The SMSF Institute Guide Book

Investing in Property through your Self-Managed Super Fund

Benefits & complexities of adding property to your Superannuation investment portfolio!

The
Self Managed Super Fund
Institute

The Self Managed Super Fund Institute

General Advice

The contents of this knowledge book are for educational purposes only and contains only general information.

Financial advice can only be given by taking into account your personal circumstances and individual goals.

We recommend seeking specialist financial advice before making any changes to your financial situation.

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Introduction

There is so much information available on Self-Managed Super Funds (SMSF) that it could be difficult to know exactly where to turn even for the most basic questions.

Setting up and running a SMSF can be easy, but it is not for everyone. There is plenty to consider when choosing to set up your own SMSF. However, with the right guidance the advantages for those who do decide to manage their own super can be quite substantial.

This knowledge book provides a general overview of the basics of SMSF and specifically the role of direct property investment within a self-managed super fund. It is for those who are thinking about setting up a SMSF or for those who have a SMSF and would like more information on property investment. While there are a myriad of benefits to property investment, it is important that you are aware of some technical aspects and what investment limitations exist for property within your SMSF.

There are a number of other sub topics in having and running a SMSF. Insurances, Trust structure, investment strategies, beneficiaries are just some of the areas that you can explore when operating your own SMSF. Of course, you don't have to be an expert in all these areas!

We strongly recommend that you take the time to meet with an adviser who specialises in SMSF's to help you gain the most from running your SMSF.

Your own SMSF – explore how you can take control and have the flexibility to choose how your money is invested for your future. Contact the SMSF Institute to find out more.

What is a SMSF and how is it different to superannuation?

A Self-Managed Super Fund (SMSF) is a type of superannuation fund that is 'owned' and operated by you! When most people think of Superannuation they are referring to what they know as a 'retail' or an APRA[1] regulated fund. They advertise on television and some are associated with specific industries, however generally speaking they are open to everyone who is eligible to have superannuation. There are a couple of important distinguishing factors between a SMSF and an APRA regulated fund.

First and the most important is that the trustee of a SMSF is generally also the member. The trustee is an individual or entity that controls and is responsible for running the super fund. In an APRA regulated fund, the trustee is a professional entity not a member of the fund. This means that the members of a SMSF have the capacity as trustee's to control the fund, the investments within the fund and the amount of money dedicated to each investment at any given time. The trustee is also legally responsible for administration and compliance of the fund. SMSF's are regulated by the Australian Taxation Office (ATO) and must comply with the Superannuation Industry Supervision Act (SIS Act 1993).

In an APRA regulated fund, the member of that fund has very little input into the daily running of the fund, the investment decisions and the control of when investments are bought and sold.

SMSF's are limited in the number of people (members) allowed in the fund, the maximum being up to 4 people. Generally all members must also be trustees of the fund. APRA regulated funds don't have maximum limits on member numbers.

Secondly, SMSF's also have the flexibility to allow funds to be invested directly into certain assets that may not be accessed by larger APRA funds. The most common example of this is that a SMSF can generally invest in direct residential property. APRA regulated funds will generally invest in property (residential, industrial and commercial) through listed or unlisted property trusts which comes with its own list of advantages and disadvantages.

Having a SMSF allows its members (as trustees) to have the flexibility, control and decision making ability to invest their super money. Most people who choose to have their own SMSF are not financial experts, so it is important to be guided by the right professionals and get the right advice.

Having a SMSF allows its members, as trustees to have the flexibility, control and decision making ability to invest their super money

[1]APRA is the Australian Prudential Regulation Authority and is responsible by law for supervising the Australian Financial Services industry. www.apra.gov.au

SMSF Basics

Using a SMSF to manage your superannuation money can be very rewarding, however there are a numbe of things to keep in mind when operating a SMSF.

The SMSF must always comply with the relevant legislation, namely the SIS Act 1993 amongst others. Generally a SMSF can invest in an asset as long as the investment meets the 'Sole Purpose Test[2]'.
This test basically states that the investment decisions made by the trustee of the SMSF should be aimed at providing for the members retirement in a prudent way.

This means that the SMSF must continuously meet the Sole Purpose test. Where it fails or contravenes the test it could be deemed a non-compliant fund by the ATO and consequently taxed at the highest marginal tax rate.

