



Henderson Maxwell
PRIVATE WEALTH MANAGEMENT

USING

YOUR SUPERANNUATION

WITH

GEARING STRATEGIES

TO PURCHASE

INVESTMENT PROPERTY.

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Letter From The CEO of Henderson Maxwell

Dear Investor,

Using your Superannuation to purchase an investment property with borrowed funds is a very popular topic at the moment. Many people wish to purchase more property for investment purposes, not many people know how to use Superannuation to help achieve this goal.

We hope that this eBook helps to provide a clear picture on how this strategy can help you achieve your financial and lifestyle goals.

Henderson Maxwell has been helping individuals maximise their investments through Superannuation since 2003.

Please call 1300 665 439 to book a free initial consultation with one of our Senior Financial Advisers.

Kind regards,



Sam Henderson

Chief Executive Officer

M Com (FP), B Com (Acc & FP), ADFS, DFS, FPA (Aff)

Case Study: Purchasing Property inside a SMSF

Arthur and Sally are both 48 years old and have always been firm believers in investment property having grown their residential property portfolio to two investment properties in addition to their family residence over the past 15 years.

They are currently in a financial position whereby they have geared their investment properties at 90% plus costs with the use of their family residence used as collateral to take advantage of negative gearing.

With concerns about interest rates rising and property affordability in the future, they feel there is a good opportunity to acquire another investment property. Unfortunately, the drop in property values has also affected their own gearing ratio resulting in the bank refusing to lend them any more money as they do not have sufficient equity to service another loan.

Having experienced investing in property through a number of market cycles they still have the feeling that the property area they are focusing on has good growth prospects over time.

With their objective clear, they met with their financial adviser who suggested they consider purchasing property through their self managed superannuation fund (SMSF).

Sally and Arthur already have an existing SMSF which has investments and cash of around \$275,000. Sally and Arthur are both employed full-time. Arthur earns \$150,000 per annum as a senior executive in a software company. Sally works as an executive personal assistant on \$80,000 per annum. Of the total SMSF portfolio, \$130,000 is invested in shares and managed funds and \$145,000 is sitting a term deposit maturing shortly. They are happy with the dividends that they are receiving from their shares and do not wish to sell any. Their adviser informs them that they will be able to borrow up to 70% of the value of an investment property owned by their SMSF when their term deposit matures.

They used \$135,000 of the cash available inside their SMSF as a deposit and borrowed a further \$315,000 to purchase the property within the SMSF. The property was positively geared, with the rent being used to cover the loan repayments.

Arthur salary sacrifices a further \$11,500 from his salary into his superfund. The tax Arthur pays on these concessional contributions is 15% as opposed to 38.5% had he received the contributions as a part of his normal salary. Thus he saves approximately \$2,702.50 in tax and has more cash available inside the SMSF to help pay down the investment loan faster.

Arthur and Sally were able to achieve their objective to add to new property to their property portfolio without having to use any cash flow or equity outside of their SMSF.

Introduction

Australians have always had a passion for purchasing and investing in property. Previous to 2007, most Australians could only purchase an investment property with the use of borrowings in their own name. So what was it that changed in 2007? Australians can now borrow money within their Self-Managed Superannuation Fund (SMSF) to purchase an investment property.

It has taken some time for the mortgage lenders to develop competitive loans that permit Australians to borrow within their SMSF. Despite this, many Financial Advisers still do not consider borrowing money to purchase an investment property within a SMSF as a core strategy to creating wealth to fund a retirement income. In fact, over 80% of Financial Advisers in Australia still rely on commissions as their main business income.

Henderson Maxwell understands the desire of many Australians to build their wealth using both property and shares. It is a fantastic strategy that provides all the benefits of gearing with property and having the liquidity and flexibility provided by shares. Henderson Maxwell has assisted many of its clients who have a SMSF to borrow money to purchase property within their SMSF.

