HERA
Property Group

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THE WALK TO FREEDOM

Six big reasons for buying property in your Super

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INTRODUCTION TO SMSF PROPERTY INVESTMENTS

SMSF stands for Self-Managed Super Fund, and it is a retirement savings account. In most cases, one person runs it; however, the regulations allow four family members to combine their funds into a super balance and make investments together.

There is a major difference between SMSF and other funds like retail and industry funds. Members of the fund run SMSF funds, while banks, industry bodies, fund managers, and large corporate trustees run retail and industry funds.

The Australian Taxation Office regulates SMSF funds; therefore, members must follow all the rules and regulations of the taxation office

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They will enjoy specific taxation concessions as long as they follow the rules.

The concessions are:

1. The maximum tax on income earnings on all the investments will be 15%.
2. The maximum tax on capital gains tax will be 10% if you hold the asset for a period of more than 12 twelve months.

You are taxed more when you are investing in your own name. Investment returns are reasonably higher in SMSF because less of your money is taken in taxes. Therefore, it accelerates your long-term financial growth and multiplies the value of your investments.

The best thing about SMSF is that it gives you control over your investment. You decide what, where, and when you will invest your super money.

You cannot buy direct property with traditional funds; however, you can buy it with SMSF. It includes both commercial property and residential investment. It is why SMSF is so attractive to people who want to invest in property instead of buying shares.

SMSF was not allowed to borrow money to buy property before September 2007. At that time, only the super funds that had enough cash were allowed to buy a property.

SMSF – LIMITED RESOURCES BORROWING ARRANGEMENTS

It was 2007 when rules changed, and things started to get better, and the Government of Australia introduced an exception for borrowing money. The new rules allowed SMSFs to borrow money to invest in property and shares as long as the fun satisfied a set of specific criteria.

While this seem like a solution to problem, it was a problem at the same time. The new legislation was not clear, and it created a lot of confusion and uncertainty. Therefore, the government passed new legislation in 2010 that provided more clarity and certainty to the borrowing exception. The legislation also reduced the borrowing risks for trustees of SMSF.

The exception is referred to as LRBA (Limited Resource Borrowing Agreement). The LRBA arrangement has 4 basic principles.

1 - SMSFs can borrow money from a lender, but the loan must be **"limited in recourse."** If SMSF cannot repay or default on a loan, the lender can seize only that property or asset purchased with the borrowed money. The lender cannot touch any other property or asset in the SMSF. It ensures the protection of your remaining super fund assets.

2. The borrowed money has to be used to purchase a **"single acquirable asset."** The legislation defines a single acquirable asset, and the borrowed money must be used to acquire a commercial or residential property that meets the definition. Later in this book, a section describes brief detail about what properties an SMSF can and cannot buy

3. The property must be held in trust for SMSF. Apart from that, property purchased with SMSF has to be held in a separate property trust called security custodian or bare trust. The security custodian holds the property's legal ownership, and its beneficial interest belongs to the superannuation fund and its members, where beneficial interest refers to the right to receive and enjoy benefits.

4. The SMSF has the right to transfer the property (asset) to fund once the loan has been repaid. The property is held in the bare trust until the loan is repaid. The ownership or title of the property can be transferred from trust to a self-managed super fund once the property has been paid down in full.

6 BIG REASONS WHY ONE SHOULD CONSIDER BUYING PROPERTY THROUGH SUPER

There are 6 big reasons why everyone should consider buying property through a super fund.

1. It offers investment leverage for greater investment returns. Borrowing allows you to buy assets that you cannot buy outright because you don't have enough money in your funds. You can increase the size of your investable assets of super funds by more than 100%. It means that your SMSF can get you higher investment returns. It will provide you with thousands of dollars to pay for the lifestyle you want, especially when you stop working completely or start dropping your working days.

   There are several real-life examples of how people made hundreds of thousands of dollars by borrowing money to purchase property through SMSF.

2

SMSF has a positive cash flow for property investing. Your fund must make a large initial deposit when you borrow money to buy a property through SMSF. Also, you are required to put down at least 20% to 30%. However, you can deposit as low as 10% when you buy property on your own name. This is why super property's rental income is higher than the ongoing costs in many cases. The ongoing costs include insurance, rates, strata, repayments, interests, etc. As a result, the ongoing property cash flow is always cash flow positive.

Suppose your property is not cash flow positive. In that case, your property's rental income plus your employer's super contributions should be reasonable more than the ongoing running costs of your property in the super fund. You will see real-life examples of the situation later on in this book.

3

There are significant income tax benefits. Your rental income is taxed at a minimum of 15% when purchasing a property through super fund. The comparison between super taxes to marginal tax rates tells you the benefit of super fund. You will be surprised to see that most Australians pay between 57% and 69% less tax on rental income through super.

Moreover, all your ongoing property expenses are 100% tax-deductible to your super fund. It includes depreciation allowances that can reduce and even completely eliminate taxes on super investment income and contributions.

The SMSF taxes on rental will drop to zero when you retire and convert your super into a pension. Your super fund will then receive and payout tax-free rental income to members of the super fund.

The table below shows a comparison between margin tax rates and super tax rates.

Table 1. Comparison of personal and super tax rates

Margin Tax Rate	Super Tax Rate	Difference in Tax	Super Pension Tax
35%	15%	57%	0%
39%	15%	61%	0%
49%	15%	69%	0%

- SMSF saves potentially hundreds of thousands in capital gains taxes. You will be entitled to a 50% capital gains tax exemption if you hold your property in your personal name for 12 months or more before deciding to sell it. Most Australians can reduce their tax rate on capital gains from 17% to 25%.

4 If your property was held in your SMSF, you would be entitled to a 33% capital gains tax exemption, which will be at a much lower tax rate of 15%. Therefore, you will only be taxed about 10%. Your super tax rate will drop to zero if you sell your property when you are in the pension phase. It represents a remarkable tax savings of hundreds of thousands of dollars. It means that your SMSF would keep a much bigger share of the proceeds from selling an investment property as compared to when you sell it while you hold the property in your name.