When it comes to investments the advantages of running a SMSF are numerous.
For example a SMSF can choose to invest in:

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- - Direct Property, including non-owner occupied
- residential property, commercial and industrial
- property and property used to carry on a
- business
- - Managed Funds
- - Direct Shares (Australian and International)
- - Term Deposits and cashAntiques, collectible
- and personal use items

Investing in some of the assets above requires the SMSF Trustee to follow certain rules.
For example, investing in Art or a collectible car will mean that the trustee cannot drive the car or hang the art work at home. The asset cannot be used personally so the trustee will need to arrange for the car to be garaged and transported by someone else and the art work displayed in a gallery.

While running a SMSF involves following certain rules, with the right guidance from professionals it can give you, the trustee the flexibility to choose when and how your money is invested. Additionally the trustee will have the ability to direct funds to investment classes that are only available directly to SMSF's.

[2]Superannuation Industry (Supervision) Act 1993 (SISA) Subsection 62(1)

Setting up a SMSF

Setting up a fund can be easy. As the ATO is responsible for overseeing the SMSF industry it has set up guidelines through its website[3] and the government money smart website[4]. It details what you will need to do in order to establish and run a SMSF.

A few things you will need to consider when setting up and running a SMSF.

A Trust Deed	A trust deed is the legal document that governs the setup, day to day running and management of a SMSF. It should define who runs the fund, their responsibilities and purpose of the fund. You need this document to establish the fund.
Register the fund	The fund needs to be registered with the ATO. This can usually be completed online for a small fee.
Investment Strategy	An investment strategy is a document that sets out the trustee instructions on which investments or asset classes the fund can participate in.
Bank Accounts	Your SMSF will need to set up its own bank account. This is the account that will accept contributions and payout any ongoing fees related to taxation, advice, auditing and accounting fees.
Insurances	SMSF trustees are required to consider personal insurance(s) for its members as part of the overall strategy of the fund. This is particularly important if the members are considering rolling over superannuation funds where there are existing insurance policies in place.
Audit	It is a requirement that the SMSF is audited every year. This is easily arranged through an approved SMSF auditor.
Tax return	Like most legal entities, the SMSF must lodge annual statements in a tax return. It is important that you use an appropriately qualified accountant with experience in SMSF's in addition to other qualified professionals such as Financial Advisers and auditors.

IMPORTANCE OF RECORD KEEPING

One of the most important (and easiest) aspects of running a SMSF is maintenance of proper records. Records should be kept for transactions of assets and receipts kept for expenses such as accounting and adviser fees. Additionally, it is important to record all decisions made by the trustee in form of minutes or notes of meetings as this shows due consideration by the trustee(s) when making a decision for the SMSF. Most records must be kept for up to 10 years.

[3]https://www.ato.gov.au/Super/Self-managed-super-funds/

[4]https://www.moneysmart.gov.au/superannuation-and-retirement/self-managed-super-fund-smsf

Property Basics

One of the main attractions for members to set up their own SMSF is the ability to invest directly into commercial and residential property using superannuation money. Investing in direct property in Australia has long been a favoured asset class for long term wealth creation. Investment in property using the SMSF tax structure remains relatively modest compared with Listed Shares and Cash according to the 2014 ATO SMSF report.

