Self-managed superannuation funds investing in property

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INTRODUCTION

As a segment of the superannuation industry, self-managed superannuation funds (SMSFs) display a wide range of characteristics. Some have investment portfolios with highly diversified arrangements traded on a regular basis. Others invest within a limited range and have investments which stay in the fund for a long while. Provided the fund investments fall within the requirements of the fund’s governing rules, the relevant legislation and earn sound returns for members then everyone should be happy.

One of the main reasons for having an SMSF is the control and flexibility trustees/members have over the fund investments. Control allows the trustees to determine the type of investment and the timing of purchases and sales of those investments to maximise returns to members. Another reason for having an SMSF is the ability to buy and sell particular investments directly rather than invest indirectly via a managed fund arrangement. Examples include listed and unlisted shares, fixed interest investments and real estate.

The rules surrounding an SMSF purchasing investments from the open market on an arm's length commercial basis is relatively simple and generally no different to anyone investing on their own behalf. Providing the governing rules of the fund and the fund’s investment strategy permit the investment then it can be purchased. For example, an SMSF is able to purchase residential and commercial property from the open market at auction or by private treaty providing it is done on full commercial terms.

Complexities can arise when a superannuation fund wishes to acquire some investments from parties “related” to the fund. This may occur where investments are owned by a trustee or member of the SMSF, their relatives or an entity such as a partnership, trust or company which any of them are able to control individually or jointly. Under the Superannuation Industry (Supervision) Act 1993 (SIS Act) these relationships and arrangements are referred to as related party investments.

If a superannuation fund wishes to purchase or acquire an investment from a related party trustees should always seek advice on the application of the SIS Act before taking any action. The reason is that there are a number of very complex provisions which have a great deal to say about superannuation funds investing in or acquiring investments in these situations. These provisions are designed to ensure a superannuation fund is maintained for the required purposes, that is, to provide benefits for members on retirement, disability etc and to provide benefits to dependants on the member’s death.
Under the SIS Act there are eight basic tests for investments to be met by the fund. These are:

- Ensuring the fund satisfies the sole purpose test of providing superannuation benefits (section 62);
- Restrictions on assets that can be acquired (purchased or transferred) from related parties, for example, members of the fund or their relatives (section 66);
- Prohibitions on loans to members or their relatives (section 65);
- General prohibition on the fund borrowing (section 67);
- All transactions must be undertaken on an arm’s length commercial basis (section 109);
- Ensuring the fund has a suitable investment strategy (section 52);
- Ensuring the fund satisfies the in-house assets test (sections 69 to 85); and
- Financial assistance to members or related parties (section 65).

Superannuation funds that invest in property can potentially produce income and/or capital growth. The issue of risk and return on an investment is something that the trustees and their advisers need to assess and decide whether or not the potential investment return will benefit members in retirement.

The proposals in this year’s Federal Budget and the restrictions on undeducted contributions highlight the need to revise some strategies when contributions are made to a superannuation fund either in cash or in specie. It also means superannuation is part of a long-term planning horizon rather than an arrangement commencing as someone nears retirement.

**ACQUIRING PROPERTY**

A property can be acquired and owned by a superannuation fund in a number of ways. The trustees of a superannuation fund can acquire a property either from the market or related parties. Where it is purchased from the market there are few restrictions. However, attention should be paid to various fund documents which include the fund’s trust deed, investment strategy and the relevant legislation. However, limits apply to the type of property that can be acquired if it is from a related party such as a member, trustee or relative of a member or trustee.

In some circumstances a superannuation fund may wish to acquire only part of the property rather than all of it. Reasons for acquiring part of the property may include the lack of resources in the fund to be used for investment or it may not be consistent with the fund’s investment strategy to purchase the whole of the property.

**OWNING THE PROPERTY OUTRIGHT**

A superannuation fund may purchase all of a property. In these cases it must be ensured that the investment is consistent with the fund’s investment strategy and asset allocation. Any acquisition of the property must also be made on an arm’s length basis. To establish that the acquisition is on an arm’s length basis the trustees should ensure all transactions are recorded and all relevant documents retained by the fund.

**OWNERSHIP OF THE PROPERTY WITH OTHER PARTIES**

There are two methods of owning property with others – tenants in common and joint tenancy. A tenant in common arrangement is where the owners of the property have rights to a distinct proportion of the property none of which can be physically identified. Joint tenancy is where each owner of the property does not own a clearly identified proportion of the property. On the death of a joint tenant their interest in the property ceases and the ownership of the property is with the remaining tenants.

A superannuation fund owns property with others as tenants in common and not as joint tenants.

**TYPE OF PROPERTY**

The SIS legislation recognises two types of property that can be owned by the superannuation fund – business real property and any other property.

Business real property is real estate which is used exclusively for business purposes by anyone. For example, if a property is used solely to operate one or more businesses then it will meet the definition of business real property. If part of the property is used partly or wholly for residential or private purposes then it will not be regarded as business real property in most cases.

There are two exceptions to the basic rule. This is where the property is used for primary production purposes such as a farm or part of the property is used for residential purposes to form an integral part of the business. In the case of a farm an area of up to two hectares can be used for residential purposes and the farm will continue to be treated as business real property. An example of a residence forming an integral part of the business would be a motel where the manager is usually required to live on the premises.

There is no restriction on the proportion of the fund which can be invested in property. Therefore it is possible for a fund to hold up to 100 per cent of its investments in property although most superannuation funds hold less than this level.

