THE DOVER GUIDE TO SELF-MANAGED SUPERANNUATION FUNDS

(AND SMSF PRODUCT DISCLOSURE STATEMENT)

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DOVER FINANCIAL ADVISERS

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Greetings

I have pleasure in attaching your copy of "the Dover Financial Planners' Guide to Self-managed Superannuation". The Guide contains numerous practical tips and advices and helps you set up and run self-managed superannuation funds for your clients.

Contact Dover if we can help you in any way.

Dover's experience and expertise lends itself to creating a guide like this. Our team of 50 professional staff has helped literally thousands of clients set up and run their own SMSFs. We know the ropes on what to do and how to do it. It's fair to say we have more experience in this area than any other firm in Australia and currently act as advisors for more than one thousand SMSFs and over the years have set up more than 10,000 SMSFs. Our parent company, McMasters', is a multi-disciplinary practice including solicitors, accountants, and financial planners to provide a one stop shop for SMSF services.

Superannuation, and particularly self-managed superannuation, is better than ever and should be a mandatory part of every client's financial planning strategy. For people approaching age 60, the benchmark rate of tax for tax planning purposes is now 15%, and for people and dentists over age 60 it is less than 15%. If you have not sat down with us to discuss how a SMSF can change your life, you should, before it is too late.

This manual does not cover SMSF planning strategies: these change constantly and are covered in the superannuation section of our website www.dover.com.au and you should refer to these materials for a summary of the options open to you.

All care has been taken in preparing this manual, but no responsibility is accepted unless you are a McMasters' accounting client and have confirmed the matter in writing with us under our normal working procedures. This advice is general advice and not personal advice.

I hope you enjoy our website and appreciate this manual.

Please feel free to contact me on 03 9583 6533 or terry@mcmasters.com.au should you wish to learn more about how we can help you set up and run a SMSF practice or how we can help you create a more profitable financial planning practice.

Yours faithfully

Terry McMaster
Director

PART 2.1: WHY IS SUPERANNUATION SO GOOD?

Introduction

Superannuation, whether through a SMSF or a managed fund, should be a critical part of any financial planning strategy. This is particularly so once a person approaches or passes age fifty. As retirement draws near, the limit on deductible contribution increases and, hopefully, income and other assets are rising, creating an increased ability to contribute.

It's fair to say the tax rules for superannuation are now so good that many people age 60 or approaching age 60 will not pay tax at much more than 15%, if not less.

Getting the snowball rolling early is critical to the amount available on ultimate retirement. This has always been the best strategy but the Treasurer's announcements under the "Simple Super" regime on 9 May 2006 made it more so. These changes are outlined in part 2.2 of this manual.

Why is superannuation so good?

Superannuation is so good because of the Government's deliberate policy on retirement incomes. The population is aging. Future governments cannot afford to pay a pension to the aged in the way they do now. The numbers just do not add up. There will be too few workers and too many non-workers for things to go on as they are now.

The Government's emphasis is on creating an environment conducive to self-sufficiency in old age. The tax system encourages people to put away money to pay for their retirement. This is done by:

(i) allowing generous tax deductions for contributions to super funds;

(ii) taxing fund income, including capital gains, at concessional, even nil, rates; and

(iii) allowing tax concessions to the withdrawal of benefits, which usually mean that benefits, particularly pension benefits, are derived tax free.

As a result, an investment in a SMSF will perform better than an identical investment in a non-super environment. The tax concessions mean more cash is available for investment and the after tax return on investments is higher. This means an investment will almost always get greater after tax returns in a super environment than in the client's own hands.

An example might help. Assume John has earned $100,000 and wishes to invest it. His options are to receive it and then invest it in his own name or to receive it and

then invest it in his SMSF. John's marginal tax rate is 45%. The SMSF's tax rate is 15%. Assume John can earn 10% pa on any investment he makes. If John invests his cash in a SMSF he will have $34,200 more at the end of year one. He will also earn more each year thereafter, as a result of having more available to invest.

