

GUIDANCE NOTE - SMSFS & PROPERTY

GUIDANCE FOR CPA AUSTRALIA PUBLIC PRACTITIONERS

FINANCIAL ADVISORY SERVICES

The decision to establish a self-managed super fund (SMSF) requires careful consideration. While an SMSF offers greater control and flexibility, this freedom comes with added duties and responsibilities which can carry significant penalties if breached.

Despite this, there seems to be an increasing popularity in establishing a SMSF to buy property. While SMSFs can legitimately borrow to invest in real property, like any investment, it's not without risk.

ASIC have also stated that a recommendation to purchase real property through an SMSF is financial product advice. This is because while property itself is not a regulated financial product, the SMSF being the vehicle through which the investment is purchased, is.

Therefore an adviser cannot recommend a SMSF trustee purchases a property through their SMSF unless the adviser is appropriately licensed under the Australian Financial Services licensing (AFSL) regime.

This guidance note focuses on three areas:

1. Key factors when considering property investment through an SMSF;
2. Borrowing to invest within an SMSF; and
3. Guidance for providing property and SMSF advice.

Please note: The accountants' exemption, Regulation 7.1.29A, was repealed on 1 July 2016. Accountants can no longer recommend the establishment or winding up of a self-managed superannuation fund unless they are appropriately licensed.

1. KEY FACTORS WHEN CONSIDERING PROPERTY INVESTMENT THROUGH AN SMSF

There are a number of important factors that must be considered, discussed and explored with a client before considering recommending property as an investment through an SMSF.

| FACTOR | ISSUES TO CONSIDER |
|--|--|
| Establishing an SMSF | <p>A client should not choose to establish an SMSF simply because they want to invest in property without proper consideration of all the risks, benefits and associated costs involved.</p> <p>An SMSF can allow greater control, broader flexibility in choice of investments and other estate planning benefits compared to alternative superannuation structures. However, it also requires the trustee to devote time, skill and prudential responsibilities, including compliance with a range of legal obligations to ensure the fund remains compliant.</p> <p>Refer to CPA Australia's <i>Guidance note for advising on SMSFs</i> for more information.</p> |
| Investment strategy | <p>Does the SMSF investment strategy allow for the investment into direct real property?</p> <p>An investment strategy must be prepared and implemented for an SMSF to ensure compliance with the SIS Act and regulations. The investment strategy should demonstrate the purpose for the investment and considerations of the associated risks.</p> <p>The SMSF trust deed must specifically allow for borrowings if the trustees intend to acquire property using finance.</p> |
| Restrictions on the acquisitions of assets | <p>The property cannot be acquired from a related party of a member of the SMSF unless the property satisfies the definition of 'business real property'. If it doesn't satisfy this definition then it must not be rented or lived in by a member of the fund or any of the member's related parties.</p> <p>In this case where the property is business real property, then the rent can be paid from a related party directly to the SMSF at market rates.</p> |
| Risk | <p>Buying any property involves risk so it is important that appropriate due diligence is undertaken before any decisions are made. Possible risks include:</p> <ul style="list-style-type: none"> • valuation risk – which may require a larger deposit to be paid • occupancy risk – a loss of tenant or no tenant may impact the SMSFs cash flow and ability to meet other liabilities as they fall due; and • borrowing risk – potential interest rate rises (or rent decreases) may impact the ability of the SMSF to meet loan repayments. |
| Diversification | <p>The high cost of an individual direct property may mean that the SMSF is heavily weighted in one asset class. Trustees are also obliged to consider diversification as part of their investment strategy within the SMSF.</p> <p>Diversification also helps limit investment risk if any one asset class underperforms.</p> |

| FACTOR | ISSUES TO CONSIDER |
|------------------------|--|
| Return | <p>While property is a growth asset and traditionally outperforms inflation, it cannot be assumed that the returns made by many through investing in property in the past will emulate what happens in the market in the future.</p> <p>If the property is the dominant asset within the fund, will it be able to generate adequate investment returns to fund the client's retirement?</p> |
| Liquidity | <p>If the property is going to be the main asset of the fund, the trustees will need to ensure that there is sufficient liquidity to meet its liabilities such as loan repayments, fees, insurance premiums, taxes and the payment of member benefits such as pensions and death benefits.</p> <p>They may need to do this via accumulation of additional liquid investments and possibly putting appropriate life insurance policies in place for members to protect against unplanned death benefit payments.</p> |
| Costs | <p>There are a variety of fees involved when initially purchasing property including valuation, legal, stamp duty and bank fees. There may also be advice fees and ongoing management fees. These fees will increase the overall cost of the initial property and must be carefully considered when structuring a property purchase transaction.</p> <p>There will also be many other ongoing running costs such as maintenance, repairs, rates and insurance for example. Building and Landlord insurance may also be necessary to protect the investment. These costs are in addition to the normal costs of running the SMSF itself.</p> |
| Legal obligations | <p>It is important when purchasing property that all required documentation is completed and executed in the correct manner. The SMSF must be established before the contract to purchase the property is signed. It is important that the correct names are on the title of the property and all other documents are checked, to avoid common errors resulting in property titles being registered in incorrect names.</p> <p>Geared property cannot be owned directly by the SMSF, rather the property must be legally owned by a separate holding trust where the SMSF is the 'beneficial owner'.</p> <p>It is very important to ensure all required documentation is prepared and executed properly and in compliance with the relevant legislation, as failure to do so can result in significant associated costs to unwind arrangements and redo contracts.</p> |
| Tax considerations | <p>There are a number of tax advantages of purchasing property within in an SMSF. This includes a maximum tax rate 15% on net rental income in accumulation mode and 0% when in full pension mode. Further, where the property is sold after being held for more than 12 months any resulting capital gain will incur a maximum 10% capital gain tax rate or 0% if in pension mode.</p> <p>However, for some clients it may in fact be more tax effective to purchase the property in other structures or their own name instead of via a SMSF.</p> |
| Alternative structures | <p>When purchasing property consideration should be given to alternative structures, such as unit trusts and joint ventures.</p> |