Let's look at an example to help you understand it better:

Suppose you purchased an investment property for $700,000. The property's value grew to 1,600,000 in 15 years. The capital gain, in this case, is $900,000.

The tables below show significant savings in capital gains that you can get when you hold property through SMSF.

Table 2. Capital gains tax calculation on a $900,000 gain in super accumulation phase

Taxable Income in Personal Name	Personal Tax Payable	Super Tax Payable	Tax Savings
$0	$191,123	$90,000	$101,123
$50,000	$214,632	$90,000	$112,463
$120,000	$248,932	$90,000	$158,932
$180,000	$278,332	$90,000	$188,322

It is a risk-free return. Table 2 shows that the amount of money you can keep due to paying fewer capital gains tax, ranges between $101,123 and $188,322 if you purchased property in your SMSF.

Table 3. . Capital gains tax calculation on a $900,000 gain in super pension phase

Taxable Income in Personal Name	Personal Tax Payable	Super Tax Payable	Tax Savings
$0	$191,123	$0	$191,123
$50,000	$214,632	$0	$214,463
$120,000	$248,932	$0	$248,932
$180,000	$278,332	$0	$278,332

Table 3 shows the risk-free capital gains tax savings you would get when you sell the property during the pension phase. The table shows that the capital gains tax savings during the pension phase range between $191,123 and $278,332, which is more substantial.

5

SMSF offers you rapid debt reduction. The pre-tax contributions to your SMSF can help you pay off your super investment loan in a small amount of time. The pre-tax or concessional contributions include personal deductible contributions, salary sacrifice, and compulsory employer super guarantee.

It is because super contributions are taxed at a maximum of 15%, which is lesser than the marginal tax rate. In other words, more money will be available to repay your SMSF loan for every dollar that you contribute to your loan through SMSF.

Let's look at an example.

The table below compares the amount of money left over by someone who is earning $15,000 in income and uses the after-tax proceeds to repay debt versus the salary sacrificing $15,000 and using the after contributions tax proceeds to repay debt. The comparison shows how much more debt can be reduced in SMSF.

Before Tax Contribution	Marginal Tax Rate	Net Amount to Pay Off Loan Principal	Concessional Super Contribution	Taxable Income in Personal Name	Personal Tax Payable	Super Tax Payable
$15,000	34.5%	$9,825	$15,000	15%	$12,750	$2,925
$15,000	39%	$9,150	$15,000	15%	$12,750	$3,600
$15,000	49%	$7,650	$15,000	15%	$12,750	$5,100

The risk-free principal reduction can increase from $5,175 to $7,350 if the gearing tax benefits reduce the contributions tax within the SMSF to zero percent. We will show you an example of it later on in this book.

SMSF reduces taxes for high-income earners that pay division 293 taxes. You must pay an additional high-income contribution tax of 15% on your concessional or pre-tax super contributions over $250,000 from 01 July 2017 of current over $300,000. It can increase your contribution tax by 100%, which means your contribution tax increases from 15% to 30%.

There are not many ways to reduce your high-income contributions tax. However, you can reduce the original 15% general contributions tax with strategic tax planning through share and property investment. The result is that you reduce your total pre-tax contributions taxes from 30% to 15%. Therefore, super contributions are still a highly attractive proposition for people with high incomes.

WHAT ARE THE RISKS OF BORROWING TO BUY PROPERTY THROUGH SUPER?

We have looked at the benefits of super. Now let's look at the risks of super and how you can manage them.

1. There are plenty of risks of investment losses. You gear into a property to magnify returns when buying a property through super in a rising market. In the same way, you can make losses if the market fails, and you borrow money to buy a property through super. Keep in mind that property prices tend to bounce back quickly when you invest for a longer time horizon, and your property is held in a blue-chip location.

2

It can reduce cash flow due to loss of employment. There is always a chance that your SMSF property expenses exceed your expected rental income. When that happens, then your concessional contributions must meet the shortfall. Keep in mind that your concessional contributions should be enough to fund the SMSF property expenses in most cases. You might not have enough surplus cash flow available to pay the shortfall if you lose your income and are not making contributions to your super fund.

Ideally, your fund should have enough liquid assets or in cash to maintain any type of shortfall for some time. It will help you maintain cash flow until you find work again and contribute to your SMSF again.

3

There is always a chance of an increase in interest rates. It is one factor that you must consider before you decide to buy a property through SMSF. Sometimes interest rates suddenly increase, and it can affect the cash flow of your fund. Experts suggest that you should not model your cash flow on today's interest rates. They also suggest that people should assume an increase of 2% in interest rate when working out their property cash flow. It will ensure that rental income and super contributions will be more than enough to fund if any shortfall occurs.

There is another way to reduce the risk of a shortfall. You can either purchase a property at a lower purchase price or put in a larger deposit to reduce the amount of money you will need to borrow.

4

Sometimes you lose income due to reasons like the death of a member, or accident, or sickness. When that happens, then the fund will have to meet the shortfall of property expenses. The only way to pay for the shortfall is to consume liquid assets of the fund. It is not a sustainable approach in the long run because your liquid assets will decrease over time.

You should ensure that you have enough income to minimize risk. You should have life and permanent disability insurances. It will eliminate or reduce the impact on your SMSF cash flow due to a member's injury, illness, or death.

WHAT PROPERTIES CAN AND CAN'T BE PURCHASED THROUGH YOUR SUPER?

It is essential to understand what you can and cannot buy through super when you borrow money to purchase property through it. There are some limitations of SMSF that you should know about.

