

# Is the Age Old Battle between Property & Superannuation finally over?

## Why is there a war?

Since time immemorial it has been argued by numerous opponents as to whether the benefits of investing in property outweigh the tax concessional environment of superannuation.

From a cynic's point of view, one could say that the opponents opinion's debate varied considerably depending on their own bias. And this bias seems to be greatly influenced by the advisor's commission structure.

Funnily enough, analysis provided financial advisors proved, without a doubt, that superannuation and shares is the way to go whereas just as convincing arguments, raised by property spruikers, real estate agents and mortgage brokers, suggested that property was by far the superior investment.

Who should you believe?



## **A new battalion – property and superannuation join forces?**

The battlefield has changed and changed dramatically.

Why would you choose;

*Property instead of Super*

*Or*

*Super instead of Property*

*When you can have the best of both worlds instead.*

## **Why has the front line shifted?**

New laws introduced in September 2007 allow Self Managed Superannuation Funds (SMSF's) to, for the first time, buy geared property in a simple and uncomplicated manner.

SMSF's can now select a property of their choice, be it;

- residential
- commercial,
- or rural

and borrow up to 75% of the value of the property.

Previously an investor had to choose between;

- using his spare funds to invest in a negative geared property,
- OR contribute the funds to superannuation. Let's have a look at an example comparing the two alternatives.

## Comparing the two – Option 1:



*Take Johnny who is 35 and purchases an investment property.*

*Presuming average capital growth of 7% and rental yield of 5% (both very achievable) the following scenario occurs at age 60.*

**Value of Property: \$1,775,328**  
**Mortgage owing: \$350,000**  
**Net Value: \$1,425,328**

*Plus, the property has been cash flow positive since year 7 netting a cash flow of \$584,480 which Johnny could use for further property investing.*

Taking tax out of this amount will bring the returns down to:

**Net Capital Gain: \$1,211,529**  
**Net Cash flow: \$409,136**  
**Overall Outcome: \$1,620,665**

*(\*Presuming a 30% tax rate, 8.5% IO Mortgage rate, rent yield grows at 6% in line with property growth, excess cash flow taxed)*

## Comparing the two - Option 2:

Compare this to Sally who invests the same amount as Johnny into superannuation. Presuming the same growth and yield (if his superannuation was invested in a well diversified growth portfolio) he would achieve a superannuation balance of **\$432,658** by age 60. This is well short of the gains made by Johnny.



*(\*Presuming a 15% tax rate, contributions include the initial deposit and the cash flow shortfall and cease in year 7 when property cash flow positive, no CGT as investment held until after age 60)*

## Comparing the two - An un-biased opinion

As any professional advisor and serious investor should know there is more to consider than the pure numerical outcome. Whether considering property or superannuation other important factors need to be considered.

One of the most important factors is the stage of the investor's lifecycle.

In the working years of an investor's life a strong cash flow allows the possibility of using gearing strategies to maximize returns thus making property a preferential option.

Once the investor reaches the pre-retirement phase, it may be unwise to take on the risk of gearing. Therefore, this may be the preferential time to consider locking away as much as possible into super.

The most common investment strategy seen in the baby boomer era was to invest all surplus funds into accessible investments including property and shares and then cashing these in and contributing the funds into super just prior to retirement. The only disadvantage of this strategy was a potentially very large Capital Gains Tax bill.

## Who shot this strategy down?

However, this strategy has been dramatically hampered by the Governments new contribution rules which only allow \$25,000 a year (and \$50,000 a year if over 55) of concessional contributions per year.

The effect of the new contributions rule is to significantly disadvantage generation X and Y. It is fair to say that most young singles and young families have better things to do with their money and more pressing needs than to make the most of their \$25,000 per year contribution limit. Then when they are getting closer to retirement and have more surplus funds they will be prevented from, like their pre-decessors, making large contributions just prior to retirement.

