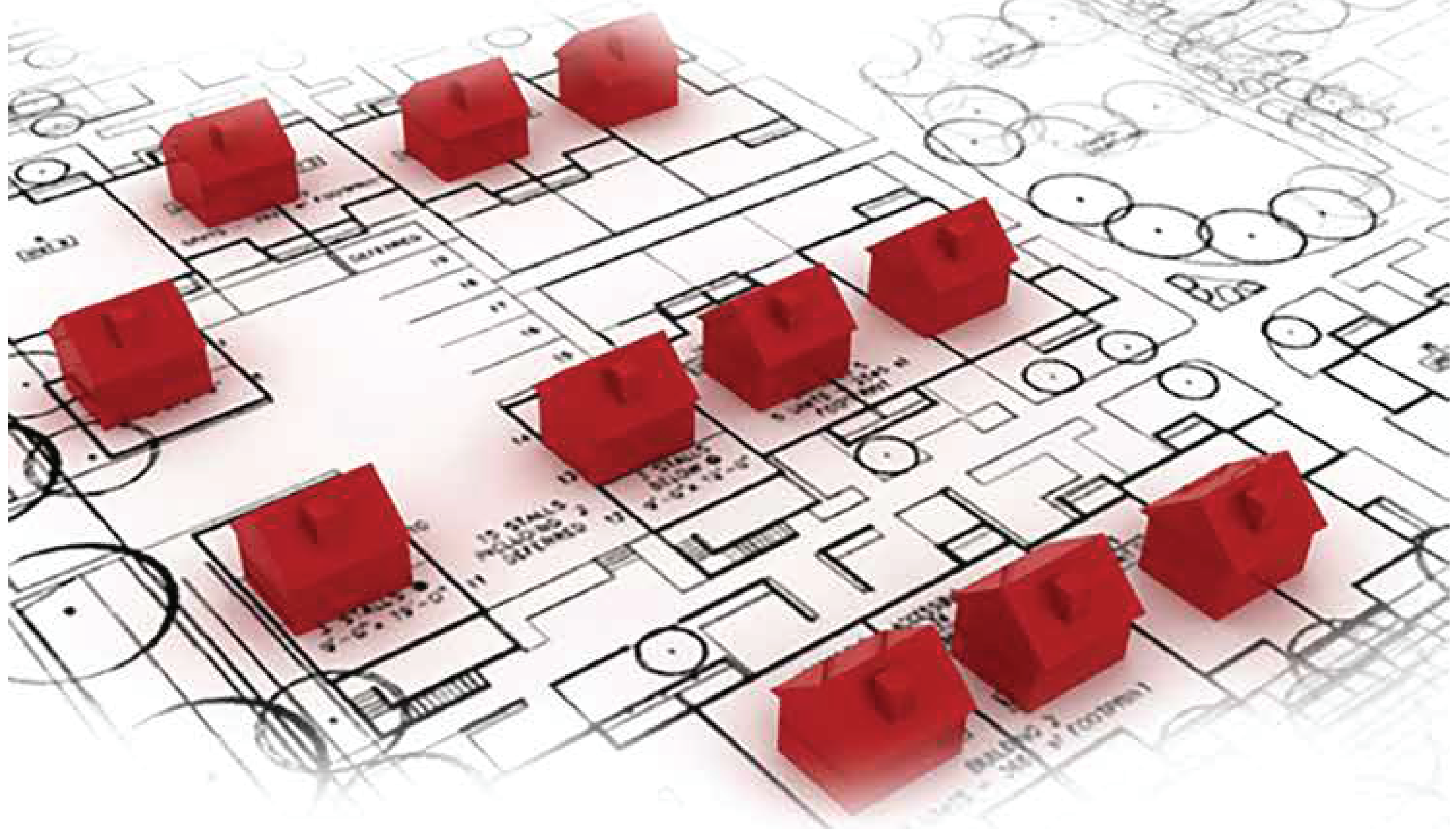
Buying PROPERTY WITH SUPER

2017 EDITION

THE PROS + CONS



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We look forward to meeting you soon.

Wealth Adviser

Contents

Introduction

'Self-Managed Superannuation Funds' (hereafter referred to as SMSFs) can be a tax effective and efficient way of saving for your retirement. However, a few words of caution are needed, as with many other new trends, people can easily fall victim to rash decisions, smooth operators and well-meaning (but wrong!) advice.

One increasing trend is to use your SMSF as a vehicle with which to buy property. This could be a positive financial move, if it is appropriate for your circumstances and is properly set up and managed.

The purpose of this guide is to focus on some of the issues surrounding buying properties within SMSFs. We will look at some of the basics, including what you can and cannot do, as well how to set up a property investment within an SMSF and how to arrange finance. In addition, we will outline some of the potential pitfalls and benefits of this investment method. We trust that the information provided here will be informative and beneficial as you decide whether going the 'Property in SMSF route' is the right thing to do in your circumstances.

The specific focus of this eBook will be on issues surrounding investment properties inside SMSFs. For a more general introduction to Self-Managed Superannuation Funds see the Wealth Adviser eBook: *Your Guide to Establishing and Operating a Self-Managed Super Fund (SMSF)*.

Editor's Note:

On 29 November 2016, The Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016 received royal assent, which means those aspects of the proposed reforms became law. These are the most significant changes to superannuation in a decade. It is essential that these changes are considered in light of any decisions you make in relation to SMSF property investment.

