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# Self Managed Superannuation Funds

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# Super Funds Allowed to “Borrow”

That is the wording being used and some talk suggests super funds can borrow in the same fashion as other entities. This is not correct; there are many restrictions on the circumstances under which a super fund can “borrow”. The two most important being that the loan must be have limited recourse and that assets of the super fund cannot be used as security.

By the way the borrowing does not have to be for property it can be any other assets that a super fund is permitted to purchase.

The way the approved loans work, the super fund borrows money from the ” lender”, the lender’s only security is an asset held in trust for the benefit of the super fund. This is where the limited recourse comes in. The Lender can only recover this property if the super fund defaults. The Lender has no further right of action against the super fund’s assets.

Due to the high costs of these loans (though they get more and more competitive as time goes by) a way around this problem maybe to borrow from the bank under normal conditions and then provide the appropriate loan to your super fund yourself. In these circumstances asset held in the trust cannot be used as security for your borrowings. Another option may be to persuade the bank to offer the limited recourse loan but reduce the premium by offering your personal guarantee.

# A Summary of the Issues with SMSF Borrowings

When the laws were changed to allow superfunds to borrow (if the lenders recourse was limited to the asset the fund borrowed to purchase) there was, surprising, very few changes to the legislation. It left the field wide open, so the object of this article is to list the relevant issues.

The Must Haves – Clearly required by legislation or ATO warnings

1) An “instalment” trust must be set up to hold the new asset until it is no longer required as security
2) The asset purchased must be of the type permitted to be purchased by SMSFs ie not domestic rental properties from members or not in breach of the in house asset rules
3) The purchase must be within the scope of the investment strategy
4) The SMSF trust deed must allow borrowings in this fashion
5) The sole motive of entering into the transaction must be to provide for the retirement of the SMSF members.
6) The lender of the funds must not have access to any of the superfund’s other assets, in the event of default the lender can only take the asset held in the instalment trust.
7) If the lender is a member, the funds must be lent to the SMSF at no more than market rates.
8) If personal guarantees are given to the bank the member must sign an agreement that should the SMSF default they will not attempt to recover their out of pockets from the SMSF.

Note you must not utilise the equity in an asset held in the security trust to purchase another property.

# The Benefits:

Borrowing through your superannuation fund combines four very sought after benefits:

1) Asset protection – providing your contributions to the super fund are not out of character, your creditors cannot access your super fund’s assets in bankruptcy.
2) Negative gearing – by salary sacrificing or if you have no employer support by making tax deductible contributions to the superfund you are effectively getting a deduction for those payments at your highest marginal rate. If the property is negatively geared in the superfund it will not have to pay the 15% tax on those contributions because they will be offset against the rental property losses. This is nearly as good as if the property was in your own name for tax deduction purposes but it gets even better .....
3) Unlike, if the property was still in your name when you sell or it becomes positively geared the superfund is the one taxed on it at only 15% for the net rent and 10% for the capital gain. Or if the fund has changed to pension stage there is no tax on the net rent or capital gain.
4) You get a tax deduction for principle repayments because you get a tax deduction for the super contributions that make the principle repayments but the superfund will have to pay 15% tax on those

contributions. So if you are in the 31.5% bracket you are getting a 16.5% tax deduction for making principle repayments, still a lot better than no tax deduction if you make them in your own name.

# SMSF Auditors will be getting a lot tougher

From the 1st July, 2008 the ATO got a lot tougher on Self Managed Superannuation Funds (SMSFs). The rules are mostly the same but the penalties have increased and a lot of the discretion has been taken away from the SMSF auditor so we will have to report to the ATO what might be considered only a minor infringement. The penalties to a trustee of a SMSF are now up to $5,500 or 2 years jail for breaches as simple as not appointing an auditor at least 30 days before the SMSF's tax return is due to be lodged. An added worry here is the shortage of accountants, so don't leave it till the last minute. You can expect your auditor to dob you in too, as he or she would be risking a $5,500 fine or 6 months goal if they don't.

Here is a list of other breaches that auditors are required to report to the ATO:

- Not meeting the definition of a SMSF. The fund cannot have more than four members and they must all be trustees or directors of the trustee if it is a company. The parent of a minor member can be trustee or director for them. Trustees cannot be paid by the fund for their services and no member can employ another member unless they are family. There must be at least two trustees or a company as trustee.
- The trustee or if applicable its directors must not be disqualified from acting. Each year the trustee must make a declaration to this affect. If they do become disqualified and they are also a member of the fund then they may have to move their interest in the fund into a public fund within 6 months of becoming disqualified. A disqualified person is a person convicted of an offence involving dishonesty, a person who has been penalised regarding a SMSF, a bankrupt or under some other form of legal disability
- Documents must be provided to the auditor within 14 days of any request to do so.
- The monies and assets of the fund must be kept separate, for example not accidently deposited into a non SMSF bank account. A safe guard here would be to arrange for dividends to be automatically debited to the SMSF's bank account. As the cheque will have the name of the trustees on it, it would not be hard to mix SMSF dividend cheques up with private cheques. An unintentional error of depositing dividends in the wrong account is not reportable to the ATO if the Trustee rectifies the situation as soon as he or she becomes aware of it.

If you cannot put the asset in the name of the SMSF (which maybe as simple as the trustees names with ATF after them) and it has to be held in just the personal names of the trustees then make sure you prepare a minute declaring that the asset was purchased on behalf of the SMSF.

- All investments by the fund must have the sole purpose of providing for the members' retirement or family in the event of their death, that is why investments in works or art of jewellery are difficult to justify. Life insurance is acceptable because it provides for the member's family in the event of their death but trauma insurance, that pays a benefit on the diagnosis of a major medical problem would not fit this definition.
- Maintain an investment strategy. This is a minute the covers the fund's investment objectives, the member profile ie years till retirement, risk factors, cash flow and diversification, ideally setting out a percentage of the funds to be held in each asset class.

It is important that each year you review this statement to make sure it does not contradict the activities of the fund.

- The SMSF must not lend to members or their relatives, this includes allowing them to get behind in their rent for business premises used in the member's business. The prohibition of providing financial assistance to a member is quiet wide, the ATO have issued draft ruling SMSFR 2007/D2 with their opinion and examples.
- The SMSF must not purchase assets from members and their relatives with the exception of business real property and widely held shares. There are also concessions in the event of marriage breakdown, inhouse assets up to 5% of the funds assets and units or shares in non geared companies or trusts.
- If a member purchases an asset off the SMSF or sells one to it, the price must be at market value consideration.
- Assets held by the fund must not be mortgaged in anyway.
- Other than business real property, the fund can only invest 5% of the funds assets in items used in a members business
- Minutes must be kept
- Each new trustee must sign a declaration within 21 days of being appointed. If this is not done within at least 14 days of the 21 day deadline we are required to appoint this contravention to the ATO.
- The contributions received by the fund must be within the limits set on contributions ie work requirements, age etc.

The above list is an ATO minimum; your auditor may consider other breaches significant enough to report to the ATO. The message is: if you don't fully understand your role as trustee of your SMSF then don't make a move without consulting your accountant.

# Retirement Planning

If you are thinking that later in life you will sell off some properties to live off the proceeds or simplify your life, don't leave it so late that you can't reduce the affect of the capital gain by contributing to superannuation. The right retirement planning now means paying no tax at all by the time you reach 60 until you die. With the use of a transition to retirement pension you can also arrange your affairs so that you pay no more than 15% tax from the time you reach 55 even though you are still working.

If you are looking to pay no tax at all once you reach 60 then you need to plan to only have $21,680 in taxable income each as a member of a couple, outside of superannuation. This is the figure for 2008, it is index each year, just as your rents will increase so will that threshold. But what happens when you run out of depreciation to claim? The next trap could be that you may not be able to spend all your income. You will be forced every year to draw a minimum amount out of your pension fund. This is a percentage of the total amount in there. The percentage increases as you get older. If you don't spend all this it could earn you income and push you over the tax free threshold mentioned above. Terrible problem to have but a good reason to start out with earnings considerably under the threshold while you still have the opportunity to move funds into superannuation.

Ultimately, you will need to find some clever ways to cash in your properties without losing too much to CGT. You need to look at each of your properties and see if any of them would fit into the following tricks: Taxable Gain of less than $100,000 after the discount and owned in joint names. This is a great one to sell just after you retire if you are over 50, though if you are over 65 you will need to carefully combine the work test and having so little in wages that you qualify to claim a tax deduction for your superannuation contribution.

The Beach shack with a huge capital gain. Hopefully you have had the foresight to hold, in your rental property portfolio a little beach shack that will suit you very well for your retirement. Being by the beach will probably also mean it has heaps of capital gains tax attached to it. Never mind if it is still considered you home when you die your heirs inherit the property at the market value at your date of death. Yes, all the lurking CGT liability disappears. This means you have effectively covered both your old home and this beach house as your main residences during the time you owned your old home. Don't worry if you are living somewhere else in your later years you can rent the place out for 6 years and still have it considered your main residence when you die but if you go over the 6 years it maybe more profitable to not rent it out. You see the 6 year rule extends to an indefinite period if the property is not income producing. Now what about getting the beach house into a state suitable for your retirement? Make sure you do all the repairs to get it into just as good condition as it was in when you purchased it, while it is still a rental or at least in the same financial year that it was a rental so the cost will be fully deductible.

The house you used to live in before you updated to your current one. The last place you want your main residence to be is the property you live in because any expenses (including interest, rates, insurance, repairs and even light globes and cleaning materials) that are not claimed as a tax deduction can increase the cost base if it was purchased after 20th August, 1991. If it is a rental then those expenses would have been claimed as a tax deduction. So if you have a previous home that is now a rental see how little CGT you would have to pay if you sold it but left your main residence exemption there for 6 years after you moved out.

The family home, being classic baby boomers you probably have a house that is far too big for your needs now. If you can't use the trick above, this can usually be sold free of CGT and without reducing deductible debt ie deductions against income outside of superannuation. If you can utilize the trick above still do the sums on this option after claiming all the holding costs while you lived there the CGT maybe minimal. It's not just the costs while it wasn't covered by your main residence exemption that increase your cost base it is the costs for the whole time you lived there.

Pre CGT property Note if your home is pre CGT make sure you leave your main residence elsewhere if you have ever lived in any of your other properties. A Pre CGT property is the best one to sell later in life (maybe the nursing home nest egg) as your death will mean it loses its pre 1985 status anyway so you have made the most you can of it and as the proceeds will be tax free you don't have to worry that you are too old to put them into super.

Consider changing the property to commercial. This is something to do while you are still able to contribute to superannuation. You see a property that is used solely in a business can be transferred into your superannuation fund. Superannuation law does not specify that it be a commercial building though you would probably be in a bit of bother if the business isn't legally allowed to operate there. A change of use to home occupation won't cut it because you would have to live there as well which would mean it wasn't solely used for business. The business does not have to be your own business and it can be any type. For example professional rooms which domestic properties easily adapt to. Just remember that transferring the property into your SMSF will still create a CGT liability for you and if you put some of the proceed of the sale into the superannuation fund to help it pay for the purchase the fund will pay 15% tax on them if you claim the contribution as a tax deduction.