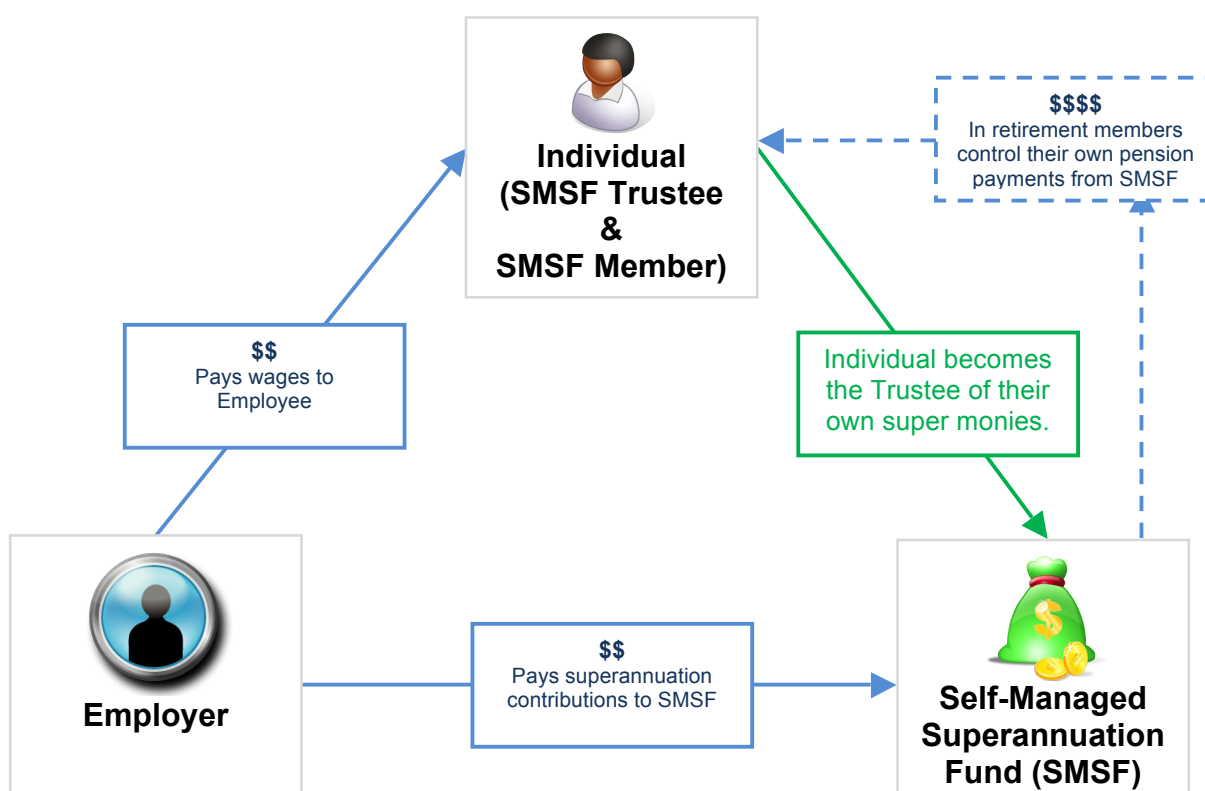
After meeting with one of our Financial Advisers, you may be surprised as to how tax effective and investment savvy it is to use an SMSF as a vehicle to help you build a property portfolio to fund your retirement.

What is a Self-Managed Superannuation Fund?

A Self-Managed Superannuation Fund (SMSF) provides an opportunity for up to four people to pool their superannuation and create their own personalised fund to manage their superannuation.

Investors who wish to purchase an investment property with their Superannuation monies will need to establish their own SMSF.

