INVESTMENT PLUS
ACCOUNTING GROUP

# How To Buy A Property With A SMSF

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# Introduction

Self-Managed Superannuation Funds' (SMSFs) are a tax effective and efficient way of saving for your retirement. For many Australians, SMSFs are increasingly being used to purchase property. The advantages of a self-managed super fund depend on your circumstances, abilities, and inclination.

If you set up a self-managed super fund (SMSF), you're in charge – you make the investment decisions for the fund, and you're held responsible for complying with the super and tax laws. It's a major financial decision and you need to have the time and skills to do it. An SMSF must be run for the sole purpose of providing retirement benefits for the members or their dependants.

Maintaining an SMSF requires extensive financial and legal knowledge which is why competent financial advice is needed. Before committing to an SMSF, it is important to understand the advantages and disadvantages of SMSFs

This guide is a summary of the important facts that you need to consider when establish a SMSF for the purpose of property investment. There are very specific rules which apply to setting up and managing a SMSF, therefore you should seek independent advice from your accountant, financial advisor and a solicitor.

If you are not familiar with how to establish and operate a SMSF, we recommend that you download our "Guide to Operating SMSF's".

# Advantages Of Owning A Property Through A SMSF

There are a number of advantages to holding property inside an SMSF, as opposed to owning it in your own name.

**Concessional tax on rental income**

A concessional tax rate applies to superannuation investment earnings, rent received by your SMSF and you will be taxed at a maximum rate of 15%. Because certain expenses related to the ownership of the property such as land rates, property maintenance etc will generally be tax deductible to the fund – the effective tax rate may come down even further.

**Concessional tax on future capital gains**

Special superannuation tax rates also apply to any capital gain made as a result of an increase in the property's value. As a result, depending on when you decide to sell the property, any capital gain your fund makes on the sale of the property may be completely tax-free.

- If you sell the property while still in the "accumulation" phase, the fund will generally pay CGT of up to 10% on any growth in the property value assuming that the property has been owned for at least 12 months).
- On the other hand, if you decide to sell the property after you have transferred it into the "pension" phase, within your SMSF, any capital gain will be exempt from tax altogether

**Increased superannuation opportunities**

In addition to the above, where the property owned by your SMSF is the property from which you run your own business, superannuation rules require your business to pay a commercial rate of rent to the fund – providing you with a way to accelerate your superannuation savings.

The rent that your business pays into your SMSF will be tax deductible to your business, but more importantly for superannuation purposes, it will not be treated as a superannuation contribution. The ability to make tax deductible rent payments into your superannuation fund – without this rent counting towards these limits – enables you to build your retirement benefits quicker and tax efficiently.

### Additional Benefits

There could also be other benefits from holding property within your SMSF.

For example, superannuation assets are generally protected from creditors in bankruptcy situations.

If you are a small business owner, superannuation assets are not included when determining your eligibility for the generous small business CGT concessions that apply when you sell your business or retire. By planning ahead, you can ensure that you better qualify for these concessions.

### Using a LRBA to Purchase Property

Trustees of self-managed super funds (SMSFs) are generally prohibited from borrowing money, subject to limited exceptions under the super law. One of these exceptions is for ***limited recourse borrowing arrangements*** (LRBA). A LRBA involves an SMSF trustee taking out a loan from a third-party lender. The trustee then uses those funds to purchase a single asset (or collection of identical assets that have the same market value) to be held in a separate trust.

### Advantages of LRBA loans

- It can help to diversify your SMSF's investments into other assets like commercial property.
- If you're a business owner, you can buy business premises.
- It protects the other assets in your SMSF from "recourse" or from the lender selling those assets to recoup any losses that weren't covered by the sale of the property you purchased.
- The maximum CGT rate drops from 15% to 10%, where a property is held for more than 12 months.
- If you're not too close to retirement age, you can actually use concessional super contributions in order to pay down your loan faster. You don't get this benefit with a standard home loan.