Following are the properties that you can buy in a self-managed super fund:

Houses

Duplexes

Townhouses

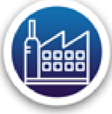
Office suites

Existing apartments

Off the plan apartments

Overseas property

Retail shops



Other commercial properties

Following are the properties that you cannot buy in an SMSF:

- Property that you plan to rent out to a related party or to yourself
- The primary residence for yourself
- Property that you or your family member owns. It includes all those properties that those companies and trusts own, which you or your family control.

Remember that you can purchase a commercial property that you or a related party owns, but it should only be used to carry on a business.

You can also buy properties in an SMSF under limited recourse borrowing arrangements. However, it is more complicated because the property must satisfy the rule of a single acquirable asset under the limited recourse borrowing arrangements. A property is usually considered a single acquirable asset on a single block of land or a single title. Things get complicated when the property sits on multiple titles

There are certain rules for a property with multiple titles to be considered the single acquirable asset.

1. The titles have to be dealt with together under the Territory or State laws.
2. The physical property permanently attached to the land is called fixture,

The property cannot be split into multiple assets. It must only be considered one asset to be a single acquirable asset. Therefore, you cannot buy the following types of properties under a limited recourse borrowing arrangement:

- A vacant piece of land on which you intend to construct a separate property
- A serviced apartment which includes a furniture package
- An apartment that has a car park on a separate title
- A factory complex on multiple titles (in most cases)
- Two or more blocks of land that are adjacent to each other

The biggest problem is that you cannot tell whether a property is a single acquirable asset. Sometimes it may look like a single acquirable asset, but it is not. Therefore, we recommend you discuss it with an expert, or you may end up losing a big portion of your cash to failed property settlements or ATO penalties.

We suggest you speak with an SMSF expert before you purchase your SMSF property. It will ensure that the property you are purchasing is allowable under SMSF rules. This step is even crucial when you plan to buy a property through LRBA.

UNDERSTANDING IMPLICATIONS OF REPAIRS AND IMPROVEMENTS

Under a limited recourse borrowing arrangement, an SMSF can use borrowed funds to maintain or repair property held under LRBA. However, you must remember that you cannot use the borrowed funds to renovate the property.

Below are the definitions of maintenance, repairs, and property improvement under SMSF regulations.

A **"repair"** is when you replace or restore a part of a property or asset which is worn out or damaged due to wear and tear, but you do not change its character. Repair is a tax-deductible expense to your fund.

"Maintenance" is the work done to a property to prevent deterioration, damage, and defects. Maintenance ensures that the property stays in its present condition.

Remember that it is impossible to use borrowings from a limited recourse borrowing arrangement to maintain or repair the property if your SMSF already owns it.

"Property improvement" means substantially increasing the value or functional efficiency of the property. It occurs when you add new features to bring the asset to a more desirable or valuable condition. Some other factors point to an improvement too, including any work that will significantly enhance the property's salability and increase the ability of the property to produce income.

The property is considered a new asset or a new replacement when property improvement occurs. Therefore, it is not allowed under limited recourse borrowing arrangements. Property improvement is not tax-deductible like property maintenance and repairs. It is because it is generally considered a capital expense.

We recommend that you always get an expert opinion to avoid breaching LRBA rules. It can be confusing for you to determine whether property improvement or property repair has been made. Many people cannot correctly interpret LRBA rules, and they mistakenly consider property improvement as property repair or maintenance.

STEP-BY-STEP GUIDE TO SETTING UP AN LRBA AND BUYING PROPERTY THROUGH SUPER

It is a complicated task to set up the correct structure of SMSF if you do not know how to do it. Following is a simple explanation of the 11 step process to get familiar with LRBA and buy a property through SMSF.

1. The first step is to get advice from a specialist. We highly recommend it because it is complicated to establish an SMSF with an LRBA (limited recourse borrowing arrangement). A financial planner or accountant is the right person to seek advice from, and he will ask you the questions mentioned below to move forward:

- How much do you have as a combined super saving with any other member of your family who can join your fund? Don't forget that you can group your super savings with a maximum of 3 other members of your family.

- How much does each family member contribute to the super fund, and does any member plan to contribute more after-tax contributions or salary sacrifices?

- How much can your SMSF fund borrow?

- Can you bear the level of stress involved in SMSF and LRBA? Remember that you will face several challenges such as a rise in interest rates, loss of contributions, tenant vacancy, and decide whether your super fund could comfortably continue to meet property and SMSF's ongoing expenses.

- What is the most reasonable purchase price for your fund?

Your SMSF adviser will be able to help you after you have done the following tasks:

- Make a comparison of your present super strategy with an SMSF property investment strategy.

- How much could your fund potentially increase after seven years?

- Understand every risk that is associated with gearing.

After you have answered the questions mentioned above, you will have a clear picture of your condition. It will help you decide if a self-managed

2

The second step is to establish the correct structure for your SMSF. You will have to establish a fund with a trust deed if you do not already have an SMSF. It will allow your self-managed super fund to borrow money for buying a property. Be very careful at this step. There are several cases where a person purchased a property through his SMSF, but it did not settle because his trust deed did not allow it.

Find out if your existing trust deed allows you to borrow money to buy property if you already have a self-managed super fund. You can either change or amend the deed if it does not allow you to borrow money for acquiring property. You will also need to document your investment strategy for setting up your SMSF fund.

3

The third step is to roll over all super member funds into your self-managed super fund. The funds need to be available in the cash account of the property, so your fund can invest or pay for a deposit on the investment property. You cannot personally invest or pay for the deposit and then get a refund from your fund. Ensure that all super member funds are rolled over before you start looking for investment property. Moreover, your employer, salary sacrifice, after-tax contributions, and personal deductible are flowing through the cash account of the SMSF.

