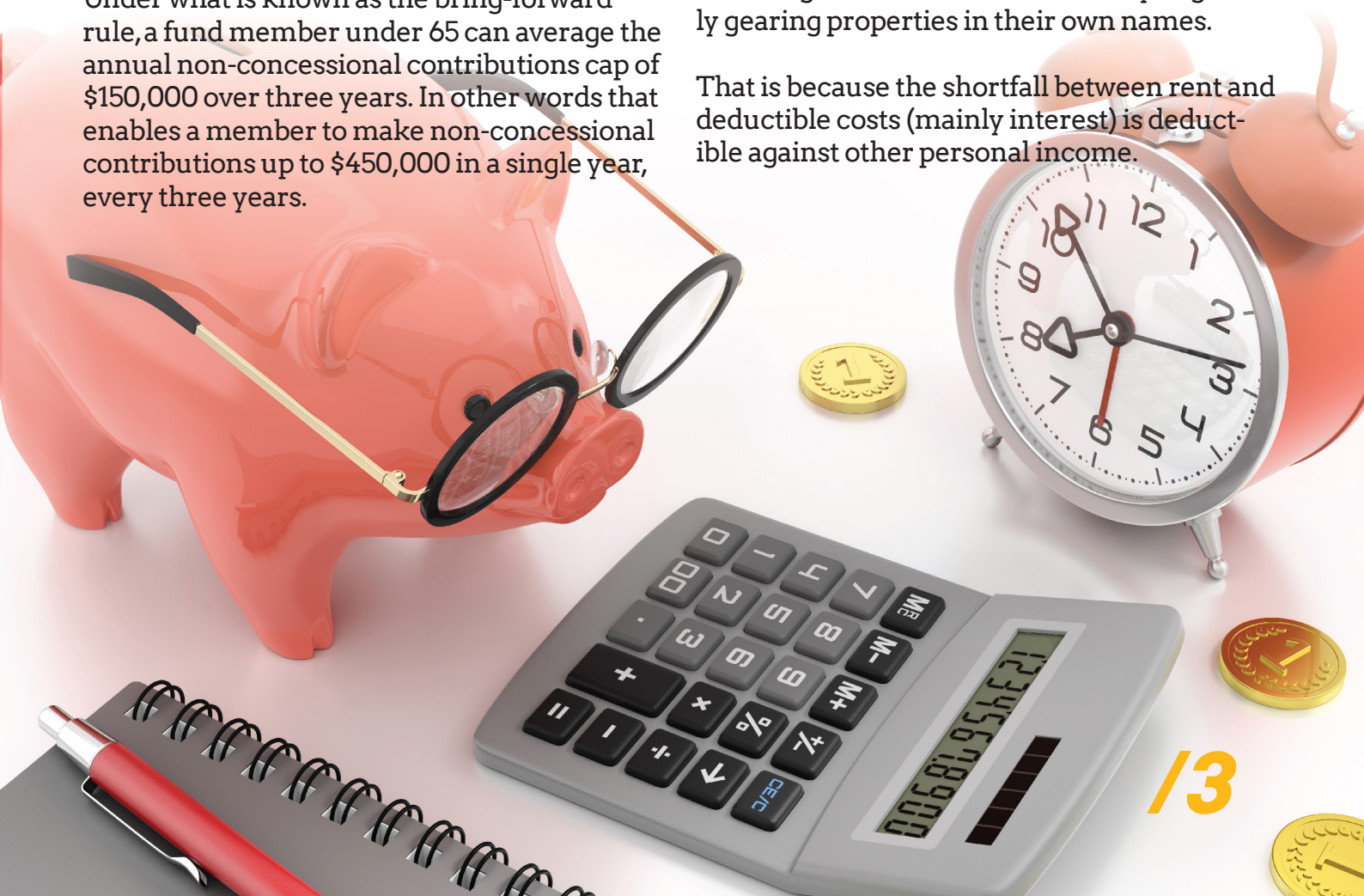
The answer will depend on the circumstances of the fund and the members.