# How To Purchase A Property Using A SMSF

There a few methods of purchasing a SMSF property:

- Cash purchase
- Tenants in common
- Use of a 13.22c Trust
- LRBA (borrowing funds using a Limited Resource Borrowing Arrangement)

For detailed information about these methods, please see below.

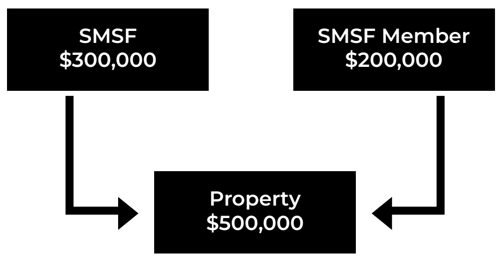
## Purchase Method | Cash

Purchasing a property with cash has benefits, including not having to pay monthly mortgage payments, and the costs and fees associated with the mortgage process. No having to pay monthly interest is obviously the biggest benefit of this method.

## Purchase Method | Tenants in Common

A TIC (Tenants in Common) arrangement is a type of ownership of real property by two or more parties. All tenants in common have an equal right to the property, even if their percentage of interest is not equal or the living spaces are different sizes. There is no “right of survivorship” if one of the tenants in common dies, each interest may be separately sold or willed to another (unlike a Joint Tenancy arrangement where the interest passes automatically to the survivor upon the death).

**Example:** A property valued at $500,000 is purchased by the SMSF and a related party who contributes $200,000 in their personal capacity.



### How a SMSF and TIC arrangements operate

This method involves an arrangement between the SMSF and a related party to the SMSF (e.g., a member of the SMSF in their personal capacity). This strategy allows for other investors (including related parties) to participate in the transaction when the SMSF does not have sufficient capital to complete the deal on its own, or, where the investor is looking to take advantage of the concessional tax treatments available in superannuation for future income and capital gains (in particular in pension phase) on the SMSFs holding in the TIC. Percentage holdings are determined at purchase and are listed on the contract of sale and recorded on the title of the property.

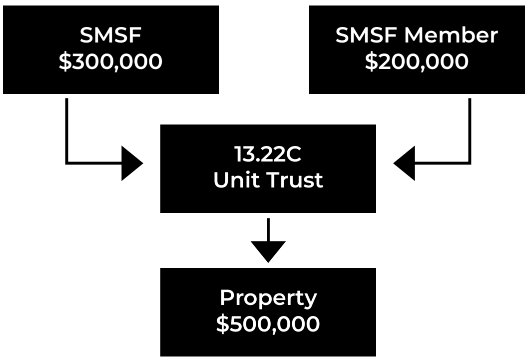
| Rules governing TIC arrangements – Please refer to the diagram above | |
|---|---|
| **Personal Use Restriction** | There must be no personal use of the property whatsoever. For example, if it was a holiday rental, you (or another related party) could not use it personally just because a portion of it is owned by you outside of your SMSF. |
| **Gearing** | The SMSF member's $200,000 contribution can either be cash or borrowed monies.  However, this member cannot use the property acquired (i.e. their interest in the TIC arrangement) as security for their personal borrowing. The member would have to use other personal assets to secure their loan. |
| **Tenants in Common Rules** | As the tenants in common are generally related parties, the SMSF cannot buy the tenant in common's interest in the property (assuming a related party). If the SMSF wishes to acquire the related parties' interest in the property (in this case the member's $200,000 interest) only where the property meets the definition of 'business real property' can the SMSF acquire the member's interest. The solution to this problem is by using a Unit Trust that complies with Regulation 13.22C of the Superannuation Industry (Supervision) Regulations 1994 Act (13.22CUnit Trust). Talk to your Accountant to clarify the rules relating to establishing unit trusts |

# Purchase Method | Investing using a 13.22C Unit Trust

### Purchase Method | Investing using a 13.22C Unit Trust

An alternative method of buying a property as tenants in common, would be to establish a Trust and each SMSF member can purchase units in a 13.22C Unit Trust, which acquires the $500,000 property. (see diagram below).

This method will overcome some of the restrictions associated with TIC arrangements such as those involved when acquiring a related parties' interest, as well as borrowing restrictions.