2. SMSFs AND BORROWINGS

An SMSF can borrow money to purchase a single asset (or a collection of identical assets). In each case the investment must be legally held on trust (the holding trust), with the SMSF trustee as the beneficial owner. Once the borrowings are repaid the legal ownership of the property then reverts to the SMSF. This arrangement is known as a limited recourse borrowing arrangement (LRBA). One of the important considerations with an LRBA is that borrowed monies cannot be used to fund capital improvements to the associated property.

There are no restrictions on who can provide the finance for the SMSF, meaning it could include any financial institution, a related entity or a member of the fund.

An LRBA is not a regulated financial product. However, as discussed earlier ASIC have stated that an adviser cannot recommend a SMSF trustee invest in property through their SMSF unless the adviser is appropriately licensed under the AFSL regime.

3. Guidance for providing property and SMSF advice

In addition to complying with the legal obligations when providing financial product advice, such as complying with the best interests duty, ASIC has provided practical tips for advisers to consider when recommending property as an investment within an SMSF in Report 337 SMSFs: *Improving the quality of advice given to investors*.

This guidance includes factors to consider before recommending a client establish an SMSF, considerations such as the development of an investment strategy for the SMSF including the need for diversification.

These tips include:

- Explain the importance of a diversified SMSF investment strategy. A well-diversified investment strategy can improve the risk and return profile of the SMSF, whereas an undiversified investment strategy magnifies risk. Importantly, the client should be aware that this will be difficult to achieve if the SMSF has a lower balance.
- If a client seeks advice on a single asset class, provide a clear and unambiguous warning to the investor about the risks associated with an undiversified portfolio. If advice on a single asset class would be inappropriate for the client, refrain from providing advice.
- When advising a client to set up an SMSF that invests directly in real property, the statement of advice (SOA) must set out the basis for the advice, including the personal circumstances relevant to the investor that make the recommended strategy appropriate.

ASIC also expect the SOA will set out the advantages, disadvantages of the SMSF investing in property, including:

- the benefits and risks of leveraging super to purchase an asset a client may be not able to ordinarily afford
- the concessional tax rate available to income received from an SMSF holding a beneficial interest in an asset acquired under a LRBA
- the high upfront costs of purchasing the real property (e.g. stamp duty, loan fees, estate agent location fees)
- ongoing costs of managing and maintaining the property (e.g. repairs, improvements, rates, insurance)
- it may not be able to be sold quickly to convert to cash or to pay a pension or death benefit
- the risk that the real property may become untenanted or suffer damage
- the risk that the value of the real property may decrease.

REFERENCES

Australian Taxation Office

The ATO have a range of SMSF resources including:

- *Thinking about self-managed super*
- *Setting up an SMSF*
- *Managing your fund's investments*
- *Taxpayer Alert TA 2012/7 Self-managed superannuation funds arrangements to acquire property which contravene superannuation law*

<http://www.ato.gov.au>

Australian Securities Investment Commission

ASIC resources include:

- Regulatory Guide 175 *Licensing: Financial Product Advisers – Conduct and disclosure*
- *INFO 182 Super switching advice: Complying with your obligations*
- *Report 337 SMSFs: Improving the quality of advice given to investors*

www.asic.gov.au

CPA Australia

CPA Australia offers a range of SMSF resources, training and events including:

- Financial advice and regulations: Guidance for the accounting profession
- RG 146 Compliance Solution, which includes the Advising in SMSFs Assessment
- SMSF Trustee Education Program
- SMSF Conference
- SMSF Financial statement and compliance audit.

www.cpaaustralia.com.au

Acknowledgements

This document is an initiative of the Retirement Savings Centre of Excellence.

Issued July 2016