

HOW TO BUY COMMERCIAL PROPERTY



IN A SELF-MANAGED SUPER FUND (SMSF)

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Before you get started

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Before acting on any information contained herein you should consider if it is suitable for you. You should also consider consulting a suitably qualified financial, tax and/or legal adviser.

Information in this handbook is no substitute for professional financial advice.

We encourage you to seek professional financial advice before making any investment or financial decisions. We would obviously love the opportunity to have that conversation with you, and at the rear of this handbook you will find information about our authorised representative and how to go about booking an appointment.

If ultimately you decide not to meet with us we still encourage you to consult with another suitably licensed and qualified financial adviser.

In any circumstance, before investing in any financial product you should obtain and read a Product Disclosure Statement and consider whether it is appropriate for your objectives, situation and needs.

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Letter from the Wealth Adviser Library

Dear Reader

Welcome to the Wealth Adviser Library

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

Knowledge gives you a huge advantage

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

Take the next step

Wealth Adviser (a division of WT Financial Group Limited) supports more than 400 privately owned and operated advice practices around the country. We invite you to engage with one of our advisers to discuss what it was you were hoping to achieve when you obtained this handbook, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find details on how to book an appointment.

Wealth Adviser Library

Introduction

More and more investors are becoming aware of the benefits that can be gained through channelling their retirement savings into Self-Managed Super Funds (hereafter simply referred to as SMSF's). The range of investment options within SMSF's is quite extensive (provided you keep on the right side of the rules). One potentially lucrative investment avenue is investment in commercial property.

The purpose of this guide is to take a look at some of the basics (e.g. 'Why do it?' and 'How should I go about it?') of investing in commercial property with your SMSF.

The specific focus of this eBook will be on issues surrounding commercial properties inside SMSF's.

- For a more general introduction to Self-Managed Superannuation Funds see the www.wealthadviser.com.au eBook: "Your Guide to Establishing and Operating a Self-Managed Super Fund (SMSF)"
- For a general discussion of Property in SMSF's see our other eBook: "Your Guide to Buying Property in a Self-Managed Super Fund"

Property in an SMSF: the basics

A SMSF is a superannuation fund set up for the benefit of 1-4 members who are also the trustees¹ of the fund. To be recognised and regulated by the Australian Taxation Office (ATO) a SMSF must comply with the Superannuation Industry Supervision Act 1993 (hereafter referred to as SISA) and other rules and regulations governing SMSF's. If the fund complies, and remains compliant, it will enjoy significant reduced tax rates (when compared to 'regular' investments) namely:

- 15% on the income of the fund

- 10% on realised capital gains on investments held for more than 12 months.

In order to continue to enjoy concessional tax rates compliance with SISA and ATO standards should be investigated and confirmed on a regular basis. The fund should also meet the so-called 'Sole Purpose Test'. This states that all the investment activity of the fund should be aimed at securing and providing retirement benefits for the members (or for dependents if a member dies before retirement).

Prior to 2007 SMSF's were not allowed to borrow funds. This meant that property investment wasn't an option for any but the very strongest funds. Recent changes to the Superannuation Industry Supervision Act (SISA) now make it possible for SMSF's to borrow funds under some clearly defined conditions. This means that Australians can now continue their 'love affair' with investment property whilst using their primary retirement investment vehicle. This is certainly not an option for every investor and all the usual warnings about carefully considering all your options still apply! It does, however, open up some exciting and tax efficient avenues towards maximising your retirement income.

You could certainly consider this option if you:

- Are ten years or more from retirement
- Are in stable employment and therefore in a position to make regular contributions to your super fund
- Have more than \$200,000 (or 40% of the intended property purchase price) in your fund
- Are willing and able to take an active interest in the growth of your retirement portfolio

¹There are some exceptions to this e.g. if a member is a minor or is legally disqualified. In such cases the member must be represented by another trustee. The qualifications and functions of trustees will be discussed in more detail in our SMSF eBook entitled: Your Guide to Establishing and Operating a Self Managed Super Fund (SMSF)

What you can and cannot do with property in a SMSF

The changes to the SISA mentioned above allows a SMSF to borrow money to acquire any asset which a SMSF is permitted by law to acquire directly. All borrowing activity must meet the following criteria:

- Funds should be borrowed to acquire an asset
- The asset should be held in trust with the SMSF holding a 'beneficial interest' (this concept will be explained later on)
- The SMSF should have the right to acquire direct legal ownership, following the making of one or more payments, after gaining the beneficial interest.
- Borrowers should only have rights, in the case of loan defaults, over the original asset and not over the rest of the assets of the SMSF. (This is often referred to as 'limited recourse')

It should be clear from the above that the setting up of a property loan to an SMSF can be quite complicated. It is therefore very highly recommended that you seek professional advice before attempting to take this route. Many lenders will, in fact, require proof that such advice was sought before considering a loan application.