Figure A - Structure of a Self-Managed Superannuation Fund



The characteristics that differentiate a SMSF from other Superannuation structures are:

- **Limited members** - A SMSF can have between 1-4 members.
- **Trustees are also members** - All members must be trustees of the SMSF. All Trustees must be members of the SMSF. This is to ensure that all trustees have a vested interest that the assets are managed appropriately as they are the direct beneficiaries.
- **Regulated by ATO** - SMSF's are regulated by ATO – *Superannuation industry Supervision Act 1993 (Cth)*



- **Sole Purpose Test** - As Trustee of your own Superannuation Fund, you are legally responsible for ensuring your SMSF complies with superannuation legislation. The main responsibility of the Trustee is to ensure the SMSF meets the '**Sole Purpose Test**'. The 'Sole Purpose Test' stipulates that the only reason the SMSF exists is to provide the members with a pension when they retire. The Trustee or the members cannot enjoy any additional benefits such as paying themselves a fee for managing the SMSF, hiring or renting assets to family members at discounted rates or the provision of any benefit that is outside the scope of providing a pension when retired.
- **SMSF are a separate legal and tax entity** - The Trustee of a SMSF is responsible for ensuring a tax return is lodged every financial year and that the fund is audited by a qualified Auditor.

Benefits of Establishing a Self-Managed Superannuation Fund

By establishing a SMSF, you may have more flexibility and choice of investments coupled with the opportunity of better control of your superannuation benefits and management of the investment portfolio. Some of the benefits of opening your own SMSF are:

- **Control** - A SMSF will give you a greater degree of control over your superannuation investments. It affords a greater degree of investment flexibility as compared to the use of other superannuation vehicles such as master trusts.
- **Investment Choices** – A SMSF gives you the flexibility to hold direct equities within superannuation as desired. You are also able to own direct property within your SMSF by setting up a Debt Instalment Trust which allows you to gear into super to fund the purchase of the property.
- **Lower Fees** - Provided the SMSF maintains a sufficiently sized investment portfolio there is the potential for lower costs in the long term than investing through the use of public offer funds.
- **Favourable income tax structure** - Whilst you are still working, all income generated by assets inside the SMSF are taxed at 15% (If you were to own these same assets in your own name you will be taxed at your marginal tax rate which can be as high as 46.5%)
- **Favourable rate of Capital Gains Tax** - If you own assets within the Superannuation environment for more than 12 months, any capital gains will be taxed at 10% as opposed to 15% if the assets were owned for less than 12 months. (If you were to own these assets in your own name, the capital gain is added to your income from employment and then taxed at your marginal tax rate which can be as high as 46.5%)

In summary, a SMSF is merely a tax structure given favourable tax treatment to allow its members build wealth to provide tax-free income in retirement.

	<p><u>How much tax could you be paying on your personal investments?</u></p> <p>Up to 46.5% if your total income is over \$180,000 Up to 38.5% if your total income is under \$180,000 Up to 31.5% if your total income is under \$80,000 Up to 16.5% if your total income is under \$37,000</p>
	<p><u>How much tax you could be paying on your superannuation investments?</u></p> <p>15% if the assets are held in your SMSF and you are still working. 0% of your assets are held in your SMSF and you are drawing a pension.</p>



Things to Consider Before Establishing a Self-Managed Superannuation Fund.

