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CASE STUDY

Buying an investment property individually
versus
Buying in a self managed super fund

In this case study we examine the costs and benefits of buying an investment property in a self managed superannuation fund, compared with the traditional method of buying an investment property in individual names.

The Couple

Ian is age 44 and his wife Jenny is age 41.

Both have steady jobs.

Ian earns $80,000 before tax and Jenny earns $60,000 before tax. Their incomes increase by 3% per annum.

They have paid off their home and are looking to use the equity in their home to buy a residential investment property. Their home is worth $800,000.

They want to be able to have any investment loan paid off within 10 years as Ian would like to be able to retire early.

They spend $80,000 per annum on general cost of living expenses.

Their Investments

They have $50,000 in the bank.

Ian has a superannuation balance of $120,000.

Jenny has a superannuation balance of $40,000.

Both superannuation funds are low cost industry funds, invested in “balanced” investment options.

The Property

They are looking to purchase a property at a cost price of $350,000.

The property can be rented to a good tenant for $400 per week. This rent increases by 3% per annum.

Expenses associated with owning the property are $5,000 per annum, increasing by 3% per annum.

The property is able to depreciated for tax purposes at the rate of $5,000 per annum.

We have assumed the property grows in value at a rate of 5% per annum.

Option 1 – Private Purchase

Under this option Ian and Jenny purchase the investment in joint names as their marginal tax rates are the same.

Ian and Jenny borrow $350,000, using their home as security and buy the property in joint names. Their loan is established as a principal and interest loan over 10 years at an interest rate of 6% per annum. Their standard loan repayments are $3,886 per month. This is just affordable for Ian and Jenny and they have agreed that if they have any surplus money that it will be used to pay down the loan.

They pay $11,240 in stamp duty and incur legal and other purchase costs of $2,000. These costs are paid for using funds held in the bank account.

Option 2 – Buy the Property in a Self Managed Super Fund

Under this option, Ian and Jenny establish their own self managed super fund and transfer the full balance of their superannuation accounts (total $160,000) into their own fund. They seek advice in relation to their strategy from a professional financial planner and establish their fund using the services of a professional superannuation fund administrator. They incur a total of $3,500 in professional fees as a result.

The initial balance of their superannuation is invested as follows: $30,000 in a bank account in the super fund's name and $130,000 in "balanced" investment options.

Using the services of their professional super fund administrator they establish all of the necessary documentation for the super fund to borrow money. This also costs $3,500. These fees and the fees mentioned previously are paid for out of the super fund's bank account.

Ian and Jenny then borrow $350,000 from their bank, using their house as security. The terms of the loan from their bank are identical to Option 1. They then lend $350,000 to their super fund to purchase the property, taking security limited only to the property being purchased. Their loan to their super fund is for the same term and at the same interest rate as the loan from their bank. As a result, the payments they receive from their super fund are identical to the payments they are required to make to their bank. Also, the interest they receive from their super fund, whilst it is taxable, is offset exactly by the interest deduction they receive on the interest they pay to their bank. As a result, there is no cash flow effect on Ian and Jenny personally.

The super fund then purchases the property in accordance with the special conditions required by the documentation. It is required to pay stamp duty of $11,240 and legal and other purchase costs of $2,000, the same as that payable for the private purchase. This is paid for out of the super fund's bank account.

As Ian and Jenny both have surplus income, on the advice of their financial planner, they arrange for Ian to salary sacrifice $17,000 per annum of his income into their new super fund. Jenny also salary sacrifices $19,000 per annum of her income into their new super fund. This level remains the same each year. This will ensure that they do not breach the new superannuation contribution limits proposed in the 2009 Federal Budget. They also agree that any further spare money should be utilised by Ian contributing into super, on an after tax basis. Their ongoing financial affairs are managed in consultation with their financial planner. An ongoing fee of $150 per month (increasing by 3% p.a.) is charged by their financial planner for this service. These fees are paid for by their super fund.

Their super fund administrator charges a fee of $2,400 per annum (increasing by 3% p.a.) to attend to all of the administrative issues associated with the super fund, including lodgement of tax returns and other administrative paperwork. These fees are also paid out of the super funds bank account. Their financial planner acts as a liaison point between the administrator and Ian and Jenny to simplify the management of their super fund. This service is included in the fees paid to their financial planner.