Reform	New rule from 1 July 2017
Concessional contributions cap reduced from 1 July 2017	Concessional contribution cap $25,000 p.a. for everyone
Deductibility of personal contributions	Rules restricting the ability to claim a tax deduction for personal contributions removed
Reduction in Division 293 tax threshold for very high income earners	Income threshold for Division 293 tax reduced to $250,000
Introduction of transfer balance cap of $1.6 million	The transfer balance cap of $1.6 million applies to restrict the amount of benefits that can be used to pay retirement phase income streams
Transitional Capital Gains Tax (CGT) relief	Transitional CGT relief available where the super fund is required to move assets to accumulation phase to meet other amendments
Taxation of assets supporting Transition to Retirement (TTR) income streams	Income and realised capital gains on assets supporting TTR income streams assessable to the super fund
Non-concessional contributions (NCCs) restricted where total super balance exceeds $1.6 million	The NCC cap reduced to nil where total super balance equals or exceeds $1.6 million as at 30 June in the previous financial year
NCC cap reduced and bring forward rules modified	Annual NCC cap of $100,000 or $300,000 under the bring forward rules. Bring forward only available where super balance below $1.6 million
Spouse contribution tax offset	Offset available for spouse contributions made on behalf of a spouse earning less than $40,000

Further detail on these changes can be found in the Wealth Adviser eBook: *2017 Superannuation Reform – What this means for you*

Property in SMSF's: The Basics

An SMSF is a superannuation fund set up for the benefit of not more than four members who are also the trustees[1] of the fund. To be recognised and regulated by the Australian Taxation Office (ATO) an SMSF must comply with the Superannuation Industry Supervision Act 1993 and other rules and regulations governing SMSFs (hereafter referred to collectively as *superannuation laws*).

If the fund complies and remains compliant, it will enjoy significant reduced tax rates (when compared to 'regular' investments) namely:

- 15% on the income of the fund in accumulation phase
- 10% on realised capital gains on investments held for more than 12 months in accumulation phase
- Nil % on income and capital gains in retirement phase[2]

To continue to enjoy concessional tax rates, compliance with the superannuation rules and ATO standards should be investigated and confirmed on a regular basis. The fund must also meet the *Sole Purpose Test*. This states that all the investment activity of the fund should be aimed at providing retirement benefits for the members (or for dependants if a member dies before retirement).

Prior to 2007 SMSFs were not allowed to borrow for investment purposes, which meant that property investment wasn't an option for most fund members. It is now possible for SMSFs to borrow funds under some clearly defined conditions. Property investing within your superannuation fund is certainly not an option for everyone and this should only be considered as one option in light of your overall situation and specific goals and objectives.

[1] There are some exceptions to this e.g. if a member is a minor or is legally disqualified, the member must be represented by another trustee.

[2] From 1 July 2017 the transfer balance cap limits how much super can be transferred into retirement phase. The Government will remove the tax-exempt status of income from assets supporting Transition to Retirement Income Streams (TRIS). From this date earnings will be taxed at 15 per cent

What you Can and Cannot Do with Property in an SMSF

The changes to the superannuation laws mentioned above allow an SMSF to borrow money to acquire any asset which an SMSF is permitted by law to acquire directly. All borrowing activity must meet the following criteria:

- funds can only be borrowed to acquire a single asset
- the asset should be held in trust with the SMSF holding a 'beneficial interest' in it (this concept will be explained later on)
- the SMSF should have the right to acquire direct legal ownership
- in the case of loan default a lender should only have rights over the original asset and not over the rest of the assets of the SMSF. (This is often referred to as 'limited recourse').

The setting up of a property loan within an SMSF can be quite complicated. It is therefore highly recommended that you seek professional advice before attempting to take this route.

In addition to the loan criteria set out above, there are some very specific guidelines as to the kind of property transactions that would comply with superannuation laws.

The following types of property transactions would generally be allowed. An SMSF can:

- purchase an investment property and rent to tenants who are not fund members or relatives
- purchase a *business real property* (commercial property) (including from a member or related party of the fund)
- lease a commercial property to a member or related party of the fund so long as the arrangement is on the same terms if the arrangement was on a non-arms-length, or commercial basis
- sell a residential investment property or commercial property to a member or related party of the SMSF, so long as this is on terms similar to dealing with someone on an arms-length basis.

The following types of property transactions would generally not be allowed: An SMSF cannot:

- acquire of a residential property already owned by a member or related party of the fund to the SMSF
- rent a residential property owned by the SMSF to a member or related party of the fund
- own a holiday home that is used for private purposes by members or their family, even if just one weekend in the year

Setting up a Limited Recourse Borrowing Arrangement (LRBA) to Purchase Property in an SMSF

The SMSF must be properly set-up for property investment before any property purchase can occur.

The first thing to do before you can proceed with property investment is to check your SMSFs trust deed to ensure it allows for borrowing. It may also be a good idea to clearly define the kinds of investments that will potentially be entered into and to check that they conform to the stipulations of the superannuation laws. Amendments to the trust deed maybe required.

The type of borrowing to purchase the property within an SMSF must comply with the requirements of the legislation, in that it must be a limited recourse borrowing arrangement. This means, that in the case of a default, the lender has no recourse over other assets of the fund; only on the asset which was purchased using the loan.

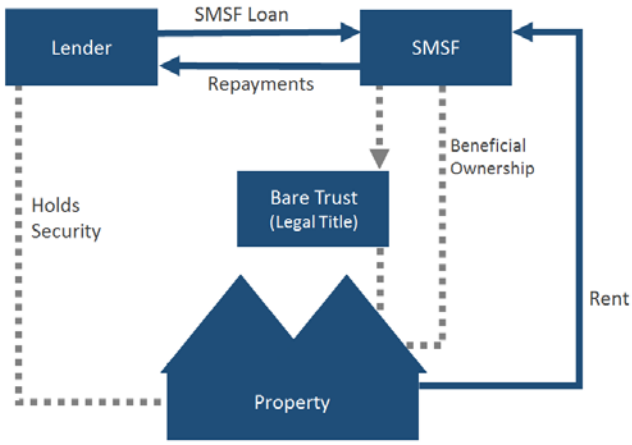
The establishment of a *holding trust* is required that will purchase the asset with the borrowed monies to be held in trust. This helps to protect the other assets of the SMSF if the loan is in default and the lender seeks recompense to satisfy the debt owed by the SMSF.

A *bare trust* is commonly used for this purpose. A bare trust acts only for the reason to be a repository of the asset in question and has no active duties to carry out, beyond vesting the trust property in the beneficiaries at the direction of the beneficial owner (the SMSF).

The SMSF will have *beneficial ownership* of the asset while the bare trust has *legal ownership*. Legal ownership can be transferred to the SMSF as soon as the asset is fully paid off. As beneficial owner, the SMSF will be credited with all income and capital growth and also be directly responsible for all mortgage payments and costs.

It is highly recommended that you seek competent legal advice to help you design the best trustee structure.

The diagram below gives a visual presentation of the structure of an SMSF property investment funded via a limited recourse loan.