4

The fourth step is to set up a bare trust to hold your SMSF property investment. The bare trust must hold the property while the SMSF is the beneficiary, and only then can your SMSF borrow money. In other words, the bare trust will be the legal owner of the property. The bare trust will hold the property for your SMSF until you repay the entire loan. The investment ownership will be transferred to your SMSF once the loan is repaid. Therefore, you will need to establish a separate bare trust that has a corporate trustee. The ownership must not be in the name of your SMSF trustee or your SMSF. It should be in the name of the corporate

5

The fifth step is to get the loan of your SMSF property pre-approved. SMSF loans are different than traditional bank loans. Keep in mind that SMSF loans are limited recourse. The bank can only seize the property held in the bare trust if you cannot repay your SMSF loan. The bank cannot touch any other of your super assets.

The best thing about a limited recourse borrowing arrangement is that it is designed to protect your SMSF trustee. The bank cannot personally pursue your SMSF trustee for the debt generated from SMSF. Lenders usually require a deposit of 30% and limit their loans to 70% of the purchase price because of the limited recourse borrowing arrangement. However, some banks will allow you to borrow loans up to 80% of the purchase price.

The banks usually require an additional 10% in liquid assets to be held by the SMSF members or SMSF as an additional layer of safety. It means that SMSF must have over 30% to 40% in their fund to secure an LRBA. Remember that SMSF lenders charge higher interest rates. SMSF loans do not come with interest rate discounts that banks generally provide to individual borrowers. Traditional investment loans come with interest rate discounts for individual borrowers.

Generally, SMSF loans are around 1% higher in interest rates. Your SMSF will give you your property price range once it has a loan pre-approval. We highly recommend that you do your research. Take your time to crunch the numbers and understand the cash flow because it is very important.

6

The sixth step is to consider all important factors. Below are the factors that you must consider:

Demographics: you must find out the tenant demographics in the area, which includes income levels, employment rates, tradesperson, white-collar professionals, etc.

- Jobs: what type of employment is in and around the area, proximity to the central business district.

- Transport: how close is the property to light rail, bus stops, and train stations.

- Recreation: Is the property close to the beach, river, and parks?

- Shops: Is the property near major shopping centers and shops?

- Vacancy rates: Does the suburb have low vacancy rates?

- Property type: Is the property of the right type for the area? For example; a studio apartment in a suburban area where there are high family ratios is not the right type of property for the suburb

The contract of sale will be sent to your solicitor after you have found your property.

7

The seventh step is to book a time to see your solicitor. It is very important that you carefully choose your conveyancer or solicitor. Compared to purchasing a property in your individual name, buying property through a self-managed super fund involves technicalities. There are many rules of SMSF, and your solicitor must be familar with them.

There are many cases where SMSF members' solicitors did not know the complex rules related to limited recourse borrowing arrangements. It costs tens of thousands to fix mistakes like these. Therefore, we advise you to get a solicitor with reasonable experience of SMSF property transactions. You will be required to provide your 10% deposit and exchange contracts after you and your solicitor is happy with the contract.

8

The eighth step is to amend your SMSF property investment loan application. After you have signed and exchanged contracts, you should return to your lender and provide them with your contract of sale and rental letter. It will confirm the proposed rental income the property will pay. It will be the time when you are required to decide the following things:

- The loan term, e.g., 25 years or 30 years
- Whether you make interest-only or principal and interest loan payments
- Whether you take out a variable or fixed loan
- Whether you establish an offset facility
- Whether you split your loan with a combination of the above conditions

The bank will do a valuation on your property once you have decided on the above things. The loan documents will be issued after the valuation has been accepted. You will then have to meet your solicitor again to go through the loan documents. The main reason for it is that your solicitor is required to sign a solicitor's certificate, which must be attached to loan documents.

solicitor is required to sign a solicitor's certificate which must be attached to the loan documents.

The executed documents will be sent back to the bank to get certified after you and your solicitor have signed the loan contract and legal documentation. After that, a settlement date will be determined.

9

The step no.9 is to find a good state agent that will help you find quality occupants. You cannot assume that your agent is a good property manager just because he sold you your SMSF property. Sometimes, the agent is a good property manager. The best way to proceed further is to talk to many state agents/managers to find the best deal.

Find out what they charge and how much rent they believe they can achieve. You should also find out what you will get for the fee. In most cases, the fee for your property manager is around 5.5% of the rental income received. We recommend that you should choose an agent that simplifies the rental process for you and pay all your property expenses out of the rental income they receive.

You will be required to sign a property management agreement once you are comfortable with an agent. After that, your agent will advertise your property for rent

10

The tenth step is to settle your SMSF property investment. A few days before the settlement, your solicitor will advise you to provide a cheque from your SMSF. It is required to make up the shortfall to settle the property. The shortfall amount includes legal fees, loan costs, outstanding 10% or 20% deposit plus, and stamp duty.

Your solicitor will organize for all the funds to be paid out which also includes the loan, and he will do it on the day of settlement. Your property will be settled once it is done. The title will be transferred to the trustee of your bare trust, and the keys will be handed over to you.

11

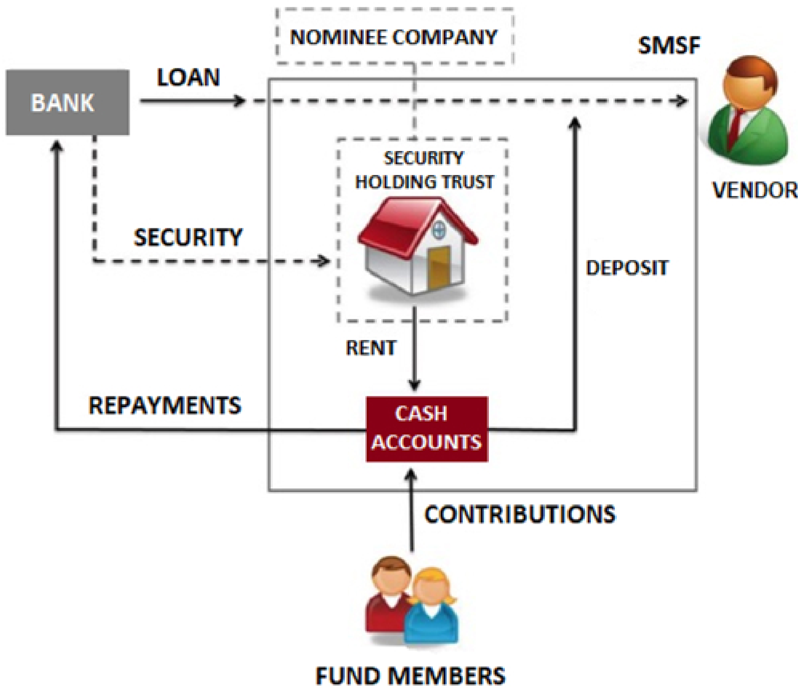
The eleventh step is to receive property rental income and paying SMSF property expenses. The legal owner of your SMSF property is the trustee of the bare trust, but no rental income will be paid to the bare trust or the trustee. Similarly, the trustee of the bare trust will not pay for the ongoing property expenses that includes property management expense, strata, rates, and loan repayments.

