SMSF Real Property with Borrowing

Leveraged property investment through SMSF
Important information

This booklet is prepared by Superannuation Accounting Services Pty Ltd and is provided solely for general guidance only. It is based on the interpretation of the laws and Australian Taxation Office rulings, including draft rulings, applicable to self-managed superannuation funds and other information available as at December 2011.

The content of this booklet is factual and does not consider your personal circumstances. Accordingly, before taking any action you should obtain professional financial, legal and taxation advice. This booklet is not a substitute for seeking your own professional advice.

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Key features and benefits

**Leverage** your SMSF to invest in real property directly.

Acquire property **faster** via concessionally taxed contributions and salary sacrifice arrangements.

Receive **net rental income** generated by property.

Property expenses **fully tax deductible** for the SMSF.

**No recourse** to SMSF’s other assets.

**Sell property** at any time.

Potential **capital growth** in property value.

**Tax effective.**
Overview

For most of us, our superannuation represents a significant proportion if not all of our savings for retirement. For this reason, it pays to take an interest. With the recent changes to superannuation, investing in superannuation has become more attractive. More and more people are taking active steps in managing their superannuation.

For those who wish to actively manage their own superannuation, they can achieve this through a Self Managed Superannuation Fund (SMSF). As the name suggest, it is a superannuation structure where those people self-manage their superannuation.

Investing in real estate directly through SMSF is not something new. What’s new is the ability to now borrow to invest in real estate.

It pays to take an interest

Until now, unless a SMSF can afford the full purchase of the real estate, the SMSF was restricted from borrowing to fund the purchase. This was the main obstacle for many. The changes now allow SMSFs to borrow to invest in real estate through a properly structured arrangement.

Investors which favour direct real estate can now leverage the purchase – meaning that the SMSF can borrow to fund the purchase – in a tax effective way to accumulate wealth within superannuation.

This booklet will provide you with information about investing in real estate through SMSF.
Self managed superannuation fund

Self managed superannuation fund (SMSF) gives you the opportunity to actively manage your superannuation. As the name suggest, it is a superannuation structure where you can self-manage your superannuation. This is achieved through the members themselves also being the trustees of the fund.

Generally, a superannuation fund is a SMSF if:

- it has four or fewer members,
- the members themselves act as trustees (except for single member fund), and
- no trustee receives any remuneration for their trustee services.

SMSF is permitted to invest in almost any investment assets, including investing in real property - residential and commercial.

The trustees hold and invest the assets of the SMSF for the benefit of the members.

SMSFs are regulated by the Australian Taxation Office. There are currently more than 450,000 SMSF and this number is growing rapidly.

A SMSF can accept rollover from any superannuation fund. This means you can rollover your existing superannuation into a SMSF.

A SMSF can accept contributions from all sources including:
- your employer (employer compulsory contributions),
- your voluntary contributions, such as salary sacrifice,
- contributions by self-employed, and
- contributions from Government in the form of Government co-contribution.

*Choice of superannuation* requires most employers to offer their employees a choice of where their compulsory superannuation is contributed, including to a SMSF. With this in mind, you may have your compulsory superannuation contribution paid into to your SMSF.
The benefits of self managed superannuation fund

The SMSF sector accounts for more than 30% of the superannuation industry in terms of assets, with $390 billions as at 30 June 2010.

If you would like more control over your future, and know how and when to invest your superannuation money, SMSF may be right for you.

Advantages

- Full control over your investments
- Investment choice and flexibility
- Tax concessions
- Retirement planning options
- Cost effective
- Effective transfer of wealth between generations

Disadvantages

- You as trustee need to invest some time to manage the SMSF
- Ensure compliance
- May require the services of professionals to assist

SMSF can invest in most investments, including but not limited to

- Shares, including instalment warrants
- Managed funds
- Fixed interest securities
- Bank or term deposits
- Real property, with or without borrowing
Investing in real property through SMSF

SMSFs must abide by the Superannuation Industry (Supervision) Act (SIS Act). A SMSF may invest directly in real property as long as it is inline with the SMSF’s investment strategy.

As a trustee, you are required to prepare and implement an investment strategy for your SMSF, and regularly review it. The strategy must reflect the purpose and circumstances of the SMSF.

SMSF can have investments in the following types of real property:

- residential property, and
- commercial property, including factory, warehouse, etc.

There are certain restrictions on acquiring property from a person or entity related to a trustee or member of the fund. There are also restrictions on the leasing the fund’s property to a person or entity related to a trustee or member of the fund.

There is an exception which allows SMSF to acquire from and lease business real property to a person or entity related to a trustee or member of the fund.

- A SMSF cannot purchase a residential property from a trustee or member of the fund or a related party, and cannot lease the residential property to a trustee or member of the fund or a related party.

- Business property can be purchased at market value from a trustee or member of the fund or related party and can be leased to a business related to a trustee or member or related party. A business property is a real property that is used wholly and exclusively by one or more businesses.

- A SMSF cannot purchase land and construct a house on that block using borrowings, or purchase a house and land package using borrowings.