Once all the correct 'architecture' is in place you can then proceed to approach lenders for finance. The SMSF finance documents should clearly spell out who are the legal and beneficial owners of the property.

After finding a suitable property, arrangements should be made to purchase the property on arms-length terms.

Once the property has been purchased, all financial dealings will be directly with the SMSF. This means that the fund will be responsible for loan repayments and expenses. It will also receive the rent. The SMSF's accounts will also show the property as an asset (not as a trust investment). This means that there will be very little actual activity required by the bare trust. When the mortgage is fully paid, the legal ownership of the property may be transferred to the SMSF.

Arranging Finance

Loans used to buy property within an SMSF differ markedly from mainstream mortgage products.

SMSF loans have to fulfil strict 'limited recourse' criteria. Limited Recourse Borrowing Arrangements (LRBAs) typically stipulate that the recourse of the lender will be limited to the fund asset that is being financed (including rights to income generated by the asset). The fact that this type of arrangement has to be in place has two important implications.

a) **It increases the amount of paperwork required to set up a loan**

b) **It means that banks or other lenders will be more stringent in following due diligence procedures in order to minimize their exposure to excessive risk**

These two factors mean that typical SMSF loan products are different and more difficult to set up compared to standard borrowing arrangements. Being prepared for this fact by carefully studying lender requirements and ensuring that all necessary documents are provided at the correct stages will facilitate the process of obtaining funding. It will also ensure that all loans comply with superannuation legislation.

What do lenders look for when lending to an SMSF?

- Property purchases and the structure of the SMSF must comply with the superannuation laws and ASIC rules (if a corporate trustee).
- Some lenders will only provide finance to SMSFs that have a corporate trustee.
- Loans for construction, refurbishment or vacant land are typically not available.
- Most lenders require a loan to value ratio of up to 70%.
- The consistency and frequency of contributions to the fund in order to assist with meeting repayment obligations.
- The expected rental income from the property.
- Many lenders will require specific powers in the SMSF trust deed and you will therefore need to amend the Deed to be in line with the requirement of the specific lender.
- Some lenders will require clear written evidence that outside financial advice was sought before they will begin to process the loan application.
- Lenders will require evidence of existing insurance or may even require funds to take out specific policies aimed at the SMSFs holding property.

Most lenders require a personal guarantee from the fund member(s) which means the lender has a right to call on the personal guarantor for any shortfall after disposal of the original asset acquired by the SMSF.

Once the finance is in place the mortgage can be managed more or less in the same way as a 'normal' mortgage, dependent upon the loan features offered by the specific lender.

When selecting an SMSF lender you should consider the ability to:

- vary the term of the mortgage
- set up offset accounts
- make additional payments
- pay off the loan at any time.

It should be emphasised once again that there are many variables involved in setting up SMSF loans and it is worth your while to make use of specialist advice before committing to a specific lender.

ATO Safe Harbours for *Related Parties* SMSF Limited Recourse Borrowing

In 2016 the ATO released its *Practical Compliance Guideline PCG 2016/5- Income tax - arm's length terms for Limited Recourse Borrowing Arrangements established by self-managed superannuation funds.*

This provides guidance on interest rates and terms, loan agreements and terms; repayment requirements, loan-to-value ratios (LVRs) and security requirements that should be assessed to determine if the SMSF the borrowing arrangement meets the requirements of this Practical Compliance Guide and are consistent with a commercial or arms-length dealing.

Limited recourse borrowing arrangements that are not consistent with arms-length or commercial terms may give rise to non-arm's length income, which is taxed at the highest personal marginal tax rate.

The trustees of an SMSF should ensure its transactions and investments are conducted and maintained on an arms-length basis. This includes the purchase and sale price of all fund assets including property and income received. These should always reflect the true market value.

In relation to limited recourse borrowing to purchase residential or commercial property, the ATO provides guidance on the terms of the borrowing that satisfy the 'safe harbour' provisions to ensure the borrowing is on an arm's length basis:

- the loan interest rate is the standard bank variable housing interest rate for investors
- the interest rate maybe variable or fixed (for a maximum of five years)
- a maximum loan term of 15 years applies
- a maximum loan-to-market value ratio (LVR) of 70%
- a registered mortgage over the property is required
- a written and executed loan agreement is mandatory monthly repayments are made on a principal and interest basis.

Property in Superannuation Mistakes

We realise that this guide may contain a large amount of new information, especially if you are not familiar with the world of SMSF property investment. It is for this reason that we decided to include a summary of the most common mistakes or cons that investors often make in this area. These will assist you to make informed decisions and help you to avoid falling into the same traps.

None of the challenges discussed following are insurmountable. They do, however, underline the importance of getting the best possible advice throughout the process.

Mistake 1
Balance of SMSF not cost-effective

Investors with very minimal funds to invest and those who are not familiar with the costs and investment options involved may find managing an SMSF prohibitively expensive. There are costs associated with establishing, operating and winding up SMSFs.

The costs of establishing and operating an SMSF with a balance of $200,000 or below are unlikely to be cost competitive, compared to alternative types of superannuation funds. The exceptions to this includes the following situations:

- The trustee is willing to make the SMSF more cost-effective by undertaking much of the SMSF administrative and investment management duties.
- A large asset (e.g. funds from another superannuation account, an inheritance or a property) will be transferred into the SMSF within a few months after the fund is established.

There are also circumstances when an SMSF with a starting balance of $200,000 or more is not in a member's best interests. For example, the member may not have the skills, time or experience to carry out the duties of a trustee.

Mistake 2
Risking Non-compliance of the Fund

Where an SMSF trustee fails to maintain their fund in accordance with legal requirements, the ATO can impose a number of penalties. Where a penalty is applied, the trustee they will generally be personally liable and they will not be able to be indemnified out of the assets of the fund. A non-complying fund may be taxed up to 47%.

Mistake 3
Lack of Trustee Time and Skill

SMSF members should have a thorough understanding of the basics of investing and adequate financial literacy and investment expertise to properly manage the fund's assets and undertake trustee duties.

Case study: John and Barbara consider an SMSF

The following example is sourced from ASIC's MoneySmart website3:

Experienced property investors John and Barbara are in their early 50s and want to set up an SMSF to use their super to purchase another investment property. They have a property portfolio worth $1 million (with investment loans of $800,000), a combined $200,000 in super and no other investments.

