The ABCs

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# of SMSFs

Meet the ordinary Aussies who have set up self-managed superannuation funds to buy property with. They talk candidly to API about the benefits, disadvantages and why it works for them.

CAROLINE JAMES

More property investors are buying real estate with self-managed superannuation funds (SMSFs) than ever before, encouraged by revised borrowing rules, tax breaks and the ability to hands-on drive retirement wealth growth.

The global financial crisis (GFC) in 2008 and the Federal Government's decision in 2009 to introduce rules allowing SMSF trustees to borrow money to buy property assets for their retirement funds have had an accumulative impact on the number of workers establishing SMSFs and using super funds to invest in property.

"Definitely, yes, the interest in SMSFs from property investors has been slowly increasing in the past two years since the limited recourse borrowing rules came into effect and banks becoming more willing to lend and more understanding of the risks involved," reports Barclay Judge, director of superannuation at Sydney-based chartered accountancy firm Nexia Court & Co.

(Just to explain, limited recourse borrowing only allows the lender to take assets named in the loan agreement.)

"It's a good way of putting your money in your retirement fund to good use.

"Where I'm seeing increasing interest is from people who aren't making any money in their existing fund structures and there are many people in their 60s who are really worried, seeing their retirement savings dropping and having to keep working or even return to the workforce since the GFC... it has been a terrible shock to many older Australians."

Judge says the strategy has multiple benefits including the fact that if a SMSF property has been financed with a bank loan, its owners can use salary-sacrificed funds to pay off the mortgage.

"What that means is you can essentially get a salary tax benefit from paying down a principal and interest loan. I don't know any other way you can do that," he says.

According to Judge, a property bought with SMSF funds and sold by the SMSF pre-retirement will attract a capped 10 per cent capital gains tax bill.

Other perks include uncapped borrowing, although banks will typically only lend up to 75 per cent of the property's value to a SMSF. A SMSF member can also draw from the equity in a personal property and lend that money to the SMSF to buy a property asset for the fund.

"That's another way to get funding for a SMSF property if not through a bank and can be a way of avoiding some costs... the fund then pays the money back to the member lender, who pays it back to their refinancer," Judge explains.

Pat Mannix, CPA at Gatherum-Goss & Associates, adds that small business owners can achieve "excellent transactions" if buying a new commercial property for their own business use in their SMSF with a loan, or moving an existing commercial property they own to their SMSF.

> **"It's a good way of putting your money in your retirement fund to good use."**

"The commercial, taxation and superannuation benefits of this transaction can be enormous for small business people and really gives them a much larger ability to provide for their own retirement while affording themselves all the asset protection that superannuation offers," Mannix says.

Buying property in a SMSF won't suit everyone, the experts stress.

You can't have any personal use of the SMSF investment property and, if borrowed funds are needed, the extra compliance costs can be hefty.

The lender will usually charge a premium interest rate of up to one per cent higher than the market rate, Judge says.

It's essential that SMSF trustees select a property asset with strong capital growth and rent-producing clout to offset the substantial upfront costs and pay down loans needed to finance the purchase.

Ultimately a SMSF holder should seek a property for their fund that will produce a steady income pre and post-retirement, and one that will grow in value.

Melbourne chartered accountant Paul Meissner of Five Ways Chartered Accountants & Business Advisory says SMSF administration is a high-risk area and "needs to be taken seriously".

He says just because you can borrow in a SMSF doesn't mean it's always right for your family's circumstances.

"Where it works really well is if you need to buy a commercial property for your business or can make substantial cash contributions to the purchase," Meissner says. He says two key questions to ask if considering an investment in a SMSF are:

- Is the investment in the best interest of the member?
- Is the sole purpose of the fund to provide retirement benefits for the member?

"Most property investments are negatively geared, which is great personally to get some tax deductions while you build capital growth in the asset. Income losses in an SMSF don't help anyone," Meissner says.

"The costs of structuring a SMSF borrowing arrangement are high, although becoming better as more banks offer products, and there are a few people offering SMSF borrowing arrangements that sound too good to be true... they are!