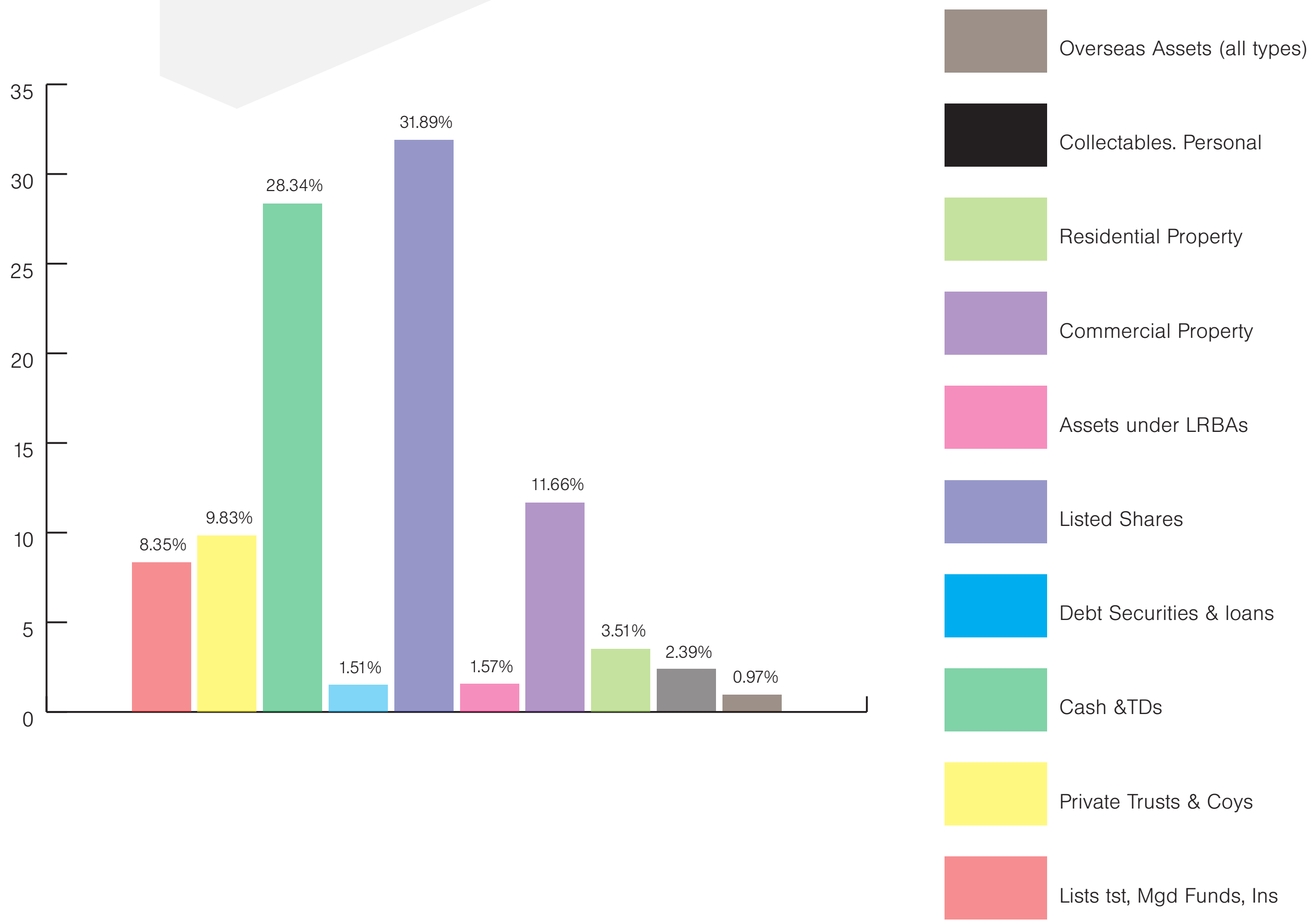


Figure 1. Asset Allocation – ATO SMSF statistical report June 2014.

Property, particularly direct property can be viewed as another asset class with its own positives and negatives. It is important when operating a SMSF with direct property in mind to consider a number elements.

LONG TERM INVESTMENT

Property values can go up and down!

The asset class of Property can be quite broad however very few analysts would disagree that regardless of how you invest in property, your focus should be long term. Long term generally means 7 years plus. The reason for this is to allow the asset time to "ride out" any volatility in the market or indeed to accumulate a sizeable increase in value.

A similar long term philosophy should apply to investments in equities. While there are some who happen to invest "at the right time" and see value increase rapidly, any investment in property should be seen as just that, an investment rather than speculation about market trends in the short term.

GROWTH AND RENTAL YIELD

The first rule of any investment made by the SMSF should always be – does it meet the Sole Purpose Test (described earlier). That is, will this provide a prudent investment for the retirement benefit of the member(s). Given this, the basics of property investment applies. Is the property in a good location? Is it close to public transport, schools and shopping centres? Is it an attractive rental property for tenants? Does it have the potential for growth in the future? How much should or could I borrow to purchase the property within the SMSF?