- ‘Off the plan’ apartment can be purchased as long as the deposit and any other amount required to secure the purchase is not borrowed, and once the apartment is completed and strata titled, borrowings can be used to complete the purchase.
SMSF borrowing to invest in real property

Up until now, most people have had no option but to invest in property outside superannuation because they do not have the full purchase price of a property and not permitted to borrow.

The changes now allow SMSFs to borrow to invest in property through a properly structured arrangement:

- The borrowing is used to acquire a single asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right (but not an obligation) to acquire the legal ownership of the assets through the payment of instalments,
- The lender’s recourse against the trustee of the superannuation fund (in their capacity as trustee) in the event of default on the borrowing and related fees, or the exercise of rights by the superannuation fund trustee, is limited to rights relating to the asset only, and
- The asset must be one that the superannuation fund trustee is permitted to acquire and hold directly (i.e. for example, a SMSF can purchase from and lease to non-related party a residential property, or purchase a business property at arms length from related party).

Benefits of leveraging

- Ability to invest directly in real property with your superannuation without having the full purchase amount. You select the property, and the timing of when to buy and sell.
- Benefit from potential capital appreciation in the property.
- The tax on any income generated by the property is taxed at a maximum rate of 15% during accumulation phase (i.e. the phase you are in when you are below pension age). In pension phase, the income may be tax-exempt.
- The property expenses, including interest expense, and depreciation allowance are tax deductible for the SMSF – which means any tax on income or contributions may be reduced to nil.
- When the SMSF sells the property, the maximum capital gains tax is 10% if held for more than 12 months, and may be tax-exempt in pension phase.
- Tax benefits when you salary sacrifice to make loan repayment – salary sacrifice contributions are taxed at 15% and can be used to make principal and interest repayment. (The property expenses, including interest expense and depreciation allowance may potentially reduce the contribution tax to nil.) The lower tax means you have more left to make the loan repayment resulting in faster ownership.
- Investing in property through SMSF is more tax effective than by negative gearing outside the superannuation environment.
How it works

To meet the requirements that enable a regulated superannuation fund to borrow, it must be structured as an limited recourse borrowing arrangement (instalment warrant type arrangement).

The arrangement requires the real property to be acquired and held on trust for the superannuation fund. The legal ownership of the property is held by the trustee of the Property Trust with the superannuation fund having the beneficial interest.

The lender will lend money to the SMSF. In return, the trustee of the Property Trust will provide a mortgage of the real property to the lender as security for the borrowing by the SMSF.

The right of the lender is limited to the real property only. The lender is able to recover money where there is a default on the borrowing by repossessing or disposing of the real property, but cannot recover such money through recourse to the SMSF’s other assets.

All income (e.g. rent income), expenses (e.g. expenses associated with holding and maintaining the real property), principal and interest loan repayment are to be met by the superannuation fund.

Diagramatic view of how it works

Self managed super fund  SMSF borrow from lender

SMSF makes loan repayments  Lender

SMSF receives net rental income from property

SMSF’s own money and borrowed money applied to the purchase of the property

Property held on trust  SMSF has beneficial interest and has the right to acquire legal ownership by making repayments

Legal ownership held by trustee of property trust and mortgaged to lender

Lender’s recourse is limited to the property
Questions & Answers

Are superannuation funds permitted to borrow?
Before amendments were made to superannuation laws, superannuation funds were not permitted to borrow or charge their assets.
In September 2007, borrowing provisions were first introduced, and subsequently amended. The new section 67A permits superannuation funds to borrow provided certain conditions were satisfied.

How is it structured?
SMSF can invest in real property with a limited recourse borrowing (an instalment warrant type structure). The structure allows the SMSF to purchase a property via a Property Trustee who holds the property in trust until the loan is repaid. The SMSF has a right to acquire legal ownership by making the repayments and the lender’s recourse is limited to that property only.

What property can SMSF invest in?
SMSF may invest in any real property, including residential and commercial real property, as long as the investment in real property is in accordance with the fund's investment strategy.

Can SMSF fund member occupy the property?
SMSF fund member and related persons cannot occupy a residential property owned by the SMSF. The SMSF cannot lease a residential property to a SMSF fund member or related persons.

Who pays for the property expenses?
As the SMSF is the beneficial owner, the SMSF is responsible for paying all the expenses relating to maintaining the property, such as rates, property agent fees, rates, levies, property insurance and maintenance costs. The SMSF will receive the rent income.

What are the Stamp Duty and Capital Gains Tax (CGT) implications?
Assuming correct documentation is in place and current legislation, nominal Stamp Duty will apply upon the transfer of the property to the SMSF in most States and Territories. As for CGT, no CGT will be payable upon the transfer. SMSF trustee should obtain their own advice.

What about land tax?
Under the structure, the SMSF is the beneficial owner of the property and is liable to pay land tax if the total land value of properties owned by the SMSF exceed the threshold amount. The rate and threshold varies according to State or Territory. SMSF trustee should obtain their own advice.

Can the SMSF sell the property?
The SMSF can direct the Property Trustee that holds the property on trust for the SMSF to sell the property, subject to repayment of the mortgage loan.

