Real Life Case Study:

How a real investor purchased a real property using superannuation

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evolvemysuper.com.au

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Introduction:

There is a significant amount of information available on the web in regards to using your superannuation to purchase investment property through a self-managed superannuation fund and a limited recourse loan.

However, the information seems largely theoretical, lacking detail and often only focuses on one particular aspect of what is a very complex process with many different hurdles that an investor needs to overcome to successfully buy property with super.

This case study uses real life information on a real Melbourne based property.

In this case study, I will demonstrate the process that I would undertake with the investor to answer the following key questions:

Contents:

1. How much do I need to have (in super and/or personal savings) to successfully complete the purchase of my desired investment property?
2. What will be the annual cash flow situation for the property within the SMSF?
3. What will the impact be to my personal after-tax earnings?
4. Would I be better off buying the same property in my personal name?
5. Will I need to provide a personal guarantee to the lender for the SMSF loan?
6. Are there any legal restrictions or compliance issues the investor needs to be aware of?

The Target Property:

The desired property the investor wishes to purchase is a brand new apartment that is being constructed in Richmond, Victoria.

Property description:	1 bed., 1 bathroom, Study, No car space, 62 Sqm
Purchase price:	$450,000 (as per contract)
Expected growth:	6.9% over 10 years (RP Data historical figures)
Expected rental income:	$430 per week (local agent assessment)
Vacancy rate:	0.6% (October 2010 for Richmond from RP Data)

<u>Expected expenses:</u>

Body corporate fees:	$2,042 per annum
Council rates:	$1,300 per annum (estimated)
Land tax:	$700 per annum
Property management fees:	$1,800 per annum (estimate 8% of rental income)
Insurance:	$700 per annum
Sundries & maintenance:	$200 per annum (new property)
Depreciation:	$13,399 first year, $8,438 p/a average over 10 years

The investor:

Name:	Michael
Age:	35
Income:	$120,000 per annum before tax
Annual super contributions:	$10,800 per annum
Salary sacrifice:	$14,200 per annum
Amount of super:	$150,000 (retail super fund)
Personal savings:	$20,000
Home owner:	Yes
Equity:	$100,000 available from a line of credit against PPR
Years to retirement:	23
Investment goals:	Capital growth orientated

The purchase, structure and loan costs:

Stamp duty on purchase:	$5,150 (concessions given due to off-the-plan)
Conveyancing & transfer fees etc:	$1,800
SMSF establishment:	$1,650 (including corporate trustee)
Custodian trust set up:	$1,650 (including corporate trustee)
Professional advice / sign off:	$2,200

St George as lender:

Application fee:	$1,500
Settlement fee:	$100
Legal fee:	$615
Annual loan fees:	$144 ($12/month)
Interest rate:	7.80%

Annual SMSF management costs:

Accounting / administration fees:	$1,680 (as quoted by Superfund Partners)
Audit fees:	$440 (expect additional $220 1st year)
ATO SMSF levy:	$150
ASIC annual fee trustee company:	$41

Step 1 – Cost to complete:

To work out exactly how much our investor Michael requires to complete the purchase of his desired investment property, we can use the St George Super Fund Loan Calculator.

St George Bank
Funds to Complete Worksheet
- Super Fund Home Loan

Version 09.04.10

Funds Required		Funds Available	
Purchase / Contract Price	$450,000	Proceeds (Existing Security)	$0
Land	$0	Deposit Paid	$0
Discharge / Payout	$0	Own Funds	$150,000
Legals	$1,800	Loan Sought	$300,000
Purchase Stamp Duty	$5,150	Inward Rollovers and Transfers	$0
Mortgage Stamp Duty	$0	Non Concessional Contributions	$0
Establishment Fee	$1,600		
Total Funds Required $	**458,550**	**Total Funds Available ($)**	**$450,000**
Surplus/Deficit ($)	**-$8,550**	**Insufficient Funds to Complete**	

As you can see from the above, I have simply entered the applicable information in the spaces provided, with the result showing that based on the included costs that there will be a shortfall of $8,550.

In addition to the $8,550 required, there are also the following establishment costs required:

SMSF establishment:	$1,650 (including corporate trustee)
Custodian trust set up:	$1,650 (including corporate trustee)
Professional advice / sign off:	$2,200
Lender legal fees	$615
Sub Total	**$6,115**

This means that if Michael wished to only borrow $300,000 from the bank, he would require at least $14,665 to successfully complete the purchase.

