



## Unlocking the benefits of Business Property in Self Managed Super

There can be significant advantages available to small business owners to hold their business premises in their Self Managed Super Fund (SMSF).

Some of these advantages have been around for several years, however the advantage can now be even greater for those aged over 60 and with possible benefits from changes in stamp duty interpretations and the new Instalment Warrant Legislation.

### Background

A business premises is generally classified as 'Business Real Property' so long as it is used 100% for business purposes. Unlike residential property, some of the restrictions in the SIS legislation do not apply to Business Real Property such as:

- Your SMSF can acquire the business premises from a fund member or related party and not contravene the acquisition rules contained in section 66 of the Superannuation Industry Supervision Act (SIS)
- Your SMSF can lease the business premises to you or a related party and it will not be an In-House asset under section 71 of SIS

Many SMSF Trustees have already used these Business Real Property exemptions to transfer an unencumbered business premises from a family business into the SMSF - either by a contribution into the fund or as an outright purchase made by the fund. However the SMSF is prohibited from acquiring the premises if there is any mortgage charge or security held over it.

The fund leases the premises to the member's business at arms length rate and terms. The fund pays maximum 15% tax on the rental income, whilst the member would obtain tax deductibility on the rental expense at 30% for a company or up to 46.5% for a sole proprietor - thereby obtaining a benefit through the different marginal tax rates.

Furthermore, if the fund is in pension mode, it could be in a position where the SMSF does not pay *any* tax on the rental income received. However the pension payments themselves may be assessable to some extent to the pension recipient if under the age of 60.

The Capital Gains Tax implications of realising gains can be a stumbling block in transferring property. The transfer of the property into the SMSF is a CGT event due to the transfer in ownership from the individual to the SMSF. However under the right circumstances the business owner may be able to claim a deduction for a portion of the in-specie contribution of the property up to the deductible contribution limit, assisting to offset the capital gains made.

Another issue has been the strict rules prohibiting a superannuation fund from borrowing or from having any charge over its assets. The new instalment warrant provisions may help overcome this problem.

### The effect of tax free pensions & transition to retirement

The new *simpler superannuation* rules effective 1 July 2007 assert that any payment received from a 'taxed' superannuation fund to a recipient over 60 from this date will be completely tax free.

Since 1 July 2005, a member over 55 has been able to commence a transition to retirement pension which does not require the usual retirement conditions to access superannuation benefits, albeit in a more restricted pension format.

Once a fund begins paying pensions, then it generally is no longer subject to income tax on investment earnings and CGT.

These rules mean for example that a 60 year old can continue to work, the business pays commercial rent to their own SMSF and obtains a tax deduction for this rent. In order to cover the cash outflow for the rent, the member receives a tax free transition to retirement pension from the SMSF so the personal cash position is neutralised. The SMSF pays no tax on the rent received because the fund is in pension mode. A fantastic outcome!

Even for those between 55 and 60 who may still be subject to tax on their pension income, the use of such a structure can be very tax effective.

The following example below highlights a structure that can save thousands in tax:

## Case Study 1

Mr and Mrs Butcher are aged 63 and 64 respectively and run their small family business as a partnership from a commercial premises that they have held freehold for over 30 years.

The premise is worth \$900,000.

Their joint net profit before tax each year is \$200,000, they pay approx. \$57,000 personal tax, leaving after tax income of \$143,000 per annum which is sufficient to fund their personal lifestyle.

Upon advice from their financial planner, they transfer the property into the SMSF as a non-concessional contribution, which is within their contributions cap of \$450,000 each using the 3 year bring forward rule.

*It should be noted that for this example we have assumed the property was purchased before the introduction of Capital Gains Tax, therefore is CGT free. If this were not the case, it may be possible to claim a deduction on part of the in-specie contribution to reduce any tax payable. Furthermore, there may be stamp duty on this transfer.*

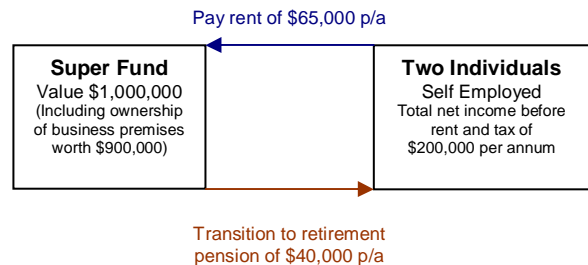
As Mr and Mrs Butcher already have \$100,000 in super between them, the total value of the SMSF is now \$1,000,000.