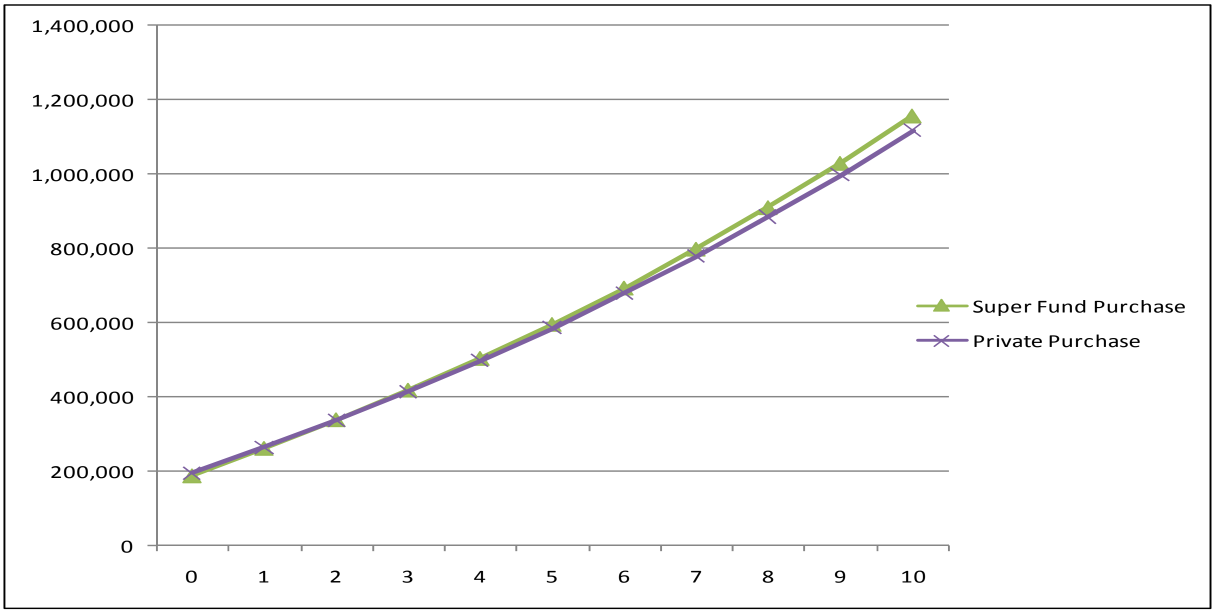
The rent from the property is credited to the super fund's bank account, as are all superannuation contributions, being compulsory employer contributions and salary sacrificed contributions for both Ian and Jenny. This is more than sufficient to pay Ian and Jenny the

$3,886 per month they need to pay to their bank. As surplus funds are accumulated in the super fund's bank account, they are reinvested into "balanced" investment options.

Comparison of Options

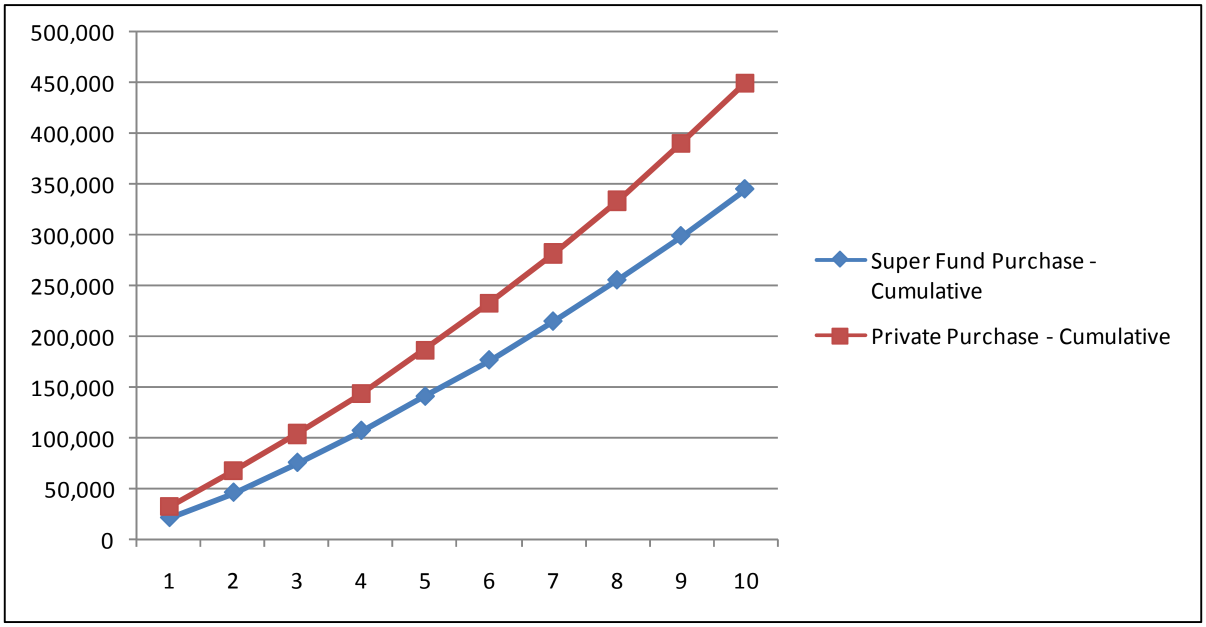
Chart 1 below shows the difference in value of Ian and Jenny's net assets (excluding the value of their own home), depending on the strategy that they choose to make the purchase. As can be seen, buying the property in the self managed super fund provides a superior result of about $40,000 in 10 years' time.

