the ULTIMATE GUIDE to

Buying Property *in your* **Self Managed Super Fund**

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> "It's easy to make mistakes when acquiring property in your super, and these mistakes could cost you your retirement."

It has become increasingly popular for self managed superannuation funds (SMSFs) to buy direct property. Often the SMSF is set up specifically to enable this transaction.

Aussies have long had a love affair with bricks and mortar so it is unsurprising to see this romance extend to our retirement savings. However, buying property in superannuation is considerably more complex and costly than many people understand.

Even if you have purchased multiple properties in your own name, it's easy to make mistakes when acquiring property in your super, and these mistakes could cost you your retirement.

We have brought together our expertise in financial planning, effective borrowing, commercial real estate and taxation to provide you a comprehensive guide to the do's and don'ts of purchasing residential or commercial property inside your self managed super fund. Let this be your guide as you consider this investment in your future.

Is Property the Right Investment for your Fund?

The most important thing to remember when making any investment inside your super fund is that your decisions must be advantageous to all beneficiaries of the fund.

> “The bottom line is that you should not invest in property unless it is aligned with your investment strategy and benefits all of the fund members.”

The law requires every self managed super fund to have a written investment strategy. That document must take into account the situation of every beneficiary, including his or her age, needs and tolerance for risk.

The bottom line is that you should not invest in property unless it is aligned with your investment strategy and benefits all of the fund members. You should be confident that the property will deliver a good income stream and has realistic prospects for capital growth. Then weigh up the pros and cons of purchasing the property in a SMSF.

There are tax advantages to purchasing a property inside super, rather than as an individual. The super tax rate of 15% on earnings and 10% on capital gains is substantially less than your personal tax rate is likely to be. That tax advantage becomes even greater when fund members move into the pension phase and are paying no tax on income.

Be aware however, that a negative gearing tax strategy is not particularly effective inside super because any tax savings will be at 15% instead of your top marginal rate.

The biggest downside of property is that it is a big, illiquid asset. A lumpy asset like this can make it difficult to diversify your fund and may tie up your cash, leaving the fund vulnerable. Having all your retirement eggs in one basket can be a risky proposition. It is important that you consider the risks before investing, and mitigate them where possible (see next chapter).

Bear in mind that superannuation rules prevent you from making personal use of the property. So if you were thinking this might be a great place when you downsize in a few years then better to buy the property outside super.

The one exception to this rule is the purchase of commercial property to rent to a fund member's business. This is allowed within the superannuation rules and is perhaps the most advantageous way to include property in your SMSF. See page 7 for more details.

Be aware also that while your fund can borrow to purchase property, you cannot use borrowed funds to improve that property, which means you cannot buy land and used borrowed funds to build a home or business premises.

Purchasing property inside super is considerably more complex and expensive than buying in your own name. There are substantial costs just to setting up and running the SMSF and the borrowing costs inside super tend to be higher. Plus there are strict guidelines about what you can and can't do and stepping outside those guidelines (even by accident) could incur substantial costs.

Managing Your Risk

It is acceptable for a super fund to take risks, but as a trustee you must clearly understand the risks you are taking on and do what you can to mitigate them.

There are 4 key areas that you should consider when assessing and managing risk.

1. Diversification

Ideally your fund should invest in a range of assets and asset classes. This spreads your risk, so if one asset or asset class loses value, you have other assets to support your fund. Obviously if a single property comprises a high proportion of your fund then this should be considered a high risk strategy.

2. Liquidity

It's important to weigh up the ability of your fund to continue to pay for its commitments. If you are borrowing you must assess that there are sufficient funds to cover any difference between your rental income and the mortgage. You must also consider what happens if you have a period without a tenant, you lose your job or something happens to one of the contributing members.

Whether or not you are borrowing you want to be confident that there will always be sufficient cash available in the fund. If the property purchase leaves the fund with little or no cash, what will happen if the fund needs money? This is particularly important as the beneficiaries approach retirement. Once in pension phase, the fund will be required to make minimum pension payments. Will the fund have enough cash to avoid resorting to a fire sale on the property?

