Hidden Assets

Are You Sitting On A Super Fund You Don’t Know About?

We all want to retire rich, right? That takes planning and money. Sometimes we get so caught up in our day to day efforts that we fail to see “hidden assets” right before our eyes. This is a story about a client of mine. The names were changed, but the story is true. Read all the way through to see how they discovered their hidden assets.

Simon and Marie run a small business which operates out of a warehouse in Dandenong Victoria. Simon and Marie are both around 40 years of age. They had started their business 2 years prior to our meeting. The business was solid, and made the couple about $100,000 per year as a combined income. Enough to make a handsome living and pay off their large family home's mortgage, but not enough to think about retirement.

I decided at our next meeting I would ask Simon about his plans for retirement, which is probably 20 years down the track. Was he making provisions for retirement by contributing into superannuation? I got the answer from Simon that I was expecting...... "My business is my retirement so I don't have much need for superannuation!"

This response brought up some other questions which needed to be asked.

Firstly, what is your business worth? If you were to sell the business tomorrow, what would somebody pay for it?
"We have never had the business valued, but it would have to be worth a bit"

What would happen if you decided not to come into work anymore, would the business run itself?
"No, we have the contact with suppliers and a lot of the customers, so we need to be there"

And thirdly, do you have a succession plan in place?
"We have a 20 year old son and 18 year old daughter who may be interested in taking over the business at some stage but we are not sure how that will work"

All three of these responses were as I expected, but were quite alarming to me. These people are relying on this business to retire, but it sounds as though they want their kids to take over and have no idea what it is worth. If business relies on Simon and Maria, is the actual business worth anything? How can this business be their retirement if they have not worked out its worth? They may be stuck working until they are 80 at this rate. And we know they want to retire at 60.

I don't like it when a client dismisses retirement planning all together. I believe it is somewhat irresponsible that they are not thinking about providing for their retirement. People have plan of what they are going to do in retirement, but it is rare that they have a plan for how they are going to do this. Often people will say they are going to travel Australia in a Campervan and play golf twice a week. More often than not people do not have a plan of how they will fund this. Or if they do, the started planning later in their working lives.

Knowing that Simon and Marie have a mortgage, with 2 kids at university living under their roof, I knew it would be hard to make contributions into superannuation because their income was funding their lives. So we needed to get them thinking about building their superannuation. Simon and Marie needed help!

I delved deeper into their personal situation based on information I already had and also by asking a few questions Previously Simon worked in a bank and Marie had worked doing administrative duties. Prior to 2008 Simon estimated his superannuation balance was about $130,000 and Marie about $80,000. Currently their balances totalled about $170,000 combined. They often wondered why they would put more money into super just to see it go down the drain even further if something like this happened again. "We only contribute 9% of what we pay ourselves because we have to. If we didn't have to contribute we wouldn't."

This is the natural feeling to have, as about 20-30% of their retirement savings went out the window. I needed to have Simon and Marie disassociate the word superannuation with this stock market crash and see it as an investment vehicle. A Self Managed Superannuation Fund (SMSF) is an investment vehicle just like the family trust they run their business from. A super fund however has much better tax advantages.

In my opinion the media are partly to blame for the negative feelings towards super of the general public. When share prices started to fall the news would report "BHP fell 10% today, hurting most Australians as this is a share held by many superannuation funds". This had people immediately associating superannuation with negative returns. Simon and Marie were no different. What I needed to do was turn their negative feelings about superannuation into understanding that superannuation is an excellent investment vehicle with extremely generous tax breaks. This was my hardest task.

Every time I brought up super, it was turned down with a negative response, even when I spoke about positives like the tax benefits and asset protection. I needed to find away to break this down and have them see the value of such an investment vehicle. I was worried for my client that if they do not consider superannuation, they will not be able to fund their retirement, even if this is about 20 years down the track.

It got me thinking about their business premises. I had just completed their financials and noticed that they had paid $21,704 in rent during the past financial year. I decided to start questioning this expense and ask why they don't own their property. "We already owe $300K on our home and the initial outlay would mean refinancing our home and trying to free up cash that way. We set up a family trust for asset protection and this would fly in the face of that as it would put our family home at risk using that as security". They made a really good point. "The business doesn't have the capacity to borrow and we get a tax deduction for the rent, so it isn't a high priority for us."

At this point I knew what my strategy was, but I just needed to get Simon and Marie to see my idea and that meant showing them the value of super. I wanted to use the money they had in superannuation as a deposit to buy a warehouse similar to the one they are currently in, and rent it to their business from their super fund. I just needed to get this message across to them.

