Capital Wealth Managers

Top 13 Mistakes when Buying an Investment Property in your SMSF

Contents

INTRODUCTION 4

MISTAKE # 1 5

Treating SMSF Property Purchases as if they are 'Normal' Transactions 5

MISTAKE # 2 6

Not Consulting an Expert to Guide the Process to Completion 6

MISTAKE # 3 7

Not Fully Understanding Lending Requirements 7

MISTAKE # 4 8

Buying a Property Before the SMSF is Properly Set Up 8

MISTAKE # 5 9

Not Setting Up the SMSF and Related Trust(s) Correctly 9

MISTAKE # 6 11

Not Adhering to Rules Governing Relationships with Related Parties 11

MISTAKE # 7 12

Not Taking Into Account Demands on Funds in Retirement Phase 12

MISTAKE # 8 13

Not Implementing Rules Concerning 'Single Acquirable Assets' 13

MISTAKE # 9 14

Not Adhering to Rules Governing Maintenance and Improvements 14

MISTAKE # 10 15

Changing an Asset so That it Becomes a 'Replacement Asset' 15

MISTAKE # 11 16

Not Appointing a Transaction Project Manager 16

MISTAKE # 12 17

Using an Old and Out of Date Trust Deed 17

MISTAKE # 13 18

Not Understanding Related Party Lending 18

CONCLUSION 19

CAPITAL WEALTH MANAGERS - FINANCIAL EDUCATION 20

INTRODUCTION

One of the most significant trends in the world of property investment at the moment is the growing use of Self-Managed Super Funds (hereafter referred to as SMSF‟s) as vehicles with which to buy property. There are obviously many benefits attached to this approach and it is one that we strongly recommend in some circumstances.[1]

SMSF's do indeed present great opportunities; however a word of caution should be sounded; that is, as with so many other exciting new trends, people can easily fall victim to rash decisions, smooth operators and well-meaning (but wrong!) advice.

The purpose of this eBook is to point out some of the pitfalls and dangers associated with taking the route to property investment in an SMSF. This will enable readers to make calm, considered an informed decisions instead of rushing to join what they believe to be the latest bandwagon.

The following mistakes are, in our opinion, the cause of some of the most significant mishaps and negative experiences associated with buying property inside a SMSF.

[1] If you require more information about general principles of holding property in a SMSF please refer to our eBook on the subject. It is entitled: *How to Use your Superannuation to buy an Investment Property in a Self-Managed Super Fund (SMSF)*.

MISTAKE # 1

TREATING SMSF PROPERTY PURCHASES AS IF THEY ARE 'NORMAL' TRANSACTIONS

This is perhaps the one mistake that lies at the root of all other SMSF property transaction mistakes.

It should always be remembered that a SMSF is an investment vehicle with a very specific purpose:

That is to provide retirement income in line with superannuation laws and regulations

It therefore follows logically that regulators will want to make sure that all SMSF's are used with this purpose in mind (sometimes called the 'sole purpose test') and that they are not treated as convenient pots of cash with which to pursue investment whims.

Maintaining and showing compliance with relevant legislation should therefore always be very high on the agenda of trustees of SMSF's. This means that people buying property inside a SMSF should take care to forget everything that they think they know about buying property as 'private citizens' and try to make sure that they studiously follow the correct procedures for this type of transaction. Some of these procedures will be pointed out as we continue with this eBook

Mistake # 2

Not Consulting an Expert to Guide the Process to Completion

It should be clear from the above that buying property within a SMSF can be quite complex (although certainly not impossibly difficult!).

The ability to buy property in this way is also a fairly recent development. This means that many people you will deal with in the course of such a transaction will not be quite sure as to what the right procedures, protocols and strategies for successful completion might be. It would therefore be very much worth your while to get someone on side who does know what he/she is talking about when it comes to SMSF property investment.

Ideally such a person should be prepared to 'shepherd' the deal through from A to Z. Getting such an expert on side might seem like an expensive proposition at first but you will almost certainly find that the time and money that you will save in the process will make it more than worth your while.

Mistake # 3

Not Fully Understanding Lending Requirements

Loans used to buy property within a SMSF differ markedly from more mainstream mortgage products. SMSF loans have to fulfil strict 'limited recourse' criteria.

Limited Recourse Borrowing Arrangements (LRBA‟s) typically stipulate that the recourse of the lender will be limited to the fund asset that is being financed (including rights to income generated by the asset).This arrangement protects trustees from being personally pursued for debt or other liabilities generated by the SMSF.

The fact that this type of arrangement has to be in place has two very important implications:

- It significantly increases the amount of paperwork required to set up a loan
- It means that banks or other lenders will be much more stringent in following due diligence procedures in order to minimize their exposure to excessive risk.