After discussing their options with a financial adviser, Barbara and John decide that an SMSF is not right for them. They realise that a property investment through an SMSF would further increase their debt and reduce the diversification of their assets. Barbara is also concerned about the cost, time and responsibility required to run an SMSF, especially as they get older. Instead they decide to concentrate on paying off their debt and making extra contributions to their super.

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[3] Source: ASIC's MoneySmart website, moneysmart.gov.au, 29 March 2017

Mistake 4
Lack of consideration of diversification

Pursuing a property strategy could mean that you put your eggs in a single basket in relation to investment asset classes. Property is unlike shares as an investment because you can't as easily diversify.

Diversification is a risk reducing strategy and depending on your stage in life or risk tolerance needs to be considered. This considers the asset allocation of your portfolio to multiple asset classes, including cash, fixed interest, property and shares.

Mistake 5
Not Understanding the Risks associated with Gearing

Gearing is where money is borrowed to finance the acquisition of an asset in the expectation that this asset will appreciate over time and income and gains exceed the holding and financing costs. Gearing may be used to accelerate the process of wealth creation by allowing an investor to make a larger investment than would otherwise be possible.

Conversely however, gearing will magnify any losses. Therefore, any gearing strategy should also be prudent enough to protect the investor from being forced to sell investments at a low point in investment markets.

Mistake 6
Having an Inappropriate Investment Risk Profile for Direct Property Investment

Investors who are exceptionally risk averse or who prefer not to take a 'hands on' approach to managing their retirement savings are likely to be unsuited to an SMSF. As with all investments, you need to determine whether this is the right strategy for you and your needs. Financial advice can be invaluable in terms of helping you make this decision. A professional financial adviser will consider your appetite for the risk associated with each of the investment asset classes such as cash, fixed interest, shares and property; the additional risk associated with gearing; and your personal preferences.

Mistake 7
Having No or an Inadequate Investment Strategy

The trustees of an SMSF are directly responsible for drawing up an investment strategy for the fund. An SMSF is not a 'set and forget' investment. You will therefore have to do some solid research and projections before making the final decision on whether to include property in your fund.

Such a strategy may consider whether the members of the fund have other retirement or investment savings they can draw on outside the SMSF and whether the SMSFs investments are appropriately diversified.

SMSF trustees should conduct a regular review of the fund's investment strategy to ensure it remains current. Some people may find this aspect of the investment process quite challenging and this is obviously where expert advice would be of assistance.

Mistake 8
Expecting to have the same protection as non-SMSF members

If there are disputes, SMSF members don't have access to the Superannuation Complaints Tribunal (SCT), as is available to other non-SMSF, regulated funds. Instead, the parties in dispute may need to commence legal proceedings to have the issue resolved by a court, which can be extremely expensive and time consuming.

In addition, if an SMSF trustee loses their money as a result of fraud or theft, they are not entitled to receive government compensation, as may be available to public offer superannuation funds.

Mistake 9
No Debt Repayment/Exit strategy

Consideration of a repayment and exit strategy is important in the evaluation of any borrowed funds. You should always borrow within your means (i.e. not overcommit yourself). In relation to property investments within an SMSF, this consideration will include:

- the potential timing of any future property resale
- the loan structure (e.g. interest only, fixed or variable interest rate etc.)
- the size of the loan
- the term of the loan
- the repayment schedule.

Mistake 10
Not Taking into Account Demands on Funds in Retirement Phase

Property is an illiquid asset, and a common mistake is not planning well in advance for the liquidity requirements of the SMSF.

Upon retirement a superannuation pension will be commenced from the fund. There are strict rules requiring that set amounts must be paid out from the fund dependent upon your age, and the balance of the superannuation pension. Drawdown amounts can range from 4% per year if under age 65 to 14% at age 95.

Assuming your SMSF comprises only of direct property investments, netting 2.5% income after expenses, the resultant net income will not be sufficient to comply with the minimum required the 4-5% annual drawdown for a superannuation pension. This cash flow squeeze could force you to sell the property if you haven't planned well for it.

Trustees will have to make sure, in light of this, that funds will be available to meet drawdown demands. If this is not available from income from property and other assets held in the fund, it may lead to the need to sell the property when the market cycle is not in your favour to meet drawdown obligations. This could result in the property being sold at a loss.

This is obviously not a desirable situation and drawdown requirements should be a serious consideration when SMSF trustees are planning and making decisions regarding their fund's investment strategy.

Mistake 11
Having No or Inadequate Insurances

Lenders will also require evidence of adequate insurance cover for the SMSF property loan. This includes insurance on the value of the property asset itself, as well as income protection insurance for SMSF members. The income protection is important to ensure the continuation of contributions into the fund in order to service the loan repayments and offset interest costs.

Mistake 12
Poor Property Selection

A property is a major investment and you need to choose wisely. Ironically, many investors will use the services of professional advisers for smaller investments such as shares, but will often go it alone with property, which is a much larger investment. Common investment property mistakes include the following:

- Confusing price with value - Cheap does not necessarily equate with good value in property. There is an old mantra in property "location, location, location".
- Over valuing rental yield potential and undervaluing the potential for capital growth.
- Buying in regional areas that are very dependent on just one or two local industries - An example is the recent mining boom which saw house prices rise sharply before plummeting back to reality in the subsequent downturn. Many workers left regional towns as mining activity decreased, and the demand for property in these areas has declined accordingly. Many investors have been left with vacant properties and outstanding loans valued at more than their properties are currently worth.

Mistake 13
Buying Property in the Name of an Individual rather than the Fund

This is perhaps the most common mistake associated with this investment strategy. It is also one that can be very difficult to rectify. It often occurs when sales are entered into without proper thought being given to the correct steps in setting up a property in an SMSF. Since an individual may not hold such a direct interest, this simple mistake may result in the entire arrangement being deemed non-compliant by the ATO.

The following scenario occurs all too often:

The property purchaser falls in love with a property and decides that it should become part of their portfolio. Scared that the property might slip from their grasp, they make an offer and pay a deposit from their own pockets as soon as they are able to do so.

A few days later they show up at the offices of their financial adviser, declaring:

"We bought a property; we should therefore probably start thinking about setting up an SMSF!"

