10 things you should know before buying property in your SMSF

1. SMSF must have an investment strategy

No SMSF can exist to create wealth without an investment strategy. An investment strategy is a set of rules or guidelines as to how a trustee intends to invest funds and contributions on behalf of members to achieve their objectives.

An investment strategy can be simple, but it must include actionable strategies to maximize member investments, provide diversification across asset classes, include a strategy for paying benefits and maintaining liquidity and take into account each member's term to retirement, at minimum.

An investment strategy may also define a set of criteria or hurdles (for example yield, lease terms, asset size, etc) in order to draw a line between what is, and is not, acceptable as an investment by the SMSF. This may also extend to specific due-diligence requirements as part of the overall property investment strategy for a fund.

Trustees can set their own strategies or where they need help they should seek help from a professional superannuation specialist or financial adviser. Without a strategy, trustees will not be able to determine how direct or indirect property fits into their SMSF portfolio, or what exposure they need to maintain at particular stages in life with respect to when members retire.

2. SMSF can invest in any property type or sector

Generally speaking, a SMSF can purchase just about all types of property (including vacant land) which includes residential, commercial, factories, medical suites, office space, and so forth.

In order to invest widely in any type of property, trust deeds must include provisions allowing direct property as an approved investment. It must also be flexible enough to match the risk profile of the member.

Other options can include direct shares in a listed property trusts off the ASX, or investing in a non-listed property trust. These funds can have a broad exposure to commercial, industrial, office and even residential properties without the initial high purchase costs traditionally associated with direct property.

SMSFs can't buy property from a related party. It is against the law to buy an asset including property from a related party. All investments must be strictly at arm's length. Related parties to a SMSF include all members and associates of a fund, employers and their associates.

The definition of associates of a SMSF member is wide and includes: every member of the

Fund, relatives of each member, business partners of each member, and any spouse or child of business partners, and any company or trust controlled by a member or associate.

This ensures that the transaction is made purely on a commercial basis and avoids potential conflict of interest.

There are three specific exceptions clearly defined by the ATO where an asset may be purchased from a related party, including a listed security acquired at market value, business real property acquired at market value, and certain ‘in-house’ assets.

4. SMSF can buy your business property

The good news for business people is that a SMSF is allowed to invest in, or buy your business premises, provided it is used wholly and exclusively for the business.

A superfund cannot purchase or run a business. It is a direct breach of the Superannuation Industry Supervision (SIS) regulations, attracting heavy fines from the ATO. However, a SMSF can indeed purchase the property in which a business is being conducted.

When a superfund buys the business premises of its member, the business simply becomes the tenant and pays the SMSF a commercial rate of rent. If a mechanic owned a factory from which he run his business, his SMSF would be allowed to purchase that factory from him because it would qualify as business real property.

This would free up additional working capital to the business owner to expand the business. It can also facilitate the transfer of an attractive long-term real property asset into the superannuation as an investment.

When deciding to transfer business real property into their SMSF, trustees must take into account:

1. Their overall fund investment strategy

2. How this will affect all members

3. How it will affect liquidity; and

4. Whether such a transaction will dilute their diversification benefits through creating a concentrated exposure to one asset.

5. SMSF can develop property

Generally speaking a superannuation fund cannot develop property. However, should a potential development represent a small portion of the fund’s total value and is inline with the investment strategy, incorporating all the other assets in the fund, it may be successfully argued that it is appropriate.

Due to the complicated nature of the process, a specialist advice is highly recommended in order to take into account individual circumstances of the members and their fund, as well as the specific profile of any proposed development activity.

6. SMSF can borrow to buy property

In September 2007, S.67(4A) was inserted into the Superannuation Industry (Supervision) Act 1993 (SIS Act), under which SMSFs became eligible to borrow in order to acquire a property as long as they complied with a number of provisions.

Recent changes to superannuation legislation now allow SMSFs to borrow to acquire assets including residential and commercial property to support their investment strategies subject to meeting a number of requirements.