	Invests in Own name	**Invests in SMSF**
Superannuation Fund		
Gross Amount Available	100,000	100,000
Tax Payable	45,000	15,000
Net Amount Available	55,000	85,000
First Year Earnings (at 10%)	5,500	8,500
Tax Payable	2,475	1,275
After Tax Earnings	**3,025**	**7,225**
Balance at End of Year One	$58,025	$92,225

Investing in the SMSF means faster growth from enhanced after tax returns each year. No other environment accelerates the after tax value of the investment so quickly. It is worth repeating the two reasons for this:

(i) amounts contributed to the SMSF are (generally) tax deductible to the employer or member, so that both the initial amount available to be invested is greater and the pre-tax earnings each year are greater; and

(ii) the earnings of the SMSF are (generally) taxed at the relatively low rate of 15%, and 10% for capital gains so that the after tax earnings and therefore the amount of cash available for reinvestment, are greater. This has a compounding effect over time.

So, a basic investment rule must always be borne in mind. Whatever the underlying investment is, if a SMSF is used the after tax earnings rate and the growth in the value of the investment will be greater than otherwise. This means investors paying tax at 47% or close to it should use SMSFs wherever possible..

Part 2.2 The 2006 Baby Boomers' Budget

The 2006 Federal Budget was great news for anyone interested in SMSFs. The Budget announced tax cuts for all, and generous new superannuation rules that have transformed the retirement planning landscape. It's great to be sixty, or nearly sixty, particularly if you are wealthy.

In fact it's great to be any age now, if you are interested in superannuation. And we believe all doctors and dentists should be interested in superannuation and should contribute the maximum amount permitted under the law each year.

The Baby Boomers' incredible life ride continues: as they hit age 60 retirement taxes disappear and old age pension eligibility gets bigger and better than ever. But do not be jealous. If you are not yet sixty you probably will be one day, and the younger you are now the easier it is to position yourself to benefit from these generous new rules.

The specific proposals

The specific proposals are, from 1 July 2007:

(i) lump sum benefits and pension benefits for members over age 60 from funded sources (virtually all people and dentists' benefits are funded benefits) are tax free, but not those for members between age 55 and 60 or for benefits from un-funded sources (mainly public servant and politicians' funds);

(ii) the reasonable benefit limits disappeared meaning there is no limit on the amount of benefits able to be held in a superfund. This is great news for clients with excess RBLs, ie benefits of more than about $1,200,000, and thanks to a booming share market over the last 14 years many clients are in this category;

(iii) members may leave their money in the fund for as long as they like, rather than being compelled to take a lump sum or start paying a pension at a key date, such as age 65 if not working, or age 70 or 75 subject to work tests;

(iv) simpler minimum standards for all pensions. The only real rule will be that a minimum amount must be paid each year. If the fund meets these standards the income from the assets used to pay the pension will be tax free and all franking credits will be refunded in full;

(v) the age based deductible contribution limits was abolished and replaced by a maximum of $50,000 per person per annum, particularly with the trend towards older people staying in the workforce longer;

(vi) contributions can be paid up to age 75. This is great news for people still working beyond age 65 and for wealthier clients with significant investment income;

(vii) a limit on un-deducted contributions of $150,000 per person per annum contributions, or $450,000 per three years per person, from 9 May 2006, and a special rule allowing un-deducted contributions of $1,000,000 per person up to 1 July 2007;

(viii) the deduction rules for self-employed persons was harmonized with those for employed persons, ie a maximum of $25,000 ($50,000 if over age 50) per person per annum up to age 75 (compared to $5,000 plus 75% of the excess up to the age based deductible contribution limit, as applied previously); and

(ix) benefits used to pay growth pensions and complying pensions are no longer be wholly or partly exempt from the old age pension assets test; but

(x) the assets test was in effect been doubled, increasing its availability to thousands of extra persons. Many more people over age 60, some with total assets in the millions, will get the old pension. The eligibility criteria have been significantly widened, although the amount of the pension has not been changed.

Pension rules simplified

From 1 July 2007 the rules applying to superannuation benefits taken as a pension have been simplified. These rules will be:

(i) pensions paid to persons age 60 and over from a taxed super fund are tax free;

(ii) pensions paid to persons age 60 and over from an untaxed super fund are taxed at marginal rates less an 10% tax offset;

(iii) pensions paid to persons under age 60 are assessable, except for the deductible amount, and a 15% tax offset applies to the assessable pension if it is paid from a "taxed" super fund to a person between age 55 and 59; and

(iv) new pension standards will require members receiving pensions to draw down minimum amounts each year. These amounts are:

(v)

Age	Percentage of Member's Account
55 to 64	4%
65 to 74	5%
75 to 84	6%
85 to 94	10%
Over 94	14%

The minimum pension amounts have been reduced as a temporary measure as part of the Government's response to the Global Financial Crisis.