In addition to the loan criteria set out above there are also some very specific guidelines as to the kind of property deals that would comply with SMSF regulations.

The following types of transactions would generally be allowed:

- The purchase of properties that can be held as an investment or as owner-occupied business premises.
- The sale or transfer of commercial property that you already own to the fund.

- The purchase of non-owner occupied residential property under certain circumstances.

The benefits of buying commercial property with your SMSF

There are several distinct benefits associated with buying commercial property through your SMSF. In this section we will firstly focus on the general benefit of SMSF property investments before looking at some reasons why you should specifically consider commercial property.

Why invest in property with your SMSF?

The first, and perhaps most important benefit associated with this type of transaction is the fact that 'in super' transactions are subject to a much more favourable tax regime than 'ordinary' investments. Your after-tax returns are therefore likely to be much better. For example:

- Rental income from property in a SMSF will be taxed at 15%, compared with rates of up to 45% that a 'regular' investor could be paying.
- Once you start using the SMSF to provide your pension, rental income from the property will be tax free.
- The costs incurred in purchasing and managing the property (interest, depreciation, rates etc.) could very well produce a 'negative' income that you can offset against other income in the SMSF.
- Gearing² (Where you make use of borrowed funds to gain control of an appreciating asset) is one of the most effective long term wealth builders available. The fact that your SMSF can now borrow to buy property enables you to make use of this time honoured strategy to build or increase the value of your

² See www.wealthadviser.com.au eBook 'A Quick Guide to Gearing' for a more comprehensive discussion of this subject

retirement portfolio.

- The fact that properties are held inside your SMSF means that you protect yourself from the impact of Capital Gains Tax (CGT) until retirement, at which time your gains will become tax free (if current legislation is still in place by that time!).
- Assets held in an SMSF will, under normal circumstances, be protected against general debt recovery (this obviously does not apply in the case of the loan with which the asset was purchased) and bankruptcy proceedings.
- The fact that you can transfer commercial property that you already own into the SMSF allows you to 'unlock' cash to invest in your business or in other assets. You can even use the funds to re-contribute to your SMSF (subject to individual contributions limits of course).

Just a few words of warning: As with any other SMSF, a SMSF containing property investments will have to be properly administered and managed. You will have to constantly make sure that all the activities of the fund comply with relevant legislation and regulations. Penalties for non-compliance can be very severe. You will also need to make sure that a solid long term investment strategy is in place and be willing to navigate the challenges of obtaining finance for SMSF related deals. These challenges are by no means insurmountable and they certainly do not provide sufficient reason to shy away from SMSF property investments. They do, however, underline the importance of getting the best possible advice throughout the process.

Why invest in commercial property?

When most people think about property investment the image of a landlord owning several residential properties immediately springs to mind. It is true that significant returns, and solid investment growth, can be achieved through investing in residential property.

However many investors miss out, either through fear or ignorance, on the opportunities in another, potentially lucrative, market: Commercial Property.

As the term indicates Commercial Property Investment basically focuses on investment in properties where business is conducted. As with any kind of investment it is absolutely imperative that you do your homework in the form of solid market research before you invest in this area. There are, however, several advantages in doing so:

- If you can manage to obtain a property in an in-demand commercial area, you will be more or less assured of your property being continuously tenanted. Companies also tend not to relocate at the drop of a hat –like some residential tenants sometimes do. This means that commercial property can provide you with a much more stable income stream. Lease terms are often signed for as long as 5 years and even 10 year leases are not uncommon.
- Commercial lease contracts can be set up in such a way that the responsibility of repairing and insuring a commercial property rests with the tenant. The tenant is also responsible for all utility and rates bills. This means that managing a commercial property is often less labour intensive than is the case with residential properties.
- Commercial property is an ideal investment vehicle for investors who are satisfied with slow, but steady, capital growth while at the same time requiring a steady income stream.
- Commercial property leases include regular rent reviews. If a business is successful in a particular area the landlord can use this fact as leverage during these rent reviews to press for increased rents. A successful business would be much less likely to move due to a rent in-



crease than a residential tenant, thus allowing much more scope for negotiation.

