WEALTH SOLUTIONS

HOW TO USE YOUR

SUPERANNUATION

TO PURCHASE AN

INVESTMENT PROPERTY

PT WEALTH SOLUTIONS

PROPERTY IN A SMSF – THE BASICS

A SMSF is a superannuation fund set up for the benefit of 1- 4 members who are also the trustees' of the fund.

To be recognised and regulated by the Australian Taxation Office (ATO) a SMSF must comply with the *Superannuation Industry Supervision Act 1993* (SISA) and other rules and regulations governing SMSF's. 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
- 10% on realised capital gains on investments held for more than 12 months.

In order to continue to enjoy concessionary tax rates compliance with SISA and ATO standards should be investigated and confirmed on a regular basis. The fund should also meet the so-called *'Sole Purpose Test'.* This states that all the investment activity of the fund should be aimed at securing and providing retirement benefits for the members (or for dependents if a member dies before retirement).

Prior to 2007 SMSF's were not allowed to borrow funds. This meant that property investment was not an option for most funds. Recent changes to SISA now make it possible for SMSF's to borrow funds under some clearly defined conditions. This means that Australians can now continue their 'love affair' with investment property using their primary retirement investment vehicle. This is certainly not an option for every investor and all the usual warnings about carefully considering all your options still apply! It does however open up some exciting and tax efficient avenues towards maximising your retirement income.

You should certainly consider this option if you:

- Are ten years or more from retirement
- Are in stable employment and therefore in a position to make regular contributions to your super fund
- Have more than $200,000 in your fund

There are some exceptions to this e.g. if a member is a minor or is legally disqualified. In such cases the member must be represented by another trustee.

WHAT YOU CAN & CANNOT DO WITH PROPERTY IN A SMSF

The changes to SISA mentioned above allow a SMSF to borrow money to acquire any asset which a SMSF is permitted by law to acquire directly.

All borrowing activity must meet the following criteria:

- Funds should be borrowed to acquire an asset
- The asset should be held on trust with the SMSF holding a 'beneficial interest' (this concept will be explained later on)
- The SMSF should have the right to acquire direct legal ownership, following the making of one or more payments, after gaining the beneficial interest.
- Borrowers should only have rights, in the case of loan defaults, over the original asset and not over the rest of the assets of the SMSF. (This is often referred to as 'limited recourse')

It should be clear from the above that the setting up of a property loan to a 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 criteria set out above there are also some very specific guidelines as to the kind of property deals that would comply with SMSF regulations.

The following types of transactions would generally be allowed:

- The purchase of properties that can be held as an investment or as owner-occupied business premises.
- The sale or transfer of commercial property that you already own to the fund.
- The purchase of non owner occupied residential property under certain circumstances.

The following types of transactions would generally not be allowed:

- Any transaction involving owner occupied residential property.
- The transfer of residential property already owned by a related party.
- The redrawing of loan facilities into your super fund.

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BENEFITS OF USING YOUR SMSF TO BUY PROPERTY

There are several distinct benefits associated with buying property through your SMSF. They include the following:

1. Favourable tax regime than 'ordinary' investments. Your after-tax returns are therefore likely to be much better. **For example:** Rental income from property in a SMSF will be taxed at 15%, compared with the rates of up to 45% that a 'regular' investor could be paying.
2. Once you start using the SMSF to provide your pension, rental income from the property will be tax free.
3. 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 your tax bill even further.
4. It is always a good idea not to have 'all your eggs in one basket'! Buying property is an excellent way to reduce volatility and overall risk on your retirement portfolio.
5. **Gearing** (Where you make use of borrowed funds to gain control of an appreciating asset) is one of the most effective long term wealth builders available. The fact that your SMSF can now borrow to buy property enables you to make use of this time honoured strategy to increase the value of your retirement portfolio.
6. The fact that properties are held inside your SMSF means that you protect yourself from the impact of Capital Gains Tax (CGT) until retirement, at which time your gains will become tax free (if current legislation is still in place by that time!)
7. Assets held in a SMSF will, under normal circumstances, be protected against general debt recovery (this obviously does not apply in the case of the loan with which the asset was purchased) and bankruptcy proceedings.
8. The fact that you can transfer commercial property that you already own into the SMSF allows you to 'unlock' cash to invest in your business or in other assets. You can even use the funds to re-contribute to your SMSF (subject to individual contribution limits of course)
9. Potentially, even avoiding Stamp Duty on the transfer * (legal advice is required)

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CHALLENGES ASSOCIATED WITH SMSF PROPERTY DEALS

The main challenges associated with buying property through your SMSF are the following:

1. As with any other SMSF, a SMSF containing property investments will have to be properly administered and managed. You will have to constantly make sure that all the activities of the fund comply with relevant legislation and regulations. Penalties for non-compliance can be very severe.
2. The trustees of a SMSF are directly responsible for drawing up an investment strategy for the fund. It is therefore not a kind of 'set and forget' investment. You will have to do some solid research and projections before making the final decision on whether to include property in your fund. Some people may find this aspect of the investment process quite challenging.
3. The financial arrangements for buying property in a SMSF are a great deal more complex than would be the case with a 'normal' property investment. Making the right decisions and putting the right systems in place when sourcing finance can therefore sometimes be a rather complicated process.