"Get professional advice from someone you trust.

"The DIY couple you had over for dinner might have a geared property in a SMSF but that doesn't mean it's right for you."

Kevin Lee from Smart Property Advisor says for an investment property bought via a SMSF structure to succeed "it needs to be outstanding in every way".

Lee says its rental income and potential for capital growth must be exceptional if it's going to counter the costs involved in setting up a SMSF bare trust (the trustee of the holding) if a loan is needed, hefty limited recourse interest rates, annual auditing fees and costly loan application fees ($2115 for a bare trust versus about $600 in your own name).

He describes negatively gearing inside a SMSF as "a dumb strategy" and says "the only way to invest through your SMSF is to purchase residential properties for their current cash flow".

"By investing in existing properties in so-called lower socio economic areas of our capital cities and regional areas across the country, you'll be investing in affordable real estate that in many cases show current gross rental yields between seven per cent and 8.2 per cent," Lee suggests.

"With a 30 per cent deposit and funding your stamp duty and associated purchase costs, the tenants in these properties will pay off the loan attached to the property usually within 15 years – now that's the way to invest via SMSFs."

Buying off the plan for future retirement

Location: Brisbane, Queensland
Ages: 29 and 40 respectively

Vanessa & Scott Hall

Fed up with a poor-performing superannuation fund and seeking to diversify their asset base, Vanessa and Scott Hall decided to "take control" in 2011 and self-manage their retirement finances.

The Brisbane couple, parents to three young children, established a SMSF last year and say using it for property investing wasn't solely why they set up the fund, but it was a key aspect of their plan.

The Halls live in Everton Park in north Brisbane in a five-bedroom home they bought in 2008 for $740,000.

"Diversification inside superannuation is just as important as diversification outside super and the SMSF allows us to do this (buy property) in a, generally speaking, low-maintenance manner," Vanessa says. "It (property investing) wasn't entirely our objective (but) leveraging into property is an excellent strategy."

Scott, who turned 40 in November, works as a geologist for a mining and exploration company specialising in gold.

Vanessa, 29, runs her own coffee caravan business and credits her husband with driving the Halls' decision to take charge of their super destiny.

Last year, via their SMSF, the Halls bought a one-bedroom unit in Hamilton, an inner northeast suburb of Brisbane, for $326,000.

The off-the-plan unit without car park is due for completion next March. They paid a 10 per cent deposit to secure the sale from funds already in their SMSF.

They selected the property because it was "the best available in our price range and broker-recommended", Scott explains. Weekly rental income of $230 to $260 is expected on completion.

Vanessa says the unit is in a complex that will attract a lot of "good tenants", young professionals, who should produce a consistent rental income for the Halls' SMSF, which will help pay off the property's loan.

She admits that initially she was "getting too personal" with the investment property, but once she accepted it was purely a SMSF asset and she could never have direct contact with the property, she was able to "switch off" and see the property solely for its income-making and capital gaining potential.

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"We already had a lot of shares so this seemed like the right thing to do as we needed to diversify and our financial adviser was fundamental to instigating this and making us believe we could do it," Vanessa explains.

"In the beginning I was getting too personally involved and Scott said to me 'no, you've got to keep an arm's length as you'll never get near this property, its purpose is to make money for our fund', so I just stepped back and signed the papers and because I can't even see it because it isn't built yet, that has actually been a good thing because it helps you keep detached."

Vanessa agrees a SMSF isn't for everyone and should only be seen as one means of building retirement wealth via property investment.

She and Scott hope to buy more real estate assets both inside and outside of their SMSF in coming years.

Each investment must "meet a strict criteria" including evidence of long-term capital growth, population movements to its area, low vacancy rates and solid valuations.

"Long term it's important that the rental yield (of any SMSF property purchase) is strong enough to make the fund affordable and help pay down the loans but the properties must also grow in capital over time."

SMSFs 'the way of the future'

Location: Gerringong, New South Wales
Age: 38

Ashley Churchill

Former electrician Ashley Churchill is halfway to his retirement goal of six properties, one of which has been bought by his SMSF.