There are no areas of potential investment that is without risks. The commercial market is, like the residential market, vulnerable to changes in the economic climate. It also usually takes longer to sell a commercial property. It is therefore imperative that you do everything in your power to understand the local market before you invest in commercial property. As a general rule of thumb it is always better for the first time commercial investor to invest in an established commercial district with high occupancy rates and proven 'footfall'. It is true that these markets are harder to enter due to higher initial capital costs but it could very well be worth your while in the long run.

As always the 'words of wisdom' about obtaining professional advice every step of the way applies.

The basic "architecture" of SMSF commercial property investments

It should always be remembered that a SMSF is an investment vehicle with a very specific purpose: To provide retirement income in line with superannuation laws and regulations. It therefore follows logically that regulators will want to make sure that all SMSF's are used with this purpose in mind (this is sometimes called the 'sole purpose test') and that they are not treated as convenient pots of cash with which to pursue investment whims. Maintaining and showing compliance with relevant legislation should therefore always be very high on the agenda of trustees of SMSF's. This means that people buying property inside a SMSF should take care to forget everything that they think they know about buying property as 'private citizens' and try to make sure that they studiously follow the correct procedures for this type of

transaction. The basic outlines of these procedures are spelled out below.

The mechanism used to set up a SMSF property investment is sometimes referred to as an 'Instalment Warrant Structure'. It governs the activities of a super fund in borrowing and purchasing an asset that is then held in trust.

The SMSF will have beneficial ownership of the asset while the trust has legal ownership. Legal ownership can be transferred to the SMSF as soon as the asset is fully paid off.

The diagram below gives a visual presentation of the structure of an SMSF property investment. It would perhaps be a good idea to refer back to it as we go ahead and explain the different steps of setting up your investment.

The first thing to do before you can proceed with property investment is to amend your SMSF's internal rules and trust deed (if necessary) to allow for borrowing. This is an essential step!

It may also be a good idea to clearly define the kinds of investment that will potentially be entered into and to check that they conform to the stipulations of the SISA.

After finding a suitable property, arrangements should be made to purchase the property on an 'arm's length basis'³. You will have to make arrangements for the setting up of a trust (known as the 'Security Custodian Trust') that will hold the legal title of the property. It should be noted that the security trustee cannot be a trustee of the SMSF as you cannot hold something in trust for yourself. It is, however, possible to set up a separate company to act as trustee. It is highly recommended that you get competent legal advice to help you design the best trustee system.

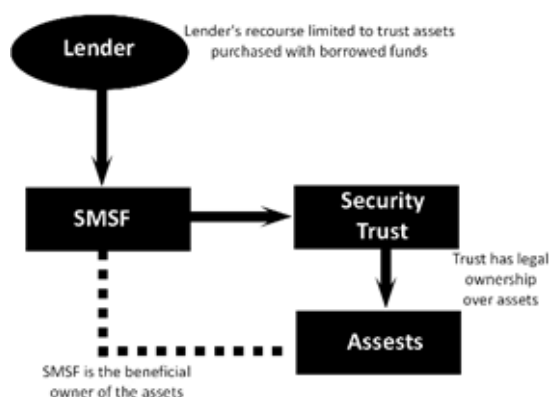
It is very important that the 'arm's length arrangement' is set up in exactly the right way. Not fully adhering to this arrangement can lead to a variety of messy situations

³ As beneficial owner the SMSF will be credited with all income and capital growth even if the property has not been paid off. The SMSF will, on the other hand, also be directly responsible for all mortgage payments and costs.

and possibly the need for costly and complex corrective actions.

Some examples of incorrect (or at the very least questionable) arrangements include:

- Where the security trust directly enters into a loan arrangement with the lender.
- Where the lender acts as the holding trustee. This could result in a clear conflict of interest and is an arrangement that might be seriously questioned by ATO.