Hopefully that is enough to get all your retirement savings exactly where you need them at minimal tax. Don't feel mean leaving the CGT to your children. They are only going to pay it if they sell the property and then there are some strategies they can also implement. For example to get the small business CGT concessions which can reduce the CGT to zero an asset has to be used in a business for 7.5 years or half the time it is owned. Leave the high CGT property to a child in business. They can use it in their business and as long as they qualify as a small business and have used the property in the business for half the time they (not you) own it they could eliminate the CGT completely.

You have to get financial planning advice to get these ideas to work at their best for your circumstances. This is just intended to get you thinking and maybe dreaming.

# SMSF Purchasing Your Rental Property

BAN TACS is getting quiet a reputation for coming up with tax solutions that are thinking outside of the box. But we have to give some credit to our imaginative clients. This one was all her idea we just had to check up on the legislation.

The client has a home that is also her place of business but it looks like a normal home on the outside. She would like to get this property across into her SMSF because she wants to live elsewhere but is happy for the business to continue operating from the house. Her question was if the business is operating from there is it business real property which qualifies for the exception under section 66(2) which will allow the SMSF to purchase it from its members. The answer is yes! She was talking about changing the zoning etc but the legislation makes not mention of commercial zoning being necessary, though on the other hand it may interfere with the argument that a business is being carried on in the premises if it is not permitted by council to do so. The property must be exclusively used in a business (not necessarily the business of the owner) so this means she would have to move out and use the whole property in the business. This also means that a simple home occupation right with council will not suffice because it would be conditional upon the owner living there.

The relevant of the Superannuation Industry Supervision Act 1993 are:

> Section 66(2) (b) if the fund is a superannuation fund with fewer than 5 members – the asset is business real property of the related party acquired at market value.
>
> Section 66(5) Business Real Property (a) any freehold or lease hold interest of the entity in real property or (b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer... Where the real property is used wholly and exclusively in one or more businesses.
>
> > Business includes any profession, trade, employment vocation or calling carried on for the purpose of profit including:
> >
> > (a) The carrying on of primary production; and
> >
> > (b) The provision of professional services
> >
> > But does not include occupation as an employee

Of course such an investment needs to be within the fund's investment strategy.

# SMSF Audit Hot Spots

There have been changes in the laws regarding Self Managed Superannuation Funds. Particularly alarming are the new penalty provisions for example we could be fined $5,500 or face 6 months imprisonment if we don't lodge the audit report on time, so please get your work in early this year.

As trustee of your SMSF you also risk a $5,500 fine or 2 years jail if you do not appoint an auditor at least 30 days before the report is due, the due date is the date the SMSF's tax return is due to be lodged. Worse still we are compelled to report you to the ATO for this contravention. In fact the list of reportable contraventions has increase considerably; it now includes a duty of the trustees to keep minutes. Each new trustee must sign a declaration within 21 days of being appointed. If this is not done within at least 14 days of the 21 day deadline we are required to report this contravention to the ATO.

Further if we request information from you and do not receive it within 14 days this is also a reportable contravention. To help keep this area tidy here is a list of the sort of material we need to perform an audit:

- The minutes, original banks statements, dividend notices, share transaction documents and rates notices
- The trust deed and investment strategy
- A declaration from the trustees that they are not disqualified from holding office, that there are no related party transactions and no charges have been made over the fund's assets
- If the portfolio includes properties, each year you need to inform us of the market value of each property and the market rent.

# CGT Cap Amount

Please note the amounts quoted in this article are now out of date and change regularly but the concept is still well worth knowing about. As always make sure you get personal financial advice before you act on anything we write.

Readers are probably aware that they can only contribute $150,000 per year into super as an undeducted contribution (ie a contribution they or their employer have not claimed a tax deduction for), though there is a concession that $450,000 can be contributed in 1 year providing nothing is contributed for the next 2 years. This $150,000 limit does not apply to CGT concessional amounts. That is the 15 year CGT exemption and the retirement exemption amounts. These amounts are tax free to the business owner and are not taxed in the hands of the super fund. The retirement exemption is limited to $500,000 in a life time. The total amount of CGT concessional amounts that can be exempted in a life time has just been increased, for 2008/09 to $1,045,000. This means with careful planning you could transfer another $545,000 into super via the 15 year concession on top of the $500,000 allowed under the retirement exemption. The 15 year exemption applies to assets that have been active in a business and owned for 15 years or more.

To maximize this strategy, it is important that the 15 year exemption is used whenever possible. Certainly, the law requires the 15 year exemption to be used rather than any other exemption whenever it is applicable. What we are suggesting is if the 15 years is getting close don't think it doesn't matter I will use the retirement exemption instead. It may be worth waiting to utilize the 15 years as you may need to use the $500,000 exemption later. Note the $500,000 life time retirement exemption limit is not indexed each year but the $1,045,000 total life time CGT concession for deposits to super is so the amount you can transfer into super from the 15 year exemption will continue to grow.

Another tactic, if you are not required to put the CGT concessional amount into super, is take $150,000 of it as a tax free payment and then contribute it to super fund as a normal undeducted contribution, using up that years threshold without affecting your life time limits. You can even take this one step further and call forward your undeducted contribution limit the following two years as discussed above.

Note if an active asset in a business is pre CGT it also qualifies to be put into a super fund without affecting the $150,000 annual cap but will count towards the $1,045,000 life time cap.

This is a complex issue that needs professional advice, the main point for readers to consider is that electing to put a capital gain that was exempted under the 15 year or retirement exemption into a super fund classed as that is a last resort if you have already used up your annual $150,000 undeducted limit because it will affect your life time limit. Though in most cases you will be forced to deposit as a CGT concessional contribution to qualify for the CGT concession in the first place, for example if you want to use the retirement exemption and you are under 55 years of age. And consider before you sell whether it may be worth holding out for the 15 years.

# The Numbers for a SMSF with an Investment Property

Borrowing in your Self Managed Superannuation Fund allows you to combine three very important goals, tax effectiveness, asset protection and leverage. The tax effectiveness allows you all the normal advantages of negative gearing but when the property becomes positively geared it will be taxed at a maximum of 15% or zero if you have reached pension stage. Capital gains will be taxed at a maximum of 10% (providing the asset has been held for more than 12 months) or zero if you have reached pension stage. If that wasn't enough in itself the asset protection provided by a superannuation fund is arguably better than even that provided by a discretionary trust (which is now under a cloud since Richstar's case). Providing you have not made an unusually large superannuation contribution to avoid creditors your creditors are not entitled to touch your superannuation savings. The only area that SMSFs lack is leverage, now that they are able to borrow there is some leverage available, the only trouble is that the asset can only be borrowed against once. You can refinance but not to draw more equity out of that asset and once the original borrowings are repaid the asset belongs to the superannuation fund which still cannot borrow against any asset it owns.

To explain how the tax effectiveness works here is an example:

**Super Fund Tax Return:**

| | | |
|---|---|---|
| Rental Income | | $30,000 |
| Superannuation Contribution | | 10,000 |
| | | $40,000 |
| *Less Expenses* | | |
| Interest | $30,000 | |
| Rates etc | 5,000 | |
| Depreciation | 5,000 | $40,000 |
| **Super Fund Taxable Income** | | **$ 0.00** |

Note this is the loss that would appear in the personal tax return if direct ownership, so same taxable income

So no contributions tax payable on the $10,000

The cash flow effect of the above is a spare $5,000 sitting in the superannuation fund, which could be used to make capital repayments. Further capital repayments can be funded by deductible superannuation contributions but these will be taxed at 15%. Nevertheless, this is much better than the person's marginal tax rate outside of super.

If the property becomes positively geared before you reach retirement, the applicable tax rate will only be 15% on net rental income and only 10% on capital gains.

Add all this to tax free income and capital gains and pensions once you reach 60 plus the asset protection of a superannuation fund it is very attractive option. Providing your contributions to the super fund are not out of character, your creditors cannot access your super fund's assets in bankruptcy.

The downsides are the lack of liquidity because you cannot borrow against a property once (ie release the equity) and bank charges and interest rates are higher.

There are many restrictions on the circumstances under which a super fund can "borrow". The two most important being that the loan must be have limited recourse and that assets of the super fund cannot be used as security.

ID 2010/169 **s**tates that a limited recourse loan can be refinanced with another bank, even if it means changing the holding trust, providing it is simply a replacement loan i.e. no extra borrowings.

Though if the new bank does want a new holding trust deed make sure the stamp duties office in your state recognises that the beneficial ownership of the property has not changed so stamp duty will not apply. The refinancing must serve no other purpose so it cannot in anyway assist with the purchase of another asset.

The way the approved loans work is that the lender's only security is the new property, super funds are still not permitted to mortgage their assets. The new property is held in a bare trust for the benefit of the super fund. This is where the limited recourse comes in.

The Lender can only recover this property if the super fund defaults. The Lender has no further right of action against the super fund's assets. So the Lender is going to want the super fund to come up with quiet a large deposit for the asset held in the trust and probably charge a higher than normal interest rate. Once the final instalment on the loan has been made the asset is transferred to the super fund.

It is important that the trust that initially holds the property is a bare trust. Section 106-50 of the CGT Act states that if an asset is held for the benefit of just one beneficiary who can at anytime instruct the trustee to transfer the asset to them then the asset was always an asset of the beneficiary (in this case the super fund) so it is not a CGT event when the asset transfers.

Don't go overboard on this strategy, remember if you are under 50 years of age you can only make $25,000 worth of deductible superannuation contributions a year. Even if you are 50 or over, so qualify for the $50,000 per year, this is only available if your superannuation balance is less than $500,000) and your investments could stay negative for longer than that yet experience enough capital growth to exceed the $500,000 threshold.

# SMSF - Investment Strategy Document

Auditors of Self Managed Superannuation Funds (SMSFs) will, from the 1st July, 2008, be required to report the SMSF to the ATO if they have not maintained an investment strategy. This is a minute that must cover all of the following:

**The fund's investment objectives** – ie the return required to achieve long term goals, income versus capital growth etc
**Each member's profile** – ie years till retirement, expected future contributions, size of fund etc
**Risk factors** – What is an acceptable risk for a higher return?
**Cash flow** – Restricting the money available to invest considering the need to pay benefits in near future and bills as they become due.
**Diversification** – Ideally setting out a percentage of the funds to be held in each asset class. Though there is no actual prohibition to investing in just one class.

It is important that each year you review this statement to make sure it does not contradict the activities of the fund.

# Superannuation of Temporary Residents

Superannuation funds holding superannuation for temporary residents will still be required to transfer the funds across to the Government but not until 6 months after the temporary resident's visa has expired. In the meantime the temporary resident can withdraw their superannuation after leaving the country. Further they will continue to be covered by any life insurance in the policy until it is transferred to the Government.