These are questions that the investor (or trustee in the case of a SMSF) must ask when looking at property for the purposes of investment and as always it is important to speak with a professional adviser when making investment decisions as the Trustee of a SMSF.

COSTS

This is another reason not to speculate with property. Purchasing a property is a big investment decision. It is important to consider the impact of costs. It is sensible to factor in about 5% of the purchase price as costs which may include Stamp Duty, legal fees, borrowing and establishment costs.

CASH AND LIQUIDITY

When investing, particularly in property it is important for a SMSF to maintain a certain amount of cash. There are a number of practical reasons for this. Typically this may be in the order of $20k to $30k or more.

- The SMSF will need to be able to account for repayments in the event that rental income ceases (vacancy) or the property is negatively geared and there is a shortfall in cashflow.
- Cash is needed to account for tax payments for income tax purposes
- Cash is needed to account for expenses such as accounting and audit fees or outgoings on the investment property or fees associated with advice.
- An adviser may account for further cash inflow through contributions via employer or members contributions.

CONTRIBUTIONS

There are a number of ways members are able to make contributions into their super fund.
The most common ways of contributing are via mandated employer contribution such as Superannuation Guarantee contributions & salary sacrifice. Additionally members can make personal contributions such as non-concessional contributions.

For the 2015 / 2016 financial year the contributions limits are:

CONTRIBUTIONS CAP	AGE OF MEMBER	
Concessional such as SG and Salary sacrifice	Under age 49 at 30 June 2015: $30,000	Aged 49 or over at 30 June 2015: $35,000
Non-concessional contributions cap for 2015–16	Under age 65 at any time during 2015–16: $180,000, or Up to $540,000 over a three year period under 'bring-forward rule'[5]	Aged 65 for all of the 2015: $180,000

[5]Clients under age 65 at any time in a financial year may effectively bring-forward two years' worth of entitlements of non-concessional contributions for that income year, allowing them to contribute a greater amount (i.e. $540,000 in 2015–16) without exceeding their non-concessional cap. This is known as the 'bring-forward rule'. If maximum contributions are brought forward into the current financial year, the person will not be able to contribute to super again for the following two financial years.

Benefits of Property in SMSF

TAX BENEFITS

Using a SMSF can be a flexible, tax effective way to invest in property. As with any asset in a complying SMSF, the tax payable on property rental income is either 0% or 15% depending on the phase of the fund[6]. Additionally any asset held longer than 12 months by the SMSF would only attract a Capital Gains tax of 0% or 10% on disposal of the asset, depending on the phase.

This is relatively small when compared to investing in an individual's own name. Where rental income is taxed at marginal tax rates, which for most members is 32.5% plus Medicare Levy.
Where an asset is held by an individual longer than 12 months the capital gain is multiplied by 50% and then added to marginal tax rates, effectively for most giving a rate of between 16.25% and 22.5% plus Medicare levy.

From a tax perspective, there could be many benefits to investing in property through the SMSF.

CONTROL

The ability for the Trustee of the fund to choose which investment property is right for its members is an important factor. The trustee can choose from virtually all types of direct property including residential, commercial and industrial. These can be new or old and with certain restrictions can even be overseas. It is this level of control and flexibility that allows trustees to make decisions in the best interest of the funds members.

BORROWING

While most SMSFs generally have a higher than average portfolio balance, purchasing a property outright using cash may be out of reach or not prudent for most SMSFs. It is important that property make up a part of a diversified portfolio across asset classes.

The ability for SMSFs to borrow has become a major point of difference and increasing popular with Trustees as their preferred vehicle to purchase direct property.

In this manner, the SMSF can also hold funds in order to make loan repayments, invest in other assets to diversify the portfolio and hold cash funds to account for expenses such as accounting.

POOLED FUNDS

SMSF's uniquely allow its members to combine their superannuation funds in such a way to allow the SMSF to collectively invest in an asset(s).
An example is where 4 members each have $120,000 in superannuation. Upon commencing a SMSF the combined total of the SMSF investable funds becomes $480,000. The fund now has the ability to leverage and invest in assets including direct property. The advantage is that each member can now access an asset with the potential for future growth that would otherwise not be accessible to that individual with a lower balance.

