THE COMPREHENSIVE GUIDE TO PROPERTY ACQUISITION VIA YOUR SMSF

ADVANTAGES | TAX IMPLICATIONS | FINANCING | UTILIZATION | COMMON PITFALLS & MORE!

- **SMSF AND REAL ESTATE**

Opting to invest in property through your Self-Managed Super Fund (SMSF) can be a strategic move to fortify your financial prospects. When executed with precision and effective management, this approach can yield substantial tax advantages, concurrently fostering long-term growth in your super fund balance.

Within this guide, we delve into the fundamentals of property investment within your SMSF, shedding light on the advantages, potential pitfalls, correct borrowing practices, and prevalent mistakes that warrant attention.

- **FIRSTLY, UNRAVELING THE SELF-MANAGED SUPER FUND (SMSF)**

A Self-Managed Super Fund (SMSF) is a trust structure designed for the administration of retirement savings on behalf of its members. To maintain compliance, SMSFs must adhere to the 'sole purpose' test, signifying their existence solely for the provision of financial benefits to members during their retirement years. Distinguishing itself from retail or industry superannuation funds, an SMSF appoints its members as trustees, empowering them to oversee operations for personal gain and uphold compliance with prevailing super and tax regulations.

- **ADVANTAGES OF PROPERTY INVESTMENT THROUGH YOUR SMSF**

Incorporating property into your SMSF investment strategy presents numerous advantages, including:

1. **Diversification for Risk Mitigation:** Property adds diversity to your investment portfolio, safeguarding your savings against underperformance in alternative investments, such as stocks.
2. **Leveraging Potential Growth**: Through strategic borrowing, your SMSF can acquire a possibly appreciating assets that might otherwise be financially unattainable, thereby introducing a robust growth element to your retirement fund.
3. **Asset Protection from Debt Collection:** Except in cases where property acquisition involves borrowing, your property is shielded from debt collection efforts.
4. **Commercial Property Options for Business Owners:** Business proprietors can leverage the option to transfer commercial properties into their SMSF, providing a unique avenue for wealth accumulation.

- **TAX ADVANTAGES OF PROPERTY WITHIN AN SMSF**

While tapping into the benefits of property investment through your SMSF, it's crucial to adhere to SISA and ATO regulations. The tax advantages include:

1. **Concessional Contributions Taxed at 15%:** Concessional contributions attract a favourable 15% tax rate within your SMSF.

2. **15% Tax on Rental Income:** Rental income from the property is taxed at a modest 15%, in contrast to the higher marginal rates (up to 47%) applicable to standard property investors.

3. **Tax-Free Rental Income in Retirement Phase:** Once your SMSF transitions to the retirement phase, rental income becomes exempt from taxation.

4. **Capital Gain Tax Exemption in Retirement Phase:** Similarly, capital gains on the property are tax-free once your SMSF enters the retirement phase.

5. **10% Capital Gains Tax Discount after 12 Months**: A 10% discount on Capital Gains Tax is applicable when the property is held for more than 12 months.

6. **Potential for Further Tax Reduction**: Property management costs, exceeding rental income, can potentially result in a negative income, further reducing your overall tax liability.

It's imperative to stay compliant with regulatory requirements to fully capitalize on these tax benefits.

- **ESTABLISHING YOUR SMSF FOR PROPERTY INVESTMENT**

If you are contemplating property investment through your SMSF, it's imperative that your fund explicitly allows for such endeavours in both the Trust Deed and Investment Strategy. For existing SMSFs, ensure compliance by reviewing and, if necessary, adjusting these foundational documents before proceeding with property acquisitions.

For those embarking on the journey of setting up an SMSF, here is a step-by-step guide:

1. **Establish a Self-Managed Super Fund (SMSF):**

- Create an SMSF Trust Deed.
- Form a Corporate Trustee.
- Document all minutes and resolutions pertinent to the SMSF.

2. **Register with ASIC & ATO:**

- Apply for an Australian Business Number (ABN) and Tax File Number (TFN).
- Note that confirmations from ASIC and the ATO for ABN and TFN could take up to 4 weeks.

3. **Open a Bank Account:**

- Once armed with the SMSF trust deed and confirmation of your Super Fund's TFN and ABN, proceed to your preferred bank to open an account under your SMSF’s name.