### How a 13.22C Unit Trust Operates

The 13.22C Unit Trust is a separate legal entity and will need its own ABN and TFN and will be required to lodge tax returns each year. The trust owns the property, can enter into the leases, receive rent and pay expenses.

The net income is then distributed to the unit holders in accordance with their respective percentage holding in the trust.

Although this ownership structure avoids some of the restrictions of a TIC arrangement, a 13.22C Unit Trust is subject to another set of strict rules that must be adhered to. Moving outside of these rules can result in the trust losing its 13.22C status and becoming a related party trust to your SMSF – raising serious concerns of non-compliance.

| What are the benefits of using a 13.22C Unit Trust | |
|---|---|
| **Acquiring additional units** | An SMSF can acquire units in a non-geared 13.22C Unit Trust from a member or 'related party'. Effectively allowing the SMSF to purchase up to 100% of the residential property from the related party.<br>The related party and/or the super fund can subscribe to new units in disproportionate amounts if more capital is needed for improvements or renovations. |
| **Borrowing Rules** | 1. The related party can borrow to acquire their units in the unit trust and then should be able to claim the interest on the loan as a personal tax deduction because the trust is income producing.<br>2. The related party can borrow to acquire their units in the unit trust and then should be able to claim the interest on the loan as a personal tax deduction because the trust is income producing. |
| **Improvements to Property** | When improvements are likely to be required with borrowed monies, using a 13.22C trust arrangement will avoid needing to meet the strict LRBA rules. Meaning it is possible to carry out a development using your SMSF monies and borrowed funds, and also enter into this deal with a related party, such as one of the members of the SMSF. |
| **Convenience** | As well as having the flexibility to adjust the respective holdings, co-ownership through a unit trust introduces a degree of administrative convenience. For example, Income and expenses do no not need to be split as they would have to under a TIC arrangement. |

# Purchase Method | LRBA – Limited

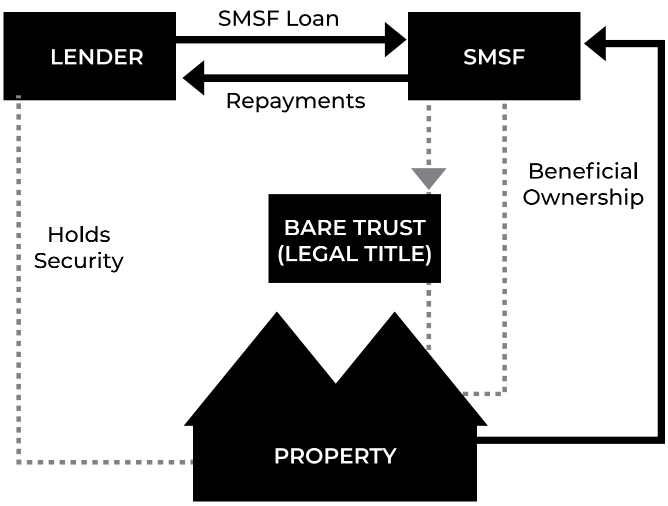
**What is an LRBA?**

A limited recourse loan is designed to enable you to borrow or gear your super into property and certain other assets, subject to strict conditions and certain limitations. This can enable the SMSF to acquire assets it currently doesn't have enough money to purchase outright.

Provided the governing rules allow for it, SMSFs can borrow to invest by using what's called a 'limited recourse borrowing arrangement' (LRBA)

To 'limit the recourse' of the lender, a separate property trust and trustee is established to hold the property on behalf of the super fund, outside the actual SMSF structure.