- Where the SMSF is named as the buyer on the sale contract. This violates the 'arm's length' arrangement that requires the security trust to act as purchaser and 'holder' of the property. This is a common but potentially very serious mistake as it may be extremely difficult to unwind.
- Where the security trust has active duties. The purpose of the security trust is to act as a holding entity for the title deeds of assets. If it takes on responsibilities that range beyond this, it might be viewed as an 'active entity' for tax purposes. The activities of trusts should therefore be kept as limited and uncomplicated as possible.

Once all the correct 'architecture' is in place you can proceed to approach lenders for finance. The SMSF can enter into direct talks with the lender and will also borrow directly from the lender on a 'limited

recourse' basis (this means that the lender will only have a 'claim' against the fund, and not the individual members, for the property purchased). Finance documents will clearly spell out who the legal and beneficial owners of the property are. Recourse arrangements will also be stipulated.⁴

Once the property has been purchased, all financial dealing will be directly with the SMSF. This means that the fund will be responsible for loan repayments and expenses. It will also receive rent as if the property was owned directly by the fund. The SMSF's accounts will also show the property as an asset (not as a trust investment). This means that there will be very little actual activity in the security trust.

When the mortgage is fully paid, the legal ownership of the property may be transferred to the SMSF.

Finding suitable commercial properties

Many investors will be looking to include commercial property that they already own in their SMSF (this will be discussed in the next section). There may, however, be many other who are keen on capitalising on the significant opportunities in the commercial section by buying commercial property for the first time. It should, again, be stressed that the trust deeds of your SMSF will first have to be amended to allow for borrowing before you go property hunting. When you do, it would be good to keep the following in mind:

- Gain expert opinions. There are, as you are no doubt aware, many spruikers offering the 'next big thing' out there. Make sure that you separate the 'fact from the fluff' by spending time with agents and other experts with a proven track record in setting up successful commercial deals over a number of years.
- Look beyond the obvious. Most investors will simply explore their

⁴Please see the Wealth Adviser EBook 'SMSF Property Loans' for more information on sourcing and setting up SMSF loans.

local areas, or industries that they are familiar with when looking for property. This can be a rather costly mistake.

By looking further afield, with the help of local experts, you may find great opportunities in some less obvious places and sectors. Some areas where investors are gaining significant yields at the moment include:

- Industrial developments in places where demand is high and construction low
- City fringe, and growth area, office buildings
- Smaller suburban shopping malls containing some speciality shops and anchored by a key tenant.

Do your homework. It may perhaps be stating the obvious but it is worth repeating that property should never be bought 'on a hunch'.

Many investors have come close to ruin through doing this. Avoid this trap through spending significant time analysing factors like occupancy rates, rental yields, interest rates etc. Going through this kind of 'due diligence' exercise

will obviously never provide you with an iron clad guarantee that your investment will be a success but it may at least prevent you from walking blindly into a disastrous purchase.

“Business real” property transfers

SMSF rules clearly state that it is not possible for investors to invest in 'owner occupied' residential properties. There is, however, a special type of transaction that can make a significant contribution to the strength of your SMSF by allowing the inclusion of commercial assets already owned by members of the fund (without breaching 'related party' rules). Setting this up will require a thorough and up-to-date knowledge of the relevant rulings and legislation and it is, therefore, highly recommended that you engage the services

of a financial advisor with experience of shepherding this type of transaction through to completion. The transaction in question is a 'Business Real Property Transfer'.

Business Real Property Transfers:

According to the exemption in Section 66(2) of the Superannuation Industry Supervision Act trustees are allowed to acquire interests in business real properties (defined below) without lease-backs to related parties falling foul of related party rules. This means that business premises belonging to trustees can be transferred into the SMSF provided that all the relevant rules are adhered to.

A 'Business Real' property is defined by ATO as:

- any freehold or leasehold interest of the entity in real property, or
- any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer, where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not), but does not include any interest held in the capacity of a beneficiary of a trust estate.

Real benefits can accrue from following this approach but it must, once again, be stressed that it will require the services of someone who has successfully advised clients in completing this type of transfer.