*So taking the above example a little further let's suppose Johnny sold his property at age 60 with the intention of rolling the funds into superannuation. He made a gain of \$1,425,328. Capital Gains Tax will be incurred on the sale bringing his net gain down to \$1,211,529. Can he contribute this to his super fund?*

*Under the current rules he will only be able to contribute \$50,000 as a concessional amount (that is; tax deductible) and \$100,000 as non-concessional. Anything over this will be taxed at 48.5%. If the current rules still apply when Johnny is 60 he may be able to bring forward three years worth of contributions and contribute \$450,000 in one year. This will still leave \$761,529 outside the super fund that he is prohibited from contributing.*

## **So what does this mean?**

What the above analysis means is that the age old argument of super Vs property is superfluous. It is redundant and advisors and investors alike need to re-consider their strategies.

The contributions restrictions require investors to consider super much sooner than later. And the new borrowing rules within SMSF's open up a whole gamete of possibilities.

## Following on from the above example:

*Johnny already has \$50,000 in his retail super fund selected for him by his employer. He chooses to roll this over to his own SMSF and use that to pay a deposit and purchase the investment property in the SMSF. Instead of paying the negative gearing shortfall personally he instead salary sacrifices this amount to his super fund to enable the super fund to meet the mortgage commitments.*

*At age 60 Johnny has accumulated the same gain on the property as above, that is; \$1,425,328 but he can now sell the property Capital Gains Tax Free (assuming he is on a pension). The positive cash flow from the rental income has also been taxed at 15% instead of 30% netting him an additional \$64,150.*

***The total gains from simply holding the property in his SMSF instead of personally are over \$277,949.***

*And of course he could have used the positive cash flow to fund another 4 or 5 properties increasing the gain to well over a million.*

## Why would you buy property in a SMSF instead of personally?

For many reasons including;

- you get the benefit of 'leverage',
- a maximum of 15% tax on any rental income in excess of costs,
- you receive a tax deduction for the loan repayments of principal (which is normally impossible) via salary sacrificing the amount required to cover the shortfall,
- asset protection - the asset is protected from creditors in the event of a lawsuit or bankruptcy (some conditions apply),

- the property can still be sold and the loan repaid at any stage,
- any capital gains on the property when sold will be taxed at a maximum rate of 10% (if asset held for more than 12 months)



But the biggest incentive of all - if you keep the properties until age 60 and commence a pension from the fund;

- any capital gain on the property will be **TAX FREE**,
- any rent on the property will be **TAX FREE**,
- any income paid out to you will also be **TAX FREE**.

The laws are only new and law complying products are now being introduced and marketed. It is envisaged that these products will hit the market like a storm once investors realize the potential. There are already over 350,000 SMSF's operating in Australia and it is likely that this figure will increase exponentially once knowledge of the loan products becomes widespread.

In fact, as at May 2010, SMSF's are growing at a rate of 2500 per month.

It is also interesting to note that this may be the first time in history that all advisors (financial planners, accountants, auditors, property advisors and mortgage brokers) have a common ground for advising clients. All advisors have something to gain by assisting clients into these products. It's not only a busy time ahead for advisors but a time to join forces and put a cease fire on the battle.



## **How to End the War and Live in Peace:**

1. Establish a SMSF - your advisor can do this in 24 hours
2. Open a bank account with a bank of your choice

3. Write to your existing funds and request them to rollover your funds to your SMSF bank account
4. Find a property - recommend that you do this through a buyer's agency. (See our Free Report as to why)
5. Arrange a loan through a broker who specializes in SMSF loans.
6. EASY AS THAT

## **Most importantly GET Proper Advice**



Ensure you consult an independent advisor who is licensed to provide Property Investment Advice, qualified and experienced in taxation and finance and regulated by ethical industry associations.

Your advisor should be willing and able to advise you, in writing;

- How many properties you can afford to buy,
- Where to buy and why,

- What returns you should expect on your portfolio,
- How much will it cost you to hold your properties per week (after tax),
- How to minimize tax,
- How to buy - individual name, company, trust or SMSF,
- Your exit strategy,
- How to insure your portfolio is safe in the event of any unforeseen circumstances,
- What will be the 'end result' - your exit strategy,
- And most importantly - will this enable you to achieve your long term income and lifestyle goals in years to come.

Yours Sincerely, Catherine Smith

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