Your property manager to your SMSF bank account must pay the rental income. Remember that the rental income cannot be paid to your personal account, and then transferred to your SMSF bank account. Similarly, all ongoing property expenses must be paid out of your SMSF bank account.

Below is the visual depiction of how the entire process works:

Now let's look at two client case studies for better understanding of SMSF property investment

CASE STUDY #1



The first case study is about James and Barbara. They will pay down their SMSF loan in a period of less than 8 years. They will also achieve compound growth on a property and share portfolio during this period.

It was 2016 when we met James and Barbara. Both of them are in mid 50s, and they earn $180,000 and $96,000 respectively. They wanted to take control of their retirement savings. They also wanted to find out if borrowing money to buy property SMSF was a good option for them. Their target is to buy a property and pay it off, so that they could have a tax-free rental income stream which helps them save for retirement.

James want to increase his SMSF by making an additional $7,900 per year in salary sacrifice contributions, and Barbara wants to contributes an additional $15,880. Their combined super total is $609,316. We established an SMSF for them. It required a legal structured that would allow it to borrow money to buy property. We also rolled over their funds from their existing super.

By April 2017, James and Barbara found a townhouse to purchase from their SMSF. It was a 4-bedroom townhouse with a value of $719,000. It had a rental income of $650 per week, ongoing property costs of $7,789, and a loan interest rate of 6%. James and Barbara also have a depreciation schedule which states $12,120 is their depreciation allowance.

We advised Barbara and James to limit their initial expenditure to a deposit of $246,080 (30% plus costs) and borrow an amount of $503,300. It was important for them to reduce debt, so we recommended that they may use their surplus super cash flow to pay down the principal of their SMSF loan. However, we asked them to do it after paying all property and fund expenses.

We also advised them to invest the remaining funds in a share portfolio that will provide amazing long term growth. Their remaining funds approximated $363,000 and sharing it in portfolio complemented their rental income to increase their tax-free retirement pension.

The below table summarizes the net property cash flow:

Income Description	Value
Rental Income	$33,800
Total Annual Income	$33,800
Expense Description	**Current Value**
Loan Interest Repayments	$33,800
Ongoing Property Costs	$7,789
Depreciation Allowances	$12,120
Total Annual Expenses	$50,107
Net Taxable Loss	-$16,307
Add back Non-cash Depreciation Expense	$12,120
Net Cash Rental Loss	-$4,187
Tax Refund	$2,446
Net Rental Loss	-$1,740

The non-cash deduction are the depreciation deductions. Depreciation is an expense for tax purposes but not an out of pocket cost, and that is why it is added back. The table below shows that the property in cash flow is negative by an amount of $1,741.

The SMSF of Barbara and James can easily pay the $1,741 shortfall and fund fees with $50,000 in yearly super contributions and dividend income. In fact, they can still retain a surplus income of $55,066 in the first year.

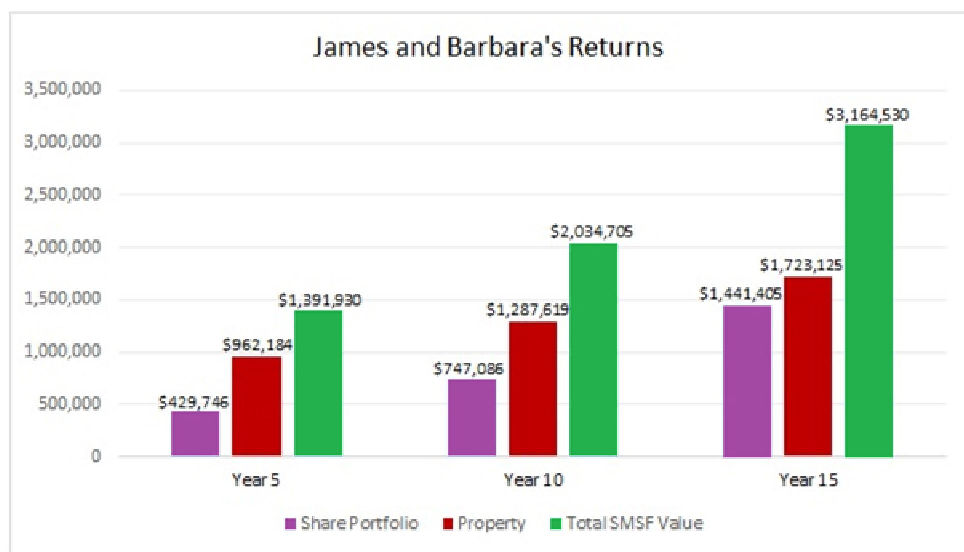
The below table shows the project summary of surplus SMSF income to pay down the original loan of $503,300.