Investing in commercial property as a “tenant in common”

A 'Tenant in Common' agreement can be used to allow a SMSF to co-invest in business real property (see above) with another investor (e.g. an individual, trust, another SMSF etc.). 'Tenants in Common' hold shared tenure rights to a property. This is normally defined as a percentage (e.g. 50% of the total) over which the owners hold full rights and privileges (e.g. the right to sell at any time, the right to benefit from

rental income etc.). The share of a TIC that a fund or individual holds can, therefore, be regarded as a 'single acquirable asset' in its own right. Some of the benefits of making use of a TIC agreement include:

- The ability to invest in business property with a related party without contravening the 'related party rules' governing SMSF's (provided once, again, that all the rules are followed). This means, for example, that a fund can purchase a share in a business property belonging to a member.
- The ability to invest in more expensive properties (that a single SMSF might not have been able to afford on its own) since there is a pooling of resources.
- Commercial property can be acquired from a fund member over time (with the SMSF's share of the TIC steadily increasing).
- The portion of a TIC property inside a SMSF will be treated according to the concessional tax rules applicable to SMSF's.

Some of the possible disadvantages associated with a TIC arrangement for SMSF's include the following:

- The rules governing borrowing money to acquire a stake in a TIC are complex and may be subject to changes as ATO issues rulings to clarify what constitutes acceptable practices.
- This arrangement cannot be used to gradually transfer ownership of a residential property to a SMSF.
- If a substantial portion of a SMSF's assets are tied up in a TIC arrangement, it could lead to liquidity problems during the pension draw-down phase.

Some final considerations

The following points should always be borne in mind by those who are considering commercial property investments in SMSF's (as well as by those who have already taken the plunge):

The maintenance of compliance is key: Whilst property investment in a SMSF can be a great strategy to maximise retirement savings it should never be regarded as a kind of 'set and forget' proposition. This attitude is particularly dangerous when it comes to the issue of compliance. Lack of compliance with the rules laid down by the ATO and other regulatory bodies can cause massive headaches and can also be very expensive to rectify. It is therefore of the utmost importance that you get the best possible advice and that regular compliance audits are conducted.

Ensure that properties are managed to the highest possible standard: Always remember that your SMSF commercial property investment is supposed to contribute significantly to your retirement funds. It is, therefore, in your own interest to ensure that properties bought in this way are managed to maximise income. The standard goals of property investors (e.g. minimising vacancies, ensuring that rents remain market related and tenant satisfaction) should therefore be pursued with energy and professionalism. Regular reviews of whether the particular property is delivering as it should (and of whether investing in another area/sector might deliver better results) should also be conducted.

Remember to plan for 'drawdown': It may seem that we are labouring the same point but it should never be forgotten that the purpose of a SMSF is to provide benefits to members (or their dependents) in retirement. This means that there are strict rules requiring that set amounts will have to be paid out from the fund in the form of a pension (this is known as 'drawdown'). Drawdown amounts can range from 5% per year at age 65 to 14% at age 95. Trustees will have to make sure, in light of this, that funds will be available to meet drawdown

demands. If this is not available from income from property held in the fund, it may lead to the need for drastic measures like having to sell assets to meet drawdown obligations.

This is obviously not a desirable situation and drawdown requirements will have to be a serious consideration when SMSF trustees make decisions on investment strategies.

Conclusion

The ability to borrow money to invest in commercial property is a fairly recent development. This means that many people you will deal with in the course of such a transaction will not be quite sure as to what the right procedures, protocols and strategies for successful completion might be. It would therefore be very much worth your while to get someone on side who does know what he/she is talking about when it comes to SMSF commercial property investment.

Ideally such a person should be prepared to 'shepherd' the deal through from A to Z. Getting such an expert on side might seem like an expensive proposition at first but you will almost certainly find that the time and money that you will save in the process will make it more than worth your while.

It is our sincere hope that the information presented above set you thinking about some of the issues that you will have to pay attention to in planning your financial future. It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this. We urge you to continue your explorations by making use of some of the other resources and eBooks from the Wealth Adviser stable. We also stand ready to serve you with independent and professional advice, so please do not hesitate to contact us if we can be of further assistance.

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We look forward to meeting you soon.

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Wealth Adviser is a division of WT Financial Group Limited
Head Office: Level 5, 95 Pitt Street Sydney NSW 2000
Telephone: 02 9248 0422