Commercial arms-length rent is calculated at \$65,000 p.a., meaning that the new joint net income of their business before tax and after rent is \$135,000. This leaves after tax income of around \$103,000.

As Mr and Mrs Butcher need \$143,000 to live off, they commence a pension with their full SMSF balances and draw the \$40,000 cash needed (which fits within 4% and 10% of their account balances per transition to retirement rules). This pension is completely tax free and makes the rental income received by the SMSF tax free.

Mr and Mrs Butcher's personal cash flow position has not changed – before and after, they receive a total \$143,000 after tax per annum. However, their SMSF has \$25,000 cash benefit through tax savings.

## New Structure



The total amount of tax paid is reduced by \$25,000 over just one year, as summarised below. This saving will compound for each year thereafter and could be worth several hundred thousand dollars over their lifetime.

	OPTION 1 SMSF owns property	OPTION 2 Individuals own property
Net income before tax - individuals	135,000	200,000
Net income before tax - SMSF	65,000	0
Total income - combined	200,000	200,000
less approx tax - individuals	(32,000)	(57,000)
less approx tax - SMSF	0	0
Net Income - combined	168,000	143,000

Note- Based on 07/08 Personal income tax rates

Further tax savings may be available through the use of concessional contributions

## Instalment Warrants

Legislation recently passed eases the previous restriction on gearing within a super fund and legitimises an investment in an 'Instalment Warrant' under certain limited circumstances. The legislation appears to be more flexible with borrowing than was expected and it is possible that further changes will be made and we recommend legal advice before acting.

The legislation allows an instalment warrant arrangement whereby the SMSF makes partial payment and effectively borrows the shortfall in order to acquire a beneficial interest in that asset. The SMSF pays for the asset via instalments including interest on the balance owing to finalise the purchase of the asset. Once the final instalment is paid, the SMSF acquires the legal ownership in the asset. In the meantime, the ownership is in trust for the SMSF until such time that the loan is fully repaid. The lender must not have any recourse over any other asset of the fund.

This effectively means that someone who previously was not in a cash position to purchase their business premises through the SMSF may now be able to use this newly available leverage to acquire the asset within the SMSF.

Alternatively, someone who was not in a position to purchase their business premises may now use their previously inflexible existing superannuation assets to achieve this.

Be mindful that the interest deduction will not yield a tax benefit to a SMSF in full pension mode, as the SMSF will not pay tax in this case.

## Case Study 2

Mr & Mrs Butcher did not act on the advice from Case Study 1 and are now aged 64 and 65 respectively and wish to reconsider. They intend to work for 5 years and the property is now worth \$1,000,000.

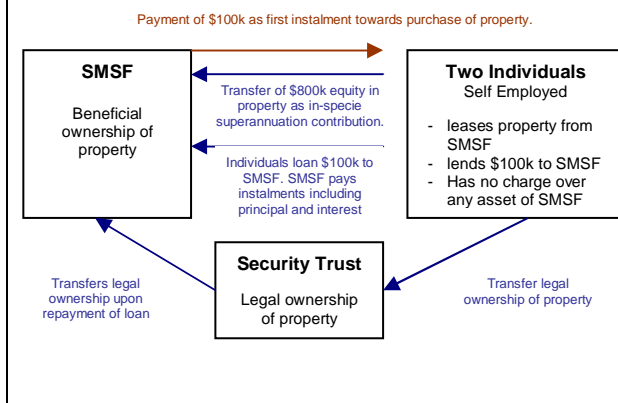
Unfortunately as Mrs Butcher has passed her 65<sup>th</sup> birthday she can no longer bring forward the non-concessional contribution for the following two years and is limited to \$150,000. Mr Butcher can still bring forward his non-concessional contributions totalling \$450,000. They can also contribute \$100k each as concessional contributions. The fund still has the \$100,000 available in existing superannuation assets.

Therefore they can potentially have a total of \$900,000 available to acquire the property, however given the property value is \$1,000,000 it is not quite enough to obtain it outright.

