



## How to borrow to buy property through your SMSF

Borrowing to invest through a self-managed super fund (SMSF) can be a simple and effective strategy to leverage your existing superannuation nest egg to leverage greater asset growth. However, as the trustee of a SMSF, you **MUST** be aware of the hidden traps in getting the structure & lending plan right, or else suffer the consequences.

There are important planning considerations to ensure you don't accidentally create circumstances that might place a surprisingly high proportion of your retirement savings at risk.

Fund trustees who are considering gearing investments for the first time should tread carefully to ensure that the borrowing complies with the strict requirements under superannuation law. They should satisfy themselves that borrowing is really in their members' best interests.

### 1. Understand the benefits of gearing

The headline benefit of a fund being able to gear is that assets can be bought that the fund could not otherwise afford given its assets and level of contributions. The obvious advantage being that capital gains are multiplied if the geared asset rises in value.

Also, earnings and capital gains are taxed concessionaly within the fund – or tax-free if backing the payment of a pension. This means that an asset can eventually be sold without ever being subject to capital gains tax.

It is interesting to note that concessional super contributions (Super Guarantee, salary-packaged or personally tax-deductible contributions) can be used to service the fund's loan, meaning that you can allocate your employers superannuation contributions (on your behalf) to paying off a house, or other investment held in your SMSF.

Recent legislation changes reduced the maximum annual contributions each individual can make (depending on your age) which indirectly makes an argument that borrowing in your SMSF is now potentially even more necessary. Put simply, borrowing is a means for SMSF's to increase the size of their assets if limited by the contribution rules.

### 2. What makes sense as a geared asset – Shares or Property?

An advantage of shares is that SMSFs can obtain a portfolio at a much lower cost than direct real estate. But fund members must be able to cope with the inherent volatility of shares – which can be magnified through gearing.

When considering property it is important to understand what has historically happened with property in Australia since Federation, that is, property has increased on average at 10% per year over 7 - 10 year periods.



It is very important to note that gearing is to a fund's detriment unless the asset increases in value.

However, one of the biggest drawbacks of gearing direct real estate is the risk that the fund can have much of its assets tied up in a single high-value asset.

An alternative to a fund borrowing to buy direct shares or units in an equity fund is to simply invest in an internally geared share fund. These funds, offered by major fund managers, can have a high level of gearing as one of their fundamental characteristics.



### 3. Understand the borrowing laws

Amendments to superannuation law three years ago allow SMSF's to borrow to invest, provided the borrowing provisions in the legislation are followed to the letter of the law. In simple terms, the geared assets must be held in trust until the funds pay the final instalment of the loan and a fund cannot give the lender recourse against the other assets of the fund in the event of a default on the loan.

Further amendments introduced recently stipulate that only a single asset or collection of identical assets may be acquired under a single borrowing arrangement. For example 1,000 BHP shares could be included under a single borrowing arrangement but not 500 BHP and 500 ANZ shares. However, SMSFs could use a single gearing arrangement to invest in a widely diversified equity fund.

With geared property, the new rules prohibit multiple titles under one borrowing arrangement even where the properties are effectively managed as a block.

### 4. False sense of security

Just because a lender cannot make a claim against other assets of your fund in the event of default, this doesn't mean your overall retirement savings are immune from serious damage. Under super law, funds can lose payments or instalments on a geared asset up until the date of default – which could be at least a third of the asset's original value. It is interesting to note that lenders typically require borrowing funds to pay up 30% - 50% of the geared asset's value plus stamp duty upfront (or as the first instalment) to reduce their lending "risk" to the SMSF.

One approach is to think of the worst possible scenario if an investment were to fail, what would be the affect on the members' retirement savings?

### 5. Caution investing most of your SMSF's value in a single geared investment

As everyone reads in most financial articles DIVERSIFY, DIVERSIFY, DIVERSIFY!

A SMSF's assets should be widely diversified in asset sectors and between individual investments. The broad aim is to spread the risks and opportunities. Tying up 100% of a fund's worth in, say, one piece of geared property means the fund's future is highly dependent on that investment's success.

Trustees of the SMSF should consider the impact on a fund's ability to pay pensions to retired members if it holds one or two "lumpy assets" and little else.

