

The 10 Common Mistakes When Buying Property Through SMSF

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INTRODUCTION

Self Managed Superannuation Funds, also known as SMSF's, have gained increasing popularity among those who are looking to invest in property. Using your superannuation funds to purchase property gives you access to a myriad of benefits inc wealth creation, tax concessions and asset protection.

SMSF's offer flexibility and control over your own investments. However, setting up an SMSF should be done with due diligence as with any undertaking involving a large amount of your hard-earned money.

This ebook will aid you in your journey into SMSF's and property investment by pointing out the common mistakes investors may encounter and offering solutions to make the process as easy as possible.

We have compiled these ten (10) common mistakes investors make when buying property via SMSF as guidelines for those who choose to take this path.



MISTAKE NUMBER 1

FAILING TO GET SERVICES FROM AN SMSF EXPERT

Although SMSF's have been around for a long time, the ability to borrow money within an SMSF is relatively new. Many people believe that it is a similar process to borrowing money outside of super. This is not the case. It is possible that most of the people you will encounter in the process may not be well-equipped with the protocols and procedures to ensure a successful outcome.



The services of a financial consultant specialising in SMSF transactions would prove to be a prudent choice in the long run as you minimise- if not eliminate altogether- wasting time, effort and money by helping you every step of the way in property investment through SMSF.

MISTAKE NUMBER 2

MISCALCULATING FUNDING DEMANDS DURING RETIREMENT PERIOD

SMSF Trustees must take into consideration the funding demands of the member's or their respective dependents during retirement as this is the primary purpose of an SMSF investment in the first place. Government regulations are in place requiring fixed amounts to be set aside from the fund in the form of a pension - widely known as 'drawdown' - ranging from five per cent (5%) annually at age 65 to fourteen per cent (14%) at age 95. Trustees must consider retirement funding demands in their investment strategies to avoid unpleasant circumstances where assets would have to be sold to meet drawdown obligations.

MISTAKE NUMBER 3

SUBSTANTIAL ALTERATION OF THE ORIGINAL ASSET TURNING IT INTO A REPLACEMENT ASSET

The ATO allows SMSF Trustees to utilise their SMSF fund's resources TO improve their existing asset, i.e.their investment property. However, such improvements must not be so extensive that the original asset will be considered as a 'replacement asset'.

ATO presents several examples of what not to do:

- Construction of a house on a vacant land lot
- Transformation of a house into a commercial unit necessitating the rezoning of the land where the house is built upon
- Subdivision of a single-titled land lot into individually-titled smaller plots
- Demolition of a house replaced with three strata title units

These examples are not considered improvements, somewhat, the asset has been sufficiently changed and is considered a replacement asset.

Replacement assets are precedents to non-compliance to SMSF guidelines by the ATO and must be prevented at all costs.

MISTAKE NUMBER 4

NON-COMPLIANCE TO THE GOVERNING RULES BETWEEN IMPROVEMENTS AND MAINTENANCE

SMSF Trustees are allowed by the ATO to borrow funds to repair or maintain their asset, but not for improvements. However, there is a certain vagueness between maintenance projects and improvements. As per ATO's draft ruling on the maintenance of an asset, actions must exclusively involve the restoration of an asset to its functional efficiency and to prevent wear and tear of same.



Once again, it would be prudent to seek an expert's opinion prior to finalising decisions for maintenance and/or improvements.

MISTAKE NUMBER 5

POOR IMPLEMENTATION OF RULES ON 'SINGLE ACQUIRED ASSETS'

Within an SMSF, the property you purchase must be deemed a "single acquirable asset." The latest ATO draft ruling on the determination of a single acquirable asset is, in essence, if an asset could not be viewed separately, even if the asset is under multiple titles, then it is a single acquirable asset.

In the same ruling, ATO cites these examples to further illustrate the rules in defining this type of asset:

- Two adjacent blocks of land

Despite the absence of a physical impediment between two adjacent properties, two blocks of land cannot be considered as a single acquirable asset, although the blocks of land may be acquired under separate Limited Recourse Borrowing Arrangements (LRBA's)

- A factory complex on more than one title

A multi-titled factory complex could be considered a single acquirable asset since the factory adds considerable value to the land and, therefore, the asset.

