

Aspirations

Live the life you desire now and in the future



Borrowing within an SMSF to purchase property

The financial press has given much recent coverage to a 'new' option for wealth creation – establishing a self-managed superannuation fund (SMSF) and borrowing to invest in direct property.



Before jumping ahead and setting up an SMSF to buy an investment property, you must be aware this area involves complex legislation and rules, and specific financial advice (along with accounting and legal advice), is required to ensure a successfully implemented strategy.

The attraction

Common impediments facing people wishing to build a direct property portfolio include accessing a deposit¹, the ability to generate surplus monthly cash flow (for negatively geared property), and the ability to borrow from a bank.

Using an SMSF can overcome these problems. In fact, subject to the trust deed and investment strategy of the fund, there are no restrictions on which asset class the funds can be invested in. An SMSF can also borrow to leverage the investment, provided the loan is a limited recourse loan for investment purposes, through a trust², as explained below.

How does borrowing to purchase property in your SMSF actually work?

The favoured trust for a limited recourse loan is an instalment trust. An instalment trust allows the SMSF to purchase a property, repaying the limited recourse loan by instalment, while the asset is held in the trust which is separate from the SMSF for the life of the loan. If the SMSF defaults on the loan, then the lender's rights are limited to the property in the trust only, while the fund's loss is limited to the equity in the property and all instalment payments made prior to the default.³

What types of property can your SMSF purchase?

Residential

SMSFs are able to purchase any residential property at public auction or a private sale, provided it is not purchased from a related party. It cannot be transferred in specie into an SMSF from related-party ownership.

The purchase of direct property must be for investment purposes only and you cannot receive any other benefit from it, so buying a holiday house with your SMSF for you or your family is strictly prohibited.

Business real property

The rules for business real property are different to that of residential property. Business real property includes commercial properties, offices, warehouses and farms. Like residential property it can be bought at auction or private sale. However, unlike residential property, it can be transferred in specie into an SMSF by related parties at market value. Business owners are also able to buy their commercial premises, and pay arm's length rental to their SMSF.

There are taxation benefits from owning business real property within an SMSF, particularly if that property was initially owned outside of superannuation, and/or you are a business owner. Each individual case must be assessed on its merits of course, and key rules still must be adhered to including contribution limits and the work test, as well as taking account of capital gains tax implications.

Appropriate diversification

Depending on the total funds available within your SMSF, your ability to diversify with direct property may be limited. Lack of diversification can increase the risk to your retirement plans if your property investment doesn't perform in line with expectations. It is important to remember even 'blue chip' property prices can lose value. Property values in the USA, UK and Ireland have

all decreased by varying degrees over 2008–2010, reminding us that past performance in any market, including property, may not repeat itself in the future. The lesson is... be careful.

Is it right for you now, or in the future?

While members of an SMSF are working to accumulate funds, assets that produce little income for the SMSF may not present any immediate problems. However, in retirement, income (and therefore liquidity), is of paramount importance when specified withdrawal amounts of income are required by law. For example, an 80-year-old member must withdraw 7 per cent of their SMSF capital each year, rising to 9 per cent from age 85.⁴

A significant concern with residential property is that it often produces less than a 5 per cent net rental yield (after expenses)⁵ and consequently insufficient retirement income. Because property is not divisible and can't be sold off 'bit by bit', unlike units in a managed fund, accessing liquid funds often results in a forced sale.

Next steps

When buying property through an SMSF you should always consider the quality of the investment with a clear understanding of the associated risks. An objective approach rather than decisions based on emotion will always serve you best in the long run.

Please feel free to contact us to discuss whether this strategy is appropriate for you.

1 Generally, a 20% deposit is required to avoid mortgage insurance.

2 The trust deed of the SMSF must allow the trustee to borrow before any limited recourse borrowing arrangement can be entered into.

3 Source: Adviser Tech: SMSF/Borrowing within SMSF Technical Bulletin.

4 www.ato.gov.au (NB: this amount represents the amount prior to the temporary halving of income stream minimums post GFC to give relief to members wishing to preserve their balances). In the long term, minimum percentage investors should consider with respect to yearly liquidity requirements for their SMSF.

5 www.rpdata.com/press_releases/australia