This could be seen as the SMSF providing financial assistance to the SMSF members by funding the loan. This could also be seen as the SMSF providing lump sum superannuation payments to fund members without satisfying a condition of release.

Rectifying this type of situation can be very complex and expensive. It can be avoided through making sure that the fund is already in existence, that trustees have been appointed and that pre-approval for purchasing a property through the fund is in place.

Mistake 14
Treating SMSF Property Purchases as if they are 'Normal' Transactions

This is perhaps the one mistake that lies at the root of all other SMSF property transaction mistakes. It should always be remembered that a SMSF is an investment vehicle with a very specific purpose - that is to provide retirement income in line with superannuation laws and regulations.

It therefore follows logically that regulators will want to make sure that all SMSFs are used with this purpose in mind (sometimes called the 'sole purpose test') and that they are not treated as convenient pots of cash with which to pursue investment whims.

Maintaining and showing compliance with relevant legislation should therefore always be very high on the agenda of trustees of SMSFs. This means that people buying property inside a SMSF should take care to forget everything that they think they know about buying property as 'private citizens' and try to make sure that they studiously follow the correct procedures for this type of transaction.

Mistake 15
Not Fully Understanding Lending Requirements

Loans used to buy property within a SMSF differ markedly from mainstream mortgage products as should now be very obvious from reading this eBook.

Not only does a borrowing arrangement within an SMSF need to comply with the strict 'limited recourse' criteria, but there are multiple layers of superannuation and taxation rules and regulations, which are constantly changing.

The ATO publishes guides, tax payer alerts and SMSF Fund Rulings, for instance that need to be adhered to in order to minimise the adverse consequences for breaching the borrowing rules. Some of these have been referenced in this eBook.

Mistake 16
Not Consulting an SMSF Leader to Guide the Process to Completion

The financial arrangements for buying property in an SMSF are a great deal more complex than would be the case with a 'normal' property investment. There are several institutions and professionals involved in the process of purchasing a property within an SMSF, including:

- the fund's financial adviser and accountant
- the real estate agent
- the vendor and their solicitor
- the fund's legal adviser
- a conveyancing solicitor
- the lender and their solicitor
- a finance broker
- the Office of State Revenue.

There is a lengthy list of distinct steps and stages that need to be executed correctly and in the right sequence.

Appointing an SMSF Leader to ensure that the transaction is executed correctly, in the right order and in the correct sequence is crucial. In this appointment, you need someone who understands the overall transaction and takes control of all the steps and processes involved.

Mistake 17
Legal Ownership of Properties are Transferred before all Proper Arrangements are in Place

The trustee and the holding trust must be established completely before any property contract is signed. As mentioned earlier, this provision is often breached because investors 'fall in love' with a property or want to rush to bag a bargain.

It cannot be emphasised strongly enough that the entity that will legally acquire the property must already exist before any contract is signed. Unwinding this very basic mistake can be very complicated and costly.

It can be avoided through making sure that the SMSF is already in existence, that trustee of the SMSF has been appointed and that pre-approval for purchasing a property through the fund is obtained.

Mistake 18
Making No or Irregular Contributions to your SMSF

A lender will likely require evidence of regular contributions to your SMSF to show the loan can be serviced. If you are unable to demonstrate this, you will need a good income and be able to convince the lender of your willingness and ability to make regular SMSF contributions in the future.

Mistake 19
Not Setting up the SMSF and Related Trust(s) Correctly

As explained earlier in this eBook, superannuation laws prohibit taking out an SMSF loan unless it meets specific criteria. The loan for a property acquired in an SMSF via a borrowing arrangement must be held in trust by a “security trustee” for the duration of the loan term.

Subsequently, one of the primary criteria is that the property title be in the name of the security trustee NOT the name of the SMSF.

This could result in the SMSF breaching superannuation laws and a forced sale of the property at a potential loss.

SMSF borrowing arrangements are complex and specific. In essence the required structure represents an arm’s length arrangement where the loan agreement is between the lender and the SMSF and the actual property transaction is between the buyer and the bare trust.

Some examples of incorrect (or at the very least questionable) arrangements include:

- *Where the bare trust directly enters into a loan arrangement with the lender.* The borrower must be the SMSF, with the other party to the loan contract being the lender.
- *Where the lender acts as the holding trustee.* This could result in a conflict of interest, as it means the lender would be loaning money to the fund as well as being the holding trustee for the fund.
- *Where the SMSF is named as the buyer on the sale contract.* This violates the ‘arms-length’ intent of the arrangement; the bare trust should be the purchaser and ‘holder’ of the property.

Mistake 20
Not Properly Managing the Bare Trust

As the holder of the legal ownership of the acquired asset, the bare trust will have to be managed appropriately to ensure continual legal compliance.

The purpose of the bare trust is to act purely as a holding entity for the title deeds of assets. These are obliged to be transferred when directed by the beneficiary. The trustee of the bare trust has no other active duties to perform; which should be passive and restrictive in nature.

If the trustee of the bare trust takes on more active responsibilities such as dealing with the property, this may jeopardise the taxation advantages afforded to such trusts.

The activities of the bare trust should therefore be kept as limited and uncomplicated as possible, and all associated paperwork kept up to date.

Mistake 21
Not Adhering to Rules Governing Relationships with Related Parties

A significant proportion of mistakes made by SMSFs have to do with the blurring of lines between fund members and related parties. Three rules that are commonly breached are listed below:

1. SMSFs are prohibited from making loans to or providing any type of financial assistance to members or their associates

2. SMSFs are prohibited from holding *in-house assets* totalling more than 5% of the total value of the fund. In-house assets are defined as investments, loans or lease arrangements in which members or *related parties* have a significant stake

3. SMSFs cannot acquire assets from fund members or other *related parties* to the fund except in the case of specified exemptions to this rule (listed securities, business real property and in-house assets that do not exceed 5% of the total market value of the fund).

Related parties include family members, relatives, business partners, a standard employer-sponsor and other associated entities. It may sound good to purchase a property from yourselves and put it into the SMSF to take advantage of the tax concessions, but it is flat out illegal. It breaches the in-house asset test rules of superannuation law and carries hefty penalties. Again, this could see the fund forced to sell the property at a loss.