None of the challenges mentioned above are insurmountable and they certainly do not provide sufficient reason to shy away from SMSF property investments. They do, however, underline the importance of getting the best possible advice throughout the process.

SETTING UP A PROPERTY INVESTMENT IN A SMSF

The mechanism used to set up a SMSF property investment is sometimes referred to as an *'Instalment Warrant Structure'.* It governs the activities of a super fund in borrowing and purchasing an asset that is then held in trust. The SMSF will have **beneficial ownership** of the asset while the trust has **legal ownership.** Legal ownership can be transferred to the SMSF as soon as the asset is fully paid off.

The diagram below gives a visual presentation of the structure of an SMSF property investment. It would perhaps be a good idea to refer back to it as we go ahead and explain the different steps of setting up your investment.

The first thing to do before you can proceed with property investment is to amend your SMSF's internal rules and trust deed (if necessary) to allow 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 with the stipulations of SISA.

After finding a suitable property, arrangements should be made to purchase the property on an 'arms length basis'. You will have to make arrangements for the setting up of a trust (known as the *'Security Custodian Trust')* that will hold legal title of the property.

It should be noted that the security trustee cannot be a trustee of the SMSF as you cannot hold something in trust for yourself. It is, however, possible to set up a separate company to act as trustee. It is highly recommended that you get competent legal advice to help you design the best trustee system.

Once all the correct 'architecture' is in place you can then proceed to approach lenders for finance. The SMSF can enter into direct talks with the lender and will also borrow directly from the lender on a 'limited recourse' basis (this means that the lender will only have a 'claim' against the fund for the property purchased). Finance documents will clearly spell out who are the legal and beneficial owners of the property.

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 rent as if the property was directly owned by the fund. 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 in the security trust. When the mortgage is fully paid, the legal ownership of the property may be transferred to the SMSF.

ARRANGING FINANCE

Setting up a SMSF property finance deal can be quite complex. Therefore, we strongly recommended that you seek professional financial advice before attempting to do so. The main reason for the differences between 'normal' and SMSF loans is the fact that the latter are tied to superannuation legislation. There are also specific tax implications if certain procedures are not followed correctly.

A 'SMSF loan' can be defined as a loan to a qualifying superannuation fund to finance the acquisition of income producing property. Lenders will normally have 'limited recourse' (as explained above) and all documents that are drawn up will have to reflect this. The legal and beneficial ownership arrangements should also be clearly spelled out.

Banks currently apply the following criteria and exclusions to this kind of loan:

- Property purchases must comply with SISA.
- Loans for construction or refurbishment are not currently being granted; the same goes for vacant land.
- Most lenders require a loan-to-value ratio of up 72% for residential property
- Many lenders will require specific powers in the SMSF trust deed therefore you may need to amend the deed to be in line with the requirements of the specific lender.
- Some lenders require personal guarantees from SMSF members, although many do not.

The main criteria that lenders will use to asses this **are:**

Debt servicing by rent, historical fund contributions and super contribution. It is highly recommended that you try to source a loan that does not require personal financials or guarantees. One of the main benefits of a SMSF loan (with no personal guarantees attached) is that it has no impact on lending outside the fund.

Once the finance is in place the mortgage can be managed more or less in the same way as a 'normal' property loan.

This includes the ability to:

- Vary mortgage terms (up to 30 years are allowed for residential property purchases)
- 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 we strongly recommend that you speak to one of our panel of specific brokers who can help you source the most appropriate SMSF loan.

SMSF PROPERTY CASE STUDY

The following case study should help to clarify some of the issues discussed:

Ron and Sandy are both 45 yrs old and have been growing their residential investment portfolio for the past 6 years and now have 4 investment properties as well as their home.

They borrowed 100% plus costs to purchase the investment properties for negative gearing purposes using their home to cover the shortfall.

They would like to buy another property, however due to property market prices falling recently they do not have available equity at the moment and their bank won't lend them more money to buy another property.

They are keen to purchase soon as they feel there will be some good opportunities to buy at very reasonable prices and are confident that over time property prices will continue to grow.
Speaking with their adviser, she suggests that they look at purchasing another property in their super fund.

