Buying Property WITH Your SMSF

The Essential Guide to Property Investment & Property Developments Within a Self Managed Super Fund

by John Collignon

[Buying Property With Your SMSF]
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From the Author

Many people are attracted to the greater transparency, choice and control that an SMSF can offer. Additionally, if you like the idea of directly owning property via your super, then a Self-Managed Super Fund is your only option.

I have written this e-book to share my extensive experience with you in the hope that it helps you make an informed decision as to whether buying property in super is the right investment path for you.

Through my experience and dealing with 1000's of self-directed investors, I have listed what I believe are the 5 main points as to why people want to use their superannuation to buy property:

1. They want to have their superannuation exposed to an asset class that they understand and trust – and to avoid the volatility of other asset classes such as shares;
2. To access an initial deposit that they would otherwise not have access to;
3. To implement tax effective retirement income strategies (think tax free rent and being exempt from capital gains tax);
4. They want to use their employer superannuation contributions to help fund the ongoing mortgage repayments for their investment property; and
5. They want to have an asset that matches their long term investment horizon objectives – property generally ticks this box.

If you *do* decide to go down this path, my key tip to you would be to make sure you surround yourself with the right team at the outset.

Buying property in super can be complicated, especially when using lending as there are quite different and strict rules that apply to borrowing in super as opposed to borrowing in your personal capacity. Too often I have seen people try to go it alone to save costs, only to end up in disastrous situations involving non-complying SMSFs (and penalties of up to 50% or more of your SMSF balance charged by the ATO). Often when these clients come to us for help it is too late, as the damage in most cases is irreversible.

People often ask whether buying a property using their super is a good idea, and the answer is always the same. We answer this by asking them these two questions: Have you ever bought property in your personal capacity? How is that going for you? Usually people who are keen to buy property using their super have had positive experience investing in real estate in their personal capacity, so they are keen to use their super to invest in a similar fashion. In the end, as simple as it sounds, it comes down to the property that you choose. You will not see good results by speculating and hoping the property market keeps going up. You need to have a clear plan in your mind on where you are investing, what type of property you are buying, when you are going to buy, and when would be a good time to sell.

I hope you enjoy the read.

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sequoia ASSET MANAGEMENT

Chapter 1: Key Regulatory Considerations

Why you should consider acting now to buy property with an SMSF

In 2013, David Murray (the former CEO of CBA and former Chairman of the Future Fund) was commissioned by the Government to deliver a report with recommendations on how to 'tidy-up' the Financial Services System.

There were 44 key recommendations handed down in the December 2014 report, spread over five specific themes:

- strengthening the economy by making the financial system more resilient;
- lifting the value of the superannuation system and retirement incomes;
- driving economic growth and productivity through settings that promote innovation;
- enhancing confidence and trust by creating an environment in which financial firms treat customers fairly; and
- enhancing regulator independence and accountability, and minimise the need for future regulation.

Of the 44 key recommendations, 43 of the changes were accepted by the Federal Government in September 2015, with only 1 recommendation not accepted. The one recommendation not accepted was that **"SMSF's be banned from borrowing to buy assets such as property and shares."**

The reasons as to why this recommendation was not accepted were as follows:

- While the Government noted that there are anecdotal concerns about limited recourse borrowing arrangements, at the time the Government did not consider the data sufficient to justify significant policy intervention.
- The Government will however commission the Council of Financial Regulators and the Australian Taxation Office (ATO) to monitor leverage and risk in the superannuation system **and report back to the Government after three years.**
- This timing allows recent improvements in ATO data collection to wash through the system. The agencies' analysis will be used to inform any consideration of whether changes to the borrowing regulations might be appropriate.

So, what does this mean for you? It means that during or shortly after September 2018, the Government is going to revisit this recommendation and make another decision on whether to ban borrowing within an SMSF.

The window is open now if you are considering implementing this strategy for your SMSF. If you are the type of person that tends to put things off or procrastinate, you might want to put this on the top of your 'to-do' list.

Chapter 2: What Is An SMSF?

Understanding the basics of a Self-Managed Super Fund (SMSF)

Unlike regular super funds, where:

- you group your superannuation money into a master trust along with 1000's of other members and;
- the investment decisions are controlled by an independent board of trustees;

the members of an SMSF are also the trustees of the SMSF. As such, an SMSF allows you to manage your own investments and control a private superannuation fund that can only be used by yourself and up to three other members.

Some quick Key SMSF rules:

- The fund must have at least one member and a maximum of 4.
- If the trustees of the fund are individuals, each member of the fund must be a trustee. If the trustee of the fund is a company, each member of the fund must be a director of the company.
- Trustees cannot receive remuneration for their trustee services from the SMSF.
- As a Trustee of your SMSF you are required to prepare and implement an investment strategy for your SMSF and regularly review it.
- As the trustee of an SMSF you are required to lodge audited financials and tax returns with the ATO (the ATO is the regulator governing SMSFs) every year and make sure that all assets are properly valued at 30 June each year.

Almost anyone can set up and run an SMSF, but bear in mind it's a major financial decision and you'll need the right advice to ensure it's structured and managed correctly to avoid getting yourself into unwanted trouble, and so that you can take full advantage of the benefits SMSFs can offer over traditional superfunds.

Short 2 minute video
What's Involved In Running An SMSF
Click here

Chapter 3: Making Investment Choices

Understand your investment options and restrictions using SMSF funds

What can an SMSF invest in?

The investment universe for SMSF's is massive. For the purpose of this book, I will be looking predominantly at buying direct property in your SMSF, as SMSFs are the only superannuation vehicle that allows you to invest directly in property, rather than indirectly through Real Estate Investment Trusts (REITs) or the like. However, an SMSF can also invest in listed & unlisted shares, derivatives, managed funds, precious metals, artwork or collectibles. In some circumstances, you can also borrow to invest in assets held in your SMSF – a big advantage that SMSFs currently enjoy over traditional superannuation funds.

What are the key restrictions?

1. The Sole Purpose Test
There exists an overarching rule that applies to all investments made by an SMSF trustee. This rule is known as **The Sole Purpose Test.** The aim of the sole purpose test is to ensure that SMSFs are maintained for **the sole purpose of providing benefits to members upon their retirement.** As a trustee of the SMSF, you need to ensure that all decisions are made with this in mind and that members do not receive any benefits from the fund prior to retirement. For example, a private property owned by the SMSF can't be used by members or their families for residential purposes, holiday accommodation or otherwise, even if they pay market rent for that property.

Short 2 minute video
The Sole Purpose Test
Click here

2. SMSFs cannot lend money or provide financial assistance
Your SMSF fund cannot lend money or provide financial assistance to a member or a member's relative. There are no exceptions to this rule.

The ATO looks very closely at dealings with related parties. As a trustee of an SMSF you need to ensure the SMSF does not breach the strict related party rules by lending to members, members' relatives or related entities of the fund. The definition of relatives is broad and includes immediate and extended family, even former spouses. In some circumstances, it also extends to people that you have common business interests with.

3. SMSFs cannot acquire an asset from a related party, except in limited circumstances
Your fund cannot acquire an asset from a related party, which includes members of your SMSF and their relatives, business partners, their spouses or children of the business partners and any trust or company controlled or influenced by a member. This means you can't sell your private home to the SMSF or acquire a property owned by anyone related to your fund.

There are a few exceptions to this rule. One is listed securities such as shares and bonds, provided they are quoted on the Australian Stock Exchange (ASX) or an approved international stock exchange. Another is business real property which is property used exclusively by one or more businesses. An investment property or holiday home does not qualify as business real property.

Other exceptions include investments in a widely-held trust, such as a managed fund, as well as investments in an in-house asset of the SMSF, provided it does not breach five percent of the total value of the fund (see below).

All investments must be acquired at commercial/market rates and form part of your SMSF investment strategy.

See chapter 5 for much more in depth coverage of this topic.

4. SMSFs must limit in-house assets to 5 percent of the fund's value
An in-house asset is an investment, loan or lease to a related party or trust of the SMSF. For example, if an SMSF buys unlisted shares in a company owned by one of the members the shares would be considered an in-house asset.

The in-house assets held in your SMSF must not exceed 5% of the total market value of your fund. It's important to watch the value of your fund and its in-house assets as you could be liable for penalties if their values fluctuate.