I would also recommend a contingency for unexpected expenses and to provide some liquidity within the newly established SMSF – meaning Michael would require approximately $17,000 of his own additional funds if he was only borrowing $300,000 from the bank.

Although there are a number of lenders that have SMSF limited recourse loan products, based on my experience and the experience of other SMSF advisers, St George seems to be the best for residential property purchases.

St George have also recently announced that they will lend up to 80% on residential properties where the SMSF has a corporate trustee. In Michael's case as he is the only member of the SMSF he has no real choice but to utilise a corporate trustee. This means Michael could simply borrow more (say $320,000) to successfully complete the purchase.

If Michael either didn't want to borrow any more than $300,000, or was using a lender that would only lend that much, he still had a number of options available to him if he wishes to complete the purchase.
Firstly, he could use his savings to make a person (non-concessional) contribution to this SMSF. This would simply involve transferring a portion of his $20,000 personal savings to the SMSF account prior to settlement and completing the necessary trustee minutes in regards to the contribution.

Secondly, he could lend the $20,000 to his SMSF as a second or additional member limited recourse loan. This strategy is good for someone in Michael's situation as he has a number of years until he can access the fund, and by loaning the money to the SMSF to the purchase of the property he has the ability to have the SMSF pay the principal back to him at his discretion.

To enable Michael to lend the additional funds to his SMSF, he would need to have an additional loan agreement drafted (by a solicitor) and specify the terms. The maximum loan term could be up to 40 years and the minimum interest rate should be no lower than the RBA cash rate. Michael would have a lot of flexibility in regards to the other terms of the loan such as interest only periods and the flexibility for the SMSF to make extra capital repayments.

A third strategy for Michael could simply be to do nothing. The particular property he is purchasing is a brand new apartment and not scheduled for completion for approximately 18 months. This means by settlement he would likely have enough additional funds in his SMSF simply from his 9% employer contributions and any interest earned on his existing $150,000 superannuation savings.

If Michael wished, he could also have another member join the fund, such as his spouse or another family member. The additional family member could transfer enough to the SMSF to provide the necessary liquidity to complete the purchase.

Step 2 – What will be the annual cash flow situation for the property be?

There are a couple of different free tools available that can be used to analyse the annual cash flow from the property.

The first one to look at is the SMF Property Purchase Calculator which will provide a simple analysis of the cash flow from the property and also the tax impact on the individual members.

Purchase costs:

Similar to what was show in the St George borrowings calculator used in Step 1, the excel calculator shows the required funds to complete as being $164,665:

Purchase costs			
Contract / purchase cost		$ 450,000	
SMSF loan amount		$ 300,000	
Loan LVR	67%		
Stamp duty		$ 5,150	
Conveyancing fees, custodian trust, professional advice		$ 5,650	
Loan establishment fees & bank legal fees		$ 2,215	Borrowing Costs
SMSF establishment		$ 1,650	
Amount needed to complete purchase		**$ 164,665**	

This amount is made up of $150,000 additional required to cover the purchase price and $14,665 in bank, structure and transaction costs.

Ongoing Annual Cash flow

To analyse the year to year ongoing cash flow position of Michael's SMSF, the best tool to use is the SMSF Property Purchase Calculator which can be found here on the BuyPropertyWithSuper.net.au website: SMSF Property Purchase Calculator

All amounts entered into the calculator are from page 2.

As expected, the property will be cash flow negative for the first seven years.

DETAILED OUTPUT RESULTS:

Annual Tax Profit	Yr 2010/11	Yr 2011/12	Yr 2012/13	Yr 2013/14	Yr 2014/15	Yr 2015/16	Yr 2016/17	Yr 2017/18
Rental Income	22185	23716	25352	27101	28971	30970	33107	35392
- Yearly Expenses	9053	9234	9419	9607	9799	9995	10195	10399
- Interest	23400	23400	23400	23400	23400	23400	23400	23400
= Cashflow	-10268	-8918	-7467	-5906	-4228	-2425	-488	1593

However, after seven years based on the assumptions we have entered into the calculator, the property will become cash flow positive.

It is important to understand that these calculations are based on a number of assumptions, such as a constant increase in value and rent of the property. In reality, there are no guarantees these increases will eventuate, and when they do they will not be linear – meaning some years will have higher levels of growth than others.

Step 3 – What will the impact be on personal after-tax earnings?

As per the calculations completed at step 2, the property will be cash flow negative for the first seven years. This means that Michael needs to make additional contributions to the SMSF via either personal (non-concessional) contributions from his after tax income, or more likely via salary sacrifice from his pre-tax income.

