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The Top SMSF Property Investment Mistakes

Former Prime Minister Paul Keating recently suggested that self-managed superannuation funds (SMSFs) should be restricted from investing in residential property.

Mr Keating told the *Financial Review*, "If I was treasurer today, I would be looking very hard at the whole entitlement or availability of debt to SMSFs. They have gearing - available to them and, of course, many of them are taking the option of buying residential property."

According to the latest Australian Taxation Office (ATO) SMSF statistics, real residential property represents 3.5% of the value of all assets held in SMSFs. This level of investment has been consistent since 2009 with the bulk of properties worth between $200,000 and $1 million. SMSF investment in commercial property is around 12%. However, what has changed is the number of investors with an average of 1,200 new investors using their SMSFs to purchase residential property each year and the explosion in limited recourse borrowing arrangements, which increased 1,758% between June 2009 and June 2014.

For many SMSFs, however, there are some very big risks if the borrowing arrangements and property purchases are not put in place correctly. If your SMSF breaches its compliance obligations it is at risk of being deemed non-compliant and losing its concessional tax status, and the trustees also risk being fined personally under the ATO's new penalty powers that came into effect on 1 July 2014.

Here are the top SMSF property issues:

Should Your SMSF Buy a Property?

Liquidity, diversification and cashflow: the *Superannuation Industry (Supervision) Act* (SIS Act) requires trustees to take heed of these elements when making any investment. When an SMSF invests in real property, there is a risk that the trustees are putting all of the fund's 'investment eggs' in one basket and the rate of return will not be enough to meet the fund's obligations.

Funds in, or entering, pension phase need to meet the minimum pension draw-down requirements. The question is, will the rental yield meet the ongoing expenses of the fund, including pension payments? Funds are required to increase the minimum pension draw-down over time: 4% at age 64, and 6% at age 75. That's an increase of 50% in draw -down obligations. Will rent increase by 50% to keep pace?

But what if a member wants a lump sum and not a pension: where will the immediate cash come from? What about when a member dies? How will the benefits be paid out from the fund? You can't sell one room of an investment property.

Can My SMSF Purchase My Investment Property?

A common question that often comes up is, can my SMSF buy a residential rental property, holiday home or house from me or someone related to me? The answer is no, not unless the property is business real property (a property used wholly and exclusively for business). And, in most cases, residential property will not meet the requirements to be business real property. It's important to bear in mind that the penalty for breaching the related party investment rules is up to 12 months in jail.

Improving a Property

If your SMSF has borrowed money to purchase a property, it cannot use any part of those borrowings to improve that property. Also, an SMSF cannot borrow money to repair an asset it already owns outright.

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However, an SMSF can use its own money to improve or repair a property acquired with borrowings, as long as the improvements do not result in the asset becoming a different asset. For example, the trustees could not change a residential property into a childcare centre or turn a vacant block of land into an investment property.

Take the example of an SMSF that borrows to buy a residential house on a large block of land ripe for development. The fund cannot subdivide the land and build another house because the borrowing rules prohibit a change in the character of an asset bought with borrowed money until the borrowings are extinguished.

Getting the Essentials Wrong

The common problem areas for SMSF trustees are often simple things in the rush of the moment or simply poor structuring.

The most obvious example is when a property is purchased by an SMSF, but the contract is in the name of the individuals. Sometimes people just get carried away and make the purchase without thinking through the details. Or where there is a related entity involved like a unit trust, but the unit trust was not established before the property was purchased or the incorrect name is inserted on the contract or registered with the titles office.

Divorce - What it Means to You (and Your Business)

Breaking up is hard to do. Beyond the emotional and financial turmoil divorce creates, there are a number of issues that need to be resolved.

What Happens When There is a Family Company?

A recent ruling from the ATO will create a tax burden for many divorcing couples that have assets tied up in a company. Previously, when a company transferred assets or cash to one of the former spouses under a Family Court order, many people took the view that the transfer was not treated as a dividend and did not trigger tax. However, in a ruling released on 30 July this year, the ATO confirmed that any settlements paid out by a corporate entity are treated as income and taxed at the relevant spouse's marginal tax rate.

If you are receiving assets from a corporate entity as part of a property settlement, it's essential that you understand the tax implications prior to settlement, or a sizeable chunk of the settlement could go to the ATO.

For business owners, outside of the tax and financial issues, it's important to not lose focus on what's important to keep the business running efficiently.

What Happens to Your Superannuation in a Divorce?

A spouse's interest in superannuation is a marital asset and can be split as part of the breakdown agreement. It's important to be aware, however, that superannuation cannot be paid directly to a spouse unless the spouse is eligible to receive superannuation (they have met a condition of release), but it can be rolled over into the spouse's fund until they are eligible to receive it. Laws exist to prevent taxes such as capital gains tax (CGT) being triggered when superannuation assets are transferred. This is particularly important where your superannuation fund holds property.

A court order or superannuation agreement is required to give effect to the agreed split in the SMSF assets or to execute a rollover eligible for the CGT rollover concession.

If you have an SMSF and both spouses are members, it's important to get advice to make sure that all of the appropriate administrative issues are taken care of. Where a divorce is not amicable, it's important to keep in mind that the SMSF trustee is required under law to act in the best interests of the fund and its beneficiaries. Anything less and the fund members may seek compensation for loss or damage.

Can You Protect Both Parties from Divorce?

In a divorce, assets are split based on a multitude of factors such as earning capacity, maintenance of children, and the assets held pre-marriage. Many couples don't go through their marriage with an equal view of how assets and income should be attributed until something goes wrong. If there is a disparity between the income levels of each spouse, there are a lot of benefits to the household in general of evening out how income flows through to the family. If your partner earns less than you, there is a very real financial benefit to topping up their superannuation as superannuation has preferential tax rates. The same goes for taxable income. If you can even out income coming into the household, it spreads the tax burden. Good planning can make a difference.

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