Business real property is also exempted from the in-house assets rule, which means your SMSF can own your business premises and lease it to a member on an arm's length basis (see chapter 5 for more information on this).

5. SMSFs cannot borrow money, except in limited circumstances
The overarching rule applying to SMSFs is that they cannot borrow unless the loan is a Limited Recourse Borrowing Arrangement (LRBA). There are a lot of restrictions, (tips and tricks) associated with this type of borrowing, so it is worth contacting us before engaging in these types of transactions. See chapter 6 for a much more detailed discussion on this topic.

Short 2 minute video
Limited Recourse Borrowing Rules
Click here

Chapter 4: SMSF Property Investing

An overview of some key points you need to know

In this chapter, I am going to take a look at a couple of key topics that are essential when investing in property with an SMSF.

Who owns the property? Who gets to keep the rent?

It might seem like a simple question, but it is probably one of the most common mistakes that I see with people buying property with an SMSF (see below chapter 7 – common mistakes). The reality is that the SMSF is the ultimate beneficiary of the property (that is, it gets all the benefit of rental income, improvement and proceeds of sale), with the trustee of the SMSF being the legal owner. This topic becomes a bit more complicated when using borrowing (see chapter 6), however the overarching question of who owns the property in super can be answered by saying that you are NEVER the owner of the property in your personal capacity. If you find yourself writing your personal name in the 'purchaser' section on the contract of sale, I strongly suggest contacting Sequoia before signing and exchanging.

The SMSF is 100% entitled to ALL rental income, or any other associated income, that the property derives. When you set up an SMSF, you will need to setup a bank account in the name of the SMSF. All income derived from the property needs to be paid into this account, and the SMSF auditor will look through every line of this account each year and tick off that this is occurring. On the flip side, all expenses also need to be paid out of this account and the SMSF is responsible for making sure it has sufficient cash flow to meet the ongoing expense liabilities.

In practice, a property manager will usually take care of the ongoing administration requirements such as paying bills and collecting rent, and will deposit into the SMSF any net rent amount each month. There is no issue with this, but as an SMSF trustee you will need to make sure you keep all statements issued by the property manager as the SMSF auditor will require these to make sure that no money has gone missing.

When borrowing, who pays the interest?

Following on from the above, the SMSF is entitled to collect all the rent and is also responsible to pay all of the ongoing running costs of the property – including paying the mortgage repayments.

When applying for the loan, the lender will ask for the BSB and account number that you want the monthly repayments to be debited from. You need to put down the SMSF's bank account details. If you put down your personal bank details, any amount that is debited from your personal account will be considered a non-concessional contribution to the SMSF, meaning, you will not be able to get this money back until you meet a condition of release (e.g. meeting pension age).

Using an Offset Account

A good strategy used by many SMSF trustees is to utilise an offset account owned by the SMSF and have the monthly mortgage repayments debited from this account.

An offset account is a type of savings account that pays no interest, and is linked directly to your loan account. Instead of receiving interest on this account, the interest payment due on the loan is calculated on the resulting balance of the loan amount less the amount of cash in the offset account. So for example, if you had a mortgage of $300,000, and had $50,000 sitting in an offset account linked to this mortgage, the bank will only charge you interest on $250,000.

This strategy has 2 key advantages for SMSF trustees that need to be understood.

Firstly, an offset account is often a comparatively good investment choice. As an SMSF trustee, you want to make sure that your funds are always invested in a way to maximise returns. An offset account provides a great investment choice to park cash when you are thinking about what to invest into next. At the time of writing this book, interest paid on most everyday accounts is about 2%, with term deposits offering up around 3% for 6 months. Having your money in the offset account effectively means that your spare SMSF cash is earning 5-6% (current SMSF mortgage interest rates), as you are saving money by not having to pay interest on the full loan amount. So when considering other investment alternatives, it would be wise to think that you need to get better than 5-6% returns, otherwise you are probably better off just leaving it in the offset account.

Secondly, an offset account helps an SMSF keep cash available for a deposit on a second property or alternative investments. There is a key rule associated with loans and SMSFs. You cannot redraw equity from a property like you can in your personal capacity. However, by using an offset account you can synthetically create the same outcome.

Let me explain with an example:

You have $300,000 cash in your newly created SMSF, and you want to buy a $500,000 property. You ask yourself the question, do you take out a loan for $200,000, or $400,000?

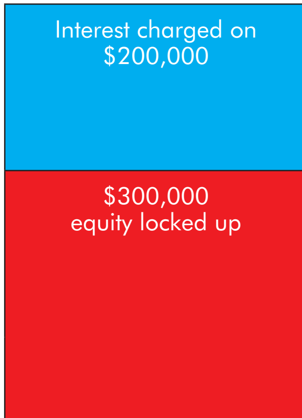
Most SMSF trustees think that is better to take out the lowest possible LVR (Lending Value Ratio – the size of the loan versus the value of the property), as being highly geared is typically not considered a good idea.

However, this is arguably the wrong approach to take with an SMSF.

Although you might think that you are taking the conservative approach by getting the smallest loan as possible, you may be shooting yourself in the foot. This is because if you apply the full $300,000 cash to the purchase of the property, you can never redraw these funds. That is, you cannot go to the bank 2 years later and ask to take out $100,000 for another deposit or to put it into an alternative investment. The only way you can access this capital in the future is by selling the property and realising the cash.

Using an offset account, you can circumnavigate this strict SMSF rule and synthetically create the same outcome, with a similar risk profile, and keep the cash available for future investments. You achieve this by using $100,000 for the deposit, taking out a loan for $400,000, and moving the remaining $200,000 cash in your SMSF into the linked offset account. The net result is that you are paying interest only on $200,000 ($400,000 loan less offset account balance of $200,000), which will be the same amount of interest you would be paying if you took out the loan originally for $200,000. However, by following this strategy you have $200,000 cash available at your disposal for, when and if you ever need it.

Option 1	**Option 2**
$500,000 Purchase Price	$500,000 Purchase Price
$200,000 Loan	$400,000 Loan
$300,000 Equity	$100,000 Equity
	$200,000 Offset Account



In most situations for SMSF trustees it is better to take out the highest possible LVR and utilise an offset account linked to the loan.

What LVR are banks willing to lend up to in SMSFs, and why are SMSF borrowing rates higher than personal mortgages?

Up until mid-2015, it was relatively easy to get an 80% LVR. Most of the major banks were offering these loans to SMSFs. However, banks tightened their lending in response to government pressure to reign in ballooning house prices in the major Australian cities and to strengthen the banks balance sheets. It is still possible to get an 80% LVR, and I see them go through often, however the banks often impose strict rules that vary from bank to bank – such as the need to have a certain % of liquid investments left over in the SMSF after settlement, or to have a certain SMSF balance to begin with before letting you go to 80%.

Typically banks are only lending up to 70% these days. So when thinking about buying property in super, go in with the mindset that you will only be able to borrow up to 70% of the value of the property – this will also be dependent on meeting serviceability tests. See below.

What are Serviceability Tests?

'Serviceability tests' are tests the banks perform to work out if you can 'service' or 'pay for' the monthly mortgage repayments that are due. Banks need to do these tests prior to approving the loan to make sure you don't default on your future repayments.

Serviceability tests vary from bank to bank, so it is always worth meeting with a good SMSF mortgage broker to go through your situation and find the best bank for your circumstances. It is not advisable to do this by shopping around on your own, as doing so may negatively impact your credit rating that all banks use behind the scenes, even if you are just making loan enquiries.

A good mortgage broker will be across the major lenders and their requirements, therefore only applying to the bank when they know you will get the best deal and have the highest likelihood of success.

SMSF serviceability calculation tests are usually quite simple. Banks will generally look at 2 things:

1. the **income** of the SMSF and
2. the **expenses** of the SMSF.

When looking at the **income** component of the calculation, there are two major income components for most SMSFs, one being employer contributions and the second being rental income from the property. The banks will add these two components together (typically discounting the rent by 4 weeks to cover possible rental vacancies) to come up with your total income for the SMSF.

With the **expenses,** the banks will typically look only to the mortgage repayments and accounting expenses to run the SMSF each year.