3. Cash Flows

If the fund is reliant on the contribution of members to fund borrowing, it is important to consider the cash flows of contributors. Remember also that the government ultimately decides on the maximum concessional contributions, which currently sit at $25,000 per annum regardless of age. Will the cash flows of the fund be sufficient even if there is a change in government policy?

With interest rates at historic lows, it is likely that interest rates will rise in the years ahead. If you are borrowing to purchase property, consider the impact on cash flows if interest rates rose to 8% or beyond.

If you are purchasing a commercial property that you plan to lease to a fund member's business, then it is critical that you also consider the cash flow position of your business. If your business is very new or just keeping its head above water, then this could be a very risky investment for your retirement fund.

4. Arm's Length Structures

As well as the financial considerations, you need to mitigate the risk of accidentally acting outside the superannuation rules and finding your asset deemed non-compliant.

This is particularly critical when your fund owns a property that is leased to a fund member's business. To ensure that the relationship remains arms length and within superannuation rules, ensure that there is a legitimate lease, rent is set at a market rate and the lease terms are enforced by the fund. A commercial real estate agent can help you to establish market rent and draw up a suitable lease.

> "Many of these risks can be mitigated through appropriate insurance coverage."

5. Insurance

Many of these risks can be mitigated through appropriate insurance coverage. Make sure the property itself is insured in the name of the SMSF Trustee. If you are borrowing consider life and disability insurance on all members to at least the value of the loan. If you are negative gearing or otherwise reliant on the contribution of members to fund the loan, consider income protection insurance.

Know The Rules

Superannuation is governed by rules and guidelines that change on a regular basis. The government expects trustees of self managed super funds to understand and stay abreast of these rules. If you make a mistake, pleading ignorance will not help your case.

> "You cannot afford to be careless about how the arrangements are structured and managed."

The first, and most important rule is the "sole purpose test". To receive superannuation tax benefits, your fund must be maintained for the sole purpose of providing a retirement benefit for members. This is one of the reasons it is so critically important to appropriately assess investment returns before buying property. If you cannot show how the property is expected to increase members' retirement income, the asset may be ruled non-compliant.

Secondly all investments made in superannuation must be made at "arms length", on a strictly commercial arrangement.

You cannot afford to be careless about how the arrangements are structured and managed.

- The purchase price, sale price and rental charges must all be at market rates.
- Usually you cannot buy, sell or rent the property to anyone associated with fund members, so no using the property as an occasional holiday home, or renting it to your relatives.
- The one exception to the above is the ability to lease a commercial property to a business owned by a SMSF member. If you are entering this arrangement then you must have a formal lease agreement and rents must be set at market rates. You cannot allow the business to get behind in paying the rent or the ATO may judge you have given financial advantage to a related party and rule the property non-compliant.
- All payments related to the property must be made by the SMSF bank account and it is essential that good records be kept. Be aware that all SMSFs must be audited annually, so there is no room for slip ups.
- The contract must be signed by the SMSF trustee, which means that the SMSF Trust must be set up prior to purchasing the property. Failure to do so could result in double stamp duty and/or capital gains tax.

If borrowing to purchase property you are required to use a Limited Recourse Borrowing Arrangement (LRBA). This type of lending is relatively new, having been introduced in September 2007 with a major update in July 2010 and further clarifications in subsequent years. As with all super rules it is critical that any borrowing arrangement follow the strict LRBA guidelines:

- The mortgage can only be secured against one property. If you are buying property with two titles (i.e. a capital city apartment with the apartment and car space on separate title) you may need to have a separate mortgage for each title.
- The mortgaged property must be held in a bare trust, also known as a holding trust. This separates the property from other assets in your SMSF, meaning the bank cannot come after these assets in the event of default. It also means that you cannot leverage the equity from another property in your fund to secure a mortgage on a new one.
- Borrowed funds can be used to repair or maintain the property but they cannot be used to improve the property. This means that loans cannot be used to renovate or to build on empty land.
- Given that LRBAs are relatively new and have changed over time, it pays to make sure that your Trust Deed is up to date. Deeds written before September 2007 are unlikely to have the relevant powers required to borrow.