Financial Year	Surplus SMSF Income to Pay Down SMSF Loan	Loan Amount at end of Financial Year
2017/18 Financial Year	$55,066	$448,234
2018/19 Financial Year	$55,120	$392,114
2019/20 Financial Year	$59,562	$333,552
2020/21 Financial Year	$64,280	$269,272
2021/22 Financial Year	$69,325	$199,947
2022/23 Financial Year	$74,642	$125,305
2023/24 Financial Year	$80,396	$44,909
2024/25 Financial Year	$86,541	$0
Total Annual Surplus Income over 8 years	$554,962	

As you can see in the above table that we estimated that James and Barbara should be able to pay off their SMSF loan of $503,300 in less than 8 years.

Now look at the below table which shows the projected summary of SMSF growth:

Year	Value of Share Portfolio	Value of Property	Total SMSF Value
In year 5	$429,746	$962,184	$1,391,930
In Year 10	$747,086	$1,287,619	$2,034,705
In Year 15	$1,441,405	$1,723,125	$3,164,530



The projected strategy outcomes shows that James and Barbara should be able to pay down their $503,300 loan in under 8 years by redirecting their surplus SMSF income into their SMSF loan.

They should have a tax-free rental income of $51,266 per year to complement a share portfolio when they retire in 15 years' time. Their tax-free rental income should pay an additional $66,032 per year in dividends. They can pay to themselves up to $117,298 per year by bringing the tax-free income.

James and Barbara will be able to pay for any lifestyle expenses because they will also have access to liquid shares with a value of $1,441,405. Moreover, they should also have a property with a value of $1,723,125 in 15 years with debt owing on it. Even in retirement, the SMSF funds of James and Barbara should continue to grow in value.

CASE STUDY #1

The second case study is about Nancy who increased her net after-debt super balance. She increased it from $126,000 to $528,333 in a period of less than 5 years by borrowing to buy property through a self-managed super fund.

We met Nancy 4 years ago when she was 50. At that time, she earned $120,000 per years, and had a retail super fund with a balance of $126,000 and no other assets outside her family home. Her employer paid the compulsory super contributions that were 9.5%.

Nancy wanted to retire at the age of 65, and we needed a strategy that could really multiply her retirement savings. There, we went over her options and advised her to establish a self-managed super fund and borrow money to buy an investment property through it. She would not be able to grow her SMSF enough with just her employer super contributions when she retires.

We worked with Nancy to determine an optimum purchase price. It should be able to meet the cash flow. However, Nancy did not have enough money for deposit plus costs which was necessary to purchase anything at that price. Therefore, we advised Nancy that she can consider buying a property off the plan, and it would be built in around 2 years. She would have sufficient funds to complete the purchase if she agrees for salary sacrifice approximately $13,600 per year into her SMSF.

However, things could change if the market drops, but it rarely happens.

Nancy decided that she would purchase a brand new 2-bedroom unit at a price of $560,000 in June 2012. The property was completed and settled in April 2015. Nancy had to put in a deposit plus costs of 20% which was $136,790, and she had to borrow $448,000 at a fixed interest rate of 5.04%. She receives a rent of %560 every week, and she pays ongoing property expenses which are $7,910. The property also provides her with another $16,760 in depreciation allowances.

Later on, some changes to depreciation deductions for property investors took place. It was 2017 when the government announced the changes in the Federal Budget. The government announced that they intend to limit the depreciation deductions property investors can claim.

The new rules say that investors can depreciate equipment and plant assets within new items or property they acquire. However, the subsequent owners who acquire a property after May of 2017 cannot claim depreciation either on existing plant or on equipment assets.

The below table summarizes the new property cash flow:

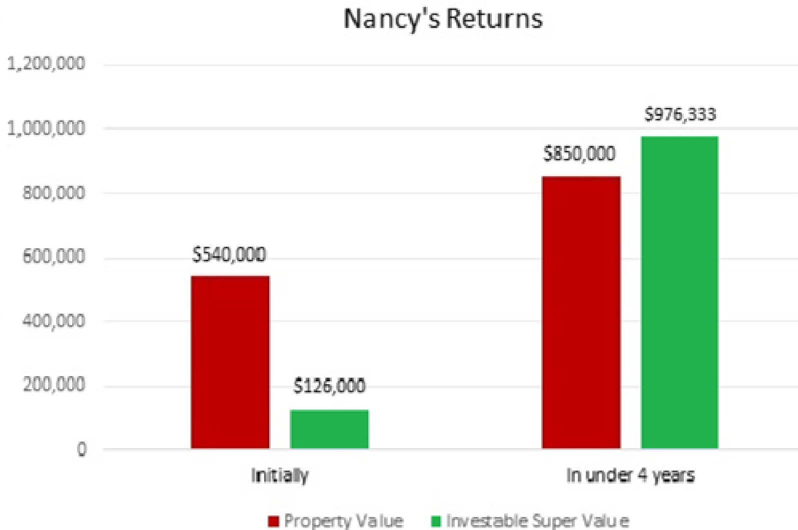
Income Description	Value
Rental Income	$29,120
Total Annual Income	$29,120
Expense Description	**Current Value**
Loan Interest Repayments	$22,581
Ongoing Property Costs	$7,910
Depreciation Allowances	$16,790
Total Annual Expenses	$47,251
Net Taxable Loss	-$18,131
Add back Non-cash Depreciation Expense	$16,760
Net Cash Rental Loss	-$1,371
Tax Refund	$2,719
Net Rental Loss	$1,378

Keep in mind that non-cash deductions are the depreciation deductions. Depreciation is an expense for tax purposes but not an out of pocket cost, and it is the reason why it is added back.

The above table shows that Nancy' property provided her with a positive cash flow of $1,378. However, it is technically negatively geared. It means that the property pays for itself.

The strategy outcomes shows that Nancy's property has grown from $540,000 to $850,000. As a result, her investable super balance increased from $126,000 to $976,333 in a period of 5 years. Nancy has increased her net super balance to $528,333 if we subtract the $448,000 loan. Every year, this investable amount will continue to compound and achieve accelerated growth. Keep in mind that it will not grow on the net value of $528,333 rather it will grow on the gross value of $976,333 of Nancy's super investments. It will significantly increase the long-term growth prospects of Nancy's fund.