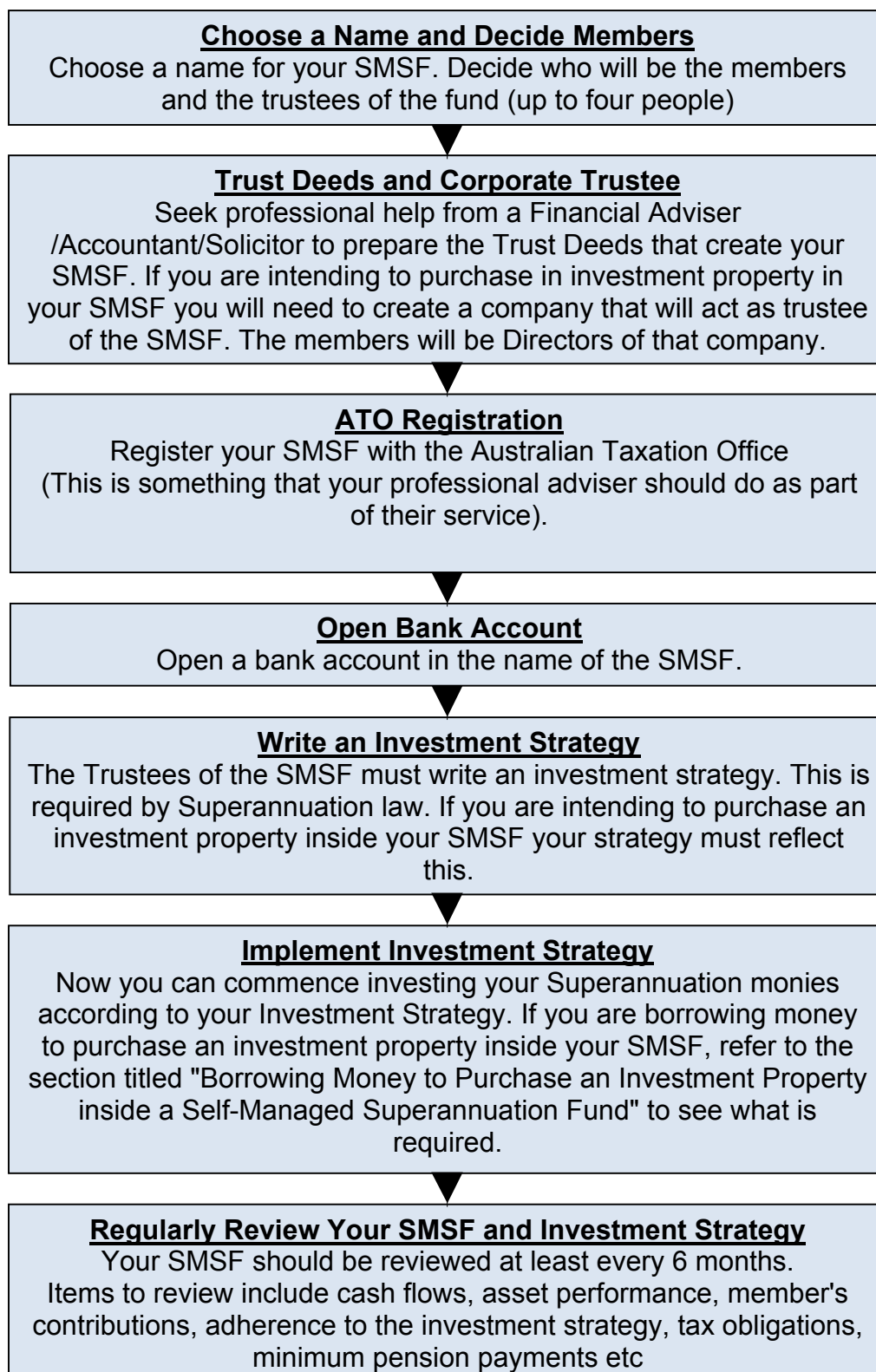
A SMSF may not suit everyone. The Australia Taxation Office has issued a detailed publication to help determine if a SMSF is appropriate for you. (Visit <http://www.ato.gov.au/superfunds/> to find out more information)

In summary, the following points need to be considered before creating your own SMSF:

- 1) Determine that a SMSF is an appropriate structure for you to manage your superannuation monies. The following aspects need to be considered:
 - a. Are you comfortable with taking legal responsibility for managing your own superannuation monies?
 - b. Do you understand how investing works?
 - c. Are the ongoing running costs of the SMSF acceptable for the amount of superannuation monies to be managed (costs of setting up the fund, accounting fees, financial adviser fees, ASIC and ATO fees)
 - d. Do you have enough superannuation to justify establishing a SMSF?
- 2) Choose if your trustee will be the members individually or will the members utilise a registered company to act as trustee where the members are the Directors of that company. (Note: If you are intending to borrow money to purchase a property inside your SMSF, many mortgage providers require that the trustee of the fund be a registered company)
- 3) Understand as Trustee what responsibilities are involved when making investment decisions for different asset/product types.
 - a. What additional legal structures are required to remain compliant with superannuation legislation when applying certain approved gearing strategies?
 - b. Do you have sufficient superannuation cash flow to support a geared property within superannuation?
 - c. Are you prepared to accept as Trustee of your SMSF the additional liability that comes with being a property landlord?