4. **Roll-over Existing Super Funds:**

- After securing the bank account, initiate the rollover of your superannuation funds from the existing super fund into the newly established SMSF account.

5. **Identify the Property for Investment:**

- To facilitate property acquisition through bank financing, a specialized structure known as a "bare trust" is essential.

6. **Establish the Custodian Trust:**

- Set up the Custodian Trust, a crucial component for structuring the SMSF's property investments. This trust holds the property on behalf of the SMSF, ensuring compliance with legal and regulatory requirements.

Ensuring meticulous adherence to these steps will lay a solid foundation for your SMSF's property investment journey. Consulting with financial and legal professionals is recommended throughout this process to navigate complexities and ensure compliance.

- **TYPES OF PROPERTY PERMISSIBLE FOR SMSF INVESTMENT**

Investing in property through a Self-Managed Super Fund (SMSF) comes with stringent guidelines governing the type of property, purchase management, and property usage. Adhering to these regulations is crucial to prevent SMSF SISA breaches, ATO penalties, and potential non-compliance issues, ensuring alignment with the 'sole purpose test' requirements.

Here's a breakdown of what a SMSF can and cannot do regarding property investments:

Permissible Actions:

1. **Residential Property Restrictions:**

- A SMSF is prohibited from purchasing a residential property from a fund member or any related party.

- Fund members or related parties are not allowed to reside in the residential property acquired by the SMSF.

2. **Development Limitations with LRBA:**

- If a Limited Recourse Borrowing Arrangement (LRBA) is utilized for property acquisition, the SMSF cannot engage in substantial development or renovation of the property.

3. **Loan Facilities Restriction:**

- The SMSF is not permitted to redraw loan facilities into its super fund after property acquisition through LRBA.

4. **Commercial Property Leasing:**

- If a SMSF acquires a commercial property, it can be leased to a fund member for business purposes.
- The lease arrangement must adhere to market rates and specific regulatory rules.

Prohibited Actions:

1. **Residential Property Transactions:**

- Purchasing a residential property from a fund member or related party is strictly prohibited.

2. **Member or Related Party Residency:**

- Fund members or related parties are not allowed to live in a residential property owned by the SMSF.

3. **Development with LRBA:**

- The SMSF cannot undertake significant development or renovation of a property acquired through LRBA.

4. **Redrawing Loan Facilities:**

- Redrawing loan facilities into the super fund post-acquisition is not allowed.

Compliance with these guidelines is essential to ensure the SMSF's adherence to the 'sole purpose test' and avoid regulatory consequences. Seeking professional advice and staying informed about evolving regulations is recommended to navigate the complexities associated with property investments within SMSFs.

- **LEVERAGING LIMITED RECOURSE BORROWING ARRANGEMENTS (LRBA) FOR PROPERTY INVESTMENT**

While traditional borrowing for property investment is restricted under S67 of the SIS Act, an exception arises in the form of Limited Recourse Borrowing Arrangements (LRBA). This framework permits borrowing within specific guidelines. Engaging an adept SMSF advisor becomes paramount to navigate this process and identify lenders offering favourable terms.

Key facets of SMSF Borrowing (LRBA) include:

1. **Borrowing Process:**

- The SMSF trustee borrows funds to acquire a designated asset.

2. **Single Asset Acquisition:**

- Borrowed funds are exclusively allocated to purchase a single asset.

3. **Custodian Holding:**

- The acquired asset is held by a separate custodian company, known as the "Custodian," in trust for the SMSF. This is structured through a trust, termed the "LRBA trust," with the SMSF maintaining a beneficial interest.

4. **Ownership Acquisition Through Repayments:**

- The SMSF gains the right to full ownership of the asset by consistently repaying the lender.

5. **Limited Recourse in Default:**

- In the event of SMSF default, lenders possess rights solely to the acquired asset, ensuring 'limited recourse.'

Given the cautious stance of lenders due to limited recourse, an experienced SMSF advisor is invaluable. Lenders typically impose requirements such as a minimum SMSF balance of $200,000, an up to 80% loan-to-value ratio for residential property, and specific powers in the SMSF Trust deed. Seeking external financial advice is often a prerequisite in the application process.