The property of Nancy is cash flow positive by $1,378, and it means that the property pays for itself. Her salary sacrifice and net employer contributions can be used to repay her debt or invest in the share market. Right now Nancy is doing a combination of both. It means she is using half of the funds to reduce her SMSF debt and other half is invest in the share markets.



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WHAT HAPPENS WHEN YOU ENTER THE RETIREMENT PHASE OF SMSF?

Moving the accumulated benefits of superannuation to pension phase is a rather common way of funding one's retirement income. For those with a self-managed super fund, few considerations are essential for starting pension. The first thing that you should know is the pension that is account-based pension. It is like an account with retirement income and operates in the super fund. It gives you regular payments, and might even earn some tax free investment income. Keep in mind that before receiving a pension with the super benefits, you need a release condition.

Some common release conditions are:

- Reaching the preservation age
- Permanently retiring after the preservation age
- Reaching age 65
- Permanent incapacity

You should check your trust deed. The trust deed of your SMSF must allow the payment of pension that is account-based pension. Review your deed and update it if necessary. It will generally require a legal professional.

You should consider the investment strategy of your funds. One of the objectives of an account-based pension may be to have your capital last throughout lifetime.

Studies indicate that negative returns' general impact could be greater if it draws down on one's capital, compared to when in accumulation phase. Remember that generally you will not be drawing down, and may be adding to your capital. Therefore, your investment strategy should take into consideration this additional risk. Your adviser will be able to assist you in determining an appropriate investment strategy for your SMSF.

You should make minimum payments. When running your account-based pension, a requirement is to make sure you draw minimum payment every financial year. This is an important criteria in maintaining the tax-free status of your fund's earnings in pension phase. The minimum amount you have to draw is a percentage of one's account balance based on the age, and it is calculated as given below

Required minimum payment amount = payment factor x account balance

The estate planning is also very important during the pension phase. If you are receiving a pension from your fund, the rules of your SMSF may allow you to nominate one of your dependents (usually your spouse) to continue to receive the pension after your death. Generally, it is referred as a reversionary pension. Alternatively, you may be able to nominate one of more dependents to receive either a lump sum payment or a pension after your death, or your estate to receive a lump sum payment.

Members become eligible to commence a pension using some or all of their superannuation balance when a member meets a condition of release.

Some older deeds may not provide for recent changes to legislation and may prohibit types of income streams that are otherwise now permissible by legislation. If necessary, trustees can amend the trust deed of the fund to allow for all permitted pension types to be paid from their super fund.

There are several conditions of release that can be satisfied to commence an income stream. Our focus is on the condition of release of a member attaining preservation age. This restricted condition of release allows people who have reached preservation age to access a portion of their superannuation benefits without having to retire.

There are some requirements of pension. A Transition to Retirement Income Stream (TRIS) can be commenced when a member attains their preservation age and must the following requirements:

- Meet minimum pension standards.
- Payments not to exceed a maximum of 10% of the account balance at the start of each financial year.

Immediately prior to commencing the pension, you must establish the value of the member's interest in the fund taking into account the valuation guidelines for SMSFs. The key components of the member's interest that must be determined:

- Preservation components
- Taxable and tax-free components

A pension may be commenced with member's full balance or a specified amount. Where a member has not satisfied a full condition of release, the TRIS will remain in accumulation phase. This means that for taxation purposes, the TRIS incurs tax up to 15% on assessable earnings and capital gains, noting that non-arm's length income is taxed at 45%.

Key elements of a TRIS Accumulation Phase are:

1. They do not count towards the members' Personal Transfer Balance Cap (PTBC), and they can be established for any amount, noting that the payment requirements are tied to the balance of the TRIS.

2. Having minimum and maximum limits calculated based on the account balance and member age at commencement and 1 July thereafter. The maximum payment amount is 10% of the account balance at commencement or 1 July.

Following are the conditions that you must meet, and then the accumulation phase of TRIS begins to convert into the retirement phase:

- You are 65 years old
- You are no longer able to get gainful employment after the age of 60
- You will never be able to work again in a job
- You have a terminal medical condition
- You are reversionary in case of a person's death

The Transfer Balance Cap (TBC) is a limit on how much superannuation can be in retirement phase and have tax free earnings. As the shift to retirement phase is only automatic when a member turns 65 it is important to document the condition of release that has been met and relevant date. Once this shift occurs the TRIS is now referred to as being in Retirement Phase'; it is sometimes called a 'Retirement Phase Pension.' This means that the TRIS can now benefit from the same tax exemptions as an Account-based Pension (ABP).

It is important to note that the 10% maximum payment restriction is also lifted at this time. A TRIS in retirement phase enjoys the same maximum as an ABP, being the full account balance.

Generally, when each TRIS payment is made, you must adjust the preservation components for the TRIS. The payments from the TRIS must be deducted from the preservation components in the following order:

- From any unrestricted non-preserved benefits
- From any restricted non-preserved benefits
- From any preserved benefits

Every member of the benefits in the TRIS become non-preserved benefits without any restrictions, but it happens once a member has satisfied the release condition. There should be a nil cashing restriction like becoming 65 years old. You can withdraw maximum 10% as payment for pension until your condition of release with a nil cashing restriction is met. There are also restrictions on the ability to commute a TRIS. When only preserved or restricted non preserved benefits are held a TRIS can be commuted to a lump sum in the following limited circumstances:

- If the member chooses to roll back the benefits to their accumulation interest

- To give effect to a family law payment split

- To give effect to a Division 293 Tax release authority for excess contributions

If a TRIS is fully commuted an individual must ensure that a pro-rated minimum annual pension payment is paid prior to the commutation. This is determined by the number of days in the pension payable period divided by the number of days in the financial year. The pension payment period includes the day of the commutation. This is not required if the TRIS ceases due to the death of the member and there is no reversionary beneficiary.