The next step is to subtract the expenses from the income, and apply a buffer of about 10% (a buffer is used by banks as a contingency in case of other expenses arising, or income is being lost due a redundancy of an SMSF member for example). If you still have a positive result in your calculation, then you are on track to getting a loan for your SMSF.

For example, Jim and Mary have just set up an SMSF. They want to buy a $500,000 property (that pays 5% rental income) and take out a $350,000 loan at 6% interest rates. They both earn $80,000 per year, and contribute $8,000 each into superannuation as employer contributions. The administration, accounting and auditing costs of running the SMSF are $2,500 per year.

Total income of the SMSF:

- $16,000 contributions
- $23,000 rental income (discounted by 4 weeks)
- **$39,000 total SMSF income**

Total expenses of the SMSF:

- $30,000 mortgage repayments (Principal and Interest)
- $2,500 other expenses
- **$32,500 Total SMSF expenses**

Looking at these simple numbers, there is $39,000 of income and $32,500 of expenses, so the SMSF should have positive cash flow and should be able to meet its monthly repayments. Even after you apply the 10% buffer, (meaning the income must be at least 10% greater than the expenses, in this example the income is 20% greater) Jim and Mary should pass the serviceability tests imposed/applied by most SMSF lending banks.

Chapter 5: Buying Property From Related Parties

As mentioned in chapter 3, any investing in your SMSF (including purchasing property) must meet the Sole Purpose Test, which means any investment decisions must be made solely to provide retirement benefits to members.

An SMSF cannot:

- Purchase residential property from a related party of the SMSF;
- Enter into a lease with a related party of the SMSF (e.g. allowing your children to rent out the inner city investment property your SMSF owns);
- Get any personal use out of the property that the SMSF owns – so if you were thinking of buying that holiday house down the coast, tread carefully!

An SMSF can:

- Purchase *Business Real Property* from a related party so long as it acquired at Market Value;
- Enter into a lease with a related party of the SMSF when the property is classified *Business Real Property* so long as the lease is at Market Value.

This is where this chapter gets interesting, and where I always get the most questions from SMSF trustees – what is *Business Real Property*? What does *Wholly and Exclusively* mean?

'Business Real Property'

To determine if a property is classified as **Business Real Property,** there is a condition that must be satisfied. The condition is that the property must be used **wholly and exclusively** in one or more businesses. Just because a property might be situated or located in an 'industrial' or 'commercial' zoned area does not mean it will always be Business Real Property.

'Wholly and exclusively'

At face value, the definition 'wholly and exclusively' is a threshold that seems like an onerous one to meet, as it suggests a complete use of the property for business purposes.

However, the ATO has pointed out (see ATO ruling Self Managed Superannuation Fund Ruling – 2009/1) that their view is that 'a common sense approach accommodates some departure from a literal application of the test'. This is a good thing for SMSF trustees, as it means there is some flexibility in the rules.

I think the easiest way to look at this topic is to go through some common examples that fall into the grey area (so to speak), as these are the type of questions I get most from SMSF trustees. These examples have been sourced from SMSFR 2009/1.

Example 1: Letting holiday flats

Ms Hend owns 2 holiday flats, which she lets for short-term accommodation at a popular holiday destination. Ms Hend and her partner manage and maintain the flats, which includes cleaning and repairing the flats, and financial tasks such as banking.

Ms Hend and her partner set up the Hend SMSF and both become members of the fund. They propose that the Hend SMSF acquire the flats from Ms Hend.

The elements of repetition and continuity of acts (e.g. cleaning and maintenance) and transactions (e.g. bookings, banking and rent) indicate the possibility of there being a rental property investment business being carried on. However, the scale of the operation is such that can not be considered a business. As there is no business conducted in respect of the premises, the property is not business real property. Any sale of the flats to the Hend SMSF would contravene the related party asset acquisition rules.

Example 2: Residential property held in a property investment business

Mr Wood owns 20 residential units that are leased to long-term residents. Mr Wood manages and maintains the flats on a full time basis living on the income generated from the leases. The units are not mortgaged.

Mr Wood would like his SMSF to acquire some of the units rather than sell the units to a non-related party.

The scale of the operation together with the elements of repetition and purpose indicate that Mr Wood is carrying on a property investment business.

Even though the tenants use the properties for their own private or domestic purposes, this use remains incidental and relevant to Mr Wood's property investment business. Consequently, Mr Wood's interest in the property on which the units are built is business real property.

Provided the acquisition takes place at market value, the units may be acquired by the SMSF without contravening the related party asset acquisition rules.

Example 3: Using a Real Estate Agent

Ms Harrington owns 10 residential units that are leased to long term residents. Ms Harrington uses the services of an agent to manage the premises.

Ms Harrington would like her SMSF to acquire some of the units rather than sell the units to a non-related party.

The units are not business real property as they are not used wholly and exclusively in a business. Ms Harrington does not carry on a property investment business as she uses a Real Estate Agent to manage the properties.

As you can see from the above examples, there is a fine line between what would be a contravention, and what wouldn't be. I strongly suggest before you go ahead and enter into any sort of arrangement involving a related party that seems to be a bit 'grey', get in touch with us and we can seek a Private Ruling from the ATO based on the facts you provide. A Private Ruling is the best and safest way to deal with this.

The above examples are a bit technical, so I have listed a further two common examples that don't require any sort of interpretation of the rules as they are generally considered to be black and white and are common strategies carried out by SMSF trustees.

Example 4: SMSF purchases café premises from a related party.

Jo and Jim run and own a café business in Bowral in the NSW Southern Highlands. They own in their personal capacity the shop premises that the café business operates from. The premises is wholly and exclusively used by the café business.

Jo and Jim decide to setup an SMSF to purchase the shop premises. So long as the transaction is done at market value, and a commercial market value lease is entered into between the SMSF and the café business, this transaction would not contravene the related party asset acquisition rules.

There are 2 main benefits for Jo and Jim carrying out this transaction"

1. they personally would receive a lump sum payment from the SMSF that they could then use to expand their current business, or pay off their own personal debts: and
2. the property would then fall into the superannuation lower tax rate environment. When they want to sell the property down the track, Capital Gains Tax is currently 10% on profits for assets held for more than 12 months, or 0% if the property is sold once the SMSF is in pension phase. (See chapter 8 for more details on SMSF tax rates).

Example 5: SMSF purchases café premises from a non-related party.

Jo and Jim run and own a café business in Bowral in the NSW Southern Highlands. They have just been informed by their landlord that the business premises that is used wholly and exclusively to run their cafe from is up for sale.

Jo and Jim decide to setup an SMSF to purchase the shop premises to purchase the property from their landlord. So long as the transaction is done at market value, and a commercial market value lease is entered into between Jo and Jim's SMSF and their café business, this transaction would not contravene the related party acquisition and leasing rules.

There are 2 main benefits for Jo and Jim carrying out this transaction:

1. their café business is no longer paying rent to a landlord that is unrelated to them. The café business will be paying rent to their SMSF; and
2. the property falls into the superannuation lower tax rate environment as per above.

In summary, I am sure that you are sitting back asking 'what if' questions. What if I did this, what if I did that? We completely understand and have to consult the ATO regularly to work out what is allowable and what isn't. If you find yourself asking these questions, get in touch with us and we will let you know if it will work or not, or we can see if it would be worth consulting with the ATO to get a Private Ruling.

If I could provide one word of advice here, it is that if you are even remotely unsure of whether your proposed transaction will comply, then do not enter into a related party transaction. You will not be able to plead ignorance and then beg for forgiveness from the ATO. They can be ruthless and claims of ignorance fall on deaf ears. The risk of non-compliance far outweighs the costs associated with doing some quick pre planning and expert consulting.

Buying Rural Property using your SMSF

Although nowhere near as common as the above business real property examples, it is possible to buy farm land from related parties in your SMSF (and also get personal use out of it) without contravening the related party rules.

There exists a special rule with the application of the 'wholly and exclusively' threshold to primary production businesses.

This special rule ensures that the threshold can be met where a part of the real property on which the business is carried on contains a residential dwelling. As pointed out in SMSFR 2009/1, the 'wholly and exclusively' threshold will be met if:

- the area containing the farmhouse that is used primarily for domestic or private purposes **does not exceed 2 hectares;** and
- the domestic or private use is **not the predominant use** of the property.