If Michael salary sacrifices, the actual reduction in his annual take home pay will be significantly less because the amounts are pre-tax:

Required Level of Support

The projected reduction /(increase) in take home pay is as follows:

2010/11	2011/12	2012/12	2013/14	2014/15	2015/16	2016/17
6315	5485	4592	3632	2600	1491	300

Based on Michael's current earnings, even in the first year he will only have to part with $121 per week to cover the short fall within the SMSF.

The amount Michael will be *required* to salary sacrifice into the SMSF may even be less because some of the $14,665 amount entered as part of the establishment costs will be borrowing costs that will be amortised – meaning a tax deduction will be claimed over the first five years.

Even though Michael is only required to maintain a certain level of salary sacrifice contributions to ensure the SMSF has enough cash to cover all the expected outgoings, it is highly recommended Michael salary sacrifice right up to his maximum of $25,000 per annum (which includes 9% SGC of $10,800 and $14,200 salary sacrifice amounts).

By making these additional contributions, Michael is firstly ensuring enough cash or liquidity within the SMSF, and secondly building up additional cash reserves that can be used for additional investments and even additional property purchases in the future.

Step 4 - Would I be better off buying the same property in my personal name?

Probably the most critical decision every property investor has to ask themself prior to any acquisition is: what name should I purchase the property in?

In our situation, we need to decide whether Michael will be better off purchasing this property in either his personal name, or via the SMSF.

A great feature of the SMSF Property Purchase Calculator is the ability to change between having a SMSF purchase the property or an individual.

Firstly, let's look at the using Michael's SMSF to purchase the property:

Annual Tax Profit	Yr 2010/11	Yr 2011/12	Yr 2012/13	Yr 2013/14	Yr 2014/15	Yr 2015/16	Yr 2016/17	Yr 2017/18
Rental Income	22185	23716	25352	27101	28971	30970	33107	35392
- Yearly Expenses	9053	9234	9419	9607	9799	9995	10195	10399
- Interest	23400	23400	23400	23400	23400	23400	23400	23400
= Cashflow	-10268	-8918	-7467	-5906	-4228	-2425	-488	1593
- Depreciation	13399	9990	9073	8569	8264	7994	7457	6999
= Tax Profit	-23667	-18908	-16540	-14475	-12492	-10419	-7945	-5406

Sale Price	481050	514242	549725	587656	628204	671551	717888	767422
- Loan	300000	300000	300000	300000	300000	300000	300000	300000
- Sale Costs	15000	15300	15606	15918	16236	16561	16892	17230
- Tax	2218	5767	10192	14810	19660	24761	30108	35727
= Net Proceeds	163832	193176	223928	256928	292308	330228	370888	414464
Return % pa	0	5.82	8.58	9.85	10.53	10.93	11.17	11.33

Required Level of Support

The projected reduction /(increase) in take home pay is as follows:

2010/11	2011/12	2012/12	2013/14	2014/15	2015/16	2016/17
6315	5485	4592	3632	2600	1491	300
2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
0	0	0	0	0	0	0

In summary, if we look at the first seven years, we see the following:

		SMSF
Initial money invested - personal	$	14,665
Initial money invested - SMSF	$	150,000
Total amount of after tax cash support (7 years)	$	24,415
Capital gains tax paid on sale	$	35,727
After tax sale proceeds (if sold)	$	370,888
Overall cash increase (proceeds less initials & support)	**$**	**181,808**
Annual return		11.17%

Secondly, we need to undertake the same analysis with Michael individually as the purchaser.

All our assumptions will be the same, with the exception of the following changes:

- The establishment fees will be reduced by $5,500 as the SMSF, Custodian and special advice will not be required
- The loan amount will be a total of $439,165 made up of:
  - Direct bank loan $360,000 (80% LVR)
  - Line of credit drawdown $79,165
- The balance of the $20,000 necessary for settlement will come from Michael's personal savings
- The yearly expenses will be reduced by $2,311 as the SMSF will not be required

Annual Tax Profit	Yr 2010/11	Yr 2011/12	Yr 2012/13	Yr 2013/14	Yr 2014/15	Yr 2015/16	Yr 2016/17	Yr 2017/18
Rental Income	22185	23716	25352	27101	28971	30970	33107	35392
- Yearly Expenses	6742	6877	7014	7155	7298	7444	7593	7744
- Interest	34255	34255	34255	34255	34255	34255	34255	34255
= Cashflow	-18812	-17416	-15917	-14308	-12581	-10728	-8740	-6607
- Depreciation	13399	9990	9073	8569	8264	7994	7457	6999
= Tax Profit	-32211	-27406	-24990	-22877	-20845	-18722	-16197	-13606