With certain exceptions preserved superannuation benefits must remain in the super system until members permanently retire after reaching their "preservation age" (currently 55) or turn 65.

The locking of benefits into superannuation could be seen as an advantage or disadvantage by some fund members.

A factor to consider is that many high-income earners gain valuable tax benefits by negatively gearing properties in their own names.

That is because the shortfall between rent and deductible costs (mainly interest) is deductible against other personal income.



6. How can my fund gear an investment property?

Superannuation law allows self-managed super funds to borrow to invest using installment warrants or similar arrangements provided strict rules are met.

Geared assets must be held in trust until payment of the final installment and lenders cannot make a claim against any other assets of the super fund, apart from the geared asset, in the event of a default on the loan

7. What are the advantages of gearing property through a SMSF?

First, a SMSF can buy an asset which may otherwise be unobtainable given the fund's total asset value and its level of contributions.

Second, capital gains are multiplied if a geared property rises in value.

Third, borrowing to invest may enable a SMSF to hold a more widely diversified portfolio than would have been possible if all or most of its savings was spent buying a single property.

Fourth, the capital gains are concessional-ly-taxed or tax-free (if the fund disposes of the property when its assets are backing the payment of a superannuation pension).

8. What are the disadvantages of gearing through a SMSF?

Gearing magnifies any gains but it magnifies any losses. Gearing is detrimental for a fund unless the property's value increases. Further, a geared SMSF faces the challenge of trying to ensure there is enough cash flow from earnings and member contributions to service.

9. What happens if my SMSF defaults on an investment loan?

The fund can lose capital and interest payments to the date of the default. As well the lender can deduct its costs of selling the geared property and discharging the loan before paying whatever is left to the fund.

That means a fund which spends all or most of its assets to pay initial loan installments could be wiped out in a worst case scenario.

Astute SMSF trustees would not borrow to invest in property or any other assets without understanding the risks.

A danger is that fund trustees may gain a false sense of security because a super fund is barred from providing any of its other assets as security for a loan.

This provision will not necessarily protect a heavily geared fund from losing much of its members' retirement savings if a property investment turns bad and loan repayments are not met.

10. Why should SMSF members be cautious about giving personal guarantees for property loans?

Although SMSFs are prohibited from providing other fund assets as security for an investment loan there is nothing in the legislation to stop a lender seeking to enforce personal guarantees in the event of a default.

11. Is my SMSF allowed to spend its entire savings on a single investment property?

Superannuation law does not prohibit a fund from owning just one asset. Some fund trustees specifically decide to have SMSF portfolios dominated by a single property asset, perhaps after considering the diversification of their other super and non-super investments.

SMSFs are required to have written investment strategies. When preparing their strategies trustees must consider investment risk, portfolio diversification, liquidity of investments, ability to pay member benefits and the members' circumstances.

Despite the requirement that fund trustees must consider diversification when preparing an investment strategy they are not required by law to diversify.

Financial planners and superannuation specialists typically urge fund trustees to recognise the possible consequences if their retirement savings are overly dependent on the profitability of a single high-cost asset.

12. What are the advantages of my SMSF owning my business premises?

Small-medium business owners commonly arrange for their SMSFs to hold their business premises for a range of reasons including tax effectiveness, asset protection and succession planning for family businesses.

A family business, for instance, would have to pay a commercial, arms' length rent to the family's SMSF. In turn the fund would pay concessional tax on the rent and typically benefit from many of the usual tax breaks available to landlords – including tax deductions for interest on a property loan.

Some fund trustees would gain a feeling of security because their family business, not some other unrelated, perhaps little-known business, is the tenant.

Founders of a family business – such as married or de facto couples – sometimes hold the premises of the family business in a two-person SMSF initially for retirement-saving, tax and asset-protection reasons. As the founders approach retirement they may decide to allow their adult children to become fund members.

Thanks in part to the adult children's super contributions such a fund might eventually be in a financial position to retain ownership of the business premises for future generations while paying the founders' retirement benefits.

Depending on the circumstances, that could provide valuable security for the family business.

