SPLITTING UP IS HARD TO DO

SMSFs are a popular way for couples to invest in property together – and with good reason. But what about when relationships go wrong? API investigates the unhappy consequences.

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Self-managed superannuation funds (SMSFs) are big news. The numbers of Australians using SMSFs as a vehicle to buy property has shot up, with the Australian Taxation Office reporting 528,700 SMSFs in operation in 2014 comprising 1,005,678 members. The overwhelming majority of funds have two members, with everyone from serious investors to mum-and-dad couples pooling their superannuation to take advantage of excellent taxation benefits.

SMSF POPULARITY

There are good reasons why combining your superannuation with a partner into an SMSF is so popular. Invested wisely, money invested in property can show far greater rate of return than the superannuation funds manage on their own: in 2014, Sydney property values increased by 12.2 per cent, comparable to the overall superannuation fund increase of 12.5 per cent before the rental income received from those properties is taken into account.

Returns aside, though, buying property with an SMSF typically carries higher entry costs. Many banks require a minimum deposit of 30 per cent of the property's value rather than the more traditional 20 per cent. Banks also require that you show you've received financial advice, which adds to the set-up costs. While the regulations are intended to safeguard the investors' interests, it can mean that individuals are unable to use their superannuation to break into the property market unless they pool their resources with a spouse. This is especially the case for women, whose superannuation balance is typically around half of that for men and who may therefore not manage to enter the market on their own.

NOT-SO-HAPPILY EVER AFTER

So far, so good. But what happens if the relationship goes south? A superannuation fund can be extremely complex to unwind, which is the last thing anybody needs at a time when they're arguing over who keeps the family pet. Depending on the structure of the fund, whether the fund has borrowed from the bank in order to purchase property, and whether the property dealings have been above board, investors could find themselves on the receiving end of a number of penalties.

"If you're going to have a super fund, you can make it as complicated as you want or as simple as you want," explains Peter Horsfield, a certified financial planner with expertise in advising on SMSF structures. Like most experts, he prefers a structure that sets up a company to own the property as corporate trustee, with the fund members as directors of that company.

"It comes at a cost, but if anything happens later on, then you have that scope and flexibility later to do things. If not, then it costs more later on because you have to unwind things, including sell assets," he explains.

Neither path is necessarily simple. Even where an SMSF is set up with a corporate trustee that allows a member to leave without necessarily dissolving the fund, the member's balance must be extracted. That means that if the fund doesn't have other assets of shares or cash, and the other member can't make a personal contribution into the fund, then the fund must sell a property

INVESTOR CASE STUDY

Doing it right: a simple split

Lisa and Paul owned a small family business. With financial advice, they established an SMSF with a corporate trustee structure and purchased a commercial property, which the SMSF then rented out to their business.

At the time of their split, the total of the property held in the fund was worth $600,000, with 25 per cent allocated to Lisa and 75 per cent allocated to Paul in reflection of their original contributions. Paul also had a share portfolio worth $200,000. He intended to carry on running the family business and wanted to keep the premises, which were ideal for the job. Lisa, on the other hand, wanted nothing more to do with either, preferring a clean split. Because Paul had shares, which are more liquid, he was able to sell $150,000 worth and buy Lisa's share of the self-managed super fund. Paul remains as the sole director of the company, and Lisa is, in her own words, "out of there".

INVESTOR CASE STUDY

Doing it wrong: a couple learns the hard way

Barbara and John pooled their superannuation to buy an investment property. Anxious to avoid high set-up costs, they established a holding trust with the two of them as joint trustees. After purchasing costs, they contributed $60,000 and $80,000 respectively to the investment purchase, and used a limited recourse borrowing arrangement to borrow the remaining funds to buy a $450,000 property.

Using their weekends, the two of them renovated the house, modernising the kitchen and landscaping the garden. Unfortunately, two years later they split up. Because there was an individual trust in place, the couple was unable to arrange things so that either could retain the property, and it was put on the market.

Being well before retirement age, the capital gains on the property – a mere $15,000 – was taxed at the 15 per cent concessional tax rate. However, the ATO then audited the property and found that because John and Barbara were renovating the property and increasing its capital value, they were in non-compliance with LRBA rules.

After penalties were levied on the couple, as well as the legal and accountancy costs involved with unwinding the fund, they found themselves with less superannuation than when they started.

to raise that balance. But what if the asset has dropped in value, or the timing's bad?