Establishing Your Own Self-Managed Superannuation Fund

Once you have decided and sought advice about whether establishing your own SMSF is appropriate for you, you can then commence the process of creating your own SMSF.



What Are the Benefits of Purchasing an Investment Property Inside a Self-Managed Superannuation Fund?

It is recommended that you consider the following points before borrowing money within your SMSF to purchase an investment property:

- **Time Horizon** - You have between 7-10+ years till retirement
- **Income and superannuation contributions** - You are earning a regular income and can afford to make additional contributions to your SMSF.
- **Superannuation balance** - You have at least \$300,000 in combined superannuation (A SMSF enables a couple to combine their superannuation monies)

The below table compares some of the benefits of owning an investment property inside a SMSF versus individual ownership.

Comparison Point	Self-Managed Superannuation Fund Property Ownership	versus	Individual Property Ownership
Tax on rent	Taxed at 15% whilst members are working. Taxed at 0% once members are retired and drawing a pension.		Taxed at marginal tax rate (up to 46.5%) regardless if members are working or are retired.
Capital Gains Tax	Taxed at 15% if asset owned for less than 12 months. Taxed at 10% if asset owned for more than 12 months. NO Capital Gains Tax payable if members are retired and drawing a pension.		Taxed at marginal tax rate (up to 46.5%) regardless if members are working or are retired.
Access to rent as a form of income.	Can only be withdrawn from the SMSF as a pension between the ages of 55-65 onwards.		Can be accessed at any time.
Use of the investment property.	Cannot be accessed for personal use by the members of the fund or any person related to the members of the fund.		Can be accessed for personal use at any time.

Deposit required	30-40%	10-20%
Cash flow	Loan repayments are made from a combination of rent, personal contributions, deductible contributions and your employer contributions.	Loan repayments are made from rent and your surplus income.
Tax effective loan repayments	<p>By making a concessional contribution to your SMSF and using that cash to repay the loan - you will have more money available post-tax to make repayments. Thus, your loan will be paid off sooner.</p> <p><u>For example:</u> Concessional Contributions are taxed at 15%. Any Concessional Contributions are then deducted from your gross salary further reducing your tax liability.</p> <p>For every dollar you contribute to superannuation you will have 85 cents after tax to make additional loan repayments.</p>	<p>All repayments on the loan are made with after-tax dollars.</p> <p>Your personal tax rate may be as high as 46.5%. After tax that leaves 53.5 cents to make any additional loan repayments.</p>

If you are operating a business, your SMSF can purchase that business property and become the landlord. This provides you with the opportunity to have your rent expense for your business acting as an income stream for your SMSF. This is tax effective for your business and provides another opportunity to build wealth with gearing property inside your SMSF.

In addition to borrowing money to buy property inside your SMSF, speak to a Financial Adviser on how you can reduce your capital gains tax liability on a business sale prior to retirement.

What Type of Property Can a Self-Managed Superannuation Fund Own?

A SMSF allows its members the freedom to control where their superannuation monies are invested. However, there are rules around what type of property a SMSF can own.

Residential Investment Properties?

YES. But with certain conditions

A member cannot transfer an existing residential investment property that they own in their own name into their SMSF.

However, a SMSF can purchase a residential investment property from a person or entity who has no connection with the SMSF.

To meet the sole purpose test, any residential investment properties must be leased or rented on an 'arms length basis' to a third person who is of no family relation to the members of the SMSF. This prohibits spouses, children, siblings, parents, grandparents, nephews and nieces, in-laws and mistresses from occupying the property that is owned by the SMSF.

Real Business Premises?

YES.

If a member of a SMSF operates a business that owns the premises in which it operates, that real business property is able to be transferred into the SMSF or purchased by the SMSF.