All the income and expenses of the property go through the super fund's bank account. The super fund must meet all loan repayments. If the super fund fails to do this, the lender only has the property held in the separate trust as recourse and cannot access any remaining assets of the super fund. The diagram below gives a visual presentation of the structure of an SMSF property investment funded via a limited recourse loan.



| Compliance Requirements \| LRBA Rules | |
|---|---|
| **Value of SMSF Assets** | SMSFs need to value all of their assets at market value, and the valuation needs to be based on objective and verifiable data. |
| **GST Registration** | If the commercial property produces a gross rental income in excess of $75,000 per annum, the fund will also need to register for GST. |
| **Purchase the property in the correct name** | The property must be purchased and held in the name of the trustee of the bare trust. Many people purchase the property first and then subsequently set up their SMSF and associated legal entities to arrange finance for settlement of the property. Failure to purchase the property in the correct name may lead to expensive stamp duty implications. |
| **Property Renovations** | If you want to make an improvement to the property that is subject to a loan, the improvement must be funded from cash reserves held within the SMSF.<br>Additionally, improvements cannot result in the asset becoming a 'different asset,' as the asset identified when the loan is put in place must continue to be the asset that is held on trust under the loan. |

**The Single Acquirable Asset Rule**

This rule requires that the borrowed money must be used to acquire a 'Single Acquirable Asset'.

Put simply, a single acquirable asset can be defined as a single object of property; for example, an apartment, residential property, or a block of vacant land. Further, the single acquirable asset can comprise two separate assets at law and be treated as the one asset for the purpose of borrowing in an SMSF.

Under both scenarios the two assets will be treated as one single acquirable asset, and as such, borrowing can be used to acquire them.

Two common mistakes made by SMSFs using borrowed funds to buy property include:

- Borrowing to build a house on an existing block of land owned already by the SMSF. A house is not a single acquirable asset in its own right. Money borrowed to build the house effectively results in the acquisition of services and building materials, not a single acquirable asset.
- Furniture packages bundled into property contracts. It is common when buying a property from a developer they will include a furniture package in the contract of sale. The ATO makes it very clear that the property and the furniture package, even if purchased together under the one contract, is not a single acquirable asset.

As such, you will need to remove the furniture package from the contract of sale for the property before exchange of contracts and enter into a separate contract to purchase the furniture package with spare cash from the SMSF, and not borrowed funds (as a furniture package is made up of multiple items, it is not considered a single acquirable asset).

# SMSF Loans – How To Arrange Finance

The lending criteria for SMSF property loans are much stricter than normal property loans as the costs of these loans are higher. Most lenders will require that your SMSF balance must be at least $250,000 before they will consider a loan. Loans for construction, refurbishment or vacant land are typically not available.

**What do Lenders look for?**

- Compliance with superannuation laws and ASIC rules (if a corporate trustee)
- Some lenders may only provide finance to SMSFs that have a corporate trustee
- Most lenders require a LVR of up to 70%
- How often you make contributions to the fund
- What your expected rental income will be
- Some lenders require clear written evidence that outside financial advice was sought before they will begin to process the loan application
- Do you have evidence of existing insurance on the SMSF property