What To Expect When Borrowing Inside Your Super Fund

As discussed in the last chapter, borrowing within your superannuation must use a Limited Recourse Borrowing Arrangement. Under an LRBA banks only have recourse against the mortgaged property. They cannot use any other assets in your superannuation as collateral.

This makes lending to super funds more risky for banks than lending to individuals. So banks are cautious. Not all banks are actually willing to lend to super funds and those that do tend to have higher hurdles than you may be used to.

When borrowing to buy property in your super fund you are likely to require a deposit of 20% on residential property and 25-35% on commercial property. Some banks also demand a liquidity premium, requiring that as much as 10% of the property value be held in cash within the fund.

Bear in mind, your fund will also need to cover all property acquisition costs, including stamp duty, government charges, legal fees and valuation fees.

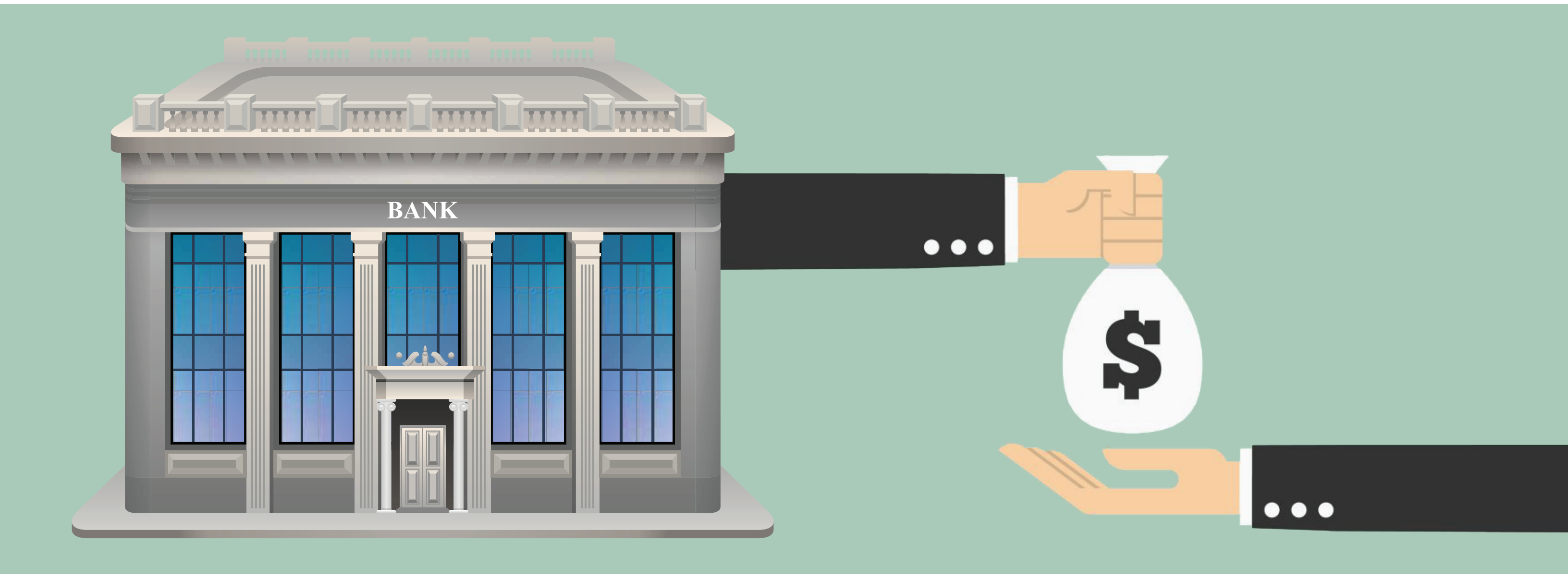
> “Not all banks are actually willing to lend to super funds and those that do tend to have higher hurdles than you may be used to.”

Since other assets in your superannuation cannot be used as collateral, expect the banks to ask for personal guarantees from the adult members of the fund.

When assessing the loan, banks will look at the overall asset position of the fund and may also look at the assets of the beneficiaries. They will consider the fund’s contribution history, expecting to see regular contributions. Depending on the property, the banks may also want to know if you have experience in managing property or have a property manager in place. If you are buying the property to lease back to a business owned by one of the fund members, the banks are likely to look at the financial position of that business.