When LRBA is in effect, superannuation legislation permits SMSF trustees to maintain or repair assets. However, improvements or developments are restricted. Maintenance involves actions to prevent damage, while repairs restore a damaged asset to functional efficiency. Borrowing for changes altering the asset's nature or character is expressly prohibited under these regulations. As such, meticulous adherence to legal and administrative requirements is crucial when navigating LRBA for property investment within the SMSF framework.

- **ASSESSING THE FULL SPECTRUM OF SMSF COSTS**

Prior to delving into property investments or divestitures within your Self-Managed Super Fund (SMSF), a comprehensive understanding of associated costs is crucial to gauge their impact on your super balance. The array of costs to consider includes:

1. **Upfront Fees:**

- Initial fees incurred during the establishment or acquisition phase of your SMSF.

2. **Legal Fees:**

- Costs associated with legal processes, including document preparation, compliance, and any legal advice sought.

3. **Advice Fees:**

- Fees related to professional financial advice sought during the planning, setup, or ongoing management of your SMSF.

4. **Stamp Duty:**

- Tax imposed on property transactions, varying by jurisdiction. It's essential to factor in this significant cost.

5. **Ongoing Property Management Fees:**

- Fees for the ongoing management of the property, covering tasks like tenant relations, maintenance, and property administration.

6. **Bank Fees:**

- Charges levied by banks for services related to your SMSF, including account management and loan administration.

7. **Borrowing Costs:**

- Costs specific to borrowing within your SMSF, encompassing interest payments, loan establishment fees, and any associated charges.

8. **SMSF Property Loan Costs:**

- SMSF property loans often carry higher costs compared to conventional property loans. These may include higher interest rates and additional fees.

Considering these various costs is paramount for an accurate assessment of the financial implications on your super balance. It's essential to note that SMSF property loans, in particular, can be more expensive compared to other property loans. Therefore, a meticulous evaluation of the overall cost structure, in conjunction with potential returns, is necessary to make informed decisions and optimize the financial performance of your SMSF. Seeking advice from financial professionals can provide valuable insights into navigating these costs effectively.

- **AVOIDING COMMON MISTAKES IN SMSF PROPERTY INVESTMENT**

Embarking on property investment within your Self-Managed Super Fund (SMSF) requires careful consideration to sidestep common pitfalls. Here are some key mistakes to avoid:

1. **Using Personal Funds for Deposit:**

- Depositing funds for property purchase from personal accounts instead of the SMSF's account, often due to oversight or the absence of an established SMSF account.

2. **Neglecting Trust Deed and Investment Strategy Amendments:**
- Failing to amend the Trust Deed and Investment Strategy to accommodate borrowing and property investment, risking non-compliance.

3. **Incorrectly Naming the SMSF on Sale Documents:**
- Naming the SMSF as the buyer on sale documents, violating the 'arm's length' rule. Utilizing the Bare Trust structure is the recommended alternative (Depends on state).

4. **Overlooking Risk and Investment Profile Assessment:**
- Neglecting a thorough evaluation of risk and investment profiles before delving into property investment, especially crucial for those with limited resources or nearing retirement.

5. **Premature Property Purchase:**
- Concluding property purchases before fully establishing the Trustee and Holding Trust structures, inviting potential compliance issues.

6. **Residential Property Transactions with Self or Related Parties:**
- Purchasing residential property from oneself or a related party to the SMSF, contravening regulations.

7. **Improper Usage of SMSF Property:**
- Living in or renting out SMSF property to oneself or related parties, even intermittently, can lead to compliance issues.

8. **Borrowing for Property Improvements:**
- Borrowing to enhance or alter the nature of an existing property, breaching superannuation regulations.

9. **Inadequate Security Trust Management:**
- Poor management of the security trust, resulting in non-compliance with SMSF regulations.

10. **Insufficient Cash Flow Planning:**
- Failing to account for ongoing expenses, interest payments, accounting, audit fees, and other costs, leading to cash flow challenges.

Navigating SMSF property investment requires meticulous attention to detail, compliance with regulations, and strategic financial planning. Seeking guidance from experienced SMSF advisors can help steer clear of these common pitfalls and optimize the benefits of property investments within your SMSF.