This is a great exemption for anyone wanting to, for example, run a Christmas tree farm, a vineyard, or graze cattle on land owned by their SMSF, while living in the private residential homestead on the farm.

So, it begs the obvious questions that needs answering – how will the ATO apply the 'wholly and exclusively' test to rural property? Here are 3 good examples provided by the ATO that will go a long way in answering this question.

Example 1: Primary production business with private residence

The Harrison Vineyard is owned and managed by Peter and Denise Harrison who are members of the Harrison SMSF.

The property has 10 hectares planted out with vines and on half a hectare of the property they have built a private residence in which they live.

The vineyard business has a grape supply agreement with a local winery for the next 5 years. This agreement forms the basis of a business of primary production that is being conducted on the property.

The Harrison SMSF acquires the property (not including the grape supply agreement) from Peter and Denise at its market value. Peter and Denise then lease the property from the SMSF.

The property is business real property of both the Harrison SMSF (after it acquires the property) and of Peter and Denise at all times. At all relevant times, the Harrison SMSF and Peter and Denise hold either a freehold interest in the land or a leasehold interest in the land. The use of the private residence is permitted under the specific application of the 'wholly and exclusively' test. Therefore, the property is used wholly and exclusively in Peter and Denise's business at all times.

Accordingly:

- The acquisition of property by the Harrison SMSF from Peter and Denise does not contravene the related party asset acquisition rules
- The freehold interest in the property is not an in-house asset of the Harrison SMSF.

Example 2: Primary production business with private residence

Lesley-Anne owns and operates a cattle farm of 40 hectares. She breeds cattle in a primary production business. Lesley-Anne lives on the property and has built a large home. She is also a keen gardener and maintains a large hedge maze and ornamental lake and garden. The total area of the property that she uses for private or domestic purposes is about 3 hectares.

Lesley-Anne is a member of the Jasper SMSF. She wants to sell the property to the trustee of the Jasper SMSF at market value.

Because Lesley-Anne uses more than 2 hectares for private and domestic purposes, the 2 hectare exception will not apply.

In this case, the non-business use of the property is not entirely incidental and relevant to the underlying primary production business, nor is it minor or trifling. Therefore, as the property is not used wholly and exclusively in a business, it is not *business real property* of Lesley-Anne. Any acquisition of the freehold interest in the land by the Jasper SMSF will contravene the related party asset acquisition rules.

Example 3: Mr Peters' poultry farm – unused paddocks

Mr Peters operates a poultry farm. His business is run from a property on which 4 large poultry sheds are constructed. The property also consists of 2 paddocks that are unused. Mr Peters sometimes considers building more poultry sheds on the unused land but is yet to pursue any definitive plans to this end.

Mr Peters is a member of the Nest Egg SMSF. Mr Peters wants to sell and lease back the property on which his poultry farm is located at market value to the Nest Egg SMSF.

The property is *business real property* of Mr Peters. In this case, the property is used to an appreciable degree in the primary production business of Mr Peters. The property therefore satisfies the 'wholly and exclusively' threshold under the business use test. Accordingly, the farm can be sold at market value to Nest Egg SMSF without contravening the related party asset acquisition rules. The farm will not be an in-house asset of the Nest Egg SMSF when it is leased back to Mr Peters.

Although not a very common strategy, a lot of people do ask how they can buy farmland in their SMSF. What normally stops people in their tracks is that banks are very unwilling to lend to SMSFs to buy rural property, so be prepared to either provide a related party loan to the SMSF or fund the purchase of the property with available cash in your SMSF.

Chapter 6: Key Rules Around Borrowing And Structures Required To Buy Property In Your SMSF

This is an important chapter as many SMSF trustees entering the market to buy property require a loan either from a related party or from a financial institution, such as a bank.

There are some strict and confusing rules in this space. Below I have covered off the rules I feel are the most important to keep an eye out for when buying a property in your SMSF using a loan.

Key rules

1. The Limited Recourse Borrowing Rule.

One of the key rules when borrowing through an SMSF is that the loan must be made on a 'limited recourse basis'. What this means is that the lender's recourse (i.e. the debt recovery action the lender can take against the borrower) must be limited to the asset that is the subject of the loan. The reason for this rule is to stop banks (or other lenders) raiding the remaining assets of your superfund if you default on your loan.

You might be thinking this is great! Finally consumers are getting a win over the banks! But don't be fooled, the banks are not silly – they will often make the trustees sign a personal guarantee to cover amounts owed to the banks and the interest rates charged on SMSF loans are often slightly higher than traditional investment property loans for this reason.

2. 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. This often happens when two assets are inseparable, such as an apartment with a car park on separate title that cannot be sold separately, or two assets that are acquired under a single contract, such as a house and land.

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).

3. Repairs, Maintenance and Improvements

Money borrowed under a Limited Recourse Borrowing Arrangement (LRBA) can be used to carry out 'Repairs' and 'Maintenance'; however it **must not** be used to make 'Improvements' to the asset.

I have yet to see anyone take out a loan to carry out repairs or maintenance with the use of a loan, as the documentation required to put the loan in place is often more expensive than the value of the work being done. So in practice what will normally happen is that the SMSF will pay for the repairs or maintenance from the cash reserves of the SMSF. As such, I will skip over this and focus on making 'improvements' to the property held by the SMSF as this is where most questions and auditing issues arise.

You cannot borrow to make improvements to a property. What this means is that 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.

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.

General test: If an improvement will fundamentally change the character of the asset as a whole, then this will result in a different asset being held on trust under the loan. If this happens, you will be in contravention of the superannuation laws.

In the table below I have listed some examples of improvements being made to properties subject to an SMSF loan, and whether or not they would contravene the SMSF lending rules.

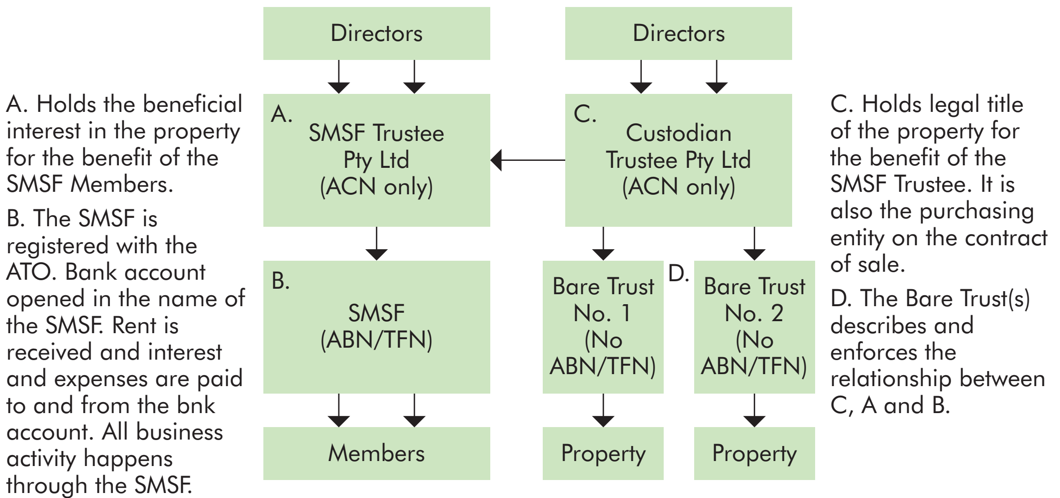
Scenario	Result
Buying a vacant block of land under an LRBA and subdividing it into multiple titles	✘ The improvement has resulted in a different asset
Buying a vacant block of land under an LRBA and building a house on the vacant land	✘ The improvement has resulted in a different asset
Fire demolishes house under an LRBA and is replaced by three strata titled units	✘ The improvement has resulted in 3 different assets
A residential house under an LRBA is converted into a restaurant	✘ The improvement has resulted in a different asset
A room in a residential house under an LRBA is converted into a home office	✔ The improvement would NOT result in a different asset
The following improvements to residential house under an LRBA: A kitchen renovation, an extension to add two bedrooms, a swimming pool, a garage or an outdoor entertainment area	✔ The improvements would NOT result in a different asset
The addition of a fully functional 'Granny Flat'	✔ The improvement would NOT result in a different asset

As you can see, you need to tread carefully in this space. Please get in touch with us if you want to discuss this topic further, and if needed, we can organise a private ruling from the ATO prior to you entering into a potential non-compliant transaction.