Sale Price	481050	514242	549725	587656	628204	671551	717888	767422
- Loan	439165	439165	439165	439165	439165	439165	439165	439165
- Sale Costs	15000	15300	15606	15918	16236	16561	16892	17230
- Tax	7809	12160	20678	29569	39817	51658	64095	77166
= Net Proceeds	19076	47618	74277	103004	132986	164166	197735	233860
Return % pa	0	24.59	-9999	-9999	28.89	27.2	25.74	24.51

Required Level of Support

The projected reduction /(increase) in take home pay is as follows:

2010/11	2011/12	2012/12	2013/14	2014/15	2015/16	2016/17
6411	6865	6296	5500	4556	3520	2504
2017/18	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**
1369	160	-1219	-2586	-4320	-6178	-8169

In summary, if we look at the first seven years, we see the following:

	Personal
Initial money invested - personal	$ 20,000
Initial money invested - SMSF	$ -
Total amount of after tax cash support (7 years)	$ 35,652
Capital gains tax paid on sale	$ 77,166
After tax sale proceeds (if sold)	$ 233,860
Overall cash increase (proceeds less initials & support)	**$ 178,208**
Annual return	25.74%

Comparison between purchase in personal name or SMSF

For Michael, if we look at the overall cash return over the seven year period, he will be better off by buying the property through a SMSF.

	SMSF	Personal	Comparison
Initial money invested - personal	$ 14,665	$ 20,000	$ 5,335
Initial money invested - SMSF	$ 150,000	$ -	-$ 150,000
Total amount of after tax cash support (7 years)	$ 24,415	$ 35,652	$ 11,237
Capital gains tax paid on sale	$ 35,727	$ 77,166	$ 41,439
After tax sale proceeds (if sold)	$ 370,888	$ 233,860	-$ 137,028
Overall cash increase (proceeds less initials & support)	**$ 181,808**	**$ 178,208**	**-$ 3,600**
Annual return	11.17%	25.74%	14.57%

Discussion points:

- Purchasing the property via SMSF requires less of Michael's $20,000 personal savings
- Because of the funds available within Michael's SMSF, he will not be required to drawdown on his line of credit if he buys using the SMSF, meaning these monies will still be available for additional investments outside super
- Over a seven year period Michael's personal after tax income will be reduced by an additional $11,237 if he buys in his personal name. This means buying property within a SMSF will have less personal impact on his lifestyle
- The rate of return on the personal side is higher due to the higher level of gearing
- If Michael decided to keep the property for more than seven years, it would become cash flow positive in year 8 within the SMSF, and year 10 if held in his personal name
- If the property was sold when Michael was paying a transition to retirement pension from his SMSF (age 55 plus), then the capital gain would be tax exempt. This means 0% tax. Compare this to up to 46.5% tax if the property was held in Michael's personal name.
- Michael may be able to obtain a lower interest rate on borrowings, such as a 'professional package' discount if he purchased in his personal name rather than the SMSF
- Due to the higher initial costs and limitations around a SMSF developing or (significantly) improving a property where a limited recourse loan has been used, if the property was an older property with renovation or development potential that may be sold within a shorter period of time, then purchasing in his personal name would more likely be a better option for Michael
- If instead of purchasing a residential property with a 4-5% yield, Michael was looking to purchase a commercial property (with a good lease) at a yield of 8-9%, then the property within the SMSF would likely be cash flow positive from day one

In summary, for someone in Michael's situation purchasing this type of property, a SMSF should be the preferred purchase vehicle. For other types of properties, buying in the name of an individual or a trust may be more suitable. It really comes down to the type of property, the property investment strategy and the situation of the individuals involved.

Step 5 – Determining whether a personal guarantee will be required for the SMSF loan

By default, all banks that lend to SMSFs through limited recourse loan products will require personal guarantees from the members of the SMSF. It is possible however to negotiate out of this requirement if it can be shown that the personal guarantees are not necessary.

A bank lender is more likely to remove the need to have personal guarantees from the members if it can be shown that the annual rental income derived from the property will be at least 1.5 times the amount of the annual interest payments.

However, it is not that easy. Some banks do not take into consideration 100% of the expected rental income, and also have an 'indicative' interest rate that is often significantly higher than the advertised rate. Using St George as an example, then only take into consideration 80% of the income and the indicative interest rate is 9.25% (last time I checked) – which is significantly higher than the 7.80% actual rate on their super fund home loan product.