CASE STUDY
Suppose a SMSF has $200,000 in cash and the trustee have determined that leveraged investment in real property is consistent with the fund’s investment strategy.

The SMSF wish to buy a property for $375,000 plus $25,000 in stamp duty and acquisition costs. The SMSF will make initial payment of $150,000 and borrow the remainder through a limited recourse borrowing with the property as security.

This leaves the SMSF with a buffer of $50,000. After settlement, the SMSF trustee arranges for the property to be leased to an unrelated party. The rent, contributions and other SMSF income are used to make repayments and pay property expenses. Once the loan is repaid, the legal ownership of property can be transferred to the SMSF.
Is it suitable for me?

There are things you should consider. In relation to investing in real property through SMSF, they include:

- Is a SMSF a suitable structure for me? Consider whether you have the time and skills, or pay for professional advice.
  
  You should also consider the costs involved and how switching to a SMSF will affect you superannuation.

- Is real property investment consistent with the SMSF’s investment strategy?

- Can the SMSF achieve the appropriate level of diversification?

- Is the purpose of the SMSF strictly for retirement benefits only?

  Note that the personal use of assets, including real property, of the SMSF is against superannuation laws. For example, the SMSF cannot rent residential property to you or any other person related to you.

Some of the things you should take into consideration in determining whether it is right for you.

If you are thinking about borrowing to invest in property, you should also consider:

- Whether the strategy is suitable for you.

- Whether the strategy is consistent with the SMSF’s investment strategy.

- Comfortable with gearing to increase capacity for return.

- The ability of the SMSF to service the repayments, principal and interest repayment.

- Looking to invest for a medium to long-term period.

The above are provided as a guide and are not exhaustive.

Remember, SMSFs are great for some people but they are not suitable for everyone.

If you are unsure, get professional advice.
Fees and charges

The fees and charges applicable for the establishment of the Real Property Instalment Warrant are below.

**SELF MANAGED SUPERANNUATION FUND**
If you do not have an existing SMSF, a SMSF will be established for you and applicable fees apply. This is a once-off fee.

**REAL PROPERTY INSTALMENT WARRANT**
A Real Property Instalment Warrant can be established to enable your SMSF to borrow to invest in real property. This is a once-off fee and there is no on-going or maintenance fees.

Other costs

There are costs associated with managing your own superannuation and investing in real property through your SMSF. They include:

**ACCOUNTING AND AUDIT FEES**
A SMSF is required to present audited financial statements, lodge income tax & regulatory return with the Australian Taxation Office and provide members with member information for each financial year.

The fees for complying with this obligation ranges from $1,150 upwards. Superannuation Accounting Services can provide you with this service at competitive fixed fee. For current fee, contact Superannuation Accounting Services on 1300 735 254 or visit their website at www.superaccounting.com.au.

**AUSTRALIAN TAXATION OFFICE SUPERVISORY LEVY**
This is a levy imposed on all SMSF by the Australian Taxation Office. The levy is currently $180 each financial year.

**PROPERTY COSTS**
There are costs associated with acquiring and maintaining a real property and varies from property to property. Generally, they include:

- property acquisition and disposal costs, including legal fees and stamp duties
- interest expense and outgoings - such as property agent fees, rates, levies, property insurance and maintenance costs.

**OTHER COSTS**
There may be other costs associated with operating a SMSF, depending on the operation of the fund and investments, such as investment expenses, administration expenses and cost of professional advice.
Getting started

Once you have determined that borrowing to invest in real property through your SMSF is suitable for your personal circumstances, the process is as below.

1. Establish a SMSF if you do not already have one, or if you have an existing SMSF, ensure that the fund’s trust deed and investment strategy permits the fund to invest in real property with a limited recourse borrowing arrangement (an instalment warrant type arrangement).

2. Obtain preliminary loan approval from your lender. The loan should be a SMSF limited recourse borrowing. Once you have the preliminary loan approval, you can select a suitable property.

3. Complete the application form to establish a Real Property Instalment Warrant (Security Trust). This form is enclosed with this booklet. If you do not have the form, you can contact us on 1300 735 254 to obtain one. This will provide us with instructions to have the necessary documentation to establish the instalment warrant structure for your SMSF.

4. Prior to exchange of contract or entering into the contract to purchase the property, ensure you have unconditional loan approval. The Security Trust Deed may need to either be executed prior to or after the exchange of contract or entering into the contract to purchase the property. You should seek legal advice to ascertain the appropriate timing for the execution of the Security Trust Deed as this varies between States and Territories.

The trustee of the Security Trust must be the legal owner of the property with the SMSF having the beneficial interest.

After settlement, the Security Trustee will hold the property in trust and the SMSF trustee will have beneficial interest. Once the borrowing is repaid in full, the mortgage can be discharged and the legal ownership can be transferred to the SMSF trustee.

Contact us on 1300 735 254.

A real property borrowing solution for your SMSF.
Change to superannuation laws now allow self managed superannuation funds to borrow to invest in real property under certain specific conditions. This gives your self managed superannuation fund the option of purchasing real property with your superannuation without having the full purchase amount.