4. Structures Required. The property must be held in a specially designed trust commonly called 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.



What if I don't want to use a loan, do the same rules and structures still apply?

No – the rules are very much relaxed when you are not borrowing to purchase a property in super. There is no need to hold the property in a bare trust, the property is simply purchased and held in the name of the SMSF e.g. John Smith Pty Ltd ATF The John Smith SMSF.

There are also no restrictions around improving the property, for example sub-dividing a residential property and putting two brand new houses on the block of land is allowable, or even converting it to a different class of asset, such as a commercial premises, will not contravene the SMSF borrowing rules.

An example I have seen firsthand is trustees purchasing a vacant block of land in the Whitsundays that they fell in love with and wanted to live on when they retired. The SMSF did not have sufficient capital to build a house on it (and as per the above, you cannot build a house on a vacant block of land in your SMSF using borrowed funds) so the trustees plan to sit on the block of land for the next 7 years or so until they reach their preservation age and retire, then look to transfer the block of land out of the SMSF to their personal name and build the house of their dreams on it to live into their twilight years.

The disadvantage of doing a property strategy in your SMSF with no gearing is that you either have to have a sufficient amount of capital in your SMSF to begin with, or, you need to make a contribution to your fund (not a loan) to build the cash reserves up to the required balance.

Three common ways to get more money into your super fund

1. Pre tax contributions – you can put up to $25-30,000 per year (depending on your age) including your employer's contribution.

2. After tax contributions – up to a lifetime maximum of $500,000.

3. A line of credit – typically from your principal place of residence. Generally, this amount placed into your SMSF would count towards the after tax contributions cap.

Chapter 7: Property Developments in your SMSFs

Two common property development methods involving related party's and gearing

As per the above, doing a simple property development such as a subdivision is very straight forward when no gearing is involved – simply buy the block of land in your SMSF with available cash and go through the standard council procedures to split the block into two (or more) separate titles. The next step is to have the SMSF contract the builders and tradies to come and do their part of the project. Once the houses are complete, the SMSF signs up the tenants (making sure they are unrelated) and takes on the responsibility of ongoing maintenance, rates etc.

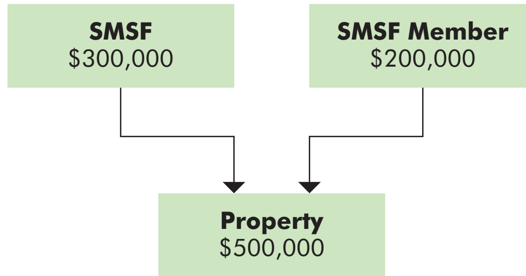
So is it possible to do a joint property venture with a related party, and/or to also use an element of gearing with this strategy?

The short answer is yes. The long answer is that it is tricky and a myriad of rules apply to carrying out a development strategy with or without a related party where gearing is involved.

There are two common strategies that SMSF trustees used to skirt around the strict SMSF property rules to allow common ownership of a property with a related party, or to legally gear an SMSF property development. This chapter will exam these two strategies in detail.

Strategy 1: Tenants In Common (TIC) with your SMSF

A TIC arrangement is a type of ownership of real property by two or more parties. All tenants in common have an equal right to use 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).



How it works with an SMSF

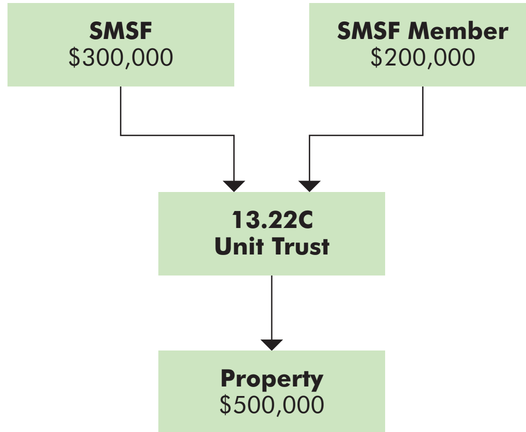
Typically, TIC arrangements involving SMSFs are between an SMSF and a related party to the SMSF (e.g. a member of the SMSF in their personal capacity). This strategy is popular as it allows for other investors (including related parties) to participate in the transaction when the SMSF does not have sufficient capital to complete the deal, 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 – tax free!). Percentage holdings are determined at purchase and are listed on the contract of sale.

Things to watch out for

1. Personal use. 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;
2. Gearing. In relation to the member's $200,000, this could be cash or borrowed monies, however, the 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 borrowing;
3. In relation to the SMSFs $300,000, this could also be cash or borrowed monies, making sure SMSF borrowing rules are met. The member can use their interest in the TIC arrangement to secure their loan;
4. As the tenants in common are generally related parties, the SMSF can not 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 (13.22C Unit Trust).**

Strategy 2: Investing using a 13.22C Unit Trust

Rather than the SMSF and the member acquiring the property together, they could invest their respective amounts in a 13.22C Unit Trust which in turn acquires the $500,000 property. Using this method it is possible to overcome some of the restrictions associated with TIC arrangements such as those involved when acquiring a related parties' interest, as well as borrowing restrictions.



From a practical point of view, 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 will own the property, 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.

Strict Rules

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.

A 13.22C Unit Trust must not:

- Borrow or allow a charge over any assets of the unit trust
- Hold an interest in another entity
- Acquire an asset previously owned by a related party (at least 3 years)
- Loan money to another entity
- Run a business
- Lease an asset to a related party, except if the asset is business real property

Broadly, this means the trust will only own residential or business real property purchased from an unrelated party and cash on deposit.

Although these rules do not allow the trust to borrow, the provisions in the regulations do not preclude an investor (including an SMSF) in the trust using borrowed monies to acquire their share of the units. (Note: The units can be held as security for the loan; however, it is unlikely that a bank will accept them. So be prepared to lodge other personal assets as collateral for the loan).

Benefits of using a 13.22C Unit Trust

1. 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 in time;
2. 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;
3. 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;
4. 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.
5. 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.

Disadvantages of using a 13.22C Unit Trust

1. Strict compliance with the 13.22C Unit Trust rules are required;
2. A unit holding in a 13.22C trust not owned by an SMSF may be offered as security for a loan (e.g. another party to the 13.22C trust could lodge their units in the trust as security for a loan). If this is done, potentially the whole trust could come unstuck in the event of that party defaulting on the loan;
3. There are additional costs to establish this structure due to the set-up of a unit trust (and corporate trustee);
4. There are ongoing running costs of this structure because the unit trust is a separate entity and must lodge a tax return each year.

In summary, both strategies discussed above have their advantages and disadvantages and as an overarching principle, Trustees of SMSFs need to make sure they always comply with the Sole Purpose Test. For more information about these strategies please click here to contact Sequoia.

Chapter 8: 10 Common Mistakes When Buying Property With Your SMSF

Many trustees make mistakes, especially when they are just starting out. Here are some of the most common mistakes made by trustees and how you can avoid them.

1) Purchasing residential property from a related party.

You would be surprised at how often this happens. The most common example is people buying personal investment properties from themselves. You cannot do this. The consequences are quite severe as well, as in addition to the potential fines imposed by the ATO for non-compliance, you will also get stung with stamp duty, not once, but twice. Firstly when your SMSF buys the asset, and secondly when you have to fix the problem and move the property back to your personal name.

2) Paying off your personal investment property using SMSF funds.

The common excuse for this mistake is that the trustee will say their personal investment property is for their retirement and, as such, they took money from the SMSF bank account to cover a few monthly mortgage repayments because they were short on personal funds – and as their SMSF is for their retirement, then there should be no issues, right? Wrong. If you want to use SMSF funds to make mortgage repayments, the property must be beneficially owned by the SMSF. Making this mistake usually always results in your SMSF Annual Reports being 'Qualified', meaning, the ATO are going to come to you for answers and may issue a penalty notice. If you do not fix the problem (i.e. beg for forgiveness and pay back the funds to the SMSF with interest) you're at a risk of the ATO deeming your fund non-complying.