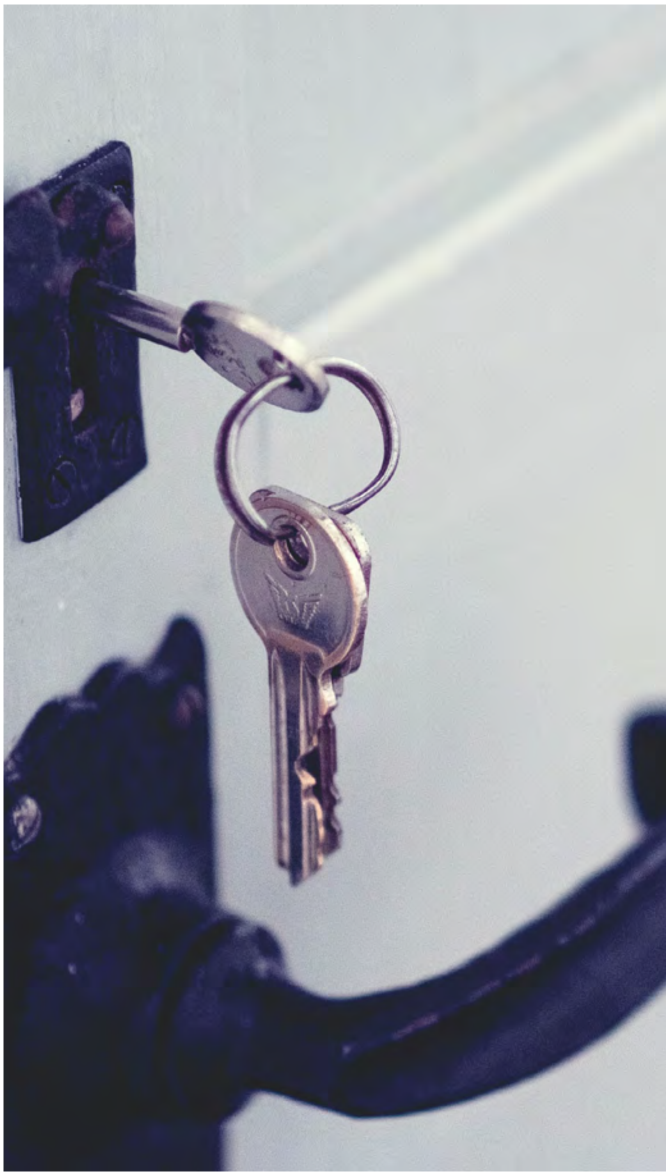
**ATO Safe Harbours for Related Parties SMSF Limited Recourse Borrowing**

**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 the following guidance in relation to 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.



# The Importance of Bare Trusts

### Holding Trusts

You are required to establish a holding trust that purchases the asset with borrowed funds held in the trust. 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).

As beneficial owner, the SMSF will be credited with all income and capital growth and be directly responsible for all mortgage payments and costs.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 and arrangements should be made to purchase the property on arms- length terms.

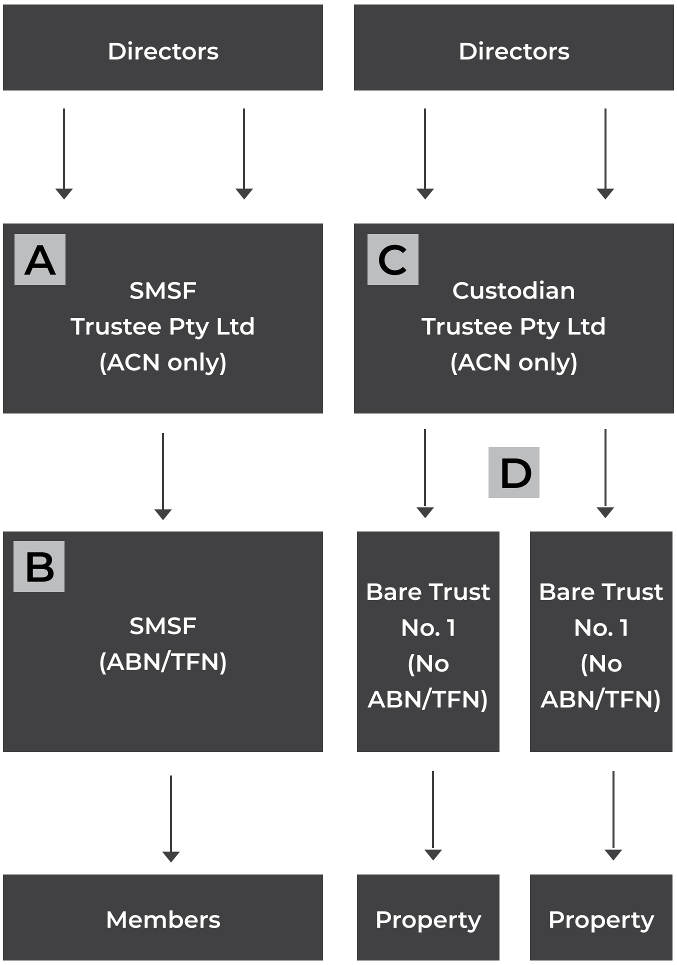
### Structures | The Importance of a 'Bare Trust'

When entering into a property transaction with your SMSF that involves taking out a loan to fund the purchase of the property, the superannuation legislation clearly states the property must be held on trust for the benefit of the trustees of the SMSF.