Earnings including capital gains, from assets supporting a TRIS in accumulation phase are subject to tax up to 15%. Earnings, including capital gains, from assets supporting a TRIS in retirement phase are exempt from tax. Non-arm's length income is taxed at 45% regardless of whether the fund is in accumulation or retirement phase.

If there is a TRIS in retirement phase and accumulation balances within the fund, it is not as straightforward. Accumulation accounts for members and retirement phase pensions are the two options for SMSF's running. TSB (Total Super Balance) of members at 30 June will decide the decision for application. The TSB is balance of all superannuation benefits and all other superannuation funds. It includes monies held in both pension and accumulation phase.

Segregation refers to the ownership of specific assets either supporting the retirement phase or supporting the accumulation phase. If all members of an SMSF have a TSB below $1.6 million segregation can be applied. As separate portfolios/assets are being held it is possible to clearly attribute any earnings to the specific phase it supports. Under this method it is simple to identify which earnings are tax free, there is additional work involved by the trustee in properly administering the fun.

Where one or more members have a TSB over $1.6 million, and any member with $1.6m is in receipt of a retirement phase income stream from any source, segregation is not allowable for tax purposes and the SMSF must adopt the proportionate method.

Where a fund is not segregated (either by choice of trustees, or due to the TSB restriction above) it is classed as being 'pooled' for tax purposes. This refers to the fund assets being in a single pool, and ownership by the retirement or accumulation phase is not identifiable. Realized capital losses can be carried forward under the proportionate method, to the extent that they are not used.

Under this method, the fund will need to obtain an actuarial certificate each financial year to determine the proportion of the fund's income that is applicable to the accumulation phase vs the retirement phase. This reduces the complexity of operations for trustees, as only once investment portfolio is held, and simplifies the administration. As a result of this the proportionate method is widely adopted as the preferred option of calculating tax.

Super benefits paid via a TRIS to a member aged 60 or over are tax free and there is no need to withhold tax or have the TRIS shown on the member's personal income tax return. For a member under the age of 60, the taxable and tax-free components determined at establishment of the TRIS will be used to determine how much is assessable and how much tax needs to be withheld, at marginal tax rates. A 15% tax offset is available on the taxable component which needs to be shown on the member's personal income tax return. It is important to confirm whether or not a member under age 60 wants to claim the tax free threshold.

It is important to maintain appropriate records including being able to show:

- The value of the TRIS commencement, when it enters retirement phase and at 1 July of each year
- The Preservation and Tax Components at commencement
- The TRIS share of the fund's earnings each year (allocated to the member's preserved component)
- The member has drawn between the minimum and maximum
- The preservation balance adjustments when you make the payments
- The date the TRIS retirement phase

Keep in mind that no new contributions cannot be added to an existing TRIS and must be kept separate.

The advantages of TRIS are given below:

- Partial access to funds prior to meeting full condition of release
- Ability to reduce working hours and use a TRIS to supplement income
- If over age 60 the TRIS payments are tax free to the member so becomes significantly more tax effective.
- TRIS in accumulation phase does not count towards the TBC.
- If contributing more than the amount being withdrawn via the TRIS, then the member balance is still growing for retirement.
- Can assist in the use of recontributing strategies, albeit subject to withdrawal and contribution limitations.

The disadvantages of TRIS are as follow:

- Drawing down on TRIS prior to retirement may mean less funds available at retirement

- If under age 60 the TRIS payments are taxable to the member. The taxable component is taxed at the marginal rate less a 15% tax offset.

- Using salary sacrifice strategies may not provide any tax benefit to low income earners and may result in more tax for high income earners i.e. Division 293 tax of 15% if your combined income and contributions exceed the threshold of $250,000, or tax on excess concessional contributions.

- TRIS in Retirement Phase counts towards the TBC so needs to be kept under the cap.

- Social security benefits are impacted by the withdrawal of funds via TRIS.

- For a TRIS in accumulation phase, there is no exempt for current pension income deduction.

There are no restrictions on the number of pensions a member can start, subject to the member's PTBC. A member can commence as many pensions as needed to suit their own personal situation. Each pension is a unique account called an 'interest.' From an administrative perspective it is much simpler to have one pension account. However, there are reasons it can be worthwhile to have multiple pension, such as preserving tax components and streaming death benefits.

The tax components are fixed at the commencement of a pension under the proportioning rule. Therefore, having multiple pensions commenced at different times will have different tax components. If you intend to withdraw more than the minimum required, you can choose to take the amount above the minimum from the least tax effective pension (the pension with largest taxable component).

Having multiple pensions allows for a death benefit to be streamed to the beneficiaries in the most tax effective manner. A death benefit to a spouse is tax free whereas to an adult child, the taxable component is subject to tax. In a blended family there may be instances where the member wants to ensure an amount goes to their spouse and also amounts to any adult children.

CONCLUSION ON BORROWING MONEY TO BUY PROPERTY IN AN SMSF

You can now understand that borrowing money to buy property through SMSF can go a long way in building a huge amount of tax-free wealth for your retirement. However, it is a complex area, and it can be a little bit tricky and intimidating. Therefore, SMSF borrowing is definitely a strategy that we highly recommend you to consider if you have $200,000 or more in your super or combined super with up to four family members in it.

Before commencing a pension, it is important to consider the member's whole circumstances in SMSF and the ability of funds to meet pension payment requirements. It is recommended to speak with a financial adviser or estate planning lawyer, if applicable.

The strategy for SMSF is suitable for you if your horizon for investment time is more than 7 years. We do not recommend if your horizon for investment time is shorter.

ARRANGE A FREE STRATEGY SESSION NOW AND WE'LL HELP YOU PLAN YOUR FUTURE

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