Temporary residents who do not claim back their superannuation before it is transferred to the Government can later claim it back from the government.

Superannuation funds will no longer be required to transfer the funds across every 12 months while the temporary resident is still in Australia so this will also help maintain any life insurance premiums.

# SMSF Using "Instalment Warrants" to Buy Shares or Units

The new rules allowing superannuation funds to borrow actually describe the sort of loan that is caught by Division 247. Fortunately, division 247 does not apply to rental properties but it does apply to non recourse loans to purchase shares or unit in a trust. The basic concept is if the interest rate charged is higher than "normal" because the lender takes the risk of the asset decreasing in value. In a limited or non recourse loan the borrower can default and the lender can only take the asset given as security. If this cannot be sold for enough to cover the original loan that is the lender's problem, not the borrowers.

The ATO is of the opinion that the premium interest charged is a fee for guaranteeing the capital return on the investment, therefore it is capital in nature and not tax deductible. This hasn't caused many problems to date because the ATO has only considered a premium to be charged when the interest rate exceeds that for personal unsecured loans. This is about to change to the interest rate for standard housing loans. So any borrowings at a rate higher than the standard housing rate, where shares or units are purchased and the lender has no recourse beyond the value of the assets given as security, will be caught and the interest not fully tax deductible. This applies retrospectively to arrangements entered into after budget night, 13th May, 2008.

# When You Can Claim Super, Has Changed

A little realised trap created by the changes to superannuation means that people who have only a small wages income say less than $450 or because you are under 18 and work less than 30 hours a week or you are over 70. Note from 1st July, 2007 you may (subject to all the normal limitations) qualify for a tax deduction for superannuation contributions you make if they are made before 28 days after your 75th birthday.

Can still not claim their superannuation contributions unless they satisfy the 10% rule. This is due to a change in the wording of the legislation so just because you could claim last year doesn't mean you will be able to this year.

For example if you are on a low wages income of less than $450 per month but have, say, a $35,000 capital gain you cannot get a tax deduction for any money you put into superannuation even though your employer is not required to contribute for you, because more than 10% of your income is from wages, even though those wages do not attract employer superannuation contributions. The best you can do in this situation is to ask your employer to salary sacrifice your earnings into superannuation.

# SMSFs and Property

With the major banks now lending to superannuation funds and the growing frustration with the performance of public funds that cannot invest directly in houses, now is the time to find out a bit more about self managed superannuation.

Self Managed Superannuation Funds (SMSFs) have always been able to purchase property, if it is in accordance with their investment strategy, but not many of them could afford to because until September 2007 they could not borrow. They can now borrow through non recourse loans.

The exciting thing is that they can provide much better asset protection and tax benefits than holding a negative geared property in your own name. Here is how it works.

Providing you do not make an unusually large contribution to defeat creditors the bankruptcy trustee cannot touch your superannuation. In my opinion it does not get better than that. Generally, asset protection means not holding a property in your own name, which usually means that the negative gearing benefits cannot be offset against your income. Certainly a loss in a SMSF cannot be deducted in your personal tax return but a contribution to a SMSF can usually be deducted in your return or if you are a wage earner you can utilise salary sacrificing to reduce your taxable income before it even reaches your tax return. For example, the super fund may have a rental property that is generating a $10,000 loss, this means if you contribute $10,000 in deductible super contributions to the fund it will not even have to pay the 15% contributions tax on that money and you or your employer will get a full tax deduction for the amount so it is as good as claiming the rental loss in your own return with the added advantage of asset protection. If you make enough superannuation contributions for the fund to be able to pay principle off the loan then the principle repayments are effectively taxed at 15% rather than your marginal rate if the property was held in your name. If you have some non cash flow deductions such as depreciation the 15% contributions tax won't even apply to your principle repayments.

It gets even better than this. The ultimate for a property investor is to get the deductions while their other income is high but reduce the tax on the capital gain. If the property is owned in a SMSF then any capital gain is taxed at a maximum of 10%. If you wait until you are 60 and it is in pension stage the tax rate is zero to the super fund and zero to you when you withdraw it from your fund.

And there is even more! A SMSF is not subject to land tax in Qld until the unimproved value of its freehold land holdings exceeds $350,000, as at 30th June, 2008.

# SMSFs And 5% In-house Asset Limit

Other than commercial real estate used in the members' business, SMSF cannot hold more than 5% of its assets in in-house assets. For example equipment it might lease to the business. This calculation is done each accounting period based on the market value of all the fund's assets. This can be a bit of a problem if the fund's assets have decreased dramatically due to the global financial crisis.

Exceeding the in-house asset limit is a serious offence and can lead to a SMSF being declared non complying. Fortunately you have 12 months to fix the problem. All you will have to do to keep your auditor happy is have a strategy in place that will correct the problem within 12 months. It is best to document this with a minute. Strategies can include reducing the amount of funds the SMSF has tied up in in-house assets and making contributions to the SMSF that are sufficient to bring the ratio back to 5%

# Column by Noel Whittaker

The Federal budget is now a distant memory but it included substantial changes to the superannuation system and the aged pension system. In a column prior to the budget I mentioned that changes to the transition to retirement pensions TTRs were a possibility and advised anyone eligible to start one and who could benefit from doing so to seek advice.

They were not mentioned in the budget so on the surface they appear to be left alone. But, as usual, the devil is in the detail. You see, TTRs can only give you large tax savings if you can salary sacrifice a hefty amount to super. Also, they work best for high income earners because they take advantage of the difference between the 15% tax on contributions to super and income tax of at least 41.5% on money taken in your pay packet.

Think about a person aged 55 earning $180,000 a year. Under the present system they could salary sacrifice $100,000 to super and lose just $15,000 in tax. However, the maximum that can be contributed by people aged 50 or over from 1 July 2009 is $50,000 and from 1 July 2012 just $25,000. A person on $180,000 a year would already be receiving $16,200 from the compulsory employer 9% contribution and so would have just $8,800 left that was able to be salary sacrificed at the 15% rate.

Despite the changes TTRs are still a useful strategy and anyone aged 55 or over should seek advice to see whether starting one is appropriate for their own situation. However, it is important to understand their benefits will be somewhat reduced from 1 July 2009 and substantially reduced from 1 July 2012.

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Noel Whittaker is a director of Whittaker Macnaught, a division of St Andrew's Australia. This advice is general in nature and readers should seek their own expert advice before making financial decisions. Noel's e-mail address is noelwhit@gmail.com
David Thompson & Julie Lockeridge from Whittaker Macnaught are regularly available to see clients in our office

# SMSFs Investment Strategy Update

Self Managed Superannuation Funds (SMSFs) are required to keep an up to date investment strategy and follow it. If the investment strategy does not comply the ATO, in extreme cases, could claim the fund is not complying and tax it at 46.5%.

Many investment strategies state the expected return on an investment. If this applies to your investment strategy, this may not be possible in the current financial climate. Nevertheless, you may want to continue to hold your current investments in anticipation of a recovery. It is important that you create a minute evaluating your position and documenting the change in strategy.

# SMSF Rulings

**SMSFR 2009/3** states the ATO considers that a SMSF may have contravened the inhouse asset rules, arm's length rules and sole purpose test if it is entitled to a distributions from a related trust but the distribution is not promptly paid across to the SMSF.

The distribution maybe considered not paid across to the SMSF if it is not paid within a month of the lodgement of the relevant trust tax return.

# Reportable Superannuation Contributions

Reportable super contributions are going to be included as part of your income for the following:

- the Medicare levy surcharge threshold calculation
- the Medicare levy surcharge (lump sum payment in arrears) tax offset
- all dependent tax offsets
- the senior Australian tax offset
- the pensioner tax offset
- the Higher Education Loan Programme and Student Financial Supplement Scheme repayments.

Before a superannuation contribution can even be consider reportable it must have been claimed as a tax deduction either by you or your employer.

Any superannuation contributions you make for yourself that you qualify for a tax deduction for, will be added back to your income when the definition of income for that particular threshold includes reportable benefits.

If you are an employee your reportable superannuation contributions will be any your employer makes for you over and above the following:

- The 9% required under the guarantee
- An amount required to be paid by an industrial agreement
- Required by the trust deed or governing rules of a super fund
- Required by a federal, state or territory law

In other words if you salary sacrifice into super it will now be a reportable superannuation contribution.

Note this only applies from1st July, 2009 so will not flow through for a while yet but employers may need to adjust their record keeping to have the necessary information available when they prepare next year's PAYG summary.

Taxpayers that qualify to claim a tax deduction in their personal tax return (generally self employed or retirees under 75 years of age) will also have that deduction added back to their income in a similar way to the reportable super amount for an employee. There is no concession for the 9% guarantee etc but on the other hand their personal contributions will not be added back when testing the thresholds for:

- the mature age worker tax offset
- the spouse super contributions tax offset
- super co-contributions
- deductions for personal super contributions.

If you are a Centrelink customer, your reportable super contributions will be included in your income to work out if you are eligible to receive certain Centrelink benefits.

# SMSFs - What They Can Own

You may think you are missing out on something because you have a friend who is using his or her SMSF to buy something they are also getting a benefit from. There is a lot of it going around. The money held in superannuation must be solely used to provide for the members retirement or their dependants in the event of their death. This is called the sole purpose test. Paragraph 15 of SMSFR 2008/2 states:

> "Investments consisting of collectables and other boutique items such as works of art, antiques, jewellery, classic cars and wine, pose particular issues in relation to the application of the sole purpose test. These kinds of assets lend themselves to personal enjoyment and therefore can involve significant current day benefits being derived by those using or accessing the asset. Trustees should be in a position to show (for example, by reference to independent expert opinion) how acquiring assets of this kind involves a reasonable investment for the SMSF."

A member cannot enjoy the benefit of an asset held in a superannuation fund. This means he or she cannot use the assets held for investment. In the case of paintings and antiques they cannot be stored in their home. In the case of holiday houses they should not even stay there for one night. SMSFR 2008/2 in example 4, paragraphs 37 to 40 make it clear that it is ok for the sole purpose test if the property is vacant and market rent is paid. The problem is once there is some private use of the asset the full value of the asset is considered to be an inhouse asset. So it is not the sole purpose test that is the problem. SMSFs are only permitted to hold 5% of their assets as inhouse assets. It is not the market value of a night's accommodation that is considered an inhouse asset it is the full value of the property so you would need to have a lot of assets in your superannuation fund before the value of the holiday home would be less than 5% of the funds assets.

# Income Insurance Through Superannuation

Certainly if you can't afford income insurance outside of superannuation then this may be the way to use your 9% employer contribution to pay for it. Note superannuation funds have very tight controls over releasing money before a member reaches preservation age (55 years at a minimum). So I asked our broker if income insurance held within a superannuation fund provided the same level of cover as that outside of superannuation considering the restrictions on super funds making payments to members under 55. Please don't confuse this analysis with holding your life insurance within your superannuation fund as death overcomes the preservation restrictions and if the benefit is paid to a spouse or dependant child then it is tax free. If you wish to leave your death benefit to someone other than this it is important that you get advice on whether your life insurance is better held outside of your superannuation fund.