The business is then required under superannuation legislation to pay normal market rent to the SMSF for the use of that real business property.

Be aware that if you are transferring the property into the SMSF, there are limits on the value of assets can be transferred into a SMSF. Current legislation allows for each member to transfer up to \$450,000 as a non-concessional contribution into your SMSF. For example, if your business has two shareholders, each being Mr and Mrs, then a total property to the value of \$900,000 can be transferred into the SMSF during a 3 year period.

Principal Place of Residence (i.e. The Family Home)?

NO. Principal Residence cannot be owned by a SMSF.

Superannuation Legislation strictly prohibits a SMSF owning the family home. This would contravene the Sole Purpose Test as you would be gaining a benefit from an asset owned by the SMSF of which its "sole purpose" is to provide a retirement pension. Living rent free or paying below market rent for a home to live in may seem like a nice benefit; however, this is not permissible.

Holiday Home?

NO. A Holiday Home cannot be owned by a SMSF.

This contravenes the Sole Purpose Test. Even if you have intentions to hire out the holiday home for any amount of time and only intend to use the property for you and your family for one or two weeks a year, this will contravene the 'Sole Purpose Test' and is not permitted by superannuation legislation. The members or any relatives to a member of the SMSF cannot use the property for personal use.

Borrowing Money to Purchase an Investment Property Inside a Self-Managed Superannuation Fund.

Purchasing liquid assets such as shares, managed funds and term deposits is normally a straight-forward process within a SMSF. More care and preparation needs to be taken when borrowing money to purchase an investment property within a SMSF.

Below is a summary of some tasks and preparation that needs to be completed before you can borrow money to purchase an investment property within your SMSF.

Step 1 – Check the rules of your SMSF

All SMSF's will have a trust deed with a set of rules attached that describe how the fund can operate. Ensure your SMSF rules allow for the fund to borrow funds on a *limited recourse nature*. You may need to upgrade your trust deed.

Step 2 – Update the Investment Strategy of your SMSF

All SMSF's are required to have a written investment strategy that is approved by the members of this fund. This investment strategy will outline what assets the fund can own. Ensure your *SMSF Investment Strategy* permits the fund to hold an investment property.

Step 3 – Establish a Debt Instalment Trust

As mentioned in step 1, SMSF's can only borrow funds on a non-recourse basis. A separate trust with its own corporate trustee will need to be established outside of the SMSF. This trust shall have legal ownership over the property with the beneficial interest belonging to the SMSF. Effectively what this equates to is that the SMSF will have an agreement with the Debt Instalment Trust to receive the title deeds to the property once the debt has been paid off.

Step 4 – Obtain a Loan

When an investment property is purchased in an individual's name the individual guarantees that loan. If the investment property does not perform well and the individual sells it at a loss, the financing institution can call on other assets the individual owns to make up the short fall. This situation cannot occur within a SMSF. Superannuation legislation states that other assets owned by the SMSF cannot be called upon to cover a loss if the sale proceeds from an investment property do not cover the loan repayment. This is called a 'non-recourse loan'. Financial institutions are more stringent in lending money to a SMSF as they carry more risk.

Help from a qualified mortgage broker may assist on the following points.

- You may need to personally guarantee the loan.
- A high deposit is required to when borrowing within a SMSF. Normally around 30%-40%
- Advice on options to fix the interest on the loan or opt for a variable interest loan.
- Advice on whether the loan will allow additional repayments

Step 5 – Purchase Investment Property

It is best to seek professional advice on what will make a good investment property. Your returns on your property can be enhanced by taking into consideration the following points:

- 1) Purchase a property that is less than 2 years old to benefit from depreciation write offs.
- 2) Purchase a property in an area that has limited supply
- 3) Purchase a property that has a good rental yield

Step 6 – Appoint a Property Manager

Appointing a property manager helps to maintain an arm's length relationship with the tenant. This is a requirement made through Superannuation Legislation.