Some banks may require a corporate trustee for the bare trust and/or SMSF trust, but other banks do not.

The nature and cost of borrowing inside super varies greatly between banks, so it really pays to shop around. It’s a good idea to have a mortgage broker provide you with the options and guide you through what it all means. Make sure you use a broker with experience securing SMSF loans.



Buying Business Property in Your SMSF

Buying a commercial property to lease back to a fund member's business is a very popular SMSF strategy, and with good reason. From a business perspective, this strategy frees up capital, which can then be invested in growth initiatives. It also provides some asset protection for the business owner in the event of financial difficulties.

> “There is no cap on rental payments, as there is on other types of contributions, so this can be a very effective way to grow your retirement fund.”

From an investor's point of view it allows you to pay rent into your superannuation. So long as you stay within market rates, there is no cap on rental payments, as there is on other types of contributions, so this can be a very effective way to grow your retirement fund. Longer term, good commercial property can provide a stable, tax-free income source in retirement.

To comply with the rules, the property must be “business real property”. This can be a factory, shop or office, but usually cannot be a house or vacant land.

As previously outlined, to comply with the arm's length rules you must have a formal lease arrangement between the SMSF and your business. Rental must be set at market rates and the terms of the lease must be enforced by the fund. If you are careless, or try to give your business a break in hard times, the ATO may deem this to be giving advantage to a related entity, which would make your arrangement non-compliant.

If you do not have experience managing commercial property consider engaging a commercial real estate agent to manage the asset and ensure it is maintained at arm's length from the fund. This can help reassure the ATO of your fund's compliance.

It is possible to transfer an existing business premises into your SMSF. The transferor can access small business capital gains tax concessions when the premises is transferred to the fund, which may reduce or eliminate capital gains tax on transfer. The NSW government gives stamp duty concessions on the transfer of dutiable property from a SMSF member to a SMSF. You should seek advice from your accountant before making the transfer.

If you are buying a new business premises inside your SMSF, make sure the purchase makes sense from an investment perspective. When you are purchasing an asset that your business will be using, it is easy to get emotional. Ensure that the numbers stack up before you start imagining your logo on the front door.

Do your due diligence on the property. Engaging contractors to inspect the property and provide you with a report usually pays dividends. Not only will it prevent you facing unexpected costs post-purchase, the tradesmen's report can be used to negotiate a better price if required.

Use a real estate agent with a specialty in commercial real estate, someone who understands the market, lease arrangements and relevant legislation.

Your Expert Team

This eBook is a collaborative effort, bringing together the collective wisdom of local experts in financial planning, lending and property. If you want to explore any of the topics discussed in this eBook, please feel free to contact us.

Melanie Zander, Proprietor

MJA Business Solutions

Melanie Zander is the founder and leader of MJA Business Solutions, which provides accounting, wealth management, and coaching to business owners on the Coffs Coast. She is also a partner in MJA Financial Services, a full service financial advisory practice. Her knowledge of taxation regulations and her experience in wealth management puts her in a unique position to understand the opportunities and pitfalls associated with property investment inside superannuation.

Cherie Parik, Principal and Licensed Real Estate Agent

Your Commercial Property Specialist

Cherie Parik has over a decade's experience managing large commercial property portfolios for international agencies, owners, fund managers and Real Estate Investment Trusts (REITs) as well as a degree in Property Economics from QUT. She brings this exceptional expertise and sophistication to the Coffs Coast as Your Commercial Property Specialist - a real estate agency specifically servicing the commercial property market in this region and beyond. Business owners and investors alike benefit from her specialist knowledge and skills.

Rod Cross, Lending Manager, Coffs Harbour Residential, Business and Agriculture

Regional Finance Solutions

Rod Cross has over 25 years experience in lending. Over a long career in banking he has worked in the commercial, corporate, agribusiness and retail sectors. In June 2015 he opened the Regional Finance Solutions' Coffs Harbour office to provide lending choice and solutions for the people of the Coffs Coast. His broad and in depth understanding of how banks work and think helps him to secure better lending arrangements.

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