**MORTGAGING THE PROPERTY**

Under the SIS legislation it is not permissible for a superannuation fund to borrow except in very limited circumstances and only for short periods. It is not possible to place a charge, such as a mortgage, over any property that is owned by the fund.

When a mortgage is placed over a property a financial institution places the mortgage over the title to the property and not the portion of the property held by each owner.

Where the property is owned as joint tenants or tenants in common it is also not possible for the other owners to place a mortgage over the property in which the superannuation fund is a part owner. If a mortgage is placed over the property then the fund would usually be in breach of the borrowing and charging of assets rules in the SIS legislation.
The following flowchart should assist to determine whether a superannuation fund is able to acquire a property:

**FIGURE 1. ACQUISITION OF A PROPERTY BY AN SMSF (OWNED OUTRIGHT OR AS TENANTS IN COMMON)**
CASE STUDIES

Case study 1. Purchase of a property from a related party
The Really Good Superannuation Fund wishes to purchase a property from a fund member. The property is divided into two separate areas — one area is used by the member's business and the other area is used for the business of an arm's length party.

It is possible for Sue and Scott, and their superannuation fund to purchase the property as it satisfies the requirement it is wholly used as business real property. However, it must be ensured that the purchase is permitted by the fund's investment strategy and asset allocation. The fund will also need to show that the purchase price of the property and the documents relating to the property were made on an arm's length basis. This may require the fund to have the property valued and documents prepared to show that ownership of the property has changed to the trustee of the fund. Also, a declaration of trust over the property may need to be prepared to show that the trustees hold the property in trust for the superannuation fund.

Other considerations relating to the purchase would relate to the capital gains issues for the member and any stamp duty or other charges that may be payable by the member.

Case study 2. Purchase of a farm from a related party
John the farmer owns a property of 200 hectares on which he runs several head of cattle. He lives on the farm on a one hectare block. John wishes to sell part of his farm to his SMSF and transfer part of the property to the fund as an in specie contribution.

It is possible for John to sell his farm to his SMSF as it satisfies the definition of business real property because the portion of the property used for residential purposes is less than 2 hectares. It is also permissible for John to sell a portion of the property to the fund and make an in specie transfer of part of the value of the property and treat it as a contribution to the fund. It may be possible for John to obtain a tax deduction up to the value of the in specie transfer, if he qualifies.

Just like the previous case it must be ensured that the purchase is permitted by the fund's investment strategy and asset allocation. The fund will also need to show that the purchase price of the property and the documents relating to the property were made on an arm's length basis. This may require the fund to have the property valued and documents prepared to show that ownership of the property has changed to the trustee of the fund. Also, a declaration of trust over the property may need to be prepared to show that the trustees hold the property in trust for the superannuation fund.

Other considerations relating to the purchase would relate to the capital gains issues for the member and any stamp duty or other charges that may be payable by the member.

Case study 3. Purchase of residential property arm’s length as tenants in common
Scott and Sue as trustees of the Billabong Superannuation Fund have decided to purchase a residential property for lease to arm’s length parties. The Billabong Superannuation Fund has about $400,000 and they estimate that the property will cost $600,000. They decide to purchase the property as tenants in common with the fund. The fund will contribute half of the cost and they will contribute the other half by mortgaging their own house. This will mean that the property purchased jointly with the superannuation fund will not have a mortgage on it.

It is possible for Sue and Scott and their superannuation fund to purchase the property as tenants in common. Sue and Scott, as trustees of the Billabong Superannuation Fund, will need to show the property has been purchased on an arm’s length basis as well as the other issue mentioned in case studies 1 and 2.

Case study 4. Proposed purchase of commercial property with a mortgage
Steve and Judi are thinking of purchasing a commercial property in their SMSF. The property will cost more than $1 million, however the fund has about $600,000 in it. If they wish to purchase the property they will need to obtain a mortgage which will need to be secured over the property.

Steve and Judi will not be able to purchase the property through their SMSF. Under the SIS legislation a superannuation fund is not permitted to borrow to finance the purchase and it is not permitted to place a charge over any fund assets. A mortgage over the property is considered to be the charging of the assets of the fund.

Case Study 5. Purchase of commercial property outright or as tenants in common
Glenn and Heather own a commercial premises that is currently mortgaged. They have an SMSF the Heatherglenn Superannuation Fund, and wish to transfer the commercial property to the fund.

Before the superannuation fund can acquire the property there are some questions that need to be answered:

- Is the property classified as business real property under the SIS legislation?
- Can the superannuation fund purchase the whole of the property from current resources and within the fund’s investment strategy?
- Can the superannuation fund purchase a part share in the property with Glenn and Heather as tenants in common? In this case the mortgage must be paid off. This could be done by Glenn and Heather mortgaging other property they own and paying off the mortgage currently over the commercial premises.

Case study 6. Proposed transfer of residential property to a fund from related parties
Charles and Alison own a number of houses and home units which they rent to arm’s length unrelated tenants. They realise they don’t have enough in their SMSF for retirement and are wondering whether they can transfer one or more rental properties.

Under the SIS legislation it is not possible for a superannuation fund to acquire rental property from fund members. The reason is that a fund is only able to acquire property which is used wholly for commercial purposes from a related party such as a fund member. Residential property which is rented is not considered to be business property under the SIS legislation.