These two factors combine to ensure that typical SMSF loan products are substantially different and significantly more difficult to set up compared to standard arrangements.

Being prepared for this fact by carefully studying lender requirements and ensuring that all necessary documents are provided at the correct stages will significantly smooth the process of obtaining funding.

MISTAKE # 4

BUYING A PROPERTY BEFORE THE SMSF IS PROPERLY SET UP

The following scenario occurs all too often:

A couple (or individual) fall in love with a property and decide that it should become part of their retirement portfolio. Scared that the property might slip from their grasp they make an offer and pay a deposit from their own pockets as soon as they are able to do so.

A few days later they show up at the offices of their financial adviser, declaring:

"We bought a property; we should therefore probably start thinking about setting up a SMSF!"

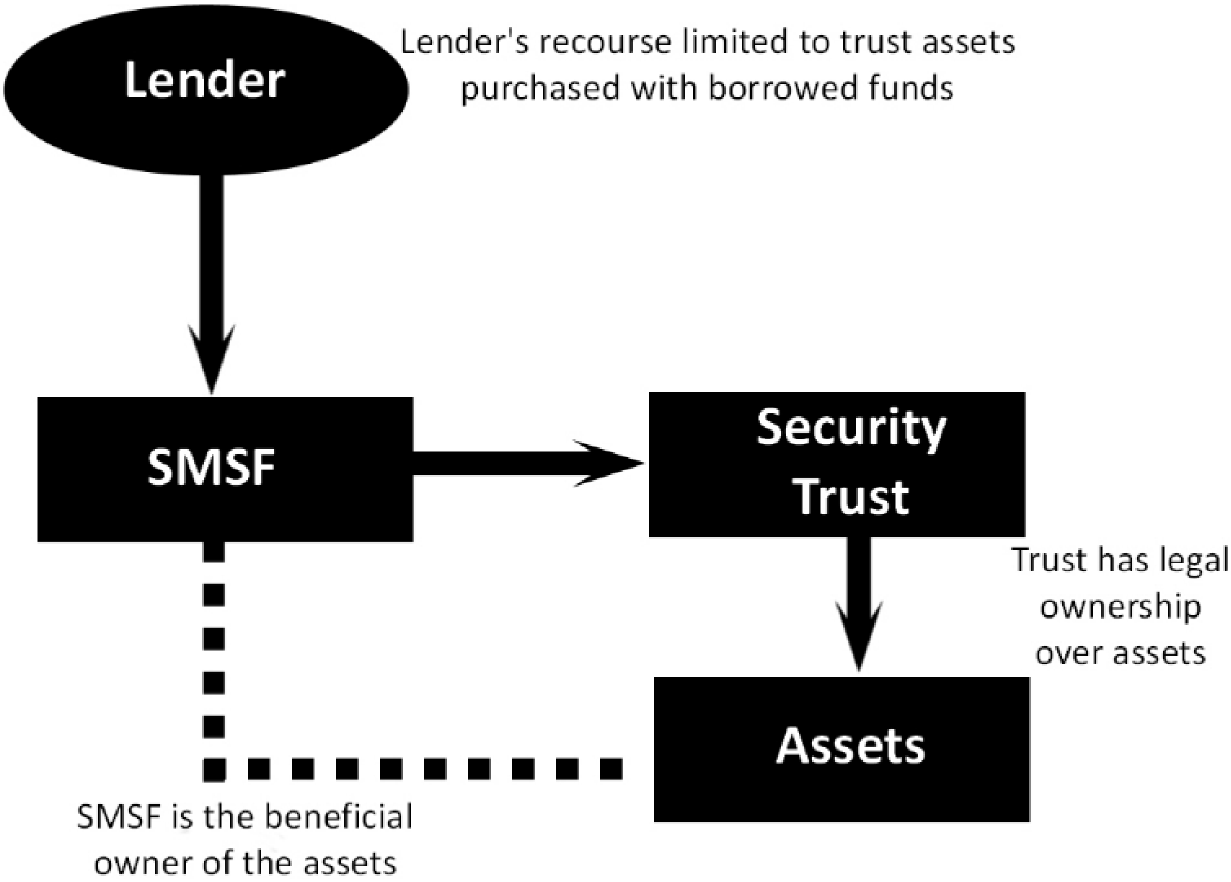
Rectifying this type of situation can be very complex and expensive. It can be avoided through making sure that the fund is already in existence, that trustees have been appointed and that pre-approval for purchasing a property through the fund is in place.

It is also highly advisable that the trustees spend a significant amount of time strategizing and planning their investment strategy. This will obviously improve their chances of purchasing a property that will perfectly fit in with the goals of the particular SMSF (instead of simply buying on a whim).