Why is a bare trust required? The policy thinking behind why the property must be held on trust for the SMSF is a protection policy for SMSFs. It removes the property from the other assets of the SMSF, thereby protecting the other SMSF assets from any potential litigation or lender claims that may arise in conjunction with the property.

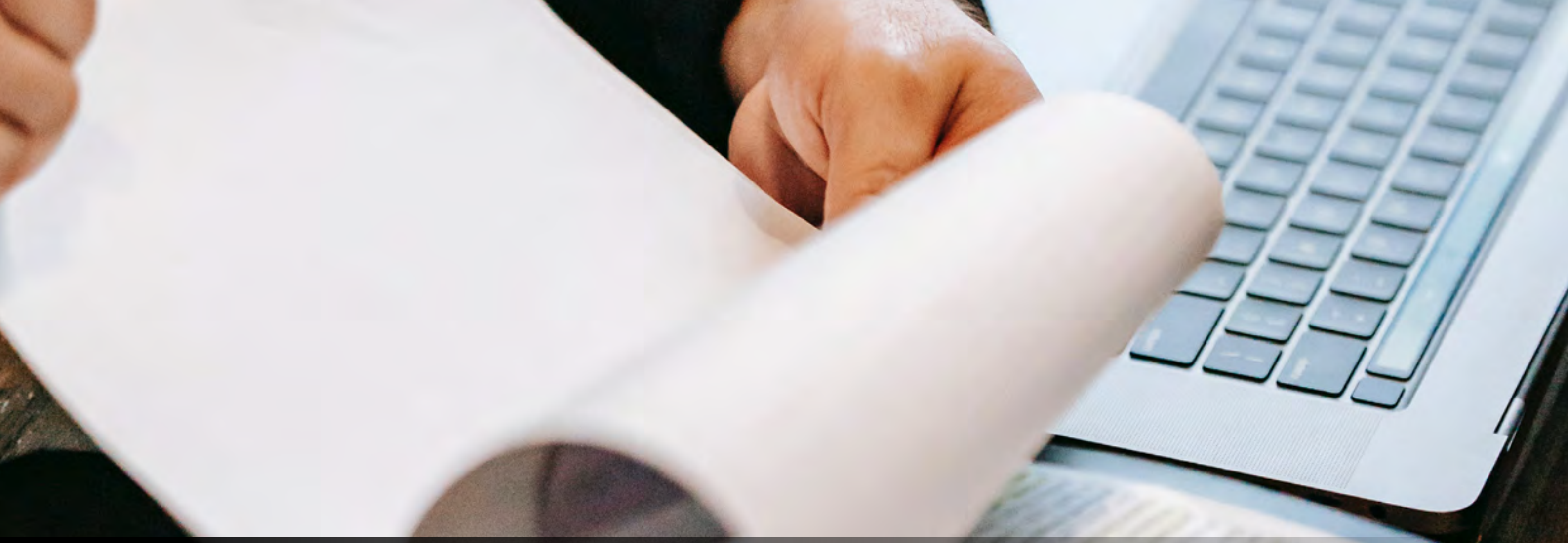
A. Holds the beneficial interest in the property for the benefit of the SMSF Members.

B. The SMSF is registered with the ATO. Bank account D. opened in the name of the SMSF. Rent is received and interest and expenses are paid to and from the bank account. All business activity happens through the SMSF.




C. Holds legal title of the property for the benefit of the SMSF Trustee. It is also the purchasing entity on the contract of sale.

D. The Bare Trust(s) describes and enforces the relationship between C, A and B.



# Tax Deductions – Property Purchased with SMSFs

SMSFs may be eligible for tax deductions and other concessions depending on the property type and how it is used.

### Residential Properties

If your residential property is rented out, you are eligible to claim a tax deduction for rates, taxes, maintenance costs as well as administration costs which cover body corporate fees, water rates and land tax. Speak to our accountant to find out what additional costs are tax deductible,

If you borrowed funds under a LRBA, the interest charges on the property is tax deductible.