3) Using residential property for personal use.

As tempting as a holiday house down the coast sounds, do not be tempted to buy one in your SMSF if you plan on using it for personal use. Although this is a hard contravention for SMSF auditors to pick up on (as personal use can be covered up and not reported) the ATO is conducting random inspections on these types of properties. If you do want to get some personal use out of your SMSF property, maybe consider a commercial premises or even a farm – there are some pretty interesting rules around rural property where you can live on the premises while running a business as well (note that lending is very difficult to obtain for this strategy though) as discussed in the above chapters.

4) Using non-compliant related party loans.

The ATO has recently clarified that it is no longer possible to make a related party loan to your SMSF to buy an asset and for the SMSF to pay zero interest to you.

If you are making a personal loan to your SMSF the terms of the loan must also be on commercial terms (and also meet the single acquirable asset rules). The common test to prove if it is a commercial loan is to say if you walked into a bank, would they offer a loan on the same or similar terms? If not, you might want to consider checking with the SMSF auditor what you are planning on doing prior to going ahead and implementing the loan to see if they would have any issues with it.

5) Breaching the Single Acquirable Asset Rule – Repairing, Maintaining and Improving the Property.

When your SMSF takes out a loan to buy an asset, it must be used only to purchase one asset. This is why it not possible to buy house and land packages, as these types of deals are normally made up of 2 contracts (one for the land and one for the house) and 2 loans (one for the land and a construction loan). The issue is two fold:

a) You can take out a loan to buy the land (so long as you can find a bank that will lend to you to do this. Serviceability for the SMSF often turns banks off lending to buy vacant land blocks), but you cannot then build on the land while it is under mortgage – even with cash reserves in your SMSF. Doing so would change the asset (i.e. it would no longer be a vacant block of land, it would be a block of land with a house on it). This is a breach of the single acquirable asset rules. See chapter 6 above.

b) Secondly, your SMSF cannot get a loan to build a house, even if your SMSF bought the land with cash (i.e. no loan). The reason for this is that the ATO says that a construction contract is made up of 100's of different items (bricks, windows, wood etc) and as such, you are not buying a 'single acquirable asset' with the borrowed monies.

If you want to do a project such as this, you would have to have sufficient cash in your SMSF to carry out the project without needing assistance of a loan as discussed in chapter 6 above.

What about Off The Plan Apartments? Off The Plan apartments are different to house and land packages because you are buying a one contract, "turn-key", asset. You pay a 10% deposit up front and then pay the balance at settlement for the completed project with the assistance of an SMSF loan.

6) Paying rent into personal bank accounts, and not into the SMSFs bank account.

A common question that I am asked is "when the tenant pays the rent, does it go to me personally, or does the SMSF get to keep it?" The answer is that the property belongs to the SMSF, so the SMSF gets to keep all income that is generated from it. On the same note, the SMSF is also liable to pay all expenses to do with the running of the property (think interest, rates, water etc). This comes back to the Sole Purpose Test – you are not allowed to get a personal benefit from the SMSF. See chapter 4 above

7) Buying properties in high risk zones, such as mining towns

I am not an expert at picking the best places to buy property and you will never hear me say otherwise. I team up with other professionals to provide my clients with this advice. One thing that I have seen all too often is people buying properties in high risk areas, only for the market to turn and their properties to be well underwater.

From Townsville to Karratha, the last 4 years has been particularly brutal for property held outside the major capital cities. People seem to be willing to take more risk with their superannuation money compared to the risk they would normally take with their own funds. As a general rule of thumb, if you don't think you would make the investment in your own name, you should probably think long and hard about making the investment decision for your SMSF.

8) Purchasing the property in the wrong entity

This is more common than you think. When you first set up an SMSF, there is a feeling of joy – the whole investment universe is now open for you to consider. You are eager, keen and excited to get your teeth stuck into investing in property. You know that your SMSF can do it; you have seen the adverts and your mate at the fishing club has told you that he is doing it too. Here's how it plays out:

- You turn up to an auction on the weekend to buy the apartment that you have been keeping an eye on, and the price looks right.

- Your funds have been rolled over from your existing super fund to fund the deposit and are sitting in the SMSF bank account. You think you are ready to go.
- The auctioneer calls last bids, you look around and you are the last person with their paddle in the air. The hammer comes down; you are the highest bidder.
- You go to the back of the room and sign the contract of sale in the name of your SMSF.
- You go home, have a glass of wine to celebrate.
- The next day you call up your bank to let them know that you have purchased a property and need to finalise the loan (see below issue on not organising finance prior to signing a contract of sale).
- Everything is going swimmingly until your bank's solicitors come back and tell you that the current arrangement is in breach of the superannuation legislation because the property has not been purchased by a custodian trustee. See chapter 6 for more details.
- What do you do?!
- Well, you pretty much have 2 choices.
  - Firstly, you can walk away from the deposit and the whole problem disappears, as with the 10% that you put down. Usually not the preferred option.
  - Secondly, you can go back to the vendor and beg them to rescind the contract of sale and sign a new one, with the correct entity on it. The reason why you have to rescind and re-execute is that people in this situation often have not set up the second company required to act as custodian trustee. As you cannot backdate the setup of a company (ASIC won't allow it), if you simply change the purchasing entity on the original contract it will be dated prior to the establishment of the custodian trustee company – obviously this cannot be a valid transaction (i.e. how can a company enter into a transaction prior to it being incorporated?). I suggest giving your adviser and your conveyancer a call immediately if you find yourself in this position.

9) Not getting borrowing organised prior to contract signing.

There are 2 scenarios that I have seen where this situation can turn into costly errors.

Firstly, when an SMSF paid a 10% deposit and exchanged contracts without speaking to a Mortgage Broker (or bank) prior. The trustee was under the impression that the SMSF could borrow up to 95% of the sale price, as they had just purchased a property in their own personal capacity, where this was allowed. They got a rude shock when trying to source a loan and it turned out that they could not find a bank willing to lend past 80% for SMSF. So what did they do? Settlement was in 4 weeks. Luckily for this trustee, they had enough capital in their own personal capacity to make a significant non-concessional contribution into their SMSF to add to the purchase price of the property. If they didn't, they would have lost the deposit as they would not have been able to settle.

The key learning point here is to always speak to a qualified mortgage broker to get an idea on your borrowing capacity prior to exchanging contracts.

The second scenario was a bit unlucky for the trustees that got caught up in it. In mid/late 2015 the major banks all tightened their SMSF lending requirements (to comply with new government liquidity and capital requirements) and many of them dropped their LVRs to 70%. AMP (at the time a major lender in this space) disappeared completely from the sector and withdrew all SMSF lending, only to return to the market 8 months later.

The issue then was that many SMSF trustees had purchased Off The Plan apartments 12-18 months prior to this change and had been given pre-approval for loans based on 80% LVRs. When settlement came around the banks told them they had to contribute an extra 10% to the purchase price to bring the LVR down to 70%. As you can probably envisage, some trustees did not have the extra 10% in their SMSF to meet this requirement (on a $450,000 property, this means having to

get another $45,000 into your superfund) and had no choice but to borrow money against their personal homes, businesses, or family members to make the contribution to their SMSFs to meet the higher required deposit amount.

The point to take out of this is that is wise to go into these transactions with a buffer up your sleeve (especially for Off The Plan developments), as you never know when the rules are going to change and catch you off guard.

10) Not having sufficient liquidity in the SMSF to support a pension payment

Let's assume the SMSF has only one asset, it is a property worth $1 million at the last 30 June valuation. The property has a $500,000 loan against it and as such has only slightly positive cash flow by $10,000 each year (i.e. where rent received is only slightly greater than all outgoings such as interest and costs). The SMSF has 2 brothers as members, one is 65 and the other 55 (both with equal member balances within the SMSF). The older brother decides that he wants to retire and starts pulling some funds out of the SMSF as a pension payment (as he knows that reaching the age of 65 is a 'condition of release').

