Future gazing

Is a geared property in your super fund a better way to maximise your nest egg? We crunch the numbers over a 10-year period to find out. **PAT MANNIX**

A question often asked by prospective investors about using a self-managed superannuation fund (SMSF) to buy an investment property is: "is gearing into a property via a property warrant better than leaving my money building in the existing fund without gearing?"

To look at this question with an unbiased approach requires a matching of yield rates and capital growth rates and a 10-year outlook.

Let's look at a SMSF that has a member's balance of $500,000 and see whether a geared property in this fund will achieve a better result than investing the money without gearing. We need to allow for a number of assumptions that will compare our example correctly. They will be that:

1. The property purchase price is $600,000.
2. The investor will put down a 30 per cent deposit on the property.
3. The property's capital growth rate is 9.5 per cent, supported by the residential mean rate for the past 20 years as reported by the ASX.
4. The yearly income yield is four per cent.
5. Inflation is calculated at four per cent.
6. Interest expense is calculated at 7.43 per cent.
7. Super contributions are $25,000 per year.
8. Tax on earnings is excluded for simplicity. In reality tax will have an effect but it isn't material and will depend on the investments of the fund.
9. The super fund's ungeared capital growth rate is 6.7 per cent supported by the mean figure reported for all superannuation funds by the Australian Prudential Regulation Authority.

If the investors purchase this property in Melbourne, for example, then the 30 per cent deposit, stamp duty and property warrant set-up costs equal $220,000.

As a result at the beginning of the 10-year cycle the SMSF's assets are $880,000 which includes a loan of $420,000 and a member's balance of $460,000.

If the investor keeps the money in ungeared assets they will start with a member's balance of $500,000.

If the nine financial assumptions above are applied then the calculated member's balance after 10 years will be: $1,615,000 if the funds are ungeared but $1,835,000 if the funds are geared.

That's $220,000 more funds in the investor's SMSF via a geared investment which will be tax free on retirement.

An excellent result with the same starting funds and yearly contributions but the investors have taken advantage of controlling their superannuation and investing it into what they know – direct property.

So we can prove that gearing into direct property is a fantastic way to increase your tax-free nest egg on retirement.

If this is the case it's worth illustrating an example of where investors can work together to maximise their superannuation.

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CASE STUDY

Mario and Robert (not their real names) run two upmarket women's lingerie stores in fashionable locations. The brothers work hard and pour what money they do make into their private mortgages, modest lifestyles and businesses. As a result of the lack of extra cash recently, they haven't put a lot of money into superannuation.

Their homemaker wives, Saskia and Maria (not their real names), have healthier super fund balances leftover from their working days.

The four are very close and they discuss the fact that their combined total of $250,000 in a multitude of small industry super funds could all be rolled together into a SMSF and a property could be bought.

The advantages of this for both families' long-term futures far outweigh the negatives, so they combine their super.

Being from good Italian stock the lads really know property so they do a lot of homework and find a good sized property in a terrific location with a very rentable house at the front and a big backyard for $550,000.

Their intention is to subdivide the back half of the property into another title.

The area where they've bought is known for having property improvements and subdivisions highly scrutinised by council and residents but they're unperturbed.

They put down a 30 per cent deposit on the property and an external bank comes up with the balance via a property warrant structure at settlement.

After purchase the four immediately start putting in plans to the local council for a subdivision of the back half while they rent out the front property.

The council eventually rejects their plans but on flimsy grounds so they go to the Administrative Appeals Tribunal and the council's decision is overturned. This is good news for the four but it has taken 18 months.

After the two titles are issued the front block with the existing property is valued at $460,000 and the back block is valued at $240,000.

That's a whopping increase in the SMSF's value in just 18 months but it shows what getting together with trusted family and some sound property judgement can do for your superannuation.

I might add that if the back block is sold in the future that it will only pay CGT of 10 per cent, no CGT on retirement or no CGT on transition to retirement. api

Note: Calculations are all compounded and correctly computed. If you have a query contact the author.

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NEW CHANGES

On March 10 the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen, announced two changes to the property warrant rules in relation to superannuation.

Firstly, only licensed advisers can recommend and implement property warrants, and secondly, a superannuation trustee who enters into a limited recourse borrowing arrangement to purchase an asset, as permitted under subsection 67(4A) of the *Superannuation Industry Supervision Act* (property warrant provisions), will be treated as the owner of the asset for income tax purposes, thereby averting the triggering of the capital gains tax (CGT) rules when paying the final instalment on the warrant.

According to Bowen, this second change, relating to ownership of the underlying assets for tax purposes, ensures that trustees of superannuation funds who have entered into permitted limited recourse borrowing arrangements won't face CGT obligations at the time the last instalment is paid.

Certain borrowing arrangements by superannuation fund trustees which are permitted by the *Superannuation Industry Supervision Act 1993* (the SIS Act) will now be financial products under the *Corporations Act 2001*. What this means is that only licensed financial service providers can offer these arrangements to self-managed superannuation funds, which cuts out accountants, mortgage brokers and real estate agents.

This is a significant change instigated by the Federal Government to make sure that the process is controlled and superannuants are protected and will affect a number of service providers.