Apply the above to Michael's SMSF purchase; to work how much rental and other investment income (excluding employer contributions) you would do the following:

Amount borrowed:	$300,000
Interest @ 9.25%	$27,750
Multiple by 1.5	$41,625
Divide by 80%	$52,031

Assuming Michael's SMSF has no other income, the property would need to generate over $52,000 of income to remove the banks need for Michael to provide a personal guarantee. It is highly unlikely that $1,000 per week rent could be achieved for this $450,000 property, as it would equate to a rental yield of more than 11.5% - highly unlikely for most properties – especially a residential property.

This means for this property and the amount of money Michael is going to borrow in his SMSF; he will be required to provide a personal guarantee on the loan.

Why are personal guarantees so important?

By not having a personal guarantee in place, it gives trustees / members of the SMSF such as Michael significant flexibility when things go wrong. If there is a default on the loan for any reason, Michael would have the option of simply walking away and his losses would be limited to only the amount of money he and his SMSF initially invested ($150,000 plus costs).

That is the difference between a limited-recourse loan that SMSFs have to use and a normal mortgage loan that is used in almost all other property purchases.

In most cases, the chances of a property devaluing to such a degree that the value is less than the loan amount outstanding are quite small. However as we have seen with recent natural disasters such as the Brisbane floods, it can happen quickly and sometimes insurance proceeds will not be enough to repay the loan.

I am sure that there will be a (very) small number of SMSF investors in Brisbane that are currently looking at having to pay a personal guarantee due to having a devalued flood damaged property and insufficient insurance.

Step 6 – What legal restrictions or compliance issues do investors needs to be aware of?

There are a number of differences between buying a property in a SMSF using a limited recourse loan compared to purchasing a property in your personal name.

Below is a quick summary of these key restrictions and how they may impact an investor such as Michael:

- The members of the SMSF and any related parties such as relatives cannot live in the property even if they pay market rent
- Any additional charge or encumbrance cannot be registered on the title (with the exception of the original mortgage by the bank)
- The loan may be refinanced, however any built up equity cannot be redrawn
- The property may be repaired and borrowings can be utilised for repairs if necessary
- There is currently nothing in the laws and regulations that prevent a property held in a SMSF via a limited recourse loan from being improved or renovated, however the ATO has indicated that any improvements *may* create a replacement asset - which is prohibited
- A SMSF cannot acquire a residential property from a related party; however it may acquire 'business real property' from related parties at market value. There are stamp duty concessions available in all states except Queensland. The small business CGT concessions can be used in many cases to eliminate any capital gains tax on the transfer of a commercial / business property to a SMSF
- Where an individual property is actually made up of separate legal titles sold together the investor may have to use separate custodian trusts (holding trusts) for each title. With Michael's apartment, if the car space is on a separate title however cannot be sold independently of the title for the apartment itself; it should be OK to have the apartment and the car space under the one custodian trust.
- Caution must be taken with the purchase of 'off-the-plan' investments as the asset that is purchased when the contract is entered into is often different to the asset which is acquired because the strata titles are not normally created until the development is complete.

Summary:

Purchasing investment properties through a SMSF using a limited recourse loan is a fantastic wealth creation opportunity – however the clock is ticking. The Government has indicated that they will review the ability for SMSFs to use limited recourse loans in approximately two years time (estimated as early 2013).

This means if you do not take advantage of the ability to combine your existing superannuation savings with leverage via a limited recourse loan now – you may miss the opportunity.

5. About me

I am 31. I am a Chartered Accountant and SMSF Specialist. I live and work on Queensland's beautiful Gold Coast.

I have a passion for educating my clients about the fantastic benefits and flexibility that a SMSF can offer them and their family.

I believe that at the moment Australian investors have a unique opportunity to combine the tax effectiveness of superannuation with the long term benefits of property investment. I see this as a key strategy that will hopefully result in more Australians becoming engaged and educated when it comes to their super – regardless of their age.

I have assisted a number of people successfully purchase property in their SMSFs using limited recourse borrowings – I have seen it done correctly, but I have also seen it done the wrong way and the problems that it can cause.

One of the main reasons I put together this case study and other guides was to share these experiences in the hope other investors and their advisers learn from them.

A summary of my qualifications are as follows:

- Chartered Accountant (ICAA)
- SMSF Specialist Advisor (SPAA)
- Diploma of Financial Services
- Bachelor of Business (majors in Accounting and Business Management)
- Justice of the Peace (QLD)

If you would like to contact me, please feel free to do so via my website:

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