Why is this a super revolution?

The average person earns about $50,000 a year and has less than $100,000 in super when he or she retires, usually at around age 58. The average total wealth for a 65 year old Australian couple is about $500,000, including the value of their home. For the average person the super rules mean they may be a hundred dollars or so a week better off after age 65 because they are getting a bit more pension and paying a bit less tax. May be they will get a bit more old age pension too.

The proposed changes are not that dramatic for the average punter.

For wealthier people the new rules present a new world of investing where the SMSF, in particular, will in effect be a tax free family investment vehicle, and where paying tax will be virtually optional for persons over age 60. And that's a large, and increasing, proportion of the population.

This is a revolution in taxation jurisprudence. It is the first time we have ever seen Government sanctioned/encouraged tax planning on such a large scale. It is not an exaggeration to say paying tax will become optional for most people over age 60.

PART 2.3 HOW MUCH DO YOU NEED TO RETIRE COMFORTABLY

The basic problem

Most people cannot afford to retire, and are blissfully unaware of this until it's too late. By "most", we mean about 80% of the population. That's a staggering statistic: about four out of five people will not have enough money for a comfortable retirement. Bear in mind that "retirement" these days can mean thirty or forty years of no salary or wages.

Australian Bureau of Statistics and Centrelink

It may be useful to reflect on figures provided by the Australian Bureau of Statistics and the Department of Social Security regarding Australians and retirement. We find these facts and figures startling and sobering.

Some facts and figures

About 80% of retired people receive the pension. The old age pension for a single person is about $8,000 a year, or about $155 a week, plus some fringe benefits. The old age pension for a married couple is about $14,000 a year, or about $270 a week, plus some fringe benefits. This is all they get to live on.

More than 50% of lump sums are consumed within the first five years of retirement. Less than 50% of lump sums are actually applied to investments, including the repayment of debts. Most lump sums are spent on travel, cars, gifts to children and other consumption decisions. The pattern seems to be to use the limited super available to subsidize the pre-retirement income, until it is all used up, ie consumed.

Most lump sums are less than $100,000. The figure is much less for women.

Few people have significant assets at retirement, apart from the family home.

ABS research shows there is a large drop in income on retirement. This is so for most people who retire, irrespective of their pre-retirement income levels. There is little correlation between pre-retirement incomes and post-retirement incomes: a high pre-retirement income does not mean you will have a high post-retirement income. Post-retirement income is determined largely by the amount of capital that has been accumulated previously, and this has only a rudimentary link with income level. Some people have low incomes yet accumulate great wealth, but the opposite is more common.

Most people experience a big drop in living standards once they knock off for the last time. The pre-retirement and post-retirement income figures look like this:

	Pre-Retirement	Post-Retirement
Nil to $8,000	2%	52%
$8,000 to $12,000	5%	25%
$12,000 to $20,000	12%	11%
$20,000 to $30,000	29%	2%
$30,000 to $40,000	23%	2%
$40,000 to $50,000	17%	1%
$50,000 to $60,000	7%	5%
$60,000 Plus	5%	2%

In other words, most people experience a sharp drop in income on retirement. More than 80% of retirees have an income no greater than the bottom 20% of employed persons. This means they are close to or on the poverty line. Less than 12% of retirees have an income of more than $30,000 a year.

There is little correlation between pre-retirement income and post-retirement income. A person on a high pre-retirement income has only marginally better prospects of being on a (relatively) high post-retirement income than a person on a middle or low pre-retirement income. It is not uncommon for a person earning more than $100,000 a year to drop to a pension of $8,000 a year on retirement.

The average person will earn more than $2,000,000 in 2010 dollars during their working life. Few will have a significant amount to show for all their hard work once they retire. Most will have less than $200,000 plus their home.

The average period of retirement is now about twenty years. Thirty years ago the average was about three years. People are now retiring earlier and living longer. The average period of retirement will continue to grow for at least twenty years. It could one day be greater than thirty years.

This means amounts saved for retirement will have to last longer than before, and will have to be a lot bigger than before. This increase in the average period of retirement also means the Government cannot afford to:

(i) increase the amount of the old age pensions; or

(ii) widen the class of persons eligible for the pension (for example, by lowering the pension age or by easing the Assets Test or the Incomes Test).

What is the message from all of this?