The reason why the rules on links with related parties are so strictly enforced is that dealings that are too close can easily be seen as failing the sole purpose test, in the sense that the fund is being used to provide benefits to the members in the here-and-now instead of in retirement.

Great care should therefore be taken to separate the personal finances and short term interests of members from the activities of the fund.

Mistake 22
Not Purchasing a 'Single Acquirable Asset'

SMSF rules require that the bare trust be set up to control what is called a 'single acquirable asset'.

In May 2012 the ATO issued a ruling covering key concepts for limited recourse borrowing arrangements in superannuation, *SMSFR 2012/1 - Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts.*

This Ruling explains the concepts of 'acquirable asset' and 'single acquirable asset', among other aspects of limited recourse borrowing arrangements.

The money from a limited recourse borrowing arrangement can only be used for the acquisition of a 'single acquirable asset'.

In relation to the meaning of an 'acquirable asset' the Ruling indicates that consideration should be given to both the substance and legal form of the asset acquired.

Further, the Ruling indicates that an asset could be viewed as a 'single acquirable asset' if multiple legal titles are involved and the titles cannot be dealt with separately.

Examples provided by the ATO in the Ruling include:

- A factory building, covered by several titles, where activities would have to cease if titles were separated, could be regarded as a 'single acquirable asset'
- A farm operating under multiple titles would not be regarded as a 'single acquirable asset', since farming activities could still be undertaken on the different parts should the titles be separated. The existence of fencing, irrigation systems or agricultural crops are not considered impediments to selling the titles separately.
- Two adjacent blocks of land only offered for sale together would not be considered a 'single acquirable asset', as the two blocks are separate assets.

Note that in the last example above, the SMSF could implement two borrowing arrangements and purchase each of the blocks of land under separate borrowing arrangements.

This is obviously a rather complex area and trusts would be well advised to get professional advice to make sure that their activities fall within ATO rules.

Mistake 23
Not Understanding Related Party Lending

The superannuation laws do not prohibit the SMSF borrowing from a related party. Simply, this means that you can lend money to your SMSF.

This is however an area you need to tread very carefully as you could unwittingly contravene other parts of the superannuation laws, such as the requirement to deal with other parties on terms no more favourable than as if they were dealing at arm's length.

That means that neither the other party nor the SMSF can gain an advantage from the transaction above what would have been available if you were dealing at arm's length (or with a non-related party, or in other words, the broad market place).

Therefore, you should not lend money to your SMSF at either a higher or lower rate, or on different terms to what would have been available with an independent third party.

Mistake 24
Breaching the Maintenance and Improvement Rules

Superannuation laws allow SMSF trustees to borrow funds for the maintenance or repair of assets. However, this provision does not extend to allowing SMSFs to borrow funds to improve assets.

The ATO's ruling, *SMSFR 2012/1 - Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts*, outlines the distinction between 'maintaining' or 'repairing' an acquirable asset and 'improving it'.

According to the ruling the *maintenance* of an asset involves actions to prevent damage or deterioration to ensure that the asset can continue to fulfil its functional role, where-as the *repair* of an asset involves bringing a damaged asset back to its functional efficiency.

Trustees are allowed to borrow to fund both these activities. They may, however, not borrow to fund activities that will substantially increase the functional efficiency or the value of an asset through the addition of new features.

This difference is best illustrated by an example provided by the ATO in the draft ruling:

If a fire substantially damages a kitchen, repairs to bring it up to its previous standard would be allowed. If, however, trustees decide to extend the kitchen at the same time this will be deemed an improvement and will not be allowed under SMSF rules.

This is, once again, quite a complex area with a lot of opportunity for confusion.

It is therefore highly recommended that trustees seek an expert opinion before making decisions on repairs and/or improvements.

Mistake 25
Using an Old and Out- Of-Date Trust Deed

If your SMSF was set up before September 2007 it probably is operating under a trust deed that would be considered “old” by today’s standards and a Deed that prohibits borrowing through the SMSF.

It is therefore important that SMSF trustees have their Deed professionally reviewed and updated when necessary to fully reflect and comply with changes in the law since 2007.

Doing this early in the transaction will save time and costs down the line, as it is almost a certainty that the lender’s lawyers will query the old Deed. This will invariably stall the process and lead to extra costs.

Mistake 26
Changing an Asset so that it becomes a ‘Replacement Asset’

SMSF trustees are not allowed to use borrowed funds to improve assets; only the existing assets of the fund can be used for this purpose.

The ATO’s ruling, *SMSFR 2012/1] - Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts* sheds some light when an acquirable asset is changed such that it becomes a different (i.e. replacement) asset.

However, care should be taken to ensure that such improvements are not so comprehensive that it creates an asset that is substantially different from the original. A resulting asset where the character of the original asset was substantially changed is called a ‘replacement asset’ according to the Ruling.

Examples of ‘replacement assets’ provided by the ATO in this Ruling include the:

- subdivision of a single plot of land on a single title into smaller plots with individual titles
- building of a house on a vacant plot of land
- demolition of an existing house and its replacement with three strata title units
- re-zoning of the land upon which an existing house stands and its transformation into commercial premises.

SMSF rules allow for 'single acquirable assets' to be obtained. This normally rules out real estate that is subdivided or that comes with more than title. Uncomfortable questions may even be asked about properties where there is no legal impediment to future sub-division, or where there is provision that certain portions may be 'assigned or transferred separately'.

Non-compliance in this area could obviously be a very serious issue and should be avoided at all costs.

Mistake 27
Not getting the best possible advice

SMSF property investments can make a real difference to the retirement prospects of the wise investor. Part of the definition of 'wisdom' in this case is, however, not to attempt to go it alone. This can, as should be clear by now, be quite a complex investment.

Making sure that you get the best possible advice in the areas of the setting up of a trust, loan products, investment projections etc. will be of paramount importance in deciding whether this is the right investment for you. Having the right professional advisers on side will also ensure that things are done in the correct way from the beginning, thus helping you to avoid mistakes that could have serious financial consequences.

The importance of gaining competent advice in this area is underscored by the fact that lenders are increasingly requiring written proof that financial advice was sought before they will even consider a loan application

Mistake 28
Not Planning for the Future

It may seem that we are labouring the same point, but it should never be forgotten that the purpose of an SMSF is to provide benefits to members (or their dependants) in retirement. There are strict rules regarding the compliance and administration of an SMSF.