13. What are the disadvantages of my SMSF owning my business premises?

Conflicting loyalties and pressures may arise if your business strikes financial problems and fails to pay its rent.

On one side the family business may require the premises to keep operating in the expectation that profits will return.

On the other side the fund's trustees – who are the same people as the business owners in these circumstances – are legally obliged to maintain the fund with the sole purpose of providing member retirement benefits.

Under superannuation law fund members must be trustees of the fund or directors of its corporate trustee.

Much of the fund's financial wellbeing may depend on regular payment of rent – particularly if a heavily geared property is the fund's sole or dominant asset.

If your business is unable to pay rent your fund may struggle to meet loan installments on a geared property and that could lead to a forced sale.



14. What happens to a fund-owned property when members retire?

Another consideration is how the tax office – in its role as regulator of self-managed super – may react to a fund’s failure to collect overdue rent from the fund members’ business.

One of the toughest actions that the regulator can enforce under the Superannuation Industry (Supervision) Act is to remove a fund’s complying status.

The market value of non-complying funds is taxed at the top marginal rate minus any non-concessional (commonly known as after-tax or undeducted) contributions. That could wipe out almost half of a fund’s assets.

The trustees can decide whether to:

Sell the property to distribute retirement benefits to members (if the property is backing the payment of a superannuation pension at the time of sale no CGT is payable).

Allow a member to acquire the property as a retirement benefit (the trustees would have to consider CGT implications).

Keep the property in the SMSF to generate income for members’ superannuation pensions (as discussed, superannuation assets backing the payment of the pension are not subject to tax on income or capital gains).

15. What are some of the key dos of SMSF property investment?

DO seriously consider gaining quality financial planning, superannuation and tax advice before your fund acquires directly-held property.

DO think about what could go wrong with the investment. Some trustees may tend to concentrate only on the positives.

DO ask yourself some tough questions before investing in property. What if the property loses value? What if my fund has difficulty servicing a property loan? What if the tenant cannot pay the rent? What if my fund is forced to sell the property quickly to pay member retirement or death benefits? What happens if husband-and-wife or de facto couples experience a breakdown in their relationship and their superannuation has to be split?

DO think about whether your fund will be adequately diversified for risk and returns if its investment portfolio is dominated by a highly valuable investment property.

DO consider whether fund members have enough death, total and permanent disability and income-protection insurance to at least cover any loan outstanding on a geared property.

16. What are some of the key don'ts of SMSF property investment?

DON'T let possible tax advantages dominate your fund's decision to invest in direct property. Think carefully about how the property stands up as an investment in its own right. Satisfy yourself that a property investment will provide an appropriate return and security for your retirement savings.

DON'T overlook the possible impact that the next halving of the standard contributions cap on concessional contributions for members over 50 may have on your fund's ability to service a property loan (this cap will fall to an indexed \$25,000 from July next year).

DON'T neglect to take into account the level of debt already being carried by your SMSF, your business and your family when deciding whether to gear an investment property within your fund.

DON'T ignore the risk of losing the tenant of a fund-owned property. Your fund may forfeit much-needed income unless a departing tenant is immediately replaced.

DON'T overlook the reality that direct property can be difficult to immediately sell for an acceptable price if the fund needs to pay out member benefits.





Setting Up a SMSF for Property



Once you have set up your SMSF you can then consider using the fund for property investment.

However, before you can do this you will need to carry out some more procedures. These are as follows:

1. Establish a legal entity.
2. Open a bank account with the tax file number and Australian Business Number in the SMSF name.
3. Complete a benefit rollover statement to transfer other super funds into the SMSF.
4. Find property, if property is your preferred investment.
5. Establish a bare trust and corporate trustee. The fee can be paid by the SMSF.
6. Arrange finance using the bare trust as the legal entity.
7. Reasons to Use Your SMSF for Property Investment

8 Reasons to Use Your SMSF for Property Investment

Property investment comes with many benefits, especially in terms of income generation in retirement. The top five reasons to use your SMSF for property are as follows:

1. You diversify your assets and reduce your risk in a market down turn.

2. Property is unrelated to your other super investments. SMSF business and residential property can give you tax, business and asset protection benefits and allow you to save for retirement.