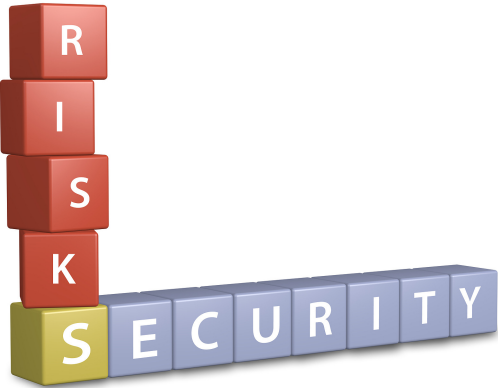
### 6. Act your age

If your fund's members are within a few years of retirement, seriously question whether it is appropriate for the fund to borrow to invest. Most investors understandably want to clear debts before retirement – whether or not those debts are held personally or through a SMSF. Typically, investments are bought for the medium- to long-term, particularly if geared. Therefore it does not make much sense for your fund to borrow to invest on the eve of retirement unless you are seriously cashed up!

## 7. How closely do you want your business and your retirement savings linked?

This is a major issue for small business owners who are thinking about arranging for their SMSF to borrow to buy the premises of their own business. Under special provisions in superannuation law, business properties are among the few assets that SMSFs are permitted to buy from their members.

Under this law, funds are permitted to receive rent from their members' businesses for fund-held business premises. This can produce excellent tax benefits including the fund paying only concessional tax on the rent.



Some of the risks to keep in mind are:

1. If your business gets into financial trouble, it may not be able to pay rent to your SMSF.
2. The premises may be difficult to rent to other tenants for an acceptable rent – depending upon the state of the market
3. The premises are uniquely equipped for your particular business.
4. If the business fails to do well and / or capital gains for the property fail to meet expectations, the retirement savings of the members could be affected.

## 8. Be aware of personal guarantees

Under the latest amendments to SMSF borrowing rules, related parties to a fund, including members, can still give personal guarantees for loans to the fund. However, under these amendments, guarantors cannot pursue their funds in the event of a default or shortfall in repayments. Lenders often insist on personal guarantees for super fund loans.

The change in the law means that the members' personal assets are obviously at risk.

In order to understand the financial advantages of borrowing to buy a property in a SMSF let's now look at a simple case study:

## CASE STUDY: Borrowing to Purchase Residential Investment Property

### Assumptions:

John is 42 years old.

He is looking to purchase an investment property for 400,000 (net 5% yield).

He owns his own home worth \$850,000 and has a mortgage of \$250,000.

He wants to fund the investment property through an equity line of credit against his principal residence.

He is employed and earns \$100,000 per annum.

He has accumulated \$200,000 in superannuation and has a SMSF.

He could potentially fund the investment property purchase through his SMSF, utilising a SIS Act compliant "non-recourse" loan with himself as the lender to his SMSF.

In order to action this strategy John will follow these steps:

- Step 1.** Establish an equity line of credit (LOC) against his principal place of residence and draw \$300,000.
- Step 2.** Personally lend \$300,000 to his SMSF via a "non recourse" interest bearing loan. The rent payments can be used to repay the LOC interest.
- Step 3.** Establish a 'security / BARE trust' to hold the investment property, recognising the beneficial interest of the SMSF in the investment property and the rights of the lender.
- Step 4.** Once the 'Trust' has been established, the SMSF can then acquire the property for \$400,000 using the \$300,000 loan and \$100,000 from the accumulated balance.

Note: the LOC could be reduced to \$200,000 if the full balance of the SMSF was used for the property, although this would have asset allocation risk for the SMSF.

The benefits of John owning the investment property in his SMSF are compelling:

	<u>As an Individual</u>	<u>In His SMSF</u>
Rental Income (30yrs)	\$878,054	\$878,054
Interest Expense (30yrs)	(\$780,000)	(\$585,000)
Rental Tax Liability/Benefit (30yrs)	(40,692)	(9,921)
Capital Gain on Property	\$418,563	\$418,563
CGT Payable	(\$86,852)	\$0
<b><u>Total Return</u></b>	<b>\$389,073</b>	<b>\$701,696</b>
<b><u>Structure Benefit</u></b>		<b>\$312,623</b>

**Key Assumptions:** 5% rental yield, 2.5%pa rental growth, 5%pa capital growth, 41.5% individual tax rate, 15% SMSF tax rate, Asset held until > age 55

**Further potential enhancements to the strategy**

John could potentially increase his superannuation contributions via a salary sacrifice arrangement and then use the increased contributions and / or returns to repay the SMSF loan. This would enable John to save tax not only on the property investment, but also at a personal income tax level.

**If you would like to book a meeting with us to discuss these opportunities further then please return to the email and click on the link in the email to book a meeting with one of our advisers.**



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