
Loosening the rules for **Property in SMSFs**

As the four major banks dominate mortgage lending in Australia, they have a huge stake in the property market. They would not want to see property values below loan values as happened in the US and Europe. My personal view is, that is one of the major reasons they have tightened rules, reduced LVRs and effectively rationed lending.

With the volatility of the stock market trustees of super funds have stayed out and are flush with cash. By comparison the property market is comparatively subdued. It is relatively stable and secure despite the prediction of doom and gloom by some commentators and economists including Steve Keen and Harry Dent. Rents are rising and employment levels are high – conditions conducive to stable if not growing, values.

Fear of losing the capital is leading SMSFs to invest in property – an investment class generating a steady (not spectacular) yield with prospects of capital growth over the long term. Property has the added advantages of being easy to understand and manage with tax advantages in the form of discounted capital gains.

When SMSF's were allowed to borrow to fund investments in property in 2007, the rules were very rigid with what you can do with that geared property – limiting the opportunity to add value to it e.g. you could not do an improvement helping increase the rent and increase the overall value.

While still complex, a new ruling from ATO, appears to have seen reason, relaxing the rules a bit making investments more attractive in SMSFs. See below for how the changes impact...

CONTENTS

Property and SMSFs: loosening the rules	2
Is the property a single asset?	2
Maintenance, repair or improvement?	3
Can you improve a property?	3
Property and natural disasters.....	3
Get advice!	4

Where are You Now? Where would you like to be? **Call if you want to chat** **Error! Bookmark not defined.**

Property and SMSFs: *loosening the rules*

If your SMSF has borrowed money (or thinking of borrowing money) to acquire 'bricks and mortar' property then there are a few things you need to know.

A **new** ATO ruling released last month helps to clarify what you can and can't do with property that is under a limited recourse borrowing arrangement (LRBA).

The ruling addresses three key areas:

- Under the borrowing rules in the Superannuation Industry and Supervision (SIS) Act, the borrowing must be used to acquire a "single acquirable asset."
 - The ruling seeks to define what constitutes a single asset.
- The borrowing rules allow an asset that is held under a borrowing arrangement to be **improved**,
 - however, the trustees cannot use borrowed funds to make the improvements. There is a fine line between what is a repair or improvement and **the ruling attempts to clarify how the ATO assess the difference between these terms.**
- Also, if you do improve the property, any improvement **must not result in the asset becoming a different asset**. The ruling looks at the factors the ATO considers, and what your SMSF auditor needs to consider, when they assess whether a property has been changed to such an extent that it is no longer the same asset.

If a fund falls outside of these rules, the fund **must sell the asset**. Imagine having to sell a property your fund recently acquired, leaving your fund with the stamp duty, legal and agent's fees (or perhaps making a loss because the market conditions were not as good as they were when you purchased the property).

Is the property a single asset?

Assuming the fund is able to purchase the asset, the borrowing rules require that the money is used to acquire a **single** asset. For example, if the fund purchased a block of units, is the block considered to be one asset or are each of the units inside the block individual assets?

In the ruling the ATO concedes that *"it may be possible ... that the trustee is acquiring a single object of property notwithstanding that it is comprised of two or more proprietary rights. However, this will only be so where ... the separate proprietary rights is distinctly identifiable as a single asset."* **The bottom line is that if the rights can be dealt with separately, then they are not a single asset regardless of how the trustee wants to treat them.**

Common examples include:

- where the fund acquires a property and the car park is held on a separate title but laws do not allow separation of ownership then there is a single acquirable asset.

- where a warehouse is constructed on multiple titles, then there may be a single acquirable asset.

Maintenance, repair or improvement?

There has been confusion in this area as ‘maintaining’ ‘repairing’ and ‘improving’ are common terms and not defined in the legislation. In the ruling, the ATO states:

- **Maintaining** generally means work done (or in anticipation) to prevent defects, damage or deterioration of an asset provided that it merely ensures the functional efficiency of the asset is maintained in its present state.
- **Repairing** generally means remedying or making good defects in, damage to, or deterioration of, an asset and contemplates the continued existence of the asset.
The ATO goes on to state that *“an asset may be acquired in a state in which a part of the asset is defective, damaged or suffering some deterioration of what would be considered to be its normal level of functional efficiency. Restoration of that part of the asset to its functional efficiency would be a **repair** for LRBA purposes.”*

The ruling seems to suggest that the repair needs to bring the item back to its original condition but not go beyond that. The cost of the repair in the context of the overall asset is also likely to be a factor in the ATOs assessment of whether or not what has occurred is repair, maintenance or an improvement.

Defining improvement remains a grey area as it is a matter interpretation whether something is merely repaired or maintained or has been improved.

Can you improve a property?

Trustees can use money provisioned under a borrowing arrangement to maintain or repair the property but not improve it.

If the trustees use money from other sources **outside** of the borrowing, **they can improve** the property as long as the improvements do not turn it into a different asset. For example, if the fund borrows money to acquire a vacant block of land and then builds a block of units on it, the asset would be fundamentally changed and considered to be a different asset.

If the fund does not have to borrow money to acquire the property, then the property can be improved as long as the investment decisions are in line with the funds investment strategy (don’t forget to minute key decisions) and all other SIS requirements are met – note there are some traps when using related parties to carry out the improvements.

Property and natural disasters

Trustees can now take some comfort in knowing that they can rebuild an asset that has been destroyed by flood or fire and not breach the borrowing rule. Using an insurance pay-out in these cases to rebuild what is essentially the same asset that existed prior to the event seems to be allowed.

Get advice!

Despite the clarifications offered by the ruling, the borrowing rules remain **complex** and rely on subjective decision making. Trustees should ensure that they **seek advice** before purchasing, renovating or changing any property held by their fund.

Where are You Now? **Where would you like to be?** Call if you want to chat ... **We look forward to being of Service**

Please do not hesitate to contact us if you would like to review & discuss your current property & tax situation, your asset protection strategy, structuring your next investment property, planning to legally minimise your tax position or just to prepare your next tax return.

We look forward to being of service. We also look forward to your referrals.

To improve our service we welcome all constructive comments on this newsletter and other materials.

For help contact **Shukri Barbara** at Property Tax Specialists at Shukri@propertytaxspecialists.com.au

Checklists and Templates

To make the compilation & reporting task for 2011 tax returns easier, clients of **Property Tax Specialists** received checklists and templates to facilitate the process ... **saving them time and money ... the 'write' way is having clear documentation**. ATO way means time/money wastage with audit investigation.

Disclaimer

The material and contents provided in this publication are informative in nature only. It is not intended to be advice and you should not act specifically on the basis of this information alone. If expert assistance is required, professional advice should be obtained.

Acknowledgement - parts of this newsletter have been taken from KnowledgeShop Pty Ltd client newsletters. Barbara & co – Property Tax Specialists is a member of the Knowledge Shop and Hayes Knight Network

Kind Regards
Shukri Barbara

Property Tax Specialists – [Prosperity & Peace of Mind](#)
Barbara & Co cpa

phone 02 9411 8133
fax 02 9412 2833
mobile 0410 588 305
post: P.O.Box 665 Chatswood NSW 2057

office
Level 5
suite 509, 71-73 Archer Street
Chatswood NSW 2067
website www.propertytaxspecialists.com.au <<http://www.propertytaxspecialists.com.au>>

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