Ashley, 38, set up a SMSF with his wife Belinda and mother-in-law Kaye Bowrey in December 2008 because he wanted to buy a red-hot property in Seven Mile Beach that he knew was about to reach the market.

The two-bedroom apartment on the south coast of New South Wales was purchased in February 2009 for $480,000.

The property is leased as a short-term holiday rental – achieving income of $980-plus per week – and is already worth $560,000, according to Ashley, who lives nearby in the coastal town of Gerringong.

"It was one of four strata title units I'd renovated several years earlier with some builder friends and, as I already owned one of the units in my own name, when one of my friends decided to sell I knew I really wanted to buy his unit through my super fund," the father of three explains.

The trio of trustees funded the purchase deposit from their rolled-over super balances and – via the SMSF bare trust – jointly borrowed $294,000 to complete the deal.

The loan is repaid via the property's holiday-letting income, wage contributions and extra contributions made to qualify for government co-contribution benefits.

Ashley is a big fan of SMSFs, describing them as "the way of the future".

Today working as a mortgage broker, he's passionate about the wealth-building power of real estate, having bought his first property for $315,000 in 1999, a four-bedroom house in Menai in southern Sydney that he sold for $686,000 last year.

He owns his four-bedroom home and bought his other Seven Mile Beach two-bedroom unit in 2002 for $163,750. It has grown in gross value by almost 200 per cent in a decade.

"As a finance broker I help others purchase owner-occupied and investment properties and so when the government decided to change the rules to allow a super fund to borrow money, this immediately got my interest," Ashley explains.

"The trigger for me was getting a super statement that showed how my money over the past three years had gone backwards.

"I then looked at my wife's statement and even though I'd been working longer and earned more money than her, she had more super, plus it was costing me approximately $1000 per annum in fees, so I then decided I could lose my money as fast as the current manager for free."

Ashley called his accountant, who he credits for "taking all the hassle away" in setting up the fund.

He sees asset protection as one of the biggest advantages of buying an investment property with a SMSF – "it's in my fund name, not my personal name, which gives it greater protection".

The biggest disadvantage is not being able to use his SMSF apartment because SMSF investments can't be used for personal purposes.

"My goal is definitely to buy more property, six is the number I need to own before I retire. I plan to leave at least one debt-free property to each of my children when I die.

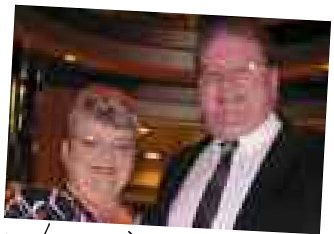
"I'd like to buy more through my super but with the current government only allowing you to contribute a maximum of $25,000 per year into your fund, it takes time to build up enough funds for the deposit so if I buy another property this year, I'll use the equity in my non-super properties to raise the deposit."

Ashley's caution to other investors considering buying with a SMSF is to get professional advice.

"If you get the right advice this investment strategy can be a great option. If you don't it could be a disaster!"

Taking control before it's too late

Location: Melbourne, Victoria
Ages: 57 and 53 respectively



Robyn O'Connell & David Nugent

Buying some professional 'hand-holding' is money well spent when purchasing the first property for a SMSF, Melbourne couple Robyn O'Connell and David Nugent suggest.

Robyn, 57, is a former director of a credit union who today works for herself as a civil celebrant.

David, 53, is a software engineer/manager who previously worked as an accountant.

The baby boomer couple rent a home in the leafy east Melbourne suburb of Wantirna South and established their SMSF in 2010 as a vehicle for buying property assets. In January they bought their fund's first property investment; a three-bedroom, two-bathroom unit in Berwick in Melbourne's outer southeast.

They settled on the $325,000 purchase in February, which rents for $350 per week.

Robyn says they're extremely satisfied with their superannuation nest egg.

"We see the biggest benefit as being in control of our destiny.