Under the new guidelines an SMSF borrows funds to acquire an asset, for example a residential and / or commercial property. A separate trust is established to hold legal ownership of the property on behalf of the SMSF. These trusts are generally referred to as security trusts or warrant trusts.

A loan is then arranged to meet the balance of the purchase price (plus costs) that the SMSF is not providing. The SMSF becomes the beneficial owner and manages the property as it would any other real estate investment.

The loan is a limited recourse loan and the property asset is used as security. In the event of a loan default, the lender only has recourse to the residential and / or commercial property. They cannot claim on any other SMSF assets.

7. Who can use the residential assets of the SMSF?

SIS law is very strict about residential property owned in SMSFs as an investment, including holiday property investments. They simply cannot be used by members or any related parties.

Members including their family, associates and business partners are restricted in using the assets of the fund unless they are business real property, and then only if they are solely used for business purposes by a member or related party, and only where commercial rates of rent and lease terms are being provided to the SMSF which owns the asset.

8. SMSF allows you to buy a retirement home

In retirement, people need an income, and a place to live. One of the most fundamental superannuation questions is whether a member can acquire a residential property asset in their SMSF that will eventually become their retirement home. There are ways this can be achieved in a SMSF structure.

A couple aged 50 might acquire an ideal investment property on the beach using their SMSF, either with cash, or with some allowable borrowings. The property in the SMSF is rented out, and the rental income plus contributions (any salary sacrifice plus any employer contributions) flow to the SMSF, less the 15% contributions tax. As cash builds up within the SMSF, the trustees use this money to pay off the loan that funded the original purchase.

After 10 years they decide the sell their primary residence and pay no capital gains tax. They may then proceed with their plans to purchase the property off the SMSF (providing tenants have left). If just before they purchase the property off the SMSF, they convert the fund into an allocated pension, as assets sold in pension phase pay no capital gains tax (CGT), then there will be no CGT on either property (note stamp duty is still payable).

Purchase proceeds are in the superannuation environment paying them tax free income (assuming 60 years of age and over) and they get to live in the dream beach-front home, purchased 10 years ago using their superannuation, in their retirement.

9. SMSF benefit in the super tax environment

As with all investments in a complying SMSF, because contributions and investments in the fund are preserved until retirement, they enjoy the beneficial superannuation tax regime.

Just like negative gearing in an individual's name, the SMSF would benefit from the same tax benefits, that is, tax deduction for the negative component of the interest, and depreciation.

However the biggest benefit is CGT. Should the fund hold the asset longer than one year and then decide to sell it then CGT drops from 15% of the gain down to 10%, and if sold in pension phase (generally over 55 years of age) CGT is 0%."

The beneficial superannuation tax environment means that income and capital gains earned from a property held in a SMSF provide greater reinvestment value, being the difference between a member's individual tax rate on income and capital gains, less the tax rate they pay within the superannuation environment.

10. SMSF must satisfy the law

It is crucial to seek professional advice. The SIS regulation is complex and requires careful consideration before implementation. One also needs to take into consideration the appropriateness of starting a SMSF and weigh up the costs relative to the potential gain.

It is mandatory that trustees, or would-be trustees, understand the law and spirit of the governing superannuation legislation (SIS). However as trustees of a superannuation fund they must also understand their obligations under the Corporations Act and the relevant taxation laws.

For trustees of SMSFs there are no excuses for not complying with the law, and the rules outlined in the trust deed and the investment strategy. Trustee obligations to the members of their funds are regulated by ASIC and the ATO.

Penalties for not following these rules can include your SMSF becoming non-compliant and losing its preferred tax status, the trustee(s) becoming disqualified to act as trustees, prosecution under law and a range of significant penalties including imprisonment for criminal breaches of the law.

Trustees should keep informed of their duties and where confused consult the ATO website www.ato.gov.au or obtain an explanation from an accountant, financial adviser or a lawyer.