They have an existing self managed super fund which has investments and cash of around $400,000. They are employed and their super contributions on their salaries go into this fund. Of the total investments, $200,000 is in shares which they don't want to sell at the moment as the prices have dropped significantly and they would like to continue to hold them. This leaves them $200,000 to put towards a property along with a loan for up to 70% of the value of the property.

Ron and Sandy are excited and find a property to buy for $450,000 which they can easily afford through their super fund. They borrow $315,000 and contribute $165,000 from the cash in their super fund. The rent from the property and other income in the fund covers the loan payments. Ron and Sandy have added to their property portfolio without having to use equity in their existing portfolio or contribute any cash from outside the super fund.

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THE NUTS & BOLTS OF BUYING A PROPERTY USING A SMSF

PROCESS OF SETTING UP A SMSF & BUYING PROPERTY

INITIAL SET UP	1 - 2 weeks
1. PT to liaise with solicitors to set up new SMSF and trustee company	
2. PT to apply for ABN and Tax File numbers	
3. PT to apply for new bank account on behalf of SMSF	

ROLLOVER OF EXISTING SUPERANNUATION	3 - 6 weeks
1. PT to review existing insurance policies and provide feedback	
2. PT to arrange for rollover of existing superannuation into new SMSF	

INVESTMENT STRATEGY	2 - 3 weeks
1. PT to provide Statement of Advice	
e.g. Following Data Collection, PT will review clients objectivies and determine appropriate investment strategy taking into account the clients risk profile, investment retirement goals and objectivies	

PUCHASE OF INVESTMENT PROPERTY	
1. PT to faciliate the property purchase transaction and liase with solicitors, banks/solicitors and real estate agents to ensure smooth transaction	
a) Obtain pre approval funding from the banks	**BEFORE** Exchange of Contracts
b) Arrange for set up of Custodian/Property Trust and Trustee Company	**AFTER** Exchange of Contracts
c) Liaise with solicitors, real estate agent and broker to assist in settlement	**DURING** Exchange & Settlement

UPFRONT & ONGOING COSTS OF BUYING PROPERTY & OPERATING A SMSF

SELF MANAGED SUPER FUND	
Option A - Initial set up of SMSF (including bank accounts, ABN, TFN and super rollover)	$2,530
Option B - Client to arrange their own super rollover and bank account	*$1,650*

CUSTODIAN / PROPERTY TRUST (to purchase investment property)	
Custodian / Property Trust (including SoA, solicitors trust deed and OSR stamping)	$5,500
** Loan - Solicitor Review Fee	$2,650
** Loan - Establishment Fee	$550
** Solicitor - Conveyancing Fee	$2,650
** Solicitor - Mortgage Document Sign Off	$2,650

*** This is an approximate fee based on previous clients, the exact fee varies with each bank/solicitor*

ANNUAL COMPLIANCE COSTS - PT PARTNERS	
Accountant	$2,200 - $3,300
Auditor	$550 - $880
ATO Levy	$259
ASIC Annual Filing Fee	$44

ANNUAL ADVISER FEE - PT WEALTH SOLUTIONS	
Fixed service fee offering based on service levels required by client i.e. we are able to offer both passive investment portfolio (e.g. index / managed funds) through to move active investment portfolio (e.g. direct equities etc.) depending on the clients risk profile	Starting from $1,650 depending on service level required by client

THE PT ADVISORY GROUP

Who are we and what makes us different?

1. PT Wealth Solutions is a privately owned, full financial services firm that operates from a non institutionally owned Australian Financial Services License. This means that we are not owned by a bank or large institution which dictates products and strategies for our clients.

2. We specialise in working on advanced investment strategies for wealth accumulators.

3. We are unique in that we provide deep expertise in sourcing and investing in direct residential investment property:
    - This means you will not be offered managed funds as the only investment solution
    - We provide a balanced approach to investing between property and shares

5. We are a fully integrated firm. The PT Group is made up of:
    - Financial Planners
    - Accountants & Tax Agents
    - Mortgage Brokers
    - Investment Property Buyers Agents

6. We have considerable Self-Managed Superannuation Fund expertise.

7. We operate a primarily fee based advice model:
    - This is different to the commission based model that is widely used in the financial advisory industry

WHAT NEXT

In planning your way to wealth you should take a holistic approach, looking at your debts and assets, present and future needs, and considering tax implications and how decisions could impact on entitlement to government benefits.

If you would like further information on this wealth building strategy, please contact **Tony Rimac from PT Wealth Solutions on 9891 1544 or tony@ptws.com.au** who can assist by providing you with the correct tax and investment advice on Self Managed Super Funds.