Shoddy super puts the house at risk

The taxman will step in if trustees break the SMSF rules

MONICA RULE

A SENIOR tax officer has come out with a warning that many self-managed super funds are buying property and other assets in ways that break the law and that the only way to undo some of the illegal arrangements may have to be by forced sale.

The Australian Taxation Office deputy commissioner Bruce Quigley put his name on Tuesday to what is called a "taxpayer alert", a document designed to put an early warning brake on non-conforming behaviour.

There are two main rules apparently being broken. One is that SMSF trustees are banned from borrowing money except where they use a device called a holding trust to buy property, and when they do that the investment has to be a "single acquirable asset". The holding trust system is usually called a limited recourse borrowing arrangement, or LRBA. The other is that they are banned from entering into related party investment transactions of more than 5 per cent of their super fund, unless they use a unit trust that complies with the Superannuation Industry Regulations of 1994.

"We have observed that some arrangements are deliberately entered into to get around the law, which can result in the fund's trustees being disqualified, facing civil penalties or even facing criminal charges," Mr Quigley said in the taxpayer alert.

And he fired a salvo against property spruikers by saying that any promoters using such arrangements could find themselves reported to the Australian Securities & Investments Commission.

The law allowing limited recourse borrowing via holding trusts came into effect in July 2010. Since the law was introduced, SMSF investments in property have grown rapidly. It has allowed SMSFs to buy property that may otherwise be out of reach, but some trustees don't fully understand that it is not an ordinary loan arrangement.

An LRBA is an arrangement where an SMSF borrows money from a lender to buy an asset. The limited recourse means that if for some reason the SMSF cannot pay the outstanding loan, the lender can take only the asset over which the borrowing took place. The lender has no recourse to any other assets.

The asset is held in a holding trust for as long as any part of the loan remains outstanding and the SMSF trustee becomes the legal owner of the asset once the loan has been fully repaid by the SMSF.

But if the LRBA is not structured correctly, it cannot simply be restructured and may involve a forced sale of the property, which could cause a substantial loss to the SMSF.

The taxpayer alert gives examples of arrangements that contravene the law which SMSFs have entered into to buy property.

For example, the loan contract and the title of the property cannot be in the name of the individual SMSF member. This arrangement contravenes the sole purpose test provision under the superannuation law, as it could be treated as the SMSF providing financial assistance to the SMSF member by funding the loan.

It would also contravene the payment standards under the law, as the loan repayments by the SMSF could be treated as lump-sum superannuation payments made to members without satisfying a condition of release.

Another example of an illegal arrangement is the title of the property being registered in the name of the SMSF trustee, instead of the holding trustee, because of the holding trust not being established.

This will not meet the strict requirements of the LRBA law as the title of the property must be registered in the holding trustee's name.

A third example given by the ATO relates to when an SMSF trustee buys a residential property from a member — that is, a related-party transaction.

This cannot be done under the superannuation law as the only types of assets that a SMSF can acquire from an SMSF member are listed securities (that is, shares listed on the stock exchange) and business real property (land and buildings used exclusively in a business).

The alert also warns against arrangements where a property acquired under the LRBA comprises two or more titles, which breaks the "single acquirable asset" rule. This cannot be done as the asset must be a single asset.

If, however, the asset is on multiple titles then it is necessary to examine whether the asset can be dealt with separately.

If the titles can be legally dealt with separately, then they will not be treated as a single asset. If two assets cannot be separated, however, because of physical or legal impediment, then they will be treated as a single asset.

It is also important to note that each holding trust can only hold one asset.

Finally, an arrangement is illegal if an asset is a vacant block of land and the SMSF intends to use the same borrowing to construct a house on the land. This cannot be done as the borrowed money cannot be used to improve an asset. This is because the property that is being held by the holding trust can be repaired and maintained by using the borrowed money but it cannot be replaced or improved.

The taxpayer alert gives the following example of an arrangement where an SMSF entered into a property investment using a related unit trust.

This arrangement shown in the illustration breaks the law in at least three ways. First, it contravenes the sole-purpose test because the SMSF is established for purposes other than to provide retirement income for members.

This is because the asset acquired by the unit trust is used as a security for the money borrowed by the members to subscribe for units in the unit trust. This is classified as the SMSF providing financial assistance to members.