"If you could own this property (or similar property) and not have any impact on your business cashflow, and not have to refinance your home would you do it?" "In a heartbeat" was Simon’s response "but that's not exactly possible is it?" This was a start and the response I was after. We left our discussions there and I told them that I would find a way to do this.

Now it was time to do some research on the property and we gathered it would cost about $370,000 including stamp duty. In 2007 laws changed, allowing superannuation funds to borrow to purchase investments. If we set up a SMSF using the $170,000 Simon and Marie already have in their super, we could borrow $200,000 and purchase a similar property to the one they are in.

So, how does this work?

We need to set up a SMSF for Simon and Marie. Let’s give it a fictitious name and call it the SM Super Fund. This will cost the client approximately $1,500 to do, but this can be paid for by using the existing money in superannuation. The fund will then need to have accounts and tax returns completed each year. At the value of the fund, this would be similar to what was being paid to the retail funds so we have reflected this in the returns.

The SM Super Fund would purchase the property through what is called a bare trust. A Bare trust is a company that is set up to hold the property in trust for the SMSF. Once the final loan instalment has been paid the property is transferred from the bare trust into the name of the SMSF. There is no stamp duty on this transfer as the property was originally held in trust for the SMSF. I don't want to speak to much about the ins and outs of how it works, as it is quite a boring topic!

The SMSF and the business will enter into a lease agreement, where the rent will remain the same as what they trust was originally paying, but will increase by CPI each year (3%). This is approximately what the rent will increase by regardless of who Simon and Marie are renting from. The rental terms will remain the same and rent must be paid monthly in advance. The key to this working is to not use the SMSF as a loan vehicle by not paying rent. If you do these sorts of things the ATO can issue a notice of non-compliance and you can lose half of the value of the SMSF in penalties. The business must continue paying its rent. The SMSF needs to run a bank account where it will make repayments to the loan. The SMSF also pays any expenses such as admin costs and can invest in other things such as shares or cash with any additional funds that have been paid in. The other option with any excess cash is to repay the loan faster than 20 years.

I sat down with an associate of mine who is a financial planner, Graham. I wanted to discuss this with an expert in financial planning and get started on doing some forecasting. We decided to be conservative when projecting. Graham decided we should use a return on a retail super fund as an average of 6% growth per annum. We also decided to use the same growth figures on any assets in the SMSF that were not property, to keep things equal. We went ultra conservative with the property growth and decided on an average growth of 2% per annum over the 20 years holding the asset. We have also estimated that rent will increase by approximately 3% per annum. We also decided that the client would continue to contribute $9000, their SGC components that they have previously been contributing.

We then needed to look at a finance strategy. Because Simon and Marie wanted to retire in 20 years, there was no point having a 30 year loan. We decided on a loan term of 20 years, and we did not have any interest only period. Using the current interest rates of 6.8% we also added 1.2% interest in case there are any rate rises along the way (8% interest). Now it was time to do calculations. Both Graham and I were excited to learn how much value we could add to Simon and Marie's wealth in retirement. This is what we found:

After 20 years of holding superannuation without investing in property we discovered that the fund would be worth approximately **$715K.** This is achieved through investments made by fund managers and also from the 9% super contributions over the 20 years. This is a solid amount to retire taking into consideration the members want nothing to do with super and it will take care of itself.

The next option was the purchase of the property. Now we need to remember that Simon and Marie were not out of pocket personally for this. They did not make any additional rental payments over the market rent, and they did not have to refinance their house or make additional super contributions above the 9% SGC. There is minimal work undertaken by Simon and Marie to run this SMSF, as the admin work can be done by the accountants, etc. There may be some additional work each year maintaining documents, but the workload it not significant. There are also superannuation administrators who can look after this sort of thing for you. After we did the calculations, we were surprised to see the value of the fund. The fund would be work a staggering **$970K.**

This means that the fund is worth an additional **<u>$255,000</u>** and it has not cost the small business owner an extra cent.

I made the phone call to Simon and Marie, and went to visit the client. I told them I had an idea that involves using their superannuation fund. Again when I mentioned this word to Simon I could tell he was sceptical about it. Now it was time to convince them, and the simplest way to convince them was to show the numbers and what we had discovered. Once I mentioned the fact that the retirement nest egg could be worth an additional $255,000 with minimal effort and no cash flow implications in their business or personally, Simon's jaw almost hit the floor.