Now back to income insurance. Tony Townsend of Townsend Insurance Services (contact phone number 07 5491 8977 ) has very kindly provided the following in-depth and frank explanation of the important issues.

The claim process is the same as if you held the policy in your own name. Benefits are able to be released from the super fund to the member as a condition of release is met under the "Temporary incapacity" release condition. The member receives the benefit as a gross amount and is taxed at their marginal rate (same as if it was held outside of super). Holding income protection via super also meets the sole purpose test in the Act under the ancillary purpose. The only disadvantage with holding income protection via super is that the features and definitions of the policy become a little more restrictive. For example ancillary benefits like immediate payments during the waiting periods may not be able to be released from the super fund as they may not meet a condition of release. Therefore the policy is normally very basic covering the client for total and partial disability. There is also normally some requirement for the client to be totally disabled during the waiting period to meet the "Temporary Incapacity" release condition. For example if you have a 30 day waiting period, the policy may say that during the 30 days you have to at least be totally off work for 14 consecutive days and then be disabled beyond the 30 days to receive a benefit. This would ensure that release conditions are met and SIS regulations. Policies outside of super can be more flexible where a 30 day waiting period would still apply but there would be no requirement to be formally off work during the waiting period which provides greater flexibility for the client to move in and out of work if need be. Importantly if structuring via a SMSF the trust deed needs to be checked and possibly amended to ensure income protection benefits can be release from the fund.

# ATO SMSF Rulings

The following are Interpretive Decisions (ID) from the ATO that were released at the end of September. It is important to bear in mind that IDs are only binding on the ATO to the extent that they will not fine you or charge you interest if the ID is similar to your circumstances and you follow it in good faith, but the ATO decide the ID was wrong. Nevertheless they will still charge you missed tax.

These ruling relate to the SMSF borrowings, which are now permitted providing the loan is of limited recourse.

**ID 2010/169**

States that a limited recourse loan can be refinanced with another bank, even if it means changing the holding trust, providing it is simply a replacement loan ie no extra borrowings. Though if the new bank does want a new holding trust deed make sure the stamp duties office in your state recognises that the beneficial ownership of the property has not changed so stamp duty will not apply. The refinancing must serve no other purpose so it cannot in anyway assist with the purchase of another asset.

**ID 2010/170**

Covers the giving of personal guarantees by the members of the fund. There was concern that as the members would have a right to recover from the SMSF any money they were forced to pay to the lender in the event of default, then the loan was not really limited recourse because the SMSFs other assets were effectively at risk. The law in this regard changed on 7th July, 2010. This ID states that the limited recourse is intended only to protect the SMSF's assets so, providing the terms of the guarantee strictly prohibit the members from recovering their losses from the SMSF, it is acceptable for them to give guarantees. This is a great relief considering many of the major banks require these guarantees. What is important now is to make sure that as part of their arrangement members who have given guarantees on or after 7th July, 2010 have entered into an agreement that they are not entitled to recover their loss from the SMSF.

**ID 2010/172**

Refers to two SMSFs borrowing together to purchase a property. This was not allowed because the property in the holding trust must be held solely for the benefit of the SMSF. Though the ruling doesn't address the issue it also does not rule out the possibility of the SMSFs borrowing separately to purchase the property as tenants in common and each holding trust just covering its SMSF share under the tenants in common title.

# Buying a Property in a Trust to Later Transfer to SMSF

The only property that a SMSF can buy off its members or their associates is business real property. This is a property that is used solely in a business (not necessarily the business of the member) though it could resemble residential property just as long as it is solely used for business.

The term associate is far reaching, in section 70 of the SIS Act, it includes entities that you control or would be expected to act in your interest. There is even an anti avoidance provision in section 66(3) to prevent you selling to an entity and then the SMSF buying from that entity. So don't let anyone talk you into buying a property in a trust so that later you can sell it to your SMSF.

# Capitalising Interest in a SMSF

Generally a SMSF can only borrow against an asset once. This means a SMSF lacks leverage because it is very difficult to borrow against the increased value of the asset.

The recent changes to the SMSF borrowing laws has left a small window of opportunity here. Section 67A(1) of the SIS Act allows for the original borrowings on the property to be refinanced but then in an attempt to limit exploitation of this provision it states:

> **(ii)** money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and

This means that you could stop paying the interest on the loan, if the bank would let you, and save the cash for a deposit on another property, then refinance the original loan and the unpaid interest.

# Did You Claim a Deduction For Superannuation Last Year?

Section 290-170(1)(b) ITAA has, since 2007, set the end of the following financial year as the deadline to notify your superannuation fund that you are claiming your superannuation contribution as a tax deduction. Further you must have advised the fund before you lodge your tax return so it really should be notified well before the end of the next financial year anyway.

The trap here is even if you don't lodge your 2010 tax return on time you must advise the superannuation fund, before 30th June 2011 that you intend to claim the contribution as a deduction, or you will simply not be entitled to that tax deduction.

The ATO has no discretion to extend this time. No matter how good your excuse you simply cannot go beyond the end of the next financial year. If you miss the deadline the contribution will be treated as an undeducted contribution so at least it won't be taxed in the hands of the superannuation fund but it is locked away until you retire.

# Capital Protected Borrowings

After the Global Financial Crisis capital protected borrowings may look pretty attractive to you. This is where you borrow to invest in shares but the bank guarantees that if at the end of the term the shares are worth less than the amount you borrowed then you don't have to make up the difference you can walk away from the investment at the end of the term with no shares and nothing more to pay. On the other hand if the investment grows then you can sell the shares, pay off the loan and walk away with your profit. Naturally enough the banks will charge you a much higher interest rate on the loan because they consider themselves to be assuming a much higher risk or for the sceptics, because they think they can get away with it.

The ATO deems a portion of the interest not to be tax deductible because it is really not interest but a payment for protecting the capital portion of your investment. The undeductible portion of the interest will be included in your cost base when you calculate the CGT on the sale of the shares. If you choose to take advantage of the capital protection and not take the shares at the end of the loan term then the portion of the interest that applies to the capital protection creates a capital loss you offset against a current capital gain or carry forward.

The area of contention is what portion of the "interest" is deductible. Initially it was the amount above the RBA's rate for personal unsecured loans. There is currently a bill before Parliament to change this to 1 percent above the housing loan interest rate and it will be backdated to cover any of these types of borrowings that were entered into after 13th May, 2008. So if you have a post 13th May, 2008 capital protected loan you may need to amend your previous tax returns unless you took the proposed legislation into account when originally lodging them. The ATO has undertaken that penalties will not apply or interest charged when these amendment results in a tax bill. It is not unusual for the personal loan rate to be twice the housing loan rate or more so it could now halve taxpayers' deductions. The proposed legislation will only require taxpayers to amend back 2 years from the date the bill receives Royal Assent.

Note the limited recourse loans required for a superannuation fund to be able to borrow to invest, are effectively capital protected borrowings. Fortunately, capital protected borrowings for real estate are not caught under these provisions so the amount of deductible interest on limited recourse loans in superannuation funds is not restricted when the borrowings are for property but the above would apply to restrict the deduction to the superannuation fund for the interest limited recourse borrowings for shares.

Now if that isn't enough to put you off capital protected borrowings consider how they work. Generally the term of the borrowing would be for 5 years. Regardless of which way the shares go you have to pay interest for that whole 5 years. As you can imagine the chances of the shares being worth less in 5 years time is very slim, in fact I challenge you to find a point in history when that was the case.

Margin loan interest is fully deductible and is usually a lower rate than capital protected loans. With the added advantage that if at any time during the 5 years you find you can no longer afford the investment at least you can sell up and pay down the loan, leaving you at worst a much smaller loan repayment. Further, capital protected loans are a more suitable investment for when the market is high and you are worried it might not go any higher. Capital growth within 5 years of a low market is virtually unavoidable.

Another trap with some of these arrangements is that if the shares go down in value the bank has a right to sell them off rather than continue to be exposed to further drops. Just because your shares are now sold and now have no chance of ever seeing the future gains they may make, you still have to pay the interest on the loan until the 5 years has expired.

# More Bullying By The ATO

The ATO penalised a taxpayer $10,000 for not notifying his superannuation fund that he intended to claim a tax deduction for his superannuation contribution. Fortunately the taxpayer could afford to fight the ATO in the AAT and won (Byron Johnston v Commissioner of Taxation). The $10,000 penalty was remitted but of course the superannuation contribution was still not deductible because of section 290-170(1)(b) . .

The following comments by the member of the AAT, S E Frost show that he considered it unfair that the ATO could mislead the taxpayer and then fine him $10,000 so he remitted the penalty.

**Mr Johnston could hardly be blamed for not being aware that he had to provide a "notice of intent to claim a deduction" to his superannuation fund. He is not a superannuation expert or a taxation expert, and the requirement for a "notice of intent" is not particularly well highlighted in the public material dealing with the tax treatment of superannuation contributions. Mr Johnston's research, undertaken around the time of the then Government's announcement in late 2006 and early 2007 of the so-called "simpler super" proposals, uncovered the deduction limits for a person his age but did not alert him to any additional administrative requirements for deductions to be allowable. In my view, the inclusion of the deduction claim in his 2008 tax return is not attributable to any extent to a failure on Mr Johnston's part to take reasonable care to comply with a taxation law.**

# SMSF Losing Tax Free Pension Status

Draft ATO ruling TR 2011/D3 is causing concern for retirees with large potential capital gains locked away in their superannuation fund.

Once you reach 60 years of age and retire or 55 years of age and take a transition to retirement pension, your SMSF does not have to pay tax on its income or capital gain. This remains the case while there is a member entitled to receive a pension. When the pensioner dies, if they do not have a spouse that is prepared to and qualifies for a revisionary pension then at the date of death the fund is no longer in pension phase. The ruling is intended to apply this back as far as 1st July, 2007.

What this means is that if an asset was sold before death no CGT would have been payable, yet if sold to pay out your heirs the fund will have to pay tax on the gain. The ATO appears to be exploiting the letter of the law and it is unlikely the legislators intended such a consequence. Let's hope that there is enough pressure brought on the government to clarify this issue in the law.

In the meantime it is worth considering liquidating the assets you have in the fund when you reach pension stage. Once you have triggered the CGT event while capital gains are tax free ie the fund is in pension stage, you can then reinvest the money. Future capital gains will of course still be exposed but at least you now have a much higher cost base and you could consider utilising this strategy on a regular basis. The problem is if the SMSF holds property, the transaction costs to buy and sell will probably exceed the tax savings. Unfortunately, the most common benefit of having your own SMSF is to be able to own direct property.

While you are liquidating assets it would be worth considering a recontribution strategy to ensure that there will be no taxable income when your superannuation is paid to your adult children. This involves drawing your superannuation out of the fund tax free then re contributing it back to the fund as an undeducted contribution. When undeducted contributions are paid to your heirs they are not taxable. A recontribution strategy needs financial planning advice.