Second, the SMSF's investment in the unit trust fails to conform to superannuation regulation 13.22C in that the structure illustrated places a charge over an asset of the related trust and it unlawfully acquired and leased a non-business real property to a related party.

The problem posed by the structure illustrated is that it places a charge over an asset of the related trust as well as leasing a non-business real property to a related party.

Finally, as the unit trust is classified as related, the transaction will need to meet the in-house assets provisions under the superannuation law. This means the SMSF's investment in the related unit trust must not be more than 5 per cent of the total asset value of the SMSF.

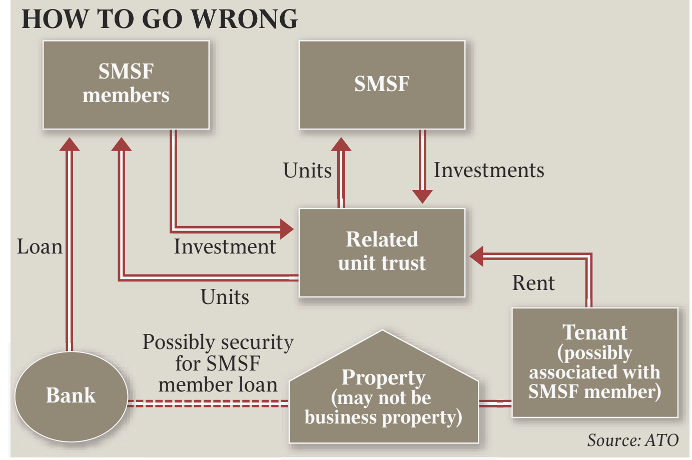
If you're looking to buy property in an SMSF, you and your adviser should read the ATO's ruling SMSFR 2012/1 that details all the key concepts of an LRBA.

Monica Rule is the author of The Self-Managed Super Handbook. **www.sunshinepress.com.au**

JAMES CROUCHER

Deputy tax commissioner Bruce Quigley speaks at the ICA Tax conference in Sydney this week

HOW TO GO WRONG



Source: ATO

Bargain-basement US homes come with built-in risks for unwary

Owning and managing property there may be best left to the pros

ANDREW MAIN

IT'S no wonder that Australian investors are being tempted by sub-$100,000 houses for sale at distressed prices in the US, what with astronomical local house prices, but there are some major traps to consider, says Alan Dixon.

And he would know, given that his family's company Dixon Advisory manages the US Masters Residential Property Fund, which has a portfolio of more than 430 houses worth at least $US165 million ($158m) across the Hudson river from Manhattan.

"We're hearing about people being offered houses in Florida that are supposedly worth, say $US150,000, for $US30,000 or $US40,000," he says.

"That sounds pretty exciting, but there are a few questions an investor should be asking.

"One, is it maybe the case that they're being offered a property by someone who paid $US20,000 for it and is flipping it to them?

"Two, where do they get that high supposed valuation?

"That's probably a pre-GFC number, which is meaningless at the moment."

And that's just the beginning.

His major concern is that outsiders don't get the nuances of where and why there are pockets of low-priced houses in the US, and there may be some long-term reasons for that, he says.

"The areas we are most concerned for investors are states with weak economies, oversupply of houses and potential permanent declines in their economy. Some examples are Detroit and parts of Florida," Dixon says.

Suppose you do buy it — and you wouldn't want to buy any house without having a reliable person on the spot give it a proper examination — you might get a good deal, particularly with the Australian dollar at current levels.

But how are you going to manage the property? There's an old adage that you should never buy a rental property that you can't drive past and, while the US road network is better than most, it's all a very long way away from Australia.

"There are two key disadvantages of direct ownership," Dixon says. "The first is paperwork and tax. You have to complete both US state and federal tax returns and will pay those taxes. Second, you have to manage a property on the other side of the world.

"How do you know whether the property is vacant or whether the manager you choose is pocketing the rent as cash? And how do you know what repairs and maintenance are required?"

Dixon's organisation is obviously talking from a position of strength, with all the economies of scale and benefits of having staff on the ground in the US, but it's all worth thinking about.

"For instance, we have an arrangement with two property maintenance companies with operations in Hudson County, New Jersey where our properties are, which means that there is always someone on call," he says. "Say, the toilet packs up on a Friday evening, it's really important to get someone over there fast. It's not clear what you would do as an individual owner of a property in Florida, for instance, in the same situation.