A good property manager will regularly inspect your property and conduct rent reviews when appropriate. You are investing to provide for your retirement and to get the best returns from your investment property the rent charged needs to reflect what is a fair market rate for both the landlord and the tenant.

Step 7 – Implement a Loan Repayment Plan

Utilising the following benefits of purchasing an investment property inside your SMSF will see the property loan paid off faster compared to owning the property in your own name:

- 1) Lower tax rate on rent inside super being 15%, thus leaving more rental income to help reduce the loan.
- 2) Concessional contributions (where you receive a tax benefit by only paying 15% tax) will save you from having to pay a higher rate of personal income tax and will help reduce the property loan.
- 3) Non-concessional contributions (where you contribute after tax dollars) will help to reduce the loan.
- 4) Contributions made by your employer will help reduce the loan
- 5) The lower loan-to-value-ratio inside your SMSF will help see the loan reduced sooner.

Step 8 – Pay-out Loan, Superannuation Fund gets full ownership.

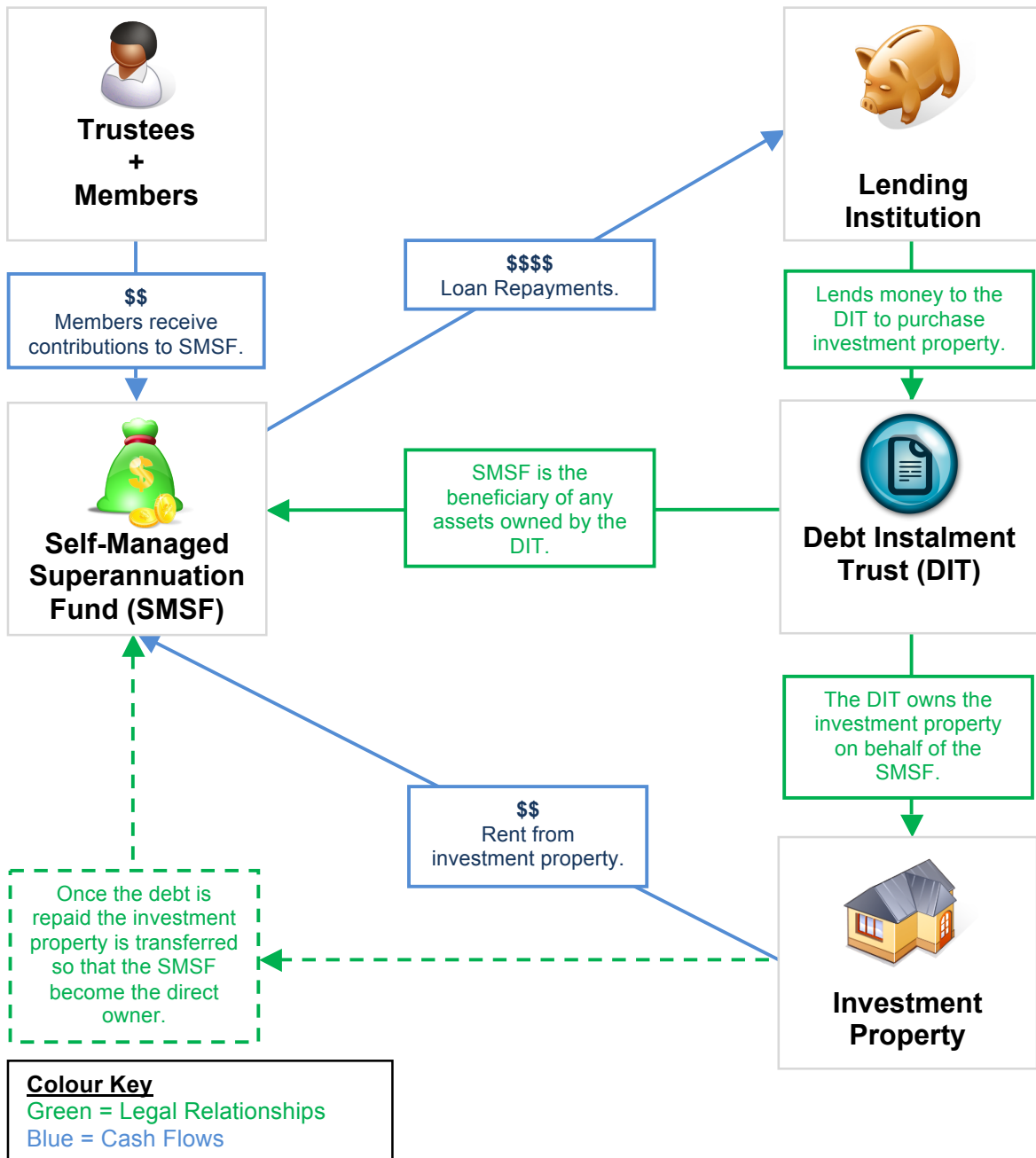
Once the loan has been repaid the legal ownership of the investment property will be moved from the Debt Instalment Trust to the direct ownership of the SMSF.