# SMSF Borrowing – New Draft Ruling

On the 14th September 2011 the ATO released draft ruling SMSFR 2011/D1 which we are predicting will go through to finalisation without any significant changes. The points it makes can be split into five distinct areas:

1) Borrowing to do work on a property – The only time a Super Fund can borrow to perform work on a property is when that property is still held in a bare trust, under a limited recourse loan and the money is only used to repair or maintain the property. Though it is important to note here that unlike the definition of repairs for income tax purposes. In this case a repair to a property can take it beyond the condition it was in when purchased and restore it to its as new state. Under no circumstances can a super fund borrow to improve a property.
2) Making changes to a property - If a property is security for a limited recourse borrowing then it must remain in basically the same state for the period it is security. For example if it is a 4 bedroom home which burns down and the insurance company rebuilds a four bedroom home that is ok but if instead you build a duplex, the original borrowing for the property no longer qualifies as permitted under SISA. The same applies for changing the property from residential to commercial or vice-versa. Another example of an unacceptable change is an extension. Note it is ok, if the property is not security for a limited recourse loan and you do not borrow the money to undertake the changes. The risk area here is borrowing to buy a farm in your SMSF, improvements that you may consider best farming practice could be considered to be making unacceptable changes to the property.
3) A SMSF can buy a property off the plan by paying the deposit out of funds sitting in the SMSF then when the property is completed, holding it in a bare trust and entering into a limited recourse loan for the rest of the purchase price. Note a furniture package cannot be borrowed for.
4) Buying properties with more than one title – Each asset that is security for a limited recourse loan must be held in its own separate holding (bare) trust. There is an exception for a collection of assets that are identical and have the same market value, so that you will not be required to have a separate trust for every single share in a portfolio. When purchasing property, if multiple blocks of land are sold as one, for example a farm, there needs to be a separate bare trust and loan for each title. On the other hand if they buy a building that straddles two titles this will be considered just one asset so only one trust is required.
5) Machinery, plant, equipment etc owned by a SMSF is treated basically the same. In other words you can borrow to make repairs but not improvements if the equipment is in a bare trust. The trap with machinery etc is when it is destroyed and replaced with a new item by the insurance company. This new item cannot replace the previous item held in trust because it is a replacement in its entirety. Accordingly, it will be necessary to take cash from the insurance company and pay out the current loan then enter into another non recourse loan arrangement for the new equipment. The wording of the legislation is exactly the same for both property and machinery it is just that when a house burns to the ground it is not replaced in its entirety simply because the land still exists.

# Frequently Asked Questions

The following is a list of points regarding superannuation that are the answer to questions commonly asked by retired people or those nearing retirement.

1) Once you reach 65 years of age you can no longer contribute to super unless you pass a work test ie work 40 hours in a 30 day period in the financial year the contribution is made. Managing your rental properties will not meet the work test. Once you reach 75 years of age you cannot contribute to super.
2) From 1st July 2017, you can only contribute a maximum of $25,000 per year to superannuation if you want to claim a tax deduction for the contribution. If you are an employee, you can only do this through salary sacrifice and your employer's contributions in relation to the guarantee also contribute towards the $25,000 cap.
3) You cannot sell a residential property to your own SMSF
4) Once you reach 65 years of age you will be allowed to have a taxable income of around mid $30k in today's dollars (mid $50k if a couple) without having to pay any tax on it.
5) The way the capital gain from a property sold outside of super, is calculated is the gain is halved for the 50% CGT discount then added to your taxable income and taxed just like any other income so some of it may go into a higher tax bracket. You may be able to put $25,000 into superannuation to reduce your income but this may still leave you with a large taxable gain.
6) Whatever you do, do not sell a property you purchased before 20th September, 1985 as the capital gain on this will always be tax free in your hands so you need to keep it as long as possible. Further it is better that this is not covered by our main residence exemption as there is no need to.
7) When a property is your home at date of death, it does not matter how much CGT would apply if you sold it within your life time, your heirs inherit it at market value at your date of death so all the capital gains tax exposure is forgotten.

# Public Superannuation Fund Checklist

We provide a lot of information on SMSFs but it is only in limited circumstances, i.e. wanting to purchase direct property, that a SMSF is worthwhile. If you want to hold shares there are even some public funds that allow you to pick and choose the companies your superannuation is invested in.

Not all public funds are the same. For example, the lower fee industry funds generally provide less options. When choosing your superannuation fund here are some of the questions you should ask:

1) Do they provide an anti detriment payment? This is a payment to your spouse and children of all the tax paid by the superannuation fund on contributions made by you or your employer, during your life time. Your heirs can also receive compensation for loss of earnings on the tax. It is important to find out how the fund calculates the anti detriment payment. For example, if they use the ATO formula your heirs will get a lot less (in fact if you have used a re contribution strategy they will get nothing under the formula method), than if they keep actual records of the amount of tax paid.
2) Do they allow binding nominations? If they simply allow you to state who you would like your superannuation paid to in the event of your death, then the trustees are not bound and can pay it to whoever they please, within the constraints of their trust deed. There are so many reasons you want control over who receives your superannuation they can't all be mentioned here, but just for starters consider that by the time you die you may have two families including step children. Further, the trustees can be more inclined to pay people living in your household than your natural descendants. The very reason these people are free loading on you i.e. they can't support themselves, could lead to them taking precedent over your own financially independent children.
3) When you switch to pension stage, do they simply move the investments you hold across to the pension fund or do they actually have to sell them down, thus triggering a CGT event at 10% and then transfer them into the pension fund where there would have been no CGT on the sale. In other words, do they force you to trigger a CGT event just to get your superannuation into a pension fund.

Don't compromise on these issues as they are worth a lot of money to you later in life (or death). It would be unusual for an industry fund to offer these.

# SMSF, GST and Commercial Property

Quite often commercial property is purchased as a going concern. The objective of the GST going concern concessions is to allow the sale to take place without any GST charges.

Firstly, we should point out that, as a general rule we advise sellers that it is better to pay the GST up front and let the purchaser claim the GST back. The bottom line is the same, it is just a matter of funding the GST until the ATO refunds it. The advantage is, that you don't have to worry about an ATO narrow view of the going concern rules coming back to bite.

Now, back to the point which is such a typical example of how the ATO can nitpick and throw the whole going concern concession out the window. In most cases when a SMSF buys a commercial property they borrow to do so. This means that the property must be purchased in the name of a bare trust, which is required to hold the property until the loan is paid off. To purchase a property as a going concern both the seller and purchaser must be registered for GST. In this situation the ATO will require both the SMSF and the bare trust to be registered for GST.

# Problems Buying A Second House Through A SMSF

As readers are no doubt aware you cannot use the equity accumulated in the first property owned by a SMSF as a deposit for another property.

Now to buy another property you are going to need, at least a 20% deposit so you will probably have to save up around $100,000 before buying the next property. The question is what can you do with these savings over the several years that it will take to accumulate $100,000? At the start you may invest it in shares but Noel Whittaker recommends that you should aim to hold shares for around 5 years. Most of the savings will be held for too short a period to make shares worthwhile. This probably just leaves holding the money in a term deposit. The trap is that you cannot maximise the return on the savings by paying off your first investment property because you will not be entitled to redraw it. This probably means the money is earning two percent less than you are paying!

A solution would be an offset account.

# SMSF Loan Structure Issues For Multiple Properties

Thanks to the fantastic response from our readers we got an answer to our question in the last edition of newsflash about offset accounts for SMSF loans. Because you can't redraw from a SMSF loan you need somewhere to accumulated funds for the next property, an offset account is perfect for this.

St George and The Rock offer offset accounts on their SMSF loan. Making further enquiries, it appears St George will only lend around 70% whereas the Rock will lend 80%. Both have similar interest rates of around 7.4% and while the Rock's establishment fees are more than St George, their monthly fee is less.

On the other hand some lenders without offset accounts charge a 1% lower interest rate on a 70% lend. If you are intending to buy just two half million dollar houses that 1% will save you $7,000 a year in interest! The catch is you will need a $300,000 deposit to buy those two houses.

The trouble with SMSFs is that they cannot access the increased equity in properties already purchased, to fund the deposit for the next property. They either have to sell assets to access the equity or save the deposit up from superannuation contributions. With the $25,000 annual cap on deductible contributions it could take up to 6 years before you can save the $150,000 deposit for a $500,000 home.

If you are going to buy more than one property in your SMSF it is important to consider just how you are going to save for the deposit on the second property. The strategy needs to be decided before you obtain the loan for your first property because even if you already have the 30% deposit for the first property you maybe better with an 80% lend so that you can get onto your next property sooner.

Now if you are only going to buy one property in your SMSF then go for the lowest interest rate available with an LVR that will allow you to buy the property you want with the funds you have available for the deposit. The availability of an offset account is not worth paying an extra 1% in interest on the loan.

If on the other hand you want more than one property have a look at just how much a 70% lend can slow you down. Let's assume you have $200,000 sitting in the SMSF in cash freshly rolled over from your employer's superannuation fund and you are looking at a $550,000 house that will earn $600 per week rent.

On a 70% lend you would need a deposit of $165,000 and $17,775 for stamp duty. Your borrowings will be $385,000 x 6.4% = $24,640 interest per year. You will be left with $17,225 cash to start saving for the second house.

On an 80% lend you would need a deposit of $110,000 and S17,775 for stamp duty. Your borrowings would be $440,000 x 7.4% = $32,560 interest per year. You will be left with $72,225 cash to start saving for the second house.

| Rental Property Numbers on a 70% Lend | | Rental Property Numbers on an 80% Lend | |
|---|---|---|---|
| Rent $600 x 52 | $31,200 | Rent $600 x 52 | $31,200 |
| Less: | | Less: | |
| Interest | 24,640 | Interest | 32,560 |
| Rates Insurance & Agents Fees | 6,500 | Rates Insurance & Agent Fees | 6,500 |
| Cost of Running SMSF | 2,000 | Cost of Running SMSF | 2,000 |
| Cash flow short fall | 1,940 | Cash flow short fall | 9,860 |
| Depreciation | 7,000 | Depreciation | 7,000 |
| Loss for Tax Purposes | 8,940 | Loss for Tax Purposes | 16,860 |

In the race to accumulate a deposit for the second house the dice are loaded against the 70% lender because you will start with less money left over from the first purchase and you need to save up 30% not 20% that is 50% more savings needed for a 70% lend. The difference is amazing. Let's assume you can somehow afford to contribute the maximum $25,000 into superannuation each year and you are looking for another $550,000 house. This means the 70% lend will need $182,775 for a deposit and stamp duty and the 80% lend will need $127,775 for a deposit and stamp duty.

| SMSF Account Running Balance 70% Lend | | | SMS Account Running Balance 80% Lend | | |
|---|---|---|---|---|---|
| Balance after purchase | | $ 17,225 | Balance after purchase | | $ 72,225 |
| Rental shortfall | (1,940) | 15,285 | Rental shortfall | (9,860) | 62,365 |
| Super Contributions | 25,000 | 40,285 | Super Contributions | 25,000 | 87,365 |
| Interest in $17,225 x5% | 861 | 41,146 | Interest in $72,225 x5% | 3,611 | 90,976 |
| Tax 25,861-8,940 x15% | (2,538) | 38,608 | Tax $28,611-16,860 x15% | (1,763) | 89,213 |
| 2nd Year | | | | | |
| Rental shortfall | (1,940) | 36,668 | Rental shortfall | (9,860) | 79,353 |
| Super Contributions | 25,000 | 61,668 | Super Contributions | 25,000 | 104,353 |
| Interest in $38,608 x5% | 1,930 | 63,598 | Interest in $89,213 x5% | 4,461 | 108,814 |
| Tax 26,930-8,940 x15% | (2,698) | 60,900 | Tax $29,461-16,860 x15% | (1,890) | 106,924 |
| 3rd Year | | | | | |
| Rental shortfall | (1,940) | 58,960 | Rental shortfall | (9,860) | 97,064 |
| Super Contributions | 25,000 | 83,960 | Super Contributions | 25,000 | 122,064 |
| Interest in $60,900 x5% | 3,045 | 87,005 | Interest in $106,924 x5% | 5,346 | 127,410 |
| Tax 28,045 -8,940 x15% | (2,866) | 84,139 | Tax $30,346 -16,860 x15% | (2,023) | 125,387 |
| Not even half way there | | | BINGO or close enough | | |

Note the gap starts to narrow the longer the period of time you have to save for, because you are paying a higher interest rate on the 80% lend. An offset account does help a bit.