"Or how about clearing snow?"

That's not a Florida issue, nor usually an Australian one, but as he points out, there are huge advantages not only in knowing whether your tenant has just invented a snowstorm, but also having a list of available service providers in the area where the house is.

"We've got a contractor who gets a list of properties to clear, and who charges us approximately half of what he'd charge his retail customers because chasing payment is so much easier."

You'd probably expect him to say this, but he has a point: "Unless you live there, this is the time when it's better to leave it to the large professional managers."

JAMES CROUCHER

What do you do when the toilet packs up, asks Alan Dixon

ROGER MONTGOMERY

Resource service firms struggling

WRITE this down somewhere prominent: "Resource service companies are contractors and contracts can be revised or cancelled without warning."

Six months ago there was high excitement from Australia's resource service companies. Capital expenditure for Australia's resource sector was expected to exceed $500 billion across the next five years. About $260bn of this was committed across 393 projects and, while $240bn worth of projects were uncommitted, optimism was sky-high.

Western Australia ($135bn), Queensland ($75bn) and the Northern Territory ($35bn) were significant beneficiaries, as they were expected to receive a combined 94 per cent of the capital expenditure. Oil and gas accounted for $197bn, or 76 per cent, of the committed capital expenditure, while mining and infrastructure (rail, ports and terminals) made up the balance.

The excitement bubble has been deflated with the iron ore price having traded down to the $US90-$US120 a tonne range in recent months, the coking coal price having declined 30 per cent to $US150/tonne, while some significant projects have recorded serious cost blowouts. Cash cow operations, such as the BHP-Mitsubishi Alliance, the world's biggest coking coal producer, are no longer. The stubbornly high Australian dollar is adding to the pain.

Suddenly, big projects are being cancelled and contracts are being revised. BHP Billiton's Olympic Dam and Port Hedland outer harbour project, Woodside's Pluto expansion, Fortescue Metal's Kings deposit and Mitsubishi's Oakajee project come to mind. Meanwhile the second wave of Australian liquefied natural gas projects including the Shell-PetroChina-Arrow LNG coal-seam gas development in Queensland and Woodside Petroleum's Browse LNG off the WA coast could remain on the drawing board, with increasing pressure from high wages and material costs and potential competition.

Earlier this week the International Energy Agency released its forecasts. While total US oil and gas production is expected to increase 35 per cent from 17 million barrels of oil equivalent a day in 2010 to 23 mboe/d in 2020, the transformation is explained by the expected 6 mboe/d surge in unconventional oil and gas production across this decade. Together with the widening of the Panama Canal by 2014, which will allow LNG supertankers to travel to Asia from the Gulf of Mexico, the US could turn into a cheap exporter of gas, in competition with Australia.

After mostly recording very strong earnings growth in the year to June, several resource service companies have since downgraded their outlook for the 12 months to June next year, and their share prices have reacted accordingly. Retribution has been quick, with Nick Bowen's termination from Macmahon Holdings (MAH) and Craig Kipp's departure from Boart Longyear (BLY).

Emeco (EMH), a leading earthmoving contractor within the mining sector, earlier this week announced the utilisation rate of its Australian fleet was down from 91 per cent in the six months to June this year to the present 66 per cent. Weaker demand and overnight contract revisions, particularly from their iron ore and coal clients, were to blame. Talk about falling off a cliff! Brokers cut their earnings forecast for fiscal 2013 and 2014 by more than one-third.

At 50c a share Emeco is selling at six times prospective consensus earnings and two-thirds of its net tangible asset backing of 76c a share. Its share price has more than halved from the capital expenditure excitement of six months ago. Nevertheless, we are wary of the forecast $443 million net debt and cautious the domestic operating environment could worsen.

One company working hard to reposition itself is Decmil (DCG). While its share price will likely be caught up by the negativity of the resource service sector, chief executive Scott Criddle has done a fine job growing the business while reducing the company's relative exposure to iron ore. Across the four years to June, revenue has gone from $255m to $555m, normalised net profit after tax has more than tripled from $12.2m to $39.1m and return on equity has risen from 16.7 per cent to 23.5 per cent.

Roger Montgomery is the founder of Montgomery Investment Management and the author of Value.able: How to Value the Best Stocks and Buy Them for Less Than They're Worth, available at www.rogermontgomery.com. His fund owns shares in Decmil.