"If there's going to be a relationship breakdown," Horsfield says, "then most of the time there's a component of money involved. When money is tight, that generally means assets are performing poorly. So you may be, at that high emotional state, selling something as a fire sale."

Quite apart from the capital gains implications that flow from selling property before retirement, there's the dreaded spectre of having to sell for less than the fund bought it for. In that case, you could lose not only your expected capital gain but other assets besides.

When you apply for a loan on behalf of your SMSF, the asset can't be held directly in the super fund, and a bare trust must be established. This is what's known as a "limited recourse borrowing arrangement", or LRBA, explains Colin Kynoch, principal of Securus Financial Services and an SMSF specialist adviser.

Under LRBAs, the amount of funds borrowed by Australian self-managed superannuation funds has skyrocketed from $497 million in June 2009 to $8.7 billion in June 2014 – an 18-fold increase. That has implications for the national economy, but it also has implications for individuals.

In theory, an LRBA means the lender can only take the asset on which the money was loaned. But, Kynoch says, "if the property was worth $400,000 and the fund borrowed $380,000, and now it's worth $340,000 – the lender will have taken personal guarantees from the trustees for the shortfall. Each member is jointly and severally liable for that debt. So, that's an implication above and beyond the tax issues".

IT'S RATHER TRICKY

There are a number of restrictions regarding what can and can't be done with properties owned within an SMSF.

"You can't be trading within your super fund," Horsfield says. "You can't be tick-and-flicking properties, by buying and renovating, because that's seen as doing it with a business. If you're found out, then you'll be paying the highest marginal tax rate instead of the concessional rate, because it's breaching purpose. And then there's a list of penalties the ATO will levy.

"They shouldn't be doing that in the first place, but it's when they're seeking to unwind the funds that the ATO is most likely to audit the fund."

If you're not sure whether your maintenance of properties held within your SMSF fall within the rules, that's an added area of stress at an already stressful time.

So, if you've set things up without a corporate trustee, or if there aren't enough other assets in the pot to buy out a member's share, then is selling the only option?

There's no rule that says an estranged couple must dissolve their SMSF, and indeed, many don't. The tax benefits of an SMSF are maximised when it's used as a long-term strategy, as properties sold after retirement age are tax-free, and so couples who are estranged but not seeking a formal property division may choose to retain the fund in anticipation of their retirement.

There's another reason why people may leave the fund as it is, and that's that more often than not, people who are separating from their partners may not consider their superannuation as being in the mix at all.

Dr Rae Kaspiew is the co-author

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of the Australian Institute of Family Studies report *Post-separation parenting, property and relationship dynamics after five years*, which involved a survey of a group of more than 9000 parents who’d split up.

Kaspiew explains: “Of the group that we’ve spoken to, 34 per cent of them included their superannuation in the total asset pool.

“Some of them might have done that in a quite formal way, others in a more informal way. The more significant issue is that 66 per cent don’t seem to have given consideration to superannuation.”

Whether it’s a deliberate decision to take advantage of tax benefits later, or simply a case of “out of sight, out of mind”, it’s not uncommon for an SMSF to remain in place after a couple separates. People who do make this choice, though, should know the terms of the trust deed will override the terms of a will in the absence of a written binding death nomination.

In the case of *Ioppolo & Hesford v Conti* [2013] WASC 389, the estranged couple were trustees of an SMSF that remained in place after their split. The wife died some years after the split, leaving a will that expressly stated that she wished her share of the superannuation fund to go to her children and that she didn’t want any of it to go to her husband. The court found that under the terms of the SMSF, her widowed husband was entitled to pay all of his wife’s superannuation benefits to himself.

“It’s a very salutary lesson for people who are splitting up”, Chris Hill, managing director of Hill Legal says, “that they make sure that they’ve done a binding death nomination, and that they make sure they read the governing rules of the fund.”

Not only that, he warns, but it’s important to make sure that the binding death nomination is completed properly, as courts are increasingly taking “a very black letter approach to all of this” and a mistake could be fatal to the wishes of the deceased.

Indeed, the nuts and bolts of bringing an SMSF to an end contain a number of salutary lessons. The main one, agree all the experts, is to get professional advice at the beginning and at the end of the life of the fund, or risk the consequences. As valuable as SMSFs can be, bear in mind that without a proper set-up and a realistic exit plan, they could be more trouble than they’re worth. API