Falling in love with an investment can be a trap

DIY super

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One of the risks associated with do-it-yourself super funds investing in property is trustees falling in love with the investment. Given a view many people have that property is an asset that generates most of its return from capital gains, an expectation can arise that the longer it is owned by the fund, the better the return will be.

A DIY fund owning a property – especially a commercial property that could be a family farm or the property from which a family business is run – can often be the reason why a fund includes the next generation in the form of adult children among the members.

A technical adviser with DIY super administrator Heffron, Meg Heffron, says once a fund has acquired a property the trustees reckon has long-term investment potential, having adult children as members can allow the fund to retain it during the pension phase.

In this case adult children actively contributing to the fund can provide the pension income for the parents. Their contributions help supply the cashflow to pay the pension while, at the same time, progressively acquiring an increasing stake in the property. If it's a business property linked to a family business, the next generation will also be working their hardest to pay the rental income that also supports the pension and builds up their super interest. It creates what amounts to an asset succession strategy where every effort is made to retain the property in a fund for as long as possible.

For DIY funds, a property buy must stack up as an investment. Photo: JIM RICE

Heffron says there are risks associated with the strategy: one being both parents dying before the adult children have built a sufficient stake in the fund. This could create a headache in circumstances where the fund doesn't have enough liquidity – assets it can easily sell – to pay tax on a death benefit.

When a super fund pays a taxable death benefit and the beneficiaries are adult children, you don't pay 16.5 per cent tax from personal sources. The fund is required to withhold the tax.

In a situation where a fund has two parents in the pension phase and two adult children as fund members and one parent dies, the surviving parent can inherit the deceased partner's interest through a reversionary pension.

If the DIY fund then becomes a three-person fund with two adult children and a parent who owns a major interest in the property, the children as individuals may have to borrow money personally to make non-concessional contributions to allow the death benefit obligations to be sorted out. This provides cash flow to the super fund to pay out the benefit, which they then inherit to pay out the personal loans.

The downside is they have been forced to contribute their inheritance to super but if the intention was to retain the property in the fund this isn't an issue.

Heffron says there are other issues, like whether the adult children members want to belong to the same DIY fund as a sibling, especially if they have a family of their own.

DIY super specialist Daniel Butler, of DBA Lawyers, says that where the fund has a major investment, it is always important to determine who will take control and if there is anyone else who might also have an interest in the fund.

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Butler says the difficulty with pensions these days is that, while it is possible to revert the pension to a spouse, the same does not apply to adult children unless they are financially dependent on the late parent. This means that on death the amount of benefit that is the late parent's interest would have to be paid out of the fund.

While it is possible to have a binding death benefit nomination in the DIY fund that distributes particular investments to nominated beneficiaries, Butler says that, as a precaution against possible conflicts that might arise between beneficiaries, the matter is also covered in the will as there is a chance that anything paid out of the super fund could end up going through the estate.

The adult children building up their interest in the DIY fund so they eventually own the fund investments is a good way to go, Butler says. So is having an automatic reversionary pension between the member and his spouse.

There can be benefits in a strategy where a fund acquires a property from members and leases it back to family members.

Richard Dwyer of Dwyer & Willett

Butler says an Achilles heel with a DIY fund where the major investment is a farm that will pass on to an adult child who carries on the business is a lack of other assets that can be passed on to other beneficiaries.

There are a couple of strategies that can be employed to deal with this. Some funds have insurance, while others seek to build other assets or cash in the fund. Sometimes the farm is not given away entirely to one beneficiary.

Instead the farming child is given a lease over the property. This keeps the business going and the non-farming children then get an income from the lease while the farmer is assured of a livelihood.

Lawyer Richard Dwyer, of Dwyer & Willett, who specialises in DIY funds buying commercial property from members, especially family farms, says there can be benefits in a strategy where a fund acquires a property from members and leases it back to family members.

In circumstances where the fund has started a pension, the fund income can be either wholly or partly tax-free. In addition, the rental payments can be claimed as tax deductions against the business profits. But the most important issue, Dwyer says, is that the property must stack up as an investment. A test of this is whether a property that isn't leased to a family member is able to be leased to another farmer, often a neighbour, for a good income.

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