Seeking financial advice is highly recommended to determine if an SMSF is appropriate for you and if purchasing direct property within this retirement vehicle is also appropriate. This should be considered in light of your overall situation and goals, among other factors such as job security, age etc.

It is advisable that trustees spend a significant amount of time strategizing and planning their investment strategy. This will obviously improve their chances of the SMSF and property purchase to perfectly fit in with their goals, instead of simply buying on a whim.

Not fully adhering to the SMSF compliance rules and superannuation laws can have a variety of consequences, including possibly the need for complex and expensive corrective measures.

Reasons to Use your SMSF to Buy Property

There are several distinct benefits associated with buying property through your SMSF.

Case Study: Peter and Tania

Peter and Tania are in their forties and own their own home but would like to invest in another property. They do not, however, have the equity available in their own home. This caused them to investigate the possibility of investing in property through their superannuation fund.

Peter and Tania have an existing SMSF with about $280,000 in investments and cash. They are both in full-time employment and their monthly superannuation contributions also go into this fund.

In conjunction with their financial adviser they decide that they would like to hold on to at least $100,000 in shares, as they believe that they are invested in industry sectors with significant growth potential. This means they have $180,000 available to use towards buying a property.

At this stage they have to do all the legwork in terms of getting ready to fund their purchase in a fully compliant way. This includes making changes to their SMSF to allow it to borrow funds and setting up the trust that will hold legal title of the to-be-purchased property.

They find a great property for $450,000 which falls within the appropriate loan-to-value ratio (LVR) for SMSF property loans. They contribute $160,000 from their SMSF; ensuring funds are set aside for liquidity and additional costs. The rent from the property they purchased, as well as other income in the fund and Peter and Tania's contributions, can now begin to cover loan payments. They have thus managed to add a property to their retirement portfolio without having to make use of the equity in their existing property or drawing on cash from outside the fund. Since they still have quite a few years until they retire, they should be in a great position to benefit from the effects of gearing (where you make use of borrowed funds to gain control of an appreciating asset) and the advantageous tax rates associated with property investment in an SMSF.

Reason 1
General Advantages of SMSFs

SMSFs generally have a number of possible advantages and these should be assessed against individual circumstances. These advantages include:

- the inclusion of family superannuation accounts to create a larger pooled balance
- control and flexibility, as trustees have the ability to tailor their fund's rules and to make decisions based on the members' needs and circumstances
- investment control and choice (as permitted by the fund's trust deed and superannuation laws), such as direct shares, corporate debt, direct property, unlisted assets and business real property
- borrowing via a limited recourse borrowing arrangement, as is the focus of this eBook
- estate planning measures, as an SMSF may allow you to exercise a higher level of control over the provision of death benefits than other types of superannuation funds. SMSFs can make binding provisions.
- Cost - while SMSFs are not necessarily cheaper to run than public offer superannuation funds, the real benefit trustees enjoy is greater control of their costs. With an SMSF, you will incur certain fixed costs. You'll be required to pay for an annual tax return and audit, as well as any ATO fees. With respect to fixed costs, the larger your SMSF balance grows the more cost- effective it becomes. The total cost of running your SMSF will depend on the investments you make within the fund and whether you decide to pay for any professional SMSF services or specialist advice.

Reason 2
Income Tax Savings

Perhaps the most important advantage associated with superannuation transactions are that these are subject to a much more favourable tax regime than 'ordinary', non-superannuation investments. Your after-tax returns are therefore likely to be much better. For example:

- Rental income from property in an SMSF accumulation phase will be taxed at 15%, compared with a marginal tax rate of up to 45% that a 'regular' individual investor could be paying.
- Once you start using the SMSF to provide your pension, rental income from the property is exempt from tax in the fund.
- The costs incurred in purchasing and managing the property (interest, depreciation, rates etc.) could very well produce a 'negative' income that you can offset against other income to reduce the SMSFs tax liability even further.

Reason 3
Benefits of Gearing

Gearing is one of the most effective long term wealth building strategies available when used appropriately. The fact that your SMSF can now borrow to buy property enables you to make use of this time-honoured strategy to build or increase the value of your retirement portfolio.

Reason 4
Capital Gains Tax (CGT) Advantages

A property owned by an SMSF may pay a lower level of capital gains tax, then an individual investor with the asset owned personally, due to the lower income tax rate in an SMSF. As capital gains are included in the assessable income of the fund, a maximum rate of 15% will apply in accumulation phase. However, assets owned for more than 12 months will be taxed at 10% on assessable capital gains.

Based on current legislation, income (and capital gains) derived to support pension is exempt from tax.

Income and capital gains are taxed at a nil rate for an income stream in retirement phase.[4]

Reason 5
Asset Protection

Assets held in superannuation funds, including an SMSF, are generally protected from creditors. However, it is important to note that this exception does not apply where a member makes contributions to their superannuation fund for the specific purpose of defeating claims from their creditors.

4 From 1 July 2017, the transfer balance cap limits how much super can be transferred into retirement phase. The Government will remove the tax-exempt status of income from assets supporting Transition to Retirement Income Streams (TRIS). From this date earnings will be taxed at 15 per cent.

Reason 6
Concessions for Business Owners

SMSF trustees are allowed to acquire interests in business real properties (defined below) without lease-backs to related parties falling foul of related party rules. This means that business premises belonging to trustees can be transferred into the SMSF provided that all the relevant rules are adhered to.

The benefits associated with this approach are substantial, including:

- the ability to transfer business assets into superannuation in a way that will reduce capital gains tax liabilities
- the ability to potentially restructure non-deductible debt into deductible debt
- the ability to make tax deductible superannuation and rent payments to accelerate the repayment of the loan.

A 'Business Real' property is defined by the ATO as:

- any freehold or leasehold interest of the entity in real property, or
- any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer, where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not). It does not include any interest held in the capacity of a beneficiary of a trust estate.
- Benefits can accrue from following this approach but will require the services of someone who is experienced in advising clients in this type of transfer.

Conclusion

Buying property within an SMSF can be quite complex (although certainly not impossibly difficult!). The ability to buy property in this way is also a fairly recent development. This means that many people you will deal with in the course of such a transaction may not be sure of the right procedures, protocols and strategies for successful completion.