[6]This is dependent on the phase of the SMSF. Where the SMSF is in accumulation phase and accepting contributions, income tax is 15%. In pension phase where the SMSF is drawn down, typically in retirement, the income tax could be 0%.

Complexities of Property in SMSF

ADMINISTRATION REQUIREMENTS

SMSF require a reasonable amount of administration to run. Professional advisers and accountants can help with this however ultimately the legal responsibility of running and maintaining the SMSF rests with the Trustee.

This means that the relevant legislation must always be followed, the investment strategy monitored and updated and above all, appropriate record keeping practices should be followed.

DIVERSIFICATION

Diversifying an investment is a fundamental aspect of long term portfolio management and a proven way of reducing risk. A SMSF Trustee must develop an investment strategy for the fund to follow that allows for prudent diversification. Complying investment strategy template can be purchased or created and is used to direct the trustee as to where to invest money on behalf of members. The investment strategy is usually based on the members risk profile and time to retirement amongst other factors for investing in specific asset classes, investment structures and asset types.

Importantly, the purchase of direct property will need to be noted and in line with the investment strategy. SMSF Trustee needs to be aware of overweighting member funds into one particular asset class. Given the large sum of money required to purchase even one property, there may be a real risk that the majority of funds in a members account is directed to one property or the Direct Property asset class. This will limit the diversification of the overall fund and is something that the trustee must monitor carefully.

[6]This is dependent on the phase of the SMSF. Where the SMSF is in accumulation phase and accepting contributions, income tax is 15%. In pension phase where the SMSF is drawn down, typically in retirement, the income tax could be 0%.

Complexities of Property in SMSF

LIQUIDITY IN ACCUMULATION AND PENSION PHASE

There are 2 general phases of superannuation, accumulation phase and pension phase. Accumulation phase of superannuation is usually defined as the period of time that a member is accruing a superannuation investment portfolio in the anticipation of funding their retirement at some point in the future.

Where property is concerned, it is important to make sure that there are sufficient liquid cash funds in accumulation phase to account for expenses such as maintenance, strata, council rates, management fees and taxation payments. Pension phase is a little different. It is no longer compulsory to "switch to" pension phase however the benefits of pension phase can be very attractive in retirement.

Pension phase of superannuation is usually defined as the period in which super fund pays out an income (pension) to its members. Importantly a member can have both phases running at the same time. For example, where the member is age 65 and still working, making contributions to superannuation, an accumulation phase account is needed. If the same member decides to draw an income from the SMSF they are able to do so via a pension phase account.

Where property is concerned there are certain rules to being in pension phase that are critical to maintaining a complying fund and having enough liquidity is vital.

Borrowing to invest in Property

LIQUIDITY IN ACCUMULATION AND PENSION PHASE

Under the superannuation borrowing rules, an SMSF can borrow to purchase an asset such as direct property. Certain rules continue to apply where the fund is purchasing an asset from a 'related party'.

While the rules do not restrict the type of asset that can be purchased, due to the requirements under the superannuation borrowing rules – referred to as Limited Recourse Borrowing Arrangements (LRBAs) - SMSFs have primarily borrowed money to purchase property investments.

Some of the more important rules are discussed below.

First, the asset that your fund purchased with the borrowed money must be a 'single acquirable asset' as defined by superannuation law. This generally means that the borrowed money can only be used to buy one property. So a property which sits on multiple titles for example may not meet the definition.