Tip - Here is a possible solution. Borrow for the first house on an 80% lend so that you can get that second property ASAP. When the values of the properties increase you can switch banks to a 70% lender that charges a lower interest rate. The SMSF lending rules prevent the loan being refinanced for an amount greater than the original borrowings and any related interest. I am not talking about increasing the loan just decreasing the LVR to 70% as a result of the increased value of the property in order to access a more competitive loan arrangement. Before you go ahead with this idea consider the refinancing costs.

# Double Your Superannuation Cap

In ID 2012/16 the ATO agree that a superannuation contribution received by the fund before 30th June but not allocated to your account by July is deductible in the year it was received by the fund but does not count towards your cap until the year it is allocated to your account.

This is a once in every two years opportunity to double your deductible superannuation contribution. This may be useful if you get caught this year with an exceptionally large income, but as it cuts out the cap for the next year it should only be used for unusual fluctuations in income such as the sale of a property.

It is important that the fund actually receives the money before 30th June. As a result you could qualify for a tax deduction for up to $50,000 in the financial year that includes that 30th June. But be careful, your contribution cap includes employer contributions under the guarantee so if you have employer superannuation support you need to make sure you do not use up your full $25,000 for the following year. Leave enough for to cover the superannuation contributions your employer is required to make. Further, if you have employer support you will need to salary sacrifice your contribution.

This article is simply a heads up, do not attempt this strategy without careful planning and professional advice.

# ATO Makes Life Difficult for Renovators Using A SMSF

The ATO has finalised its draft ruling on what a SMSF can borrow for and what it can do with assets that are held as security for SMSF borrowings on 23rd May 2012. The final ruling is SMSFR 2012/1.

The two main points are that you cannot fundamentally change the character of a property that is security for a SMSF limited recourse loan and you can only borrow for repairs when the property being repaired is security for a SMSF limited recourse loan:

1) An asset that is held as security for SMSF borrowings cannot be fundamentally changed,
2) Borrowings cannot be undertaken to improve an asset
3) Borrowings cannot be undertaken to repair an asset that is not the security for the borrowing and of course you can't mortgage an asset already owned by the SMSF
4) Each borrowing arrangement must be for an individual asset.

Between the draft and final ruling there appears to be a change in the definition of repair. The draft stated that a "repair" can restore the property to its original condition even though it needed the repair when acquired. The final ruling in paragraph 22 only states that work that "restores the function of the asset to what it was at the time it was acquired, and uses similar or equivalent materials, is a repair". Paragraph 26 appears to tone this down a little to say it is ok to borrow to undertake repairs that needed doing when you purchased the property. Then at paragraph 27 it says the greater the state of deterioration at the time of acquisition the more likely it will not be considered a repair but an improvement.

This puts renovators in an uncertain position, due to the severe penalties for non complying funds we recommend that they apply for an ATO ruling for each renovation project if it involves borrowing money to undertake the "repairs".

Renovators also need to take care not to improve the property too much. You cannot fundamentally change a property that is security for a loan. The final ruling gives a more detailed list of what would be going so far as to change a property. While you can't borrow for the following you can do these to an asset that is security for a SMSF loan:

(a) extend to add two bedrooms
(b) put in a swimming pool
(c) add a shed, garage or outdoor entertaining area
(d) put in a self contained granny flat providing it is not a separate title

Of course a property development is a fundamental change to a property so you cannot borrow to undertake a development or to buy a property you are going to develop.

# SMSF Less Protected Than Public Funds

If you are using your SMSF to buy direct property then you have no other choice than to do so through a SMSF. On the other hand if you are investing in public listed securities through your SMSF you are missing out on the protection of compensation for losses from fraud and theft that APRA provides to public funds. This compensation extends to losses through fraud or theft within the fund managers that the public fund invests in.

# SMSF R 2012/1 Off the Plan Purchases and Construction

This ruling makes it clear that SMSF can borrow the deposit for an off the plan purchase, as part of the loan for the full purchase. In reality if there is a long construction period the banks are not going to allow that sort of borrowing so the most likely way a SMSF would purchase an off the plan unit is to pay cash for the deposit. Note you are still not permitted to borrow for the furniture package.

A SMSF can borrow to purchase a house and land package but only when the asset (both land and house) does not transfer until the building is completed.

A SMSF cannot borrow to buy a block of land and then later construct a house on it. This is the case even if the SMSF has the money to pay for either the land or the house. A SMSF can buy land and then build a house on it is if it does not need to borrow for anything associated with the property.

# More Obligations on SMSF Trustees

On 7th August, 2012 the new regulations were introduced that will require the trustees of SMSFs to at least, every year, review the SMSF's investment strategy and this must include at least a comment on the insurance needs of the members. This requirement can be met by creating a minute of a meeting of the trustees (or directors of the trustee if a company), close to the end of the financial year, discussing the way the fund's assets will be invested in the future, what the insurance needs of the members are and while you are at it record what the trustees consider to be the market value of all the fund's assets (individually) at that date.

# Why a SMSF?

SMSFs are costly to set up and run and the borrowing mechanism is cumbersome. You can't access the capital growth to secure further borrowings without first selling the property. This will slow down the growth of your portfolio.

Nevertheless SMSFs are the most effective way to minimise tax and protect your assets. Even if you are declared bankrupt your creditors cannot access your superannuation unless you have recently deposited an unusually high amount to defeat your creditors.

At best the tax benefits include being able to negative gear at your personal tax rate, pay only 15% tax on the money you use to make principal repayments and pay no capital gains tax on the sale or no income tax on the net rent when it is supporting you in retirement.

Consider a rental property that is running at a loss for tax purposes of $10,000 a year. Instead of purchasing the property in your name and reducing your taxable income by $10,000 you purchase it through the SMSF and salary sacrifice $10,000 into the fund. The salary sacrifice will have the same result of reducing your income by $10,000 and the SMSF will not have to pay the contributions tax on the $10,000 it receives from you because it can offset the rental property loss against your contribution.

This seems to be the area where the confusion arises. The 15% contributions tax is poorly named. It is not a tax on contributions but a tax on the SMSF's profit and your contributions are part of its income. So in this scenario (ignoring everything else that is going on in the fund) the SMSF has no profit so pays no "contributions tax".

If the deductions for the property include depreciation, which is a non cash flow item, the extra funds can be used to reduce the principal on the loan, effectively tax free as you have not paid tax on that amount nor has your employer and nor has the SMSF. If you want to make more principal repayments you will need to salary sacrifice more into the superannuation fund and that will be taxed in the fund's hand's but only at 15%. The only catch here is each member can only contribute $25,000 a year and that includes their employer support under the super guarantee.

Once you get to 60 years of age, meet a retirement condition and put the fund into pension stage it can sell the property without paying CGT or hold it without paying income tax on the net rent. You also do not have to pay tax when the SMSF pays you any of the proceeds.

If the SMSF is not in pension phase when you sell the CGT will only be 10%. Likewise if the property is running at a profit before you reach pension phase there will only be 15% tax on the net rent.

All the advantages of negatively gearing at the tax rate of the high income earner but the property is protected from his or her creditors and when it starts to produce a return it is the SMSF tax rates that will apply not the high income earners. That is why people go to the trouble and cost of setting up their own SMSF to purchase an investment property.

# Death of SMSF Member During Pension Phase

Effective from the 1st July, 2012 a superannuation fund will not automatically be pushed back into accumulation stage immediately upon the death of the last member to take a pension. This is an important change for SMSFs with their assets tied up in property or long term share investments.

Until now there has always been the worry that if the assets are sold while the member is alive the capital gain will be tax free but when the remaining pension member dies the fund is immediately pushed out of pension phase so when assets need to be sold to pay out the death benefits their gain will be taxed at 10%.

Now the fund is allowed to remain in pension stage until the pensioner's death benefit is paid out of the fund. No delay tactics though, there is still the requirement that the death benefit be paid as soon as practicable after the member's death.

# Holding Insurance Inside Superannuation

Regular readers would be aware that the trustees of SMSFs are now required to consider their insurance cover as part of their regular review of their investment strategy. This article discusses the different personal insurances available and their suitability to being held through a superannuation fund. It is important that you minute your review of your insurance policies so extracts from this article may be useful in completing the minute.

If you do decide you need personal insurance coverage please contact the following advisors whom we trust to not only find you the best policy but provide you with a claim management service where they will deal with the insurance company on your behalf and you can just concentrate on getting better. Here are their web site addresses:

TonyTownsend: http://www.townsendinsuranceservices.com.au
Anthea O'Sullivan-Kovacevic: http://www.aokrisk.com.au

The first thing you need to consider before purchasing an insurance policy through your SMSF is that the proceeds of the policy can only be paid out to you, your spouse or your children. So if you intend someone else to be the beneficiary the policy is better held outside of superannuation.
Now to the various insurance policies available:

**Life Insurance –** premiums are not tax deductible to individuals but are fully tax deductible to the superannuation fund providing it is not a savings policy ie endowment policy. Most contributions (which indirectly pay the premiums) to a superannuation fund are tax deductible either to you or your employer. This means that by holding your life insurance inside of superannuation you will effectively receive a tax deduction for the premium. The catch is the insurance proceeds will be taxable in the hands of your independent adult children, this would not be the case if you held the policy outside of superannuation. But note proceeds from a life insurance policy held inside a superannuation fund are not taxable in your hands or your dependant children or spouse's hands. Also if you are struggling to obtain life insurance quite often a superannuation fund can obtain coverage for you as part of a bulk cover when you may be subject to conditions on an individual basis. Further, if the premium is a bit of a stretch for your household budget you could instead utilise the superannuation contribution your employer is required to make under the guarantee, to cover the premium.