It would therefore be beneficial to consult with a professional adviser who does know what they are talking about when it comes to SMSF property investment. Ideally such a person should be prepared to 'shepherd' the deal through from A to Z. Getting such an expert on side might seem like an expensive proposition at first, but you will almost certainly find that the time and money that you will save in the process will make it more than worth your while.

It is our hope that the information presented in this eBook has set you thinking about some of the issues that you will have to pay attention to in planning your financial future. It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this.

We urge you to continue your explorations by making use of some of the other resources and eBooks from the Wealth Adviser stable. We also stand ready to serve you with holistic and professional advice, so please do not hesitate to contact us if we can be of further assistance.

Readers Notes

Readers Notes

Take the next step

We trust you enjoyed this eBook and found it informative and professionally presented. Of course your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

We now invite you to take the next step and to meet with us on a no-obligation basis to discuss what it was you were hoping to achieve when you downloaded this eBook and to establish if we may be able to help you achieve your goals and objectives.

Through our *fresh approach* our experts have helped literally thousands of people of all ages and all walks of life to build, protect and manage their wealth and financial affairs.

Next you will find some information about our *fresh approach* and what sets us apart. You also find the details of how to book an appointment with one of our experts.

We look forward to meeting you soon.

Spring Financial Group

Our *fresh approach* to Financial Services

Whether you have a very specific need such as looking for a better rate on your home loan or making sure your insurance cover meets your needs; or you're considering how to develop and implement a tailored retirement, wealth creation or wealth management plan, when you deal with Spring Financial Group you can expect a *fresh approach*.

That's because instead of focusing on products we focus on helping you to develop and implement outcomes that are based on your specific goals.

Why do we call it a *fresh approach*?

Financial advice and financial planning in Australia has its origins in the early 1990s with the birth of compulsory superannuation. Prior to this we had stockbrokers, life insurance agents, accountants and bank managers.

As the planning and advice (or "wealth management") industry grew it was eventually controlled by the big banks and insurance companies keen to sell an expanding range of financial products, including of course their own managed superannuation funds.

Fundamentally, that's how it remains today. Banks and other major financial institutions now control not only the majority of product "manufacturing", they also control or directly influence the majority of advisers. Recently we have even seen "industry" superfunds move into financial planning; as well as banks take part or full ownership of larger mortgage brokerage companies and mortgage "aggregators" that smaller brokers rely on to access a range of loan options.

This ecosystem of institutional control by financial product manufacturers has led to widespread adoption of practices that can be at odds with clients' interests and objectives.

How our *fresh approach* is different

At Spring Financial Group we have built our organisation to be different. Our *fresh approach* is about you and putting your interests first without any institutional product agenda.

We don't manufacture our own products and we don't answer to an institutional master about recommendations we're able to make. What this means for you is that if a particular loan (for example) is right for you and it's not available from one lender, we're able to source it from another. Same can be said for insurance policies, and different investments options.

And when it comes to investments we recognise there's more to the world than just the sharemarket; and more to it than just managed funds run by the banks and major institutions.

We believe that finding a balance between a variety of asset classes including property, shares, fixed-income and other markets is prudent in the long term.

We also believe it's naïve to think that the future will be any different to the past. All markets rise and fall and those trends can take years to play out. Your financial life will travel over all these different terrains and the structures, investments and vehicles you use need to be compatible to these different climates. In our view, there is little point improving your financial position during a bull market only to watch it dramatically deteriorate during a crash, in particular if a crash comes on the doorstep of, or during, retirement.

A team - rather than an individual

In a financial world of increasing complexity there's too much to know and too many regulatory and legislative issues to consider for one person to master. And your financial well-being is too important to be left to a "jack of all trades, master of none". Similarly, relying on multiple experts working in silos, without the right hand knowing what the left is doing, can lead to costly mistakes, missed opportunities and even having structures working at cross-purposes.

That's why our *fresh approach* is built on the team ethos that none of us is as good as all of us.

It may be that you want to pay down your mortgage faster; or get your insurances, tax or estate planning needs in order; or that you're considering a specific investment. Perhaps you're just starting out; or starting to plan for retirement; or already retired. Regardless, our team of highly-qualified advisers will serve you without the pretence that one adviser alone knows everything.

As and when needed we'll marshal a group of professionals that includes finance, superannuation and insurance experts; property, sharemarket and alternative investment specialists; accountants and tax and legal advisers; and veteran financial advisers. And they are supported by our team of graduates who bring fresh ideas and the latest thinking from their recent tertiary study in finance, economics, business, accounting and law to the table, as well as a highly experienced and dedicated team of administrative personnel.

And rest assured, if we don't think we can add value or help you achieve the outcomes you desire, you'll be the first to know. We'll never try to make a square peg fit in a round hole!

Peace-of-mind

We correctly value psychological outcomes for our clients more than other organisations. A particular product, plan and strategy may be technically brilliant in the mind of a qualified adviser, but if it leaves you unable to sleep at night, then it is the wrong product, plan or strategy for you!

Your peace-of-mind and financial well-being are always at the forefront of our considerations when we work with you.

Let us help you to meet your financial goals and objectives by booking an appointment with one of our experts today.

Call us on:

1300 4 SPRING

Or send an email to:

info@springfg.com

Or use the Appointment Booking Request form on the following page.

Appointment Booking Request form

Please complete the Appointment Booking Request below and scan and email to:

appointments@springFG.com

Appointments are available Monday-to-Friday from 8am and until the normal final starting time of 6pm. After-hours appointments are available by request most weekday evenings and on most Saturdays if preferred. Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

Preferred appointment day and time

Day

Date

Time Am/pm

Your email address

If you would like us to contact you via email to confirm your appointment or to answer any questions you have please provide a valid email address for our records.

Email

Your Details

Title

First name

Last name

Mobile

Your partner/ spouse's name

Many people have lifestyle and financial goals that are shared with their spouse or partner. Please provide the name of your partner/spouse so one of our client services team can discuss with you whether it is appropriate for them to attend our meeting.

Title

First name

Last name

Relationship

If you're ready for a *fresh approach* to financial advice, planning and investing that is founded on Goals; Plans; and Action then we look forward to meeting with you soon.

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