Your SMSF will then benefit from the following:

- 1) If you are still working, rent will be taxed at 15% and any capital gains if the property is sold will be taxed at 15% (or 10% if the property was owned for more than 12 months)
- 2) If you are retired and drawing a pension, rent will be tax-free and any capital gains will be tax-free as well.

Structure Used to Own Property Within a SMSF

Figure B - Structure to borrow money to buy an investment property inside your Self-Managed Superannuation Fund



After following the eight steps outlined on the previous page, you will end up with a structure that looks like the above.

In summary, there are three principles that explain the above structure:

- 1) **The loan structure** - The loan will be owned by the SMSF. What makes this loan different from a conventional loan you may take out if you are investing in your own name is that even though the investment property is lodged as security against the loan, the lending institution cannot call on other assets owned by the SMSF should the investment property perform poorly and leave the lending institution in a position where a loss is made. Hence, many lending institutions will ask the members of the SMSF to personally guarantee the loan. In the event that an investment property may be sold at a loss or there is a default on the loan, the members of the SMSF will be personally liable to provide the difference.
- 2) **The ownership structure** - The investment property will not be directly owned by the SMSF, the Debt Instalment Trust will own it. The SMSF will be the beneficiary of that trust. Once the loan is paid out, the legal ownership of the investment property can then be transferred to the SMSF to own outright. There is no stamp duty or Capital Gains Tax issues when this event takes place.
- 3) **Cash flow** – Like any investment where funds are borrowed, the income earned from the investment is used to help meet the interest and principal repayments. The benefits of purchasing an investment property within a SMSF are that your employer contributions and personal contributions can be used to help repay the loan faster and more tax effectively.

Professional Advice

Henderson Maxwell – *Financial Planning Advice*



Henderson Maxwell
PRIVATE WEALTH MANAGEMENT

Henderson Maxwell advisers are specialists in investment management, superannuation and retirement planning helping you to reach your life and financial goals sooner. You deserve a genuine financial plan to give you peace of mind and confidence in your financial future.

Henderson Maxwell are independently-owned, fee-for-service, boutique, financial planning firm that prides itself on the very best in financial strategy development and client service at a reasonable cost. We place our clients' needs first and we do not "sell product" or make money from trail commissions.

RUN Property Group – *Property Advice, Procurement and Management*

RUN was founded in 2004 by a group of people who loved property. They were property investors who were tired of the service they received from traditional real estate agencies who didn't have the systems, people or resources to deliver modern standards of service. It is this attitude to customer service that has helped RUN become Australia's largest metropolitan Real Estate agency.

We now manage over \$10 billion of property investments throughout our network of local offices in Victoria, New South Wales and Queensland.

Loan Market – *Mortgage Broker*

Insert blurb on Mortgage broker

McDermott & Associates - *Solicitors*

Insert blurb on Mortgage broker

Where to Get Help and What to Do Next?

If you like the strategies contained within this booklet consult the next step for you is to consult a Financial Adviser to confirm they are appropriate for your needs.

How do the Professional Advisers fit together?