Under old rules, this would deem the acquisition of the property impossible without the ability to borrow. However, the use of an 'instalment warrant' arrangement may allow Mr and Mrs Butcher to effectively lend the \$100,000 shortfall to the fund to be repaid with interest at a later date.

<b>Transfer value of property:</b>	\$1,000,000
<b>Funded by:</b>	
Existing superannuation:	\$100,000 (cash)
Non concessional contributions (Mrs B):	\$150,000
Non concessional contributions (Mr B):	\$450,000
Concessional contributions (combined):	\$200,000
Loan from business:	<u>\$100,000</u>
<b>Total</b>	<b>\$1,000,000</b>

The transaction is summarised with the following diagram:



The instalment warrant loan of \$100,000 plus interest needs to be paid by the SMSF to the business. The instalments will be cash funded from the rental income received by the SMSF.

The interest deduction will not provide a tax benefit to the SMSF as it will be in pension mode, however on the other side the interest will be assessable to the lender (i.e. the business).

## Stamp Duty

In recent times, some state revenue departments have not applied stamp duty for in-specie property transfers. This could make the prospect of transferring a property into a SMSF more attractive, as this is an expensive component of property transfers.

There is no uniformity between states and each case seems to be circumstance specific. Always seek legal advice to determine whether any concessions are available as this is a complicated and changing legal area.

## Capital Gains on disposal

The exit strategy should be considered prior to implementing a transfer of business premises to a SMSF.

Over time the property will most likely appreciate in value. The unrealised capital gain will accumulate until such time as the asset is disposed. There will be no tax payable on this capital gain if the property is disposed of when all of the members are in pension mode.

However, if the property is sold or transferred at a time that the SMSF is not in pension mode, such as might occur after the death of the members, CGT will be payable by the SMSF. The Trustees should review potential tax ramifications over time and consider realising capital gains whilst in pension mode.

There may be additional tax payable on the actual distribution of the taxable portion of member benefits if the death benefit recipient is a 'non dependant' and also potential stamp duty payable by the beneficiary.

## Things to consider

When unlocking the benefits of operating the business premises in SMSF, consideration should be given to:

- unrealised capital gain on the premises
- ability to offset capital gains with deductible contributions
- stamp duty effect of the transfer
- requirement for borrowing
- age of each of the members of the SMSF and anticipated time before retirement

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- personal tax position of each of the members
- existing business structure and
- overall tax saving
- a tax effective exit strategy

The Trustees should obtain legal advice relevant to their specific circumstances and confirmation that the Investment and Instalment Warrant is allowed within the Trust Deed.

In addition, as the asset investment is likely to make up a substantial portion of the fund assets and there is a level of risk associated with Instalment Warrants, the Trustees should review and update the Investment Strategy prior to undertaking this strategy.

## November...

During November (the month formerly known as November), several of the SuperGuardian team members decided to grow a 'mo'. The cause – men's health, the fight against male depression and prostate cancer.

The aim this year was to raise over \$3,000. If we reached our target, the SuperGuardian Founding Directors agreed to shave off their facial hair.

This was a significant deal, as David Minns and Phil Jaquillard have had their facial hair for over 20 years.



Our Senior Accountant Trevor Goedecke, in a last ditch attempt to get the funds over the line also agreed to shave off his moustache in lieu of the cause.



**Mo Bro's from left to right** – Gavin Ma, Monte Engler, Lewis Le, John Yeatman, Michael Callisto & Ed Bernard

It was an uncomfortable month in the office – both for the 'Mo Bro's' who complained of itching, and the staff that had to look at them. However, thanks to the generous support of our staff, clients and Advisers, we managed to raise a grand total of **\$3,617**.

Phil, David and Trevor revealed their new looks at the Staff Christmas party, and we hope the fresh faces are here to stay.



Thank you and congratulations to those that participated!

## The Christmas Break

It's Christmas time and the SuperGuardian team are taking a break.

The office will be closed on Christmas Eve, the 24<sup>th</sup> December, and will re-open on Wednesday 2<sup>nd</sup> January 2008.

We will have a small number of staff working during this period but advise that any emails/queries will be handled upon our return.

**We wish you and your families a very Merry Christmas and a Happy New Year.**

For more information relating to any topics covered in this edition of Your Guardian, call **Brendan Daw** or **Ed Bernard** of our office on **1300 787 576**.



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