Smart Investment Strategy or Risky Financial Move?

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Buying a property using a SMSF: Many Australians are now using a SMSF to purchase property. This is a complex area for property investors, and this article is a quick guide to covering the pros and cons of doing so. Please consult your accountant if you are intending to purchase property via a SMSF.

SMSFs generally have several 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 article.
- 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.

Advantages of Buying a property using a SMSF

1. **Tax Advantages**

There are also tax advantages of using an SMSF. Perhaps the most important advantage associated with superannuation transactions are that these are subject to a much more favorable tax regime than ‘ordinary’, non-superannuation investments. Your after-tax returns are therefore likely to be much better.

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.

2. **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 the 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 the retirement phase.

From 1 July 2017, the transfer balance cap limits how much superannuation can be transferred into the retirement phase.

Transition to Retirement Income Streams (TRIS) are no longer classed as retirement income streams and so earnings on these assets are not tax-exempt.

3. **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. **The Basic Rules | What you Can and Cannot Do with Property in an SMSF**

The changes to the superannuation laws, 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, 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 as 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 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

5. **What an SMSF property can cost you**

SMSF property sales may have many fees and charges. These fees can add up and will reduce your super balance. Find out all the costs before signing up. Costs include:

- upfront fees
- legal fees
- advice fees
- stamp duty
- ongoing property management fees
- bank fees

Be wary of fees charged by groups of advisers who recommend each other's services. It is important to get independent advice. Anyone who gives advice on an SMSF must have an Australian financial services (AFS) license. ASIC Connect's Professional Registers will tell you if the company or person holds an AFS license.

6. **SMSF borrowing**

Borrowing or gearing your super into property involves very strict borrowing conditions. It's called a **'limited recourse borrowing arrangement'**. You can only purchase a single asset with a limited recourse borrowing arrangement. For example, a residential or commercial property. You should assess whether the investment is consistent with the investment strategy and risk profile of the fund.

Geared SMSF property risks include:

- Higher costs – SMSF property loans tend to be more costly than other property loans
- Cash flow – Loan repayments must come from your SMSF. Your fund must always have sufficient liquidity or cash flow to meet the loan repayments
- Hard to cancel – If your SMSF property loan documents and contract aren't set up correctly, you can't unwind the arrangement. You may have to sell the property, potentially causing substantial losses to the SMSF
- Possible tax losses – You can't offset tax losses from the property against your taxable income outside the fund
- No alterations to the property – You can't make alterations that change the character of the property until you pay off the SMSF property loan.

Please contact our office to initiate a preliminary discussion on the steps to assess the suitability of your buying a property in an SMSF.

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