**Trauma Insurance –** The proceeds of a Trauma policy held inside a superannuation fund would be taxable to your adult children but not taxable in the hands of your dependant children or spouse. Trauma Insurance premiums are not tax deductible to you as an individual nor are they tax deductible to your superannuation fund. But note terminal medical condition insurance is deductible to your superannuation fund but not you. Just be careful here and consider what exactly you are insuring for. If the trauma does not permanently prevent you from working or you cannot be certified as terminally ill with only 12 months to live then your payout maybe locked in the superannuation fund because you cannot meet a condition of release for example have reached retirement age or be permanently incapacitated. All in all it is better to hold trauma insurance outside of superannuation with maybe just the terminal medical condition insurance inside superannuation if that is feasible.

**Income Insurance –** Premiums are tax deductible in your personal tax return and any income received from a claim is taxable in your hands. It is not practical to hold income insurance inside your superannuation fund because many of the reasons you would be able to make a claim on your income insurance policy do not satisfy a condition of release from the superannuation fund so even though the insurance company pays up to the superannuation fund you may not be able to access this amount until you are over 55 years of age! There are some insurers who will pay the proceeds of an insurance policy held by a superannuation fund direct to the member who will be taxed on it. It is only in these circumstances that holding your income insurance inside of superannuation stacks up even close to the advantages of holding it outside of superannuation so unless you need to use your employer's superannuation guarantee contribution to be able to afford the premium, it is best to hold income insurance outside of superannuation.

**Total and Permanent Disability Insurance –** This is much the same as life insurance, the premiums are not deductible to you personally but would be to your superannuation fund. Payments from your superannuation fund to you, your dependant children or your spouse, would not be taxable. Usually any event that would trigger a claim under these policies will also satisfy a condition of release from the superannuation fund. The trap is own occupation policies that will pay up even if you are able to work but just not in your own occupation. In these circumstances the payout would be locked in the fund because just not being able to work in your own occupation is not going to satisfy a condition of release for your superannuation fund. Further, the portion of the premium that represents the own occupation cover will not be tax deductible to the superannuation fund, though absolutely none of the premium would be deductible if held outside of superannuation. Holding a TPD policy inside a superannuation fund needs careful consideration some policies can be split with the own occupation cover being held outside of the superannuation fund and the any occupation cover within. This is just one of the many reasons you should use an insurance broker help you choose the cover that is right for you.

Note if the insurance proceeds are locked in your superannuation fund they may be released under the hardship provisions but if so they will be heavily taxed. Further the hardship provisions generally require you to have been on Centrelink payments for 6 months and have mounting unpaid debts, usually only enough to cover these debts will be released.

# More About Holding Insurance Inside of Superannuation

Further to our article, in the last edition of Newsflash, on what insurance policies can be tax effectively held inside of superannuation, Tony Townsend would like to provide more advice on these types of policies. For more details about Tony visit our affiliates page http://www.affiliates.bantacs.com.au/index.php

The main disadvantages I see are as follows:

1. Insurance in super means the client must please two people/groups in order to get their hands on the money, the insurer and the trustee of the super fund. Whereas when the cover is held outside of super, if the client has met the policy terms/definition, then the money will be paid to the policy owner – it is that simple.
2. The government keeps changing the rules around super and insurance in super. Eg Once upon a time, you could hold TPD in super and claim a tax deduction. You could also hold Trauma in a SMSF if you wished - the premium wasn't tax deductible but it helped members with cash flow problems. Come 1 July 2013 a super fund cannot hold TPD Own occupation or trauma Cover.
3. Possible tax implications on benefits paid out of super. If the insured claims a TPD benefit and they are under age 55, they may have to pay up to 30% tax. Or if the super fund only pays a lump sum benefit and the death benefit is being paid to a non-dependent for tax purposes such as an adult child...there are tax implications as discussed in the last edition of Newsflash.
4. People purchasing insurance through a risk only super product and making contributions to meet the insurance premiums are eating into their concessional contribution cap of $25,000pa and this includes SG contributions made by their employer. This can be a challenge for high income earners or those clients who want to focus on accumulation.
5. Insurance cover in super may be limited in terms of benefits and features and when the super fund can release the benefit. Eg Some salary continuance policies still only have a 2 year benefit period and are indemnity only. Not good if a client has a fluctuating income where agreed value would have been best. Remember that under SIS regulation a super fund can release up to 100% of insured's pre-

disability income when it comes to income protection and temporary incapacity. If the insured/member was not working at the time or on maternity or sabbatical leave, then 100% of nothing is still nothing. Meaning the person is unable to get their hands on the money when they really need it the most.

With all that said though, I do believe that if it comes down to affordability and cash flow for the client, then some cover is better than no cover, even if it is inside super.

# SMSF Deduction Tax Rate Myth

It is not technically correct to say that tax deductions for a SMSF rental property only benefit from the 15% tax rate whereas if the property was held in the personal name of the taxpayer the rate would be much higher. Further, it ignores all the tax benefits when the property becomes positively geared or is sold, so don't let tax rates discourage you from investing through a SMSF. Of course there is much more to the decision than that. This article just analyses the tax consequences of holding a property in your own name compared with in a SMSF.

It is only the excess of expenses over rental income that is relevant for tax purposes.

Let's keep the example simple by assuming the property is old and has little or no depreciation to claim. Also assume no principal repayments are made so the taxable income/loss is the same as the cash flow in/out.

The rent income is $30,000 a year and the expenses such as rates, insurance and interest total $35,000 a year which means the property makes a $5,000 a year loss for tax purposes. This also means that the property is a cash drain on the SMSF of $5,000. How are you going to finance this $5,000? If the property was owned in your own name the $5,000 would come out of your wages. It would be very counter productive and not comparing apples with apples to say that the $5,000 cash shortfall should come out of other SMSF cash flows such as income from other investments, cash held by the SMSF or contributions by your employer. To truly compare apples the cash flow short fall should still be met from your wages.

Now if the property was held in your name then you would cough up the $5,000 from your take home pay but when you prepare your tax return, as the tax loss on the property equals the cash flow shortfall you would claim a full tax deduction for the $5,000. If your income was $100,000 a year this would be reduced to $95,000. Your rate of tax including Medicare Levy is probably 38.5% so the $5,000 tax deduction will result in a tax refund of $1,925.

If instead the property was held in your SMSF you should still meet the cash flow shortfall from your wages so you ask your employer to reduce your wages by $5,000 and put the money into your SMSF, commonly referred to as salary sacrifice. Assuming this $5,000, combined with the contributions your employer is already paying into the fund, does not exceed the $25,000 cap then the $5,000 will not be taxed in the hands of your SMSF.

The term contributions tax is a very poor choice of words. There is not actually a tax on the contributions you make to a SMSF only on the SMSF profit. The contributions that are made to the fund and claimed as a tax deduction by the contributor are considered taxable income to the SMSF. So if the SMSF has a $5,000 loss from the rental property your contributions will bring it to breakeven, not a profit so no tax will be payable by the SMSF, which means no contributions tax on the $5,000 because it has been offset. The only tax consequence of you making a salary sacrifice of $5,000 of your pre tax wages into the SMSF is that your taxable income has been reduced to $95,000. Your tax rate is 38.5% reducing your income from $100,000 to $95,000 has reduced the tax you pay on your wages by $1,925.

This is exactly the same tax result as if you had held the property in your own name which means that the $5,000 loss of the rental property was transferred to your 38.5% tax rate not the SMSF 15% tax rate.

But wait there is more, much more to this. Because the property is held in a SMSF you have the best form of asset protection available and when it produces a profit for tax purposes the SMSF 15% tax rate will apply or zero tax if the SMSF is in pension phase.

Further any capital gain on the sale will be taxed at 10% or zero if in pension phase.

Best of all if you want to make more than the $5,000 in contributions these can be used to pay down the principal of the loan. Sure the contribution will be taxed at 15% because the SMSF has no more losses to offset but if the property was owned outside of superannuation you would have to pay your marginal tax rate of 38.5% on the money before you could pay it off the loan. Making the principal payment through salary sacrificing into a SMSF moves the non tax deductible dollars spent on principal repayments, from the 38.5% tax bracket into the 15% bracket.

Generally all the up side is taxed at concessional SMSF rates, the maximum being 15%. Yet the down side, the cash flow short fall at the start of the investment is deducted at your marginal rate through salary sacrificing.

Now that is sorted let's take this one step further to consider the depreciation deductions. All other things remaining the same the depreciation would only qualify for the 15% tax rate. This is because you actually have to come up with the cash to get a tax deduction for a superannuation contribution but you don't have to for a depreciation contribution.

Let's assume the figures are the same as above but with an extra deduction of $6,000 for depreciation. If the property was in your name you would get a tax deduction for this at your marginal rate ie $6,000 x 38.5% = $2,310 refund.

If instead the property is held in a SMSF this $6,000 in depreciation applied to the example property above would make an $11,000 loss for tax purpose but as it is only suffering a $5,000 cash flow short fall you don't need to put a further $6,000 into the fund to keep it liquid. This will mean the SMSF will have a $6,000 loss to carry forward as a deduction in future years or offset against other income, which would only realise a 15% tax rate.

Remember that building depreciation has to be added back, increasing your capital gains tax when you sell, the capital gains tax rate of the SMSF is most likely to be less than your personal one so it is not all bad. Further, if you are still under your $25,000 cap you could make a salary sacrificed contribution of $6,000 to the SMSF, to pay off principal. This would reduce your personal taxable income down to $89,000 and still not be taxable in the hands of the fund because the increased losses would still offset it. Sure it has cost you $3,690 ($6,000 – ($6,000x 38.5%)) out of your take home pay but it has reduced your debt by $6,000.

So, to try and get back to comparing apples with apples, if you owned the property in your own name the $6,000 depreciation would provide you with a $2,310 tax refund that you could pay off the principal. Alternatively, you could hold the property in a SMSF and salary sacrifice $1,660 into the SMSF. As the salary sacrifice is tax deductible it would take $1,660 from your gross pay so only cost you $1021 ($1,660 – ($1,660x 38.5%)) out of your take home pay. The SMSF will use up $1,660 of its $6,000 loss, created by the depreciation, to make sure no tax was payable on this contribution and still have $4,340 ($6,000 - $1,660) in losses to offset against its other income, saving it $651 ($4,340 x 15%) in tax which it can also use to pay off the principal. That is $2,311 ($1,660 + $ 651) paid off the principal but unlike the circumstances when the property was held in your name you are out of pocket by $1,021 to achieve this (the difference between these figure will vary with your tax rate). This is an investment in obtaining the future tax benefits when it is positively geared or you sell and make a capital gain.

The numbers will work out better for SMSFs the lower the depreciation on the property. Nevertheless, it would be an extremely unusual set of circumstances where the choice to not use a SMSF gives a better tax outcome, especially once you take into account principal repayments (in addition to those discussed above) that will be taxed at 15% instead of your marginal tax rate.