Mistake # 5

Not Setting Up the SMSF and Related Trust(s) Correctly

The basic structure of a SMSF loan arrangement could be represented as follows:



In essence this structure (which is more fully explained in the eBook ***'How to buy a property in a Self-Managed Super Fund'***) represents an 'arms length' arrangement where the loan agreement is between the lender and the SMSF and the actual property transaction is between the buyer and the security (or holding) trust.

Not fully adhering to this arrangement can lead to a variety of messy situations and possibly the need for costly and complex corrective actions.

Some examples of incorrect (or at the very least questionable) arrangements include:

- **Where the security trust directly enters into a loan arrangement with the lender.** This arrangement contravenes legislation relating to borrowing to acquire assets in an SMSF.
- **Where the lender acts as the holding trustee.** This could result in a clear conflict of interest and is an arrangement that might be seriously questioned by ATO.
- **Where the SMSF is named as the buyer on the sale contract.** This violates the 'arms length' arrangement that requires the security trust to act as purchaser and 'holder' of the property.
- **Where the security trust has active duties.** The purpose of the security trust is to act as a holding entity for the title deeds of assets. If it takes on responsibilities that range beyond this, it might be viewed as an 'active entity' for tax purposes. The activities of trusts should therefore be kept as limited and uncomplicated as possible

Mistake # 6

Not Adhering to Rules Governing Relationships with Related Parties

A significant proportion of mistakes made by SMSF‟s have to do with the blurring of lines between fund members and related parties.

Funds are prohibited from making loans or providing any type of financial assistance to members or their associates. Funds may also not hold 'in-house assets' totalling more than 5% of fund value. In-house assets are defined as investments, loans or lease arrangements in which members or related parties have a significant stake.

The reason why the rules on links with related parties are so strictly enforced is that dealings that are too close can easily be seen as failing the *sole purpose test* in the sense that the fund is being used to provide benefits to the members in the here-and-now instead of in retirement.

Great care should therefore be taken to separate the personal finances and short term interests of members from the activities of the fund.

MISTAKE # 7

NOT TAKING INTO ACCOUNT DEMANDS ON FUNDS IN RETIREMENT PHASE

It may seem that we are labouring the same point but is should never be forgotten that the purpose of a SMSF is to provide benefits to members (or their dependents) in retirement.

This means that there are strict rules requiring that set amounts will have to be paid out from the fund in the form of a pension (this is known as ‘drawdown’). Drawdown amounts can range from 5% per year at age 65 to 14% at age 95.

Trustees will have to make sure, in light of this, that funds will be available to meet drawdown demands. If this is not available from income from property held in the fund, it may lead to the need for drastic measures like having to sell assets to meet drawdown obligations.

This is obviously not a desirable situation and drawdown requirements will have to be a serious consideration when SMSF trustees make decisions on investment strategies.

MISTAKE # 8

NOT IMPLEMENTING RULES CONCERNING 'SINGLE ACQUIRABLE ASSETS'

SMSF rules require that holding (security) trusts be set up to control what is called 'single acquirable assets'. This term is liable to create significant confusion especially as there were a wide variety of opinions on how this relates to property titles. A strict interpretation would state that trusts should stick with 'one asset, one title'.

Other, more liberal, interpretations worked with all sorts of technical definitions as to what a single asset may constitute. The recent ATO draft ruling provides some clarity by positing the principle that an asset could be viewed as a single asset if it cannot be dealt with separately (even if multiple titles are involved).

The examples that ATO provide in the ruling are the following:

- A factory building, covered by several titles, where activities would have to cease if titles were separated, could be regarded as a 'single acquirable asset'.
- A farm made up of portions with different titles would not be regarded as a 'single acquirable asset' since farming activities could still be undertaken on the different parts should the titles be separated.

This is obviously a rather complex area and trusts would be well advised to get professional advice to make sure that their activities fall within ATO rules.

MISTAKE # 9

NOT ADHERING TO RULES GOVERNING MAINTENANCE AND IMPROVEMENTS

Superannuation legislation allows SMSF trustees to borrow funds for the maintenance or repair of assets. This provision does not extend, however, to allow SMSF‟s to borrow funds to improve assets.

This is obviously an area where a significant amount of ambiguity may exist as trustees struggle to answer a rather difficult question:

When does a maintenance project shade into an improvement?

The ATO’s draft ruling may shed some light on the subject.

According to the ruling the *maintenance* of an asset involves actions to prevent damage or deterioration to ensure that the asset can continue to fulfil its functional role, where-as the *repair* of an asset involves bringing a damaged asset back to its functional efficiency.

Trustees are allowed to borrow to fund both these activities. They may, however, not borrow to fund activities that will substantially increase the functional efficiency or the value of an asset through the addition of new features.