The issue here is as follows:

- The net asset position of the SMSF is that each brother has $250,000 as a member balance.
- The SMSF generates $10,000 per year of excess cash.
- The minimum pension payment for 2016 for someone aged 65 is '5% of the net asset position of their member balance' (i.e. $12,500).
- As such, there is not enough free cash to meet the minimum pension payment requirement for the older brother.
- Not meeting the minimum pension payment in a financial year is a compliance breach for SMSF trustees and can result in personal fines and potentially result in your SMSF being deemed 'non-compliant' by the ATO (often resulting in the removal of all tax concessions that SMSFs enjoy).

How do you fix this? Not easily. The obvious answer is to sell the property. You would then have plenty of liquid cash to meet this minimum payment. However, this isn't usually the favoured outcome, as the property market might be flat, or the other trustee may not want to sell.

The more common approach would be to get the younger trustee to make a non-concessional contribution to the SMSF to get an extra $2,500 into the cash account of the SMSF, and make the pension payment from this additional cash to the older member so he meets the minimum pension requirement. It is important to point out that the older brother cannot make the contribution to the fund as he is older than 65 and not working – therefore prohibited from making future contributions to the SMSF.

Note: When you make a contribution to an SMSF with more than one member, that contribution gets allocated to you from an accounting angle, however, the exact cash dollars do not – they go into the asset pool. So, in the above example, the brothers owned 50% each before the additional contribution was made. Once the younger brother made the additional contribution of $2,500, the SMSF had a net asset pool of $502,500, and the younger brothers' member entitlement would grow to 50.24% of the pool of assets, with the older brother being diluted to 49.76%. So, it doesn't matter that the cash contribution was made by the younger brother and taken out by the older brother as pension payment, so long as the numbers stack up then this is the easiest strategy to get yourself out of this situation.

Just make sure you sort this out prior to June 30. If you leave it until after this, it will be too late. You cannot back date a pension payment from the bank account.

Bonus Common Mistake: Failing to lodge income tax returns on time

It is so important to lodge your SMSF tax return on time. Not only do your risk penalties for late lodgement, you go onto the ATO's black list meaning, auditors and the ATO are going to look more carefully at everything your SMSF does in the future. They will also pull forward your lodgement date for your tax returns by 6 months for the following year. When you have a property in your SMSF this puts a lot of pressure on you to get the required documentation together in time.

The lodgement date of your SMSF tax return varies, depending on whether the return is lodged by you or a registered tax agent, whether the SMSF is newly registered or if it has outstanding returns. However, the most common due date for returns lodged by a tax agent is 15 May following the end of the financial year. I strongly suggest using a professional SMSF administration firm like Sequoia Super if considering buying property in your SMSF to assist you in your administration and lodgement requirements.

Summary of Key Risks to Watch out For

- Diversification. For a lot of SMSF trustees, the property may be the only asset the SMSF owns. Not being diversified carries risks, notably, if the property falls in price you can lose potentially all of your invested capital, just like you could if you bought the wrong property in your personal capacity.
- Falling property prices. This is a risk that people often (surprisingly) forget about. Property can fall in value. If the property falls in value, your SMSF can be left holding a non-performing investment that you might not be able to sell at a favourable price.
- Loss of tenants or loss of employment. When your SMSF is borrowing, it will be required to meet monthly mortgage repayments just like you do in your personal capacity. If for some reason you lose your job, or your SMSF property has a period of no tenancy, there is a risk that you may start defaulting on your repayments which may require you to sell the property at an unfavourable price to satisfy your loan agreement with the lender.
- Leverage. You may have heard the expression that leverage can be a double-edged sword. When borrowing to buy an asset, whether it is in super or in your personal capacity, leverage can potentially magnify both gains and losses.
- Liquidity. One of the key requirements for SMSF trustees is that they must be able to meet the ongoing running costs of the SMSF (whether it be fees or pension payments). If you have all of your money locked away in an illiquid property investment (and you are unable to make cash injections into the SMSF) you may be forced to sell the property at a loss, or at a less opportunistic price, to meet these requirements.
- Ongoing documentation requirements. It can become quite onerous for SMSF trustees to keep up with all the initial and ongoing paperwork to make sure your SMSF stays compliant. A specialist SMSF provider such as Sequoia Superannuation can help you overcome these issues.
- Tax risk. The Government is always changing the rules when it comes to superannuation, so be prepared for changes that may affect your SMSF strategy – for the good or the bad. See chapter 9 for more detail.

Chapter 9: How Your SMSF Is Taxed When Buying Property.

This chapter is broken up into 5 distinct categories relating to taxation when buying a property with your SMSF.

5 Common Taxes seen by SMSFs

Your SMSF tax rates vary depending upon whether your SMSF is in Accumulation Phase or Pension Phase. Generally speaking, when your SMSF is Accumulation Phase you are still working and you have not yet reached retirement age. When your SMSF is in Pension Phase you have typically stopped working, or reached an age set out in legislation allowing you to start pulling out money from your SMSF.

When your SMSF is in Accumulation Phase the following taxes apply:

1) Income Tax

15% is the tax rate for net income earned by SMSFs. The following are some common categories of income that attract a 15% tax liability in an SMSF:

- Employer Contributions
- Rent received
- Interest earned
- Dividends and distributions

2) Expenses

Just like your personal income tax returns, when you are calculating how much income tax your SMSF is liable for, you first work out your total income, subtract allowable deductions and then multiply the resulting amount by the relevant tax rate (i.e. 15%).

The following are some common deductions available to SMSFs owning direct property.

- Interest expense on mortgages
- Body corporate fees
- General repairs
- Accounting and Auditing fees
- Legal fees (except when they're of a capital nature)
- Bank charges
- Depreciation
- Life and TPD (Total and Permanent Disability) insurance premiums and fees
- Training courses that complement the investments of the fund
- Travel costs to visit an investment property owned by the fund.

3) Capital Gains Tax

Capital gains are also taxed at 15%, unless the property has been held for more than 12 months, where the rate of tax drops to 10%. For example, if your SMSF purchased a property for $500,000 and sold it 13 months later for $600,000, the profit of $100,000 would be taxed at 10%, i.e. $10,000 tax payable (assuming no other capital expenses were available to lower the profit).

4) Stamp Duty

That annoying tax that is impossible to avoid. It doesn't matter if your SMSF is in Accumulation Phase or Pension Phase. Unfortunately just because you are buying a property through your SMSF the Offices of State Revenue (OSR) around the country provide no relief for this tax.

This is a state-based tax, as such the amount that will be payable upon purchase will be dependent upon what state the property is located. Every state provides information on their websites about current rates of Stamp Duty.

5) Land Tax

As with its ugly sister Stamp Duty above, Land Tax is also a state-based tax that is charged whether or not your SMSF is in Accumulation or Pension Phase. Unless of course you are buying the property in the Northern Territory – they do not have land tax in the Top End.

Land tax is charged on the value of the land associated with the property. Most states offer a threshold value that must be met prior to land tax being charged (for example in NSW the current land tax rate threshold is $432,000, above this amount and a tax rate of 1.6% p.a. is charged). Grouping also applies to land tax; for example if you owned 2 investment properties in NSW where the land was worth $250,000 each, you would be liable to pay land tax based on the excess $68,000 above the threshold.

In practice though, this tax is often not charged to SMSFs for the following two reasons:

- SMSF Trustees often buy apartments as the rental yields are typically higher (making serviceability easier). The underlying land value for each apartment is usually quite low and therefore doesn't usually exceed the land tax threshold.
- SMSFs are NOT grouped with other properties you already own in that state. For example, in the above example if you owned one property in your own name worth $250,000 land value, and your SMSF owned another with a $250,000 land value, neither yourself nor your SMSF would be liable for land tax as they are not grouped together and individually each falls under the $432,000 threshold.

In most situations, if you compare these taxes against buying property in any other entity that you may have, it is very likely that you will have to pay these taxes discussed above and potentially at a higher rate.

Tax concessions are one of the major reasons why SMSF trustees look to buy property with an SMSF.

The Zero Tax Zone

This is the big one. This is why buying property in super is very appealing.

Once you convert your SMSF to Pension Phase, all income and capital gains is taxed at 0%!