Simon wanted more information, so we went through how it works in terms of borrows, rental agreements, etc. I then went on to some of the other advantages of owning the property in a SMSF.

Firstly and what I believe to be the most important thing about owning investments in a SMSF is asset protection. Assets within the superannuation environment are safe from creditors if something goes wrong in the business. If Simon and Marie owned the property personally and the business went under, creditors may be able to look at the assets of the trust (and possibly its owners) to repay its debts. Although Simon pointed out that they couldn't afford the property anyway, their situation may have changed down the track where they may have been able to afford it. Where a business can afford the property, it may still be a better option to buy the property in a SMSF than in a trust or personally because of this additional asset protection.

I believe asset protection strategies are the most important strategies, but Simon and Marie were more interested in the benefits to them financially. Like most clients they want results they can actually put a figure on that is how they quantify the value of the benefits. Some clients struggle to see the value in a good asset protection strategy because there is no quantifiable value unless something goes wrong. So we decided to talk about the Tax Benefits. The tax benefits of this strategy are varied so we will break it down into chunks.

Throughout the owners working lives, the tax benefits of this strategy are not significant, as this strategy is more about building the wealth during this phase. The main benefits come once the client has retired. There are other strategies that can be built into this to save on tax and further provide for retirement, but we want to show Simon and Marie the results they can achieve from a strategy that has no cashflow drawbacks.

Once Simon and Marie retire and start drawing a pension from the SMSF, the tax benefits of this strategy (and SMSF in general) come into play. Let us start with the rental income. By the time Simon and Marie retire, we estimate the rent generated from the building will be $38,296. The income will be tax free, meaning that the full $38,296 will stay in the fund and none of this will be paid to the ATO. If this was a personal income, you would probably lose about $5K to the ATO. And that is $5K each year! Income generated from assets that fund a pension are tax free for the life of the pension. This then counts the same for capital gains on the property.

Based on our calculations, the property will be worth $520,000 with a cost base of $370,000. This means there is capital growth of $150,000. If the property was sold whilst the fund was in pension phase, there would be no tax implications, and the proceeds would stay within the super fund. Again, let’s compare this to if Simon and Marie were able to own it personally. This would add approximately $37,500 of taxable income to each of their names, and result in a combined tax of about $10,000. As you can see the tax benefits of owning in an SMSF are exceptionally good.

Simon and Marie will start drawing an income from the SMSF once they retire. After the age of 60, and pension drawn by a member of the SMSF will be drawn tax free. This means that the pension will not be taxable in their names personally. If they draw $40K to live off, the will have $40K to live off, not $40K less amounts that have gone to the Tax Office.

Simon and Marie were not only convinced this was a good strategy, but they also now had positive connections to the word "super". They no longer thought about those negative feelings, and negative returns, but thought of it as a tax beneficial investment vehicle.

Next step was to find a suitable property. Simon and Marie had 6 months left on their lease at their current premises, which meant we had time to find the perfect property and also negotiate a better deal, with a settlement that suited our needs. I enlisted the help of a real estate agent from my network of contacts. Despite the fact the properties Simon and Marie were looking at were outside this agent's area, he managed to assist with negotiation process and we managed secure a property at a better price than we imagined, but at a settlement date we wanted. As part of this process we engaged our Mortgage Brokers to source the best deal possible under this more complex borrowing arrangement. Borrowing through an SMSF is best left to the experts, as there are many rules and regulations that need to be followed. Our broker was able to assist with this.

Simon and Marie were so excited. They were able to move into a property that suited them perfectly, and the new factory even allowed for growth in the business as the it was bigger than the one they were renting.

Six months after settlement of their property Simon called and booked a meeting for me to come and see him and Marie at their new factory. Things were going along well and the business was continuing to give Simon and Marie a good living. Simon and Marie had not stopped thinking about our conversation from almost a year earlier. The fact that they had no idea what their business was worth, or whether it was worth anything at all without them running the show was playing on their minds. They wanted to know how much they could have in retirement.

This has led to a whole new set of questions for the couple. How do they build value in their business? Do they need to employ a manager? How should they build a succession plan?

To be continued....

WHAT"S YOUR STORY?

Are you sitting on hidden assets?

Are you wanting to retire at a reasonable age?

Are you trying to figure a way to have more in your Super?

If these questions are keeping you up at night, it may be time to chat.

Call for your free, no obligation consultation:

Paul Weinberg

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