Chart 1 – Net Asset Value (excluding their own home)



This difference in result can be simply explained by the difference in tax payable as can be seen from chart 2 below, which shows the cumulative amount of tax payable by Ian and Jenny personally and the tax payable by their super funds, either industry funds or self managed super funds. Even though there are higher upfront fees and ongoing fees associated with buying the property in the super fund, these are more than offset by the significant tax savings.

Chart 2 – Cumulative Tax Payable



So why is so much tax saved?

The main reason is that the loan is being repaid using before tax dollars rather than using after tax dollars. By salary sacrificing into super, Ian and Jenny are saving the difference between the tax that they would have paid at marginal rates on their income (31.5% for amounts above $35,000 and 16.5% for amounts below $35,000 from 1 July 2009) and the contributions tax paid by their super fund. In an industry fund a contributions tax of 15% is payable. However, in a self managed super fund that is in a loss making situation, due to a negatively geared property, contributions tax reduced by the amount of the losses.

Furthermore, the rental income earned by the super fund is taxed at 15% compared with 31.5% for Ian and Jenny.

It gets even better

This case study does not allow for either Ian or Jenny to commence a pension from their super fund. Both will be entitled to do so, under current law, once they have turned age 55. When this happens, the super fund is no longer required to pay tax on the rental income, further enhancing the strategy. At this stage, the rental income from the property should have increased to about $550 per week. If this was earned by Ian and Jenny personally, and their marginal tax rates remained unchanged, they would pay tax of $173.25 per week, or over $9,000 per annum more tax than their super fund would pay.

Also, if the property is sold once the super fund is paying pensions, no capital gains tax is payable, resulting in further tax savings of tens of thousands of dollars. For example, if Ian and Jenny waited until Jenny was age 60 to sell the property, and assuming they earned no other taxable income in the year of sale, they could expect to pay combined capital gains tax of more than $100,000, if the property increases in value by 5% per annum.

Ian and Jenny also have much greater protection in the event of a job loss or loss of tenant as loan repayments to them, subsequently paid to their bank, can be made by their super fund using the other investments held by their super fund until they get back to work.

A note of caution

Superannuation is a heavily regulated area and it is normally not possible to gain access to investments held in superannuation until you have retired. However, there is nothing to prevent the super fund from selling the property at any stage and investing the proceeds in other investments. There is nothing to prevent Ian and Jenny from purchasing the property from the super fund at an "arms length" price.

While the super fund owns the property it should not be rented to any related party and cannot be used by Ian and Jenny for accommodation in any way.

It is critical that investors seeking to take advantage of this method of purchasing a property seek professional advice regarding establishing their super fund, implementing an appropriate investment strategy, arranging suitable loan documentation and ongoing advice and administration services.

How can we help?

SMSF Experts offers a packaged solution for clients wishing to establish self managed superannuation funds for the purpose of borrowing to invest in property. Through its relationships with financial planners and leading providers of administration services for self managed super funds, clients are provided with professionally drafted documentation and step by step processes to achieve their goals.

Please click here for more information.