This difference might be further illustrated by an example provided by ATO in the draft ruling:

If a fire substantially damages a kitchen, repairs to bring it up to its previous standard would be allowed. If, however, trustees decide to extend the kitchen at the same time this will be deemed an improvement and will not be allowed under SMSF rules.

This is, once again, quite a complex area with a lot of opportunity for confusion.

It is, therefore, highly recommended that trustees get expert opinions before making decisions

Mistake # 10

Changing an Asset so That it Becomes a 'Replacement Asset'

SMSF trustees are allowed to use their existing fund resources (although not borrowed funds, see above) to improve assets.

Care should be taken, however, to ensure that such improvements are not so comprehensive that it creates an asset that is substantially different from the original. A resulting asset where the character of the original asset was substantially changed is called a 'replacement asset' in ATO parlance.

Some examples of 'replacement assets' provided by the ATO:

- The subdivision of a single plot of land on a single title into smaller plots with individual titles.
- The building of a house on a vacant plot of land.
- The demolition of an existing house and its replacement with three strata title units.
- The re-zoning of the land upon which an existing house stands and its transformation into commercial premises.

It is the opinion of ATO that in all of these cases the character of the assets was changed so fundamentally that it now constitutes a replacement asset and falls outside the guidelines for SMSF compliance.

Non-compliance in this area could obviously be a very serious issue and should be avoided at all costs.

Mistake # 11

Not Appointing a Transaction Project Manager

Borrowing to purchase an investment property is one of the more complex investment transactions available to investors.

There are 17 separate and distinct steps and stages that need to be executed correctly and in the right sequence.

In this process there are several institutions and professionals involved, including:

- Financial planner
- Accountant
- Your lawyer
- Bank
- Mortgage broker
- Office of State Revenue

You need to appoint a central Project Manager to ensure that the transaction is executed correctly, in the right order and in the correct sequence.

In this appointment, you need someone who understands the overall transaction and takes control of all the steps and processes involved.

Mistake # 12

Using an Old and Out of Date Trust Deed

If your SMSF was set up before Sept 2007 it probably is operating under a Trust Deed that would be considered "old" by today's standards and a deed that prohibits borrowing through the SMSF.

It is therefore an important step that the SMSF trustees have their deed professionally reviewed and updated if necessary to fully reflect and comply with the changes in the law since 2007.

Doing this early in the transaction will save time and costs down the line as it is almost a certainty that the lenders lawyers will pick up on the old deeds. This will invariably stall the process and lead to extra costs.

MISTAKE # 13

NOT UNDERSTANDING RELATED PARTY LENDING

The SIS Act (section 67a) does not prohibit the SMSF borrowing from a related party. In English that means that you can lend money to your SMSF.

This is however an area you need to tread very carefully as you could unwittingly contravene other parts of the Act, such as Section 109, which states that the parties need to deal with each other on terms no more favourable to the other party than as if they were dealing at arm's length.

That means that neither you nor the SMSF can gain an advantage from the transaction above what would have been available if you were dealing at arm's length (or with a non-related party, or in other words, the broad market place).

You should not therefore lend money to your SMSF at either a higher or lower rate or terms that would have been different to what is available with an independent third party.

We believe that this will be an area of increased scrutiny in the future.

CONCLUSION

Writing an eBook on mistakes might seem like an exercise in negativity. It should, however, never be forgotten that the purpose of studying mistakes is not simply to gloat over the mishaps that other people suffered. The purpose is rather to *take note and take care*!

The fact that others made these mistakes means that we do not have to repeat them. It is our sincere wish that the information contained in this eBook will help you to do just that. Please also rest assured that you do not have to undertake this journey alone. We have a dedicated and knowledgeable team ready to serve you with their expertise and advice.

We hope that the information presented above sets you thinking about some of the issues that you will have to pay attention to in planning your financial future. It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this.

We urge you to continue your explorations by making use of some of the other resources and eBooks from our website. We also stand ready to serve you with independent and professional advice, so please do not hesitate to contact us if we can be of further assistance.

Capital Wealth Managers - Financial Education

Financial Independence is a point in life when you are no longer dependent on work, government or family for your income. It is a point where you are generally debt free and have sufficient investments and income to look after you.

A Financial Adviser is a professional who brings together a wide array of skills, experience and disciplines to develop and execute a financial strategy to help clients achieve their goals and objectives on their journey towards financial independence.

A Financial Plan is a written document that outlines a steady path towards your financial independence.

A survey was carried out on Harvard MBA students. The question they were asked was:

"Have you set clear, written goals for your future and made plans to accomplish them?"

- 3% had goals and they were written down
- 13% had goals but they were NOT written down
- 84% had no specific goals

10 years later those same students were followed up. The 3% who had goals written down were earning 10 times as much as the other 97% combined.

Our observation from this is that written goals keep you focused and give you purpose.