PLANNING

DIY super funds can now buy property

If you're a property investor who's managing your own super fund, it's now possible to borrow to buy direct property. Pat Mannix

UNTIL the last week of September 2007, self-managed superannuation funds (SMSFs) couldn't borrow to invest in property but now the law has changed to allow SMSFs to borrow as long as it's via what's called an 'instalment warrant', which is internally geared.

Why buy geared property in super?

Tax efficiency

There's a maximum of 10 per cent capital gains tax on the sale of property if held for at least 12 months and potentially nil if sold in the pension phase. There's a maximum of 15 per cent tax on rental income.

Also, you may effectively receive a tax deduction for principal repayments via a salary sacrifice arrangement which you can't normally do.

The interest cost of the warrants is tax deductible which reduces the 15 per cent contributions tax of SMSFs. Retirement is very tax effective in that if you're over 60 there's no tax on withdrawals or pension earnings.

Affordability

A benefit of borrowing in super is that potentially you can afford to borrow more as the servicing on the loan can be funded not only from tenant rental payments but also from your employer's compulsory 9 per cent super contributions, salary sacrifice contributions, personal contributions and the government co-contribution, up to $1500 per annum.

Super is now simpler and more flexible

There's now no restriction on how much you can withdraw in retirement and no requirement to withdraw any funds until age 75.

Gearing helps overcome the super contribution cap limits

Given the huge tax breaks and flexibility super now offers, the government is capping how much you can contribute. Personal contributions are limited to $150,000 per annum or $450,000 over three years and tax-deductible contributions are limited to $50,000 per annum (under 50 years of age). By building a geared property portfolio inside super you can maximise your super benefits by allowing you to get more money into the tax effective system of super.

Your personal borrowing capacity is not affected

As the loan is taken out within superannuation it's not recorded as a liability against your name and therefore your borrowing capacity for investing or business interests outside super isn't affected.

Reduced risk

A key feature of instalment warrants is that the funds are advanced on a limited recourse basis. This means the only amount you stand to lose is your original deposit, protecting your other assets from creditors, including any other investments in your SMSF portfolio.

How does it work?

Firstly you'll need to have a complying SMSF with at least a $120,000 total account balance. You then find the property based on normal lenders' valuations.

The SMSF makes the first instalment of 20 per cent deposit plus stamp duty/ legal costs plus the first year's interest repayment. The balance of the purchase price of the property is made up by a limited recourse loan.

The property is held on trust until the final instalment is made or the property is sold. The SMSF then receives all income and capital growth while paying all the interest and associated costs.

Risks

Although there are great tax benefits and an opportunity to leverage into direct property, the following risks need to be considered:

- **Investment risk.** While borrowing to invest can magnify your returns, it can also magnify your losses if the investment makes a negative return.
- **Loan structure.** For various reasons an ordinary home loan won't be allowed under the new rules and as such it's imperative that you seek professional advice from a qualified adviser when structuring your finance within super.
- **Cash flow.** If the property is negatively geared, you need to ensure that the super fund has adequate cash flow to meet interest payments. Apart from the investment property rent, super contributions such as the compulsory 9 per cent employer super contribution are a great source of cash inflow.
- **Legislative risk.** The law could always change to prohibit borrowing in super but generally when super laws change they provide existing investors with some exemptions.
- **Preservation.** Don't forget that you can't access your superannuation until you meet a condition of release, which for most people is being over 55 and semi-retired.
- **Super rules.** Apart from your commercial property you can't buy existing property from yourself or your relatives and you can't live in the property or use it for your own enjoyment (eg. a holiday house).

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For the savvy property investor, the changes provide a huge opportunity, granting them great access to capital to diversify their super into direct property in an extremely tax-effective way. However, as with everything, there are a few simple rules you need to be aware of.

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