"We were tired of seeing our finances dwindle before our eyes... (now) if we make a bad decision, we wear it as opposed to someone else making a bad decision with our money."

Despite backgrounds in financial services, Robyn stresses that the couple found the process of establishing a SMSF, and using it to buy an investment property, at times daunting, confusing and complex.

"Even with my background I only probably knew half of what we needed to know," she says.

"Our purchase costs were about $25,000 including about $10,000 purely on advice payments from the financial adviser and accountant, so you could say we've paid about a year's worth of interest just on these services.

"(But) as long as you absorb all that information you've paid for and use it to self-manage your next purchase, it isn't lost money.

"With your first one (SMSF purchase), a bit of hand-holding is probably not a bad thing as long as you make sure you ask lots of questions and only work with people willing to teach you and pass over the critical information, as the penalties are so high you don't want to get it wrong."

The experience was made more complicated by the fact the pair needed to borrow $225,000 to pay for the purchase.

This required the establishment of a bare trust – the entity that legally has the mortgage with the lender.

Robyn and David covered the $100,000 deposit plus purchasing costs via a combination of $80,000 from a former property Robyn sold and cash funds already in the couple's super fund.

Their plan is to work hard to pay off their SMSF rental property within five years, spend a further year saving another deposit and purchase a second property for their SMSF.

David already has an investment property in Berwick, which he bought in 2006 for $227,000.

Its value has grown by more than 54 per cent in six years, yet Robyn says the couple didn't expressly set out to replicate this experience with their SMSF purchase, it's just that when the couple went shopping for a suitable investment for their super fund they could see their latest purchase was ideally "a rental property located in a good part of Berwick".

"It was very important to us that we didn't buy something that was heavily negatively geared as we expect it to be earning us money for our fund every year within a year or two," Robyn explains.

"If we can then buy another place and pay it off, when we're ready to retire we'll sell two of the (three) properties and keep the best one as a rental income."

Robyn acknowledges establishing a SMSF won't suit everyone. Asked to name the biggest disadvantage, she doesn't hesitate: "Oh, it has to be compliance, understanding what you can and can't do, making sure you're doing everything you're meant to.

"The complexity of what you have to do is daunting even for us, let alone someone with no real experience in these matters. Also having to pay for advice (initially at least), it's not a cheap thing to do.

"We paid a lot for advice initially but it was well worth the money.

"We had a solicitor who handled the conveyancing and settlement as it's a lot more complicated for a SMSF than a normal purchase and you really need to find someone who knows exactly what's required if you have to borrow (through a bare trust).

"We don't have any regrets for creating our fund, although making sure you're on top of the paperwork is vitally important.

"If that part scares you, don't do it – and be careful with insurances. Again we sought some good advice, separate to our financial planner." api

Perks of buying property with a SMSF

- People with relatively small superannuation balances may be able to access property investing.
- The ability to significantly boost an individual's retirement nest egg.
- Access to a retirement investment less likely to sharply rise and fall than shares.
- Ability to borrow to invest in property means this wealth-building strategy is available to more superannuation members.
- Builds greater confidence in people trying to save a retirement nest egg because they can 'see' the asset.
- Fund trustees can enjoy two benefits in retirement: a regular net income from the fund's property and, when sold, potentially no tax bill on its capital gain.
- Super loans are non-recourse so, if money is borrowed to purchase the asset, the lender can only recover outstanding loans against the investment property itself; all other super assets are safe.

Pitfalls when buying property with a SMSF

- If using an existing SMSF, make sure the trust deed allows for this kind of investment; if not, get it changed.
- Ensure fund insurance nominations are up to date and consistent with a 'borrowing to invest' strategy.
- Breaches of the superannuation laws can happen easily and unwittingly and can lead to financial penalties – seek expert professional advice wherever possible.
- Be wary of purchasing properties unsuitable for a superannuation fund.
- Shortfalls in cash flow may require extra contributions by super members.
- Set-up costs of SMSFs to ensure compliance and ongoing administrative costs are hefty.

Source: Martin Jandera, SMSF specialist adviser and director of Super Property Concierge

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