### Property Maintenance

Costs associated with cleaning, gardening, pest control and general repairs and maintenance is tax deductable but not the cost of improvements. Since 1 July 2017, capital works deductions have been restricted to depreciable new assets and restrictions apply to capital works deductions on depreciating second-hand goods.

### Holiday Houses

A 'holiday house' owned by an SMSF is the same as owning a residential property. However, because the property is usually leased on a short-term basis, more servicing and upkeep may be required. A deduction is usually available for replacement of utensils, bed linen, depreciating furniture and more regular cleaning of the property.

### Bed and Breakfast

A bed and breakfast, as the name suggests, is usually short-term residential accommodation and include 'breakfast' as part of the arrangement. In addition to expenses incurred for a residential property, a bed and breakfast owned by the SMSF may incur expenses for a range of expenses associated with providing goods and services to guests.

### Commercial Property

Commercial property may also be leased to related parties such as the members, trustees, their relatives, or companies or trusts that they control. The lease arrangement is required to be properly documented and any rent paid must be determined on an arm's length basis.

Seek advice from your accountant if you intend to use a commercial property owned by your SMSF.

### Vacant Land

It is possible for an SMSF to own vacant land for various purposes, such as a parking space for a business, farming land leased to a family business, or for property development. If the vacant land is used for genuine business purposes, the SMSF would be entitled to a tax deduction for expenses incurred in earning income or prospective income received from the land.

# Common Mistakes To Avoid – FAQ's

We are often asked by clients to provide guidance on how to avoid the most common mistakes. We always recommend that at any stage of your property investment journey, you always seek appropriate advice.

**1. Do you have sufficient funds in your SMSF?**

The costs of establishing and operating an SMSF with a balance of $250,000 or below are unlikely to be cost competitive, compared to alternative types of superannuation funds. You will also have to consider the time and skill required to manage your SMSF.

**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 several penalties. Where a penalty is applied, the trustee 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% (includes 2% Medicare Levy).

**3. Lack of consideration of diversification of assets**

Owning property is unlike owning shares as an investment because you can't as easily diversify. Diversification is a risk reduction strategy and depending on your stage in life or risk tolerance needs to be considered.

**4. Do you understand 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. 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.

**5. Do you have an investment strategy?**

Investors who are 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.

Financial advice can be invaluable in terms of helping you make this decision. 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.

**6. No Debt Repayment/Exit strategy**

Have your prepared a repayment and exit strategy for any borrowed funds. You should always borrow within your means (i.e. not over commit yourself). In relation to property investments within an SMSF, this consideration will include:

- When you plan to sell the property
- What loan structure you consider (e.g., interest only, fixed, or variable interest rate etc.)
- The size, term of the loan and the repayment schedule

**7. Will you have sufficient funds in the Retirement Phase?**

When you decide to retire, your fund will be in the retirement phase and you will be relying on your fund to provide you with a pension 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. Trustees must ensure that funds will be available to meet drawdown demands.

**8. Why property selection in important**

A property is a major investment, and you need to consider some of the most common mistakes property investors often make. It is best to obtain advice about the location of the property, the annual rental yield and the potential for capital growth.

**9. Purchase property in the name of the Fund NOT the individual**

This is perhaps the most common mistake when purchasing a property that is held in a SMSF. It is also one that can be very difficult to rectify. 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.

**10. Who should you contact when considering a SMSF 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 and solicitor
- a real estate agent
- the vendor and their solicitor
- the lender and their solicitor
- a finance broker
- the Office of State Revenue

### 11. 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:

- SMSFs are prohibited from making loans to or providing any type of financial assistance to members or their associates
- SMSFs are prohibited from holding inhouse assets totalling more than 5% of the total value of the fund.
- 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).

### 12. Not purchasing a 'Single Requirable Asset'

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

### 13. 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.

### 14. Do not use 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 annually.

### 15. Why should you always seek advice?

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 considering 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 strategising and planning their investment strategy.

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