- Farmland with multiple titles

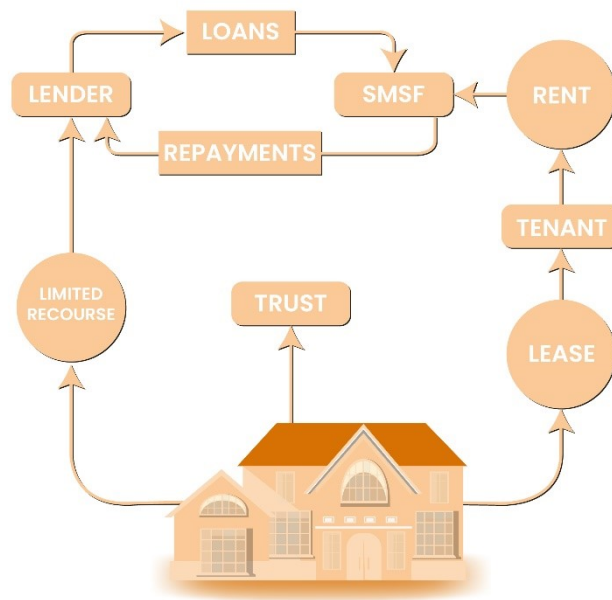
The different parts of the farmland could still be used for varying farming activities. Therefore, it could not be considered as a single acquirable asset.

The intricacy of the single acquirable asset clearly necessitates professional advice to guarantee adherence to ATO rulings.

MISTAKE NUMBER 6

IMPROPER SET-UP OF SMSF AND ITS TRUST IN LOAN ARRANGEMENTS

The ATO clearly defines SMSFs as a "special type of trust, set up and maintained for the sole purpose of providing retirement benefits to its members (the beneficiaries)." Trustees' main task is making sound investment decisions. Therefore, they must make certain any transactions entered into, especially in loan arrangements, comply with any restrictions. An SMSF loan arrangement could be illustrated summarily in this structure:



Below are examples of incorrect or problematic loan arrangements:

- The SMSF is the buyer in the deed of sale. This is in breach of the loan arrangement where the security trust is the holding entity, therefore, should act as the buyer.
- The security trust has active duties. In the above diagram, it can be ascertained that the security trusts acts as a holding entity for the title deeds of assets. The trust's actions must be simple and restricted so as to avoid trusts being considered as an 'active entity' for tax purposes.
- The lender acts as a trustee. Clearly, this conflict of interest may be questionable to the ATO.
- The security trust directly initiates the loan arrangement with the lender.

MISTAKE NUMBER 7

CONSIDERING SMSF PROPERTY PURCHASES AS 'REGULAR TRANSACTIONS'

Trustees have the primary responsibility of making sound investments to ensure maximum profit for the beneficiaries of the SMSF. Hence, trustees must bear in mind the SMSF's specific purpose of providing retirement income compliant with superannuation regulations when venturing into an investment or loan arrangement and forego the idea that they are buying as 'private citizens'.



MISTAKE NUMBER 8

INSUFFICIENT KNOWLEDGE OF LENDING REQUIREMENTS

SMSFs are allowed to enter into loans with either a bank or other lending institution through LRBA's (limited recourse borrowing arrangement) but it is typically stipulated that the option of the lender will be limited to the financed asset in order to protect trustees from personal liability. Therefore, it is implicit that this kind of arrangement would cause the lenders to practice due diligence measures to minimise their risks. Knowing all of these, the trustees must be thorough in reviewing and preparing lender requirements at each stage of the process to guarantee to obtain the funds.

MISTAKE NUMBER 9

PURCHASING PROPERTY WHEN SMSF IS NOT YET FINALISED

If you are aiming for a comfortable and worry-free retirement, an effective investment strategy should include the purchase of a property complementary to the goals of your SMSF. It is impossible to purchase a property before your SMSF is set up and then transfer it into the fund. Securing an SMSF before any asset investments increase one's chances of buying a property, the value of which is adequate to your available funds.

MISTAKE NUMBER 10

NON-COMPLIANCE WITH RULES ON RELATIONSHIP WITH RELATED PARTIES

The primary purpose of the SMSF to provide benefits for its members during retirement cannot be stressed enough. A common mistake in the administration of an SMSF is that the funds are invested in serving the short-term interest of the members instead of its goal of supplying the members' financial needs upon their retirement. The ATO is implicit in its ruling about what trustees are restricted from in dealing with related parties:

"Lend to, invest in or lease to a related party of the fund (including related trusts), more than 5% of the fund's total assets."

CONCLUSION

PURCHASING PROPERTY WHEN SMSF IS NOT YET FINALISED

This ebook was written with the intent of helping people avoid the costly mistakes in their venture into SMSFs, as listed on these pages. Although the brevity of the guidelines presented here may not give you the complete details of SMSF investment, we hope you will consider the essential issues raised here in strategising your financial future and realise that professional help is available to assist you every step of the way. In the event you don't already have a financial planner, our network is available to assist.

Good luck and happy investing.



'Tell me, and I forget, teach me, and I may remember, involve me, and I learn.' –

Benjamin Franklin

Disclaimer

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