# When Do You Need A SMSF?

There seems to be a lot of publicity lately about spruikers and Self-Managed Superannuation Funds (SMSFs). Scare tactics have also been employed by government organisations. Yes there are a lot of responsibilities in running your own SMSF but they are no more complicated than dealing with GST and other bureaucratic red tape the government seem to think it is reasonable to impose on the average taxpayer. And yes SMSFs are not for everyone but don't be lead to think that an adviser who recommends a SMSF is a spruiker. There are many, many good reasons to have a SMSF, especially if you are investing in property.

Once you reach 60 years of age and transfer your superannuation to pension phase its earnings and capital gains will be tax free to the fund and you. Further superannuation is the best form of asset protection that you can get. Even before pension phase the maximum tax on your superannuation earnings is 15% and10% on capital gains yet you will get an effective tax deduction at your marginal rate for contributions to the superannuation fund. The main downside is limited access to the funds until retirement conditions are reached. There has been much discussion about the details of SMSFs in the last couple of newsflashes and our free SMSF booklet should cover all your questions www.bantacs.com.au/booklets/SMSFs_Booklet.pdf this article is not about the details of investing through a SMSF but whether it is suitable for you.

So superannuation has the best tax concessions and asset protection, it is just a question of whether this is the right time for you to lock your money away and whether you should do it in a SMSF or a public superannuation fund. It is a no brainer if you want to invest directly in a rental property. You cannot directly hold a rental property in the superannuation regime any other way than in your own SMSF. It is the same with investing in collectibles. On the other hand, if you want to invest in shares in public companies this can be achieved through the public funds. Some even allow you to make your own choice of the companies you invest in, from their range. So if you choose to direct your superannuation savings to shares then the circumstances when a SMSF is suitable are limited to when you want to diversify into property and/or your shareholding has reached the stage where the management fee that the fund charges you as a percentage of your investment exceeds the fixed costs of owning your own SMSF. This comes into play, as you approach the $200,000 mark in superannuation savings.

The simple solution to knowing whether you should buy your next rental property in a SMSF is to see your accountant before you buy a property; they will know exactly what is right for your circumstances. If you don't have an accountant, well now that you are going to own an investment property you will need one so find one and give them the chance to examine your circumstances before you go making one of the biggest decisions in your life.

Please don't let the entire scare mongering make you distrust advisers and think you have to nut it out on your own. Just make sure you consult an accountant that is independent and knows your circumstances well. They will cost a minute fraction of the amount you will be spending on the property.

Your accountant should be able to evaluate the property, telling you how much it is going to cost you to hold, how much it needs to go up in value on average to breakeven, how to manage your loans, how to keep the appropriate records for your tax return, what the ownership structure should be and why.

Now how to pick the spruikers? Glitz, glamor, lots of advertising and pressure are not the signs of a good advisor. There is probably no one fool proof tactic but word of mouth and independence is a good place to start.

# Warning If You Have A SMSF or Are An Employer

**Employers** – If your have an employee who does not give you their superannuation fund membership details and you need to pay superannuation contributions for them you need to put the contributions into a MySuper account. The big superannuation funds offer MySuper accounts. It is worth finding out the details of how you can make these deposits so that, when racing to meet the deadline to avoid the guarantee levy, you can act quickly.

**SMSF Trustees** – From 31st May, 2014 SMSFs are required to provide employers with a super choice form that includes the SMSF's funds ABN and bank account details as well as a compliance letter with an electronic service address. The ATO form and a template for the compliance letter are available on our web site at https://www.bantacs.com.au/topics/smsf/ As an SMSF trustee you will need an electronic service address to be able to receive data messages associated with employer contributions sent using SuperStream from 1 July 2014. There are service providers that can provide you with an electronic service address for a fee. A list is available at https://www.ato.gov.au/Super/Superstream/Self-managed-super-funds/electronic-service-address/register-of-SMSF-messaging-providers/

# When Your Farm is in a Self Managed Superannuation Fund (SMSF)

It is first important to understand what is business real property, This is important for two reasons. Firstly, there is the inhouse asset rule where a SMSF cannot lease a property to a related person unless it is business real property, for that matter the related person can't even use it, lease or not. A related person includes members of the SMSF, related entities and relatives. The second point is that a SMSF cannot buy a property off a member or associates unless it is business real property. This is important if you already own the farm and are considering selling it to your SMSF.

Regardless. the whole owning a farm in a SMSF scenario is not going to work unless it is business real property. ATO ruling SMSFR 2009/1 is the go to reference on business real property. Sub section 66(5) of SISA requires the property to be real estate that is used wholly and exclusively in a business. SMSFR 2009/1 paragraph 31 allows a minor, insignificant or trifling non-business use of the property. Further, if a small part of the land is not used for any purpose at all, for example held with the plan for future expansion the property will still be considered to be used wholly and exclusively in a business. Though this will not fly if there are multiple titles and the unused portion is one complete title, reference SMSFR 2009/1 paragraph 265.

Don't threat if your home is on the farm there is a carve out to the wholly and exclusively bit in sub section 66(6). Providing the portion of the property that is used for domestic or private purposes does not exceed 2 hectares and is not the predominant use of the property the farm house will not prevent the farm being considered business real property. SMSFR 2009/1 at paragraph 223 also requires the farm to take up more than half the area.

A property held for the purpose of earning residential rent is not business real property. This begs the question of what happens if the farm house is rented out to a third party? SMSFR 2009/1 does not address this at all but there is a compendium to the ruling that does http://law.ato.gov.au/atolaw/view.htm?docid=CFR/SMSFR2009EC1/NAT/ATO/00001&recStart=1&PiT=99991231235958&recnum=4&tot=5&pn=ALL:::ALL basically it says that it does not matter whether the residential rental is to a third party or related party when it comes to farms.

# Borrowing to Buy the Farm in a SMSF

This adds another layer of issues to consider. There are all the practicalities of setting up the bare trust before you sign a contract. Before you do that you need to find a bank that is prepared to lend you the money and jump through their hoops.

SMSFR 2012/1 looks at the extra conditions placed on a property when it is security for a SMSF loan. The nature of an asset held as security for a SMSF loan cannot be changed. Normally this would mean you could not build a house on vacant land as this would change the nature of the asset from vacant land to a residential property. Paragraphs 78 to 80 of SMSF 2012/1 give an example of a cattle property with no buildings on it. The SMSF builds a cattle shed and a residence for the farmer, it is considered this does not change the nature of the property from a cattle farm, it simply provides shelter for the cattle and a home for the farmer which is still part of the operations of a cattle farm. So when it comes to farmland it is ok to build on it even though it is security for the SMSF's loan. The catch is you can't borrow to build.

There is also a requirement that each loan and each bare trust must be for a single acquirable asset. Some farms consist of more than one title. According to SMSFR 2012/1 paragraphs 52 to 57 each title would be considered at separate single acquirable asset unless there was a substantial building straddling all the titles making it impossible for them to be sold separately. This means normally a farm with multiple titles is going to have to have multiple loans and multiple bare trusts if it is going to be purchased by a SMSF.

# What is Owned by the Farmer and What is Owned by the SMSF

The next step in avoiding being caught with inhouse assets, is making sure the SMSF does not end up owning the non real estate part of the farm operations. If the SMSF owns anything used in the farming business that is not business real property ie real estate it is caught as an inhouse asset and a SMSF can only hold 5% of its assets in inhouse assets. So it is very important to know what is in and what is out. For example trees in an orchard are business real property because of their close connection to the land yet annual crops are not!

Generally, the rule is can the item be removed from the farm without damaging it or the farm. Obviously, a concrete slab becomes part of the real estate but if you move a container onto the land for storage it will not become part of the real estate because it is simply attached to the land by its own weight. It is very important that the SMSF does not pay for items that are not business real property but equally as important that the members do not pay for items that are considered to be part of the land. In the latter case you need to speak to your Accountant, first, about whether you can get around this by making an in-specie contribution reference TR 2010/1 paragraphs 30 and 32 or being reimbursed.

Some examples from ATO rulings

Part of the Land – Needs to be owned (ie paid for) by SMSF

- Trees reference SMSFR 2009/1 paragraph 83
- Grape Vines reference SMSFR 2009/1 paragraph 238
- A shed or farm house reference SMSFR 2012/1 paragraphs 78 to 80
- Relocatable Buildings that have permanent foundations with water and electricity connected reference SMSFR 2009/1 paragraph 79
- Concrete Silo or water tank reference SMSFR 2009/1 paragraph 77
- Lean-to that would cost more to remove than its separate value SMSFR 2009/1 paragraph 78
- Renovating the kitchen or bathroom of the farm house but not necessarily the plant and equipment such as the stove. Reference TR 2010/1 paragraph 206
- Slab, includes a building constructed on slab reference SMSFR 2009/1 paragraph 78
- Dam reference SMSFR 2009/1 paragraph 78
- Fencing reference SMSFR 2009/1 paragraph 78, though usually the lease would make it the responsibility of the farmer to repair fences.
- Irrigation pipes that are laid underground and cannot be removed with out being destroyed reference SMSFR 2009/1 paragraph 78.

Separate from the land – Should not be owned or paid for by SMSF

- Annual Crops reference SMSFR 2009/1 paragraph 84
- Container merely placed on the land SMSFR 2009/1 paragraph 76
- Silo merely anchored to the land but can be relocated easily without damage reference SMSFR 2009/1 paragraph 77
- Water Licence SMSFR 2009/1 paragraphs 266 to 269
- Slasher and other loose plant and equipment even though it is necessary to maintain the SMSFs property in good order.
- Irrigation would generally be plant and equipment so separate from the land though there maybe some parts that are so fixed to the land, such as underground pipes, that their removal from the land would destroy them so SMSFR 2009/1 at paragraph 78 would consider them to be part of the business real property.

Note it maybe possible to structure the lease agreement between the SMSF and the farmer so that improvements the farmer makes are not considered contributions reference TR 2010/1 paragraphs 29 to 32 and 206 but this is at the pointy end, make sure your auditor is going to accept this.

As mentioned earlier the SMSF can own a small portion of the non real estate assets (ie plant and equipment) that are then leased to the related party business. The value of the of these assets must be less than 5% of the total SMSF's net assets and a market value rent must be paid. More detail on this strategy is available in SMSFR 2009/4.

This article is general advice only and has been written to give you an idea of what properties would be suitable for a SMSF and show you just why you need to see your Accountant before you sign anything. This is just the tip of the iceberg there is so much more that needs to be considered from GST to succession planning.

# Ask BAN TACS

For $79.95 at Ask BAN TACS, https://taxquestions.com.au/ you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

# More Information

Please make sure you continue to keep your knowledge up to date by subscribe to our Newsflash reminder. There are many other booklets available on our web site https://www.bantacs.com.au/media-library/booklets/ in fact the whole web site is full of useful information so also have a look around under topics.

# How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?


......and the list goes on!
To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign

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