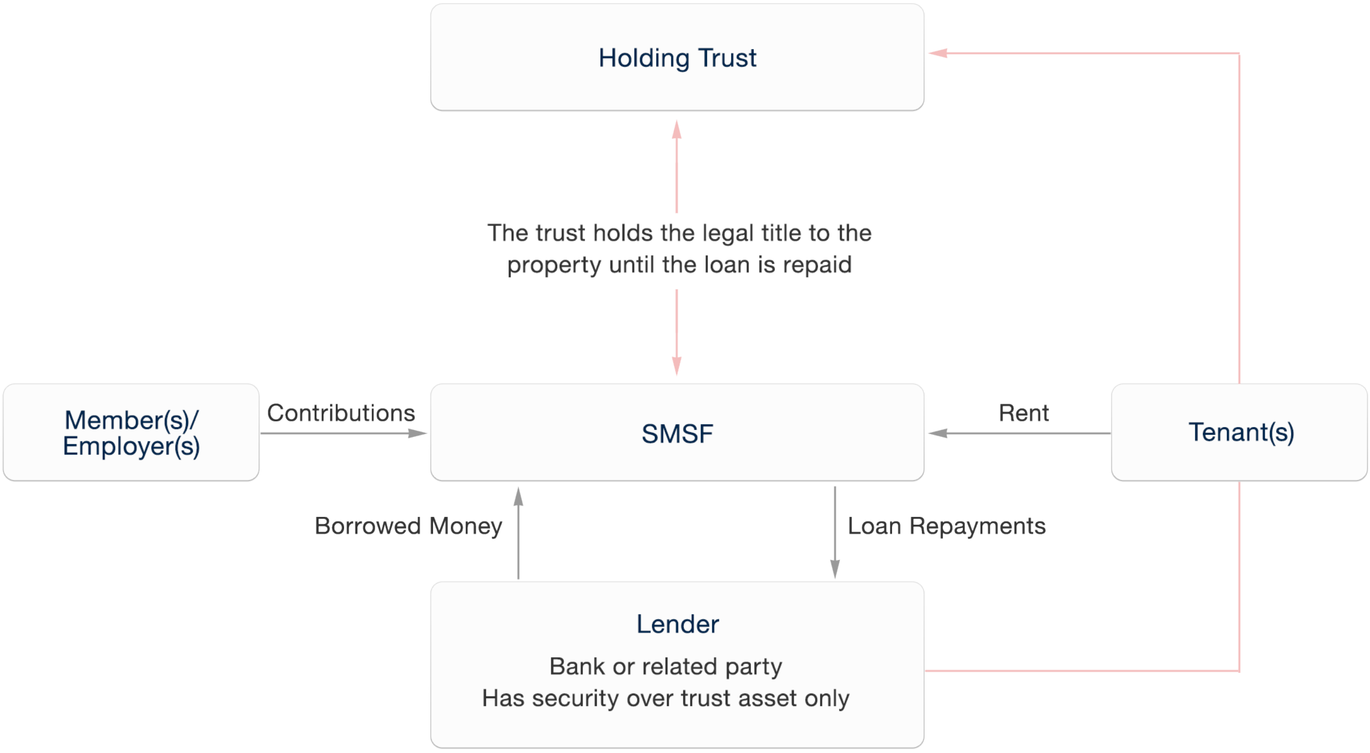
As a result, a SMSF cannot buy several properties under the one borrowing arrangement. Similarly, borrowed money cannot be used to buy a share portfolio investing in shares across different companies – this is part of the reason why borrowing to buy shares through a SMSF has not been popular.

Secondly, where a SMSF has borrowed money to buy an asset, this asset cannot generally be improved upon nor replaced while the loan is still outstanding. This means a SMSF cannot borrow to facilitate a property development.

Thirdly, in order to ensure that borrowing through your SMSF does not place other retirement investments held in your SMSF at risk, the asset that is purchased under a borrowing arrangement must be held in a specific holding trust until the loan is repaid. Further, the only SMSF asset that can be used as security for this loan is the asset that is held within this trust – hence the name Limited Recourse Borrowing Arrangements – which helps to protect other assets held inside your SMSF.

Borrowing to invest in Property

Figure 2. Example of a simple SMSF Borrowing structure



Summary

The SMSF industry is constantly updating its rules and regulations and it's important to keep up to date. The decision to commence a SMSF or indeed to purchase a property using a SMSF structure should not be considered lightly.

When considering to purchase a property within a SMSF it is important to have the right professional adviser guiding you. While you as the trustee are in control, getting the right adviser is extremely important in order to avoid common pitfalls and make the most from your SMSF and property investment.

We hope this guide has provided a small insight into the benefits of SMSF and property investment.

At the SMSF Institute, education is key! It is important for any Trustee (or would be Trustee) to continue to learn, keep up-to-date and most importantly understand the key professionals needed to help guide them through a rewarding financial journey.

Speak to the SMSF Institute today to learn more and get the right advice for your situation, goals and financial objectives.