3. Property has a strong and stable return and is a defensive growth asset. SMSF investment properties, at times, can generate higher net yields than property held under your name. This, of course, depends on variables such as, capital growth, gearing level and negative gearing tax breaks

4. Capital gains are waived when your SMSF sells an investment property and is paying a superannuation pension.

5. Other tax benefits. During the SMSF saving phase, capital gains and rental income is taxed at a concessional rate

6. The superfund pays the deposit for property investment and it also assumes the debt associated with the property.

7. The bank who loans your SMSF the funds for the property investment, recovers the debt from the superfund.

8. Property investment is not as volatile as other investments, such as the share market, so this minimizes your risk. Careful planning of your SMSF can prevent you becoming the victim of an "over geared" and "poorly diversified fund."



Some important points regarding the use of a SMSF for property investment are as follows:

- To invest in property, it is important to set up the SMSF first, including the structure above. A SMSF itself can't borrow money, and therefore a Bare Trust structure is put in place to facilitate the loans
- The only purpose of the Bare Trust (also referred to as a Property Trust) is to keep title over the investment property until the loan is paid off
- All property related costs can be paid by the SMSF
- The SMSF receive rental income and pay for all operating expenses and loan repayments
- Only one property can be added into a structure like this
- The property will revert back to the SMSF when the loan is repaid
- Funds can be borrowed from the Trustees or the bank, or a combination of yourself and the bank
- The loan type a bank would give the SMSF is a limited recourse loan, meaning the bank does not have a recourse on the SMSF should the loan default
- For this reason banks usually ask for a personal guarantee over the property from Trustees
- The maximum Loan to Valuation Ratios (LVR) is usually around 80% with residential property and 70% with commercial property when members guarantee the loans
- When there's a bank loan and a 60% LVR, the bank might not require guarantees from Trustees
- The lender to the SMSF can be the Trustees as well, so you don't have to use a bank
- Trustees can borrow from the bank and then on-lend to the SMSF - this option might make the administration easier
- The Bare Trust and Corporate Trustee are merely legal entities for holding the property and all transactions take place in the SMSF

THE STATS

- 1** According to SuperGuide, for a 65 year old, the average lump sum necessary for a "comfortable" retirement (assuming a 5% investment return during retirement) is a minimum of \$770,000 for a single person and \$1.05 million for a couple.
- 2** According to the Australian Bureau of Statistics (ABS), the median superannuation balance for a 55-64 year old male was \$91,353 and for a female of the same age it was \$54,987.
- 3** According to the ABS, for the average 35-44 year old male, the median superannuation balance is \$40,999 and the median balance for a female is \$22,601.
- 4** According to the Australian Institute of Health and Welfare, Australia has the joint fourth highest life expectancy in the world for males at 79, and the third highest life expectancy for females at 84.
- 5** According to the Association of Super Funds of Australia (ASFA), a 'modest' retirement will cost a single person \$22,585 and will cost a couple \$32,555. A 'comfortable' retirement will cost a single person \$41,186 and will cost a couple \$56,339.
- 6** According to the Australian Government Department of Human Services, living on the Age Pension will allow a single person a maximum of \$733.70 per fortnight, or \$19,076.20 per year. It gives a couple \$1,106.20 per fortnight or \$28,761.20 per year.
- 7** According to SuperGuide, the average 65 year old male can expect to live another 19 years, whilst the average female can expect to live another 22 years.
- 8** According to the ABS, over two million Australians rely on the Age Pension as their main source of household income.



LENDER

- Bank
- Member or related party

SECURITY TRUSTEE (BARE TRUST)

Property Title held here,
on trust for the SMSF

Loan

Declaration of
trust

Loan
Repayments

SMSF

This is the beneficial
owner of the property.

Property title is legally owned
by the security trustee.

Tax is paid
on rent

Rent paid
to SMSF

Usual expenses paid by tenant





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