This is a huge advantage that SMSFs have over all other types of holding vehicles. The two most common ways I see people taking advantage of this are:

a. Properties that are earning rent. Once the SMSF is converted into Pension Phase, all rent received into the SMSF is tax free. The SMSF then pays out a tax free income to the member of the SMSF (assuming the member is over 60).

b. Selling a property and not having to pay capital gains tax. This is a great trick to avoid CGT. Let's say you purchased a property in your SMSF for $500,000 when you were 50 and held onto it for 10 years until the day after you turned 60. Your SMSF sold the property for $1 million, realising a gain of $500,000. If you convert your SMSF to pension phase prior to selling this asset, you will pay **ZERO Capital Gains Tax.** If you had of held this property in your own personal capacity, you would have to pay your marginal rate of tax on $250,000 profit (after applying the CGT discount of 50%), **meaning for most people, this would be a tax saving of around $100,000-$125,000 by holding the property in your SMSF!**

Chapter 10: The Process

Sequoia has developed a streamlined method for helping you purchase direct property with your superannuation. In short, we take the headache out of the process. We facilitate the whole process for you in 3 simple steps (for non-borrowing) or 8 simple steps (if using an SMSF loan). Alternatively, you can pick and choose the services that you wish. The choice is yours.

FOR SALE

1 Complete Sequoia Application Form

2 SMSF & SMSF Trustee Company Establishment

3 Rollover of your existing superannuation to your SMSF

4 Obtain loan preapproval for your SMSF

5 Source the property

6 Establish Property Trust & Property Trust Trustee Company

7 Final loan approval & vetting of documents

8 Property settlement

1. Firstly, to buy direct property using your Super you need to establish an SMSF. To setup an SMSF please contact us to book a free phone or face-to-face meeting and to be sent the appropriate application forms.
2. Get an idea on how much your SMSF might be able to borrow. As part of our network, we have experienced mortgage brokers who can give you an idea on the amount you could borrow to buy a property within an SMSF.
3. Once you decide to go ahead and your application form has been received, Sequoia will organise the trust deeds, company establishments, bank accounts and personal insurance if requested (such as life/TPD/Income protection).
4. Once the SMSF has been established you will need to roll over your existing superannuation money into your SMSF. Once again Sequoia can assist you in this process.
5. Once you have decided on an investment strategy, if you would like to buy direct property using your SMSF you can apply to the bank for a loan. That is, you can obtain loan preapproval for your SMSF so you can start searching for a suitable property. Sequoia can again help you through this process through our recommended SMSF loans specialists SMSF Loan Experts.

6. Once you have found the investment property, you need to establish a special holding trust called a bare trust as well as the custodian trustee company. Sequoia will assist in creating these for you.
7. Once the bare trust has been established, the bank will give final loan approval and vet the legal documents.

Finally the property is settled!

You can feel safe in knowing that your hand will be held the whole way through the journey. To book a free initial consultation with a Sequoia Adviser please **click here.**

Chapter 11: Summary

If you have read the e-book this far, hopefully by now you have picked up the following:

- There are 5 main reasons why people buy property with an SMSF:
  1. they want to have their superannuation exposed to an asset class that they understand and trust – and to avoid the volatility of other asset classes such as shares;
  2. to access an initial deposit that they would otherwise not have access to;
  3. to implement tax effective retirement income strategies (think tax free rent and being exempt from capital gains tax that I covered off in chapter 9);
  4. they want the ability to use their employer contributions to pay off the mortgage; and
  5. they want to have an asset that matches their long term investment horizon objectives – property generally ticks this box.
- You have hopefully realised that you need to consider acting quickly if you want to implement this strategy with your super, as depending on potential future government changes to super, it may not be available post 2018.
- You should have an idea as to what your roles and responsibilities are as a trustee of an SMSF;
- You should have picked up that the SMSF investment universe is almost limitless, but you must keep in mind the Sole Purpose Test before implementing any investment strategy.
- You should have learned that buying a property using gearing requires additional structures to be setup prior to buying the property and that when a loan has been used to buy a property, that property can only be 'improved' using available cash in your SMSF and must not be 'improved' to an extent that it creates a different asset.
- You should understand that there is an exception to the related party rules regarding business real property.
- You hopefully have picked up that it is possible to carry out property developments with your SMSF, however, you must be very careful when doing them if you plan on using a loan as part of the process.
- Mistakes. You should have picked up that it is very easy to make mistakes when buying property with an SMSF, and I strongly encourage you speak with a professional adviser (such as Sequoia) if you are considering implementing this strategy.
- Tax. I hope you have picked up that tax is a very important consideration when considering buying a property with your SMSF, especially the Tax Free Zone referred to in chapter 9.

Chapter 12: What's next?

If you think investing in property within a Self-Managed Super Fund is the right way to secure your future, get in touch with one of our advisers and let's explore it further.

Book a free confidential discussion with us today to find out if SMSF property investment is how you want to plan for your future.

Here's what to expect after requesting a confidential discussion, and what you can look forward to during this no-charge, no-obligation consultation:

- We'll discuss key SMSF property concepts such as tax advantages, structures and practicalities on how to put this theory in to reality.
- We will provide you with a free one-on-one specialist SMSF mortgage broker who will let you know how much you can borrow.
- We will discuss the benefits of buying property inside super vs. outside super.
- You'll discover whether you can acquire commercial or residential property.
- We'll simplify the complex compliance requirements and make them easily understandable.
- We'll answer all your questions. If you're ready to move forward, we'll show you how to take the next steps.

By the end of this discussion, you will have a good understanding of whether or not SMSF property investment is right for you and how to go about investing in property using your super.

If it's the right fit for you, and you require assistance moving forward with your SMSF setup and strategy, we can assist with all aspects of the process.

If after you have spoken to one of our advisers you decide that this isn't for you right now, that's okay too. No hard feelings. The purpose of this confidential discussion is to give you the best possible information and market intelligence in order to help you make the best decision for you.

However, my final piece of advice is don't put this discussion off. Your financial future is IMPORTANT and it only makes sense to find out everything you need to make a sound decision. It's easy to think that your superannuation will take care of itself and that you 'don't need to worry about that for now'. However, it pays to be proactive when it comes to your superannuation – your future, in this regard – is really in your hands. Given the potential changes to super that may be introduced in 2018, there is no time like the present to explore investing your super in property. Book your confidential discussion with us today.

To your future success.

John Collignon

A Little Bit About Sequoia and Sequoia Superannuation

Sequoia Asset Management Pty Ltd (Sequoia) and Sequoia Superannuation Pty Ltd (Sequoia Super) are 100% owned subsidiaries of Sequoia Financial Group Ltd, an Australian Stock Exchange listed public company (SEQ.ASX). Sequoia Super was founded in 2009 and has fast become one of Australia's leading SMSF administration firms, currently servicing over 1,400 SMSF Trustees.

What Sequoia Super offers:

- **Full Service Administration including**
  - Best of breed online reporting software, including live data feeds from banks and broking houses. For a free demo, go to www.sequoia.com.au and click on the Sequoia Client Login page.

    Username: invest@sequoia.com.au

    Password: Sequoia123
  - Mailbox services, both physical and email.
  - Document Management Systems and Services.
  - ASIC & ATO agent services.
  - Payment of invoices services – saving you time and hassle of keeping on top of your accounts payable.
  - Phone assistance by experienced SMSF administration staff at any time at no extra cost.
- **Full SMSF Accounting and Auditing Services**
  - Ongoing daily reconciliation services of your accounts that feeds into your online reporting.
  - Audited Financials and tax returns completed on time each and every year.
  - Technical assistance with SMSF strategy.
  - Ability to assist in the preparation of ATO private rulings for more complex matters.
- **Access to ongoing SMSF Trustee Education**
  - Sequoia Super and the Informed Trustee ® provide regular SMSF trustee information sessions giving up to date news and education in the SMSF space.
  - Subscription to the daily share market newsletter provided by the Finance News Network, giving you up to date information on the Australian and international share markets.

What Sequoia offers:

- **Access to a dedicated SMSF Adviser**
  - At no extra cost, you will have access to a licensed SMSF adviser who can provide you with advice on SMSF strategy.
  - You will have access to the latest investment opportunities, including IPOs (Initial Public Offerings) via our ASX licenced sister company.
  - Our SMSF investment advisers are qualified to give insurance advice as well, so if you need a quote for life insurance, TPD, Trauma or Income Protection, your Sequoia SMSF adviser will be able to organise this for you.

How To Get In Touch With Us

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