The message is straightforward. Most people do not have a happy retirement. What should be relaxation and peace becomes anxiety and worry. Retirement is endured, not enjoyed. Even when an effort has been made to put money away too often it goes in just few years. Or else it suffers a long attrition, eroded by inflation and the need to subsidize living costs. Eventually most retired people are forced on to the old age pension.

A life of virtual imprisonment

This is not just our view. Philippa Smith, the CEO of the Association of Superannuation Funds of Australia, writes:

"ASFA and the Council of the Ageing have explored this question of expectations though another study. The study – "Looking Forward to Retirement- Is This As Good As It Gets" interviewed a range of retirees in differing circumstances, documenting their expenditures and experiences, including whether their current lifestyle met their previous expectations for retirement. A few had adequately planned for retirement and were relatively pleased with the result. A number had faced sickness or unemployment, which disrupted their savings plans. Common to many of the stories were sobering examples of the constraints made and the compromises made. *They described retirement as a life of virtual imprisonment rather than the freedom they had anticipated."* (in National Accountant. April 2001 page 64)

The reasons why this happens are complex. There is definitely an attitude of "she will be right" or "something will come up" in the minds of most would-be retirees. Post war convention said the Government will look after your old age and this is why we have income taxes. The baby boomers missed the Great Depression and grew up with full employment and unlimited opportunity. The advertising urge was to spend and consume and, if you could not pay for it today you could pay for it tomorrow. Two good cars, a good house and good holidays became the norm, irrespective of the underlying income or wealth level.

How much do you need to retire?

Many financial planners suggest the figure of $40,000 a year for a couple, or $20,000 per person. That's about $400 per week per person.

Try to live on $400 a week, before tax. An income of $20,000 per person carries tax of about $3,000. After tax you have $250 a week to spend. You will not go far. A more realistic figure is at least $60,000 a year. However, even this does not lead to a life of luxury. (And, as noted above, an income of $60,000 pa is achieved by less than 8% of retirees.) How much capital do you need to generate and income of $60,000 pa, and maintain the purchasing power of your capital?

Your family home

You can't count your home. You have to live somewhere, and if you do not own your home you have to rent. This will add at least $15,000 a year to your cost of living.

Realistic earning rates

Empirical evidence shows investment long term returns, adjusted for inflation, average about 10%. Given the need to preserve capital, it is a bit ambitious to expect much more than this.

Inflation

In recent years prices have risen by between 2% and 4% per year. Let's assume inflation is 3%. This means the first 3% of income each year has to be kept and added to the capital. If you do not, its real value will fall and eventually it will not be able to pay your living costs. Never forget inflation when you are doing your sums, particularly when your time frame extends beyond a few years. Even at a low rate of 3% pa, a dollar today will only be worth 67 cents in ten years time, 45 cents in twenty years time and 33 cents in thirty years time.

Obviously if inflation jumps up this will need to be factored into the equation.

How much will it cost to live?

There is no easy answer to this question. It depends on the age, lifestyle, aspirations, preferred living arrangements, financial commitments and expected longevity of the individuals concerned. It also depends on how well you invest once you have retired.

Some people are comfortable on $40,000 a year, and some are quite uncomfortable on $80,000 a year. Travel costs a lot, particularly with the Australian dollar so low. Some people have to budget for elderly parents, or younger children. Some people receive inheritances. Some people generate income from part-time businesses and part-time employment in retirement. Some people live to 100, and some die soon after retiring.

So who knows how much is needed to retire comfortably.

Many advisors say living costs drop after age 70 or so. People become less active at this age, and this leads to lower living costs and a reduced need for income. Travel appears to be particularly hard after age 70, and this means living costs drop. But what about special accommodation and health needs: these can cost a small fortune?

What if you live to be 90? What if you live to be 100?

How much do you need to retire comfortably?

CPA Australia reports the Government Actuary as saying that the amount needed is 11.25 times the average of the last three years of salary/income immediately before retirement. This amount will tend (given certain assumptions) to produce an income equal to 75% of the pre-retirement income. For example, if your income is $100,000 a year before retirement, then you need $1,125,000 in assets to generate an annual income of $75,000 a year after retirement. This assumes an earnings rate of 6.6% pa.

This multiple of 11.25 is probably too high for most people. The Australian share market has averaged about 12% pa since 1950. It is reasonable to assume that in the

future it will average at least 10%. This means an amount of $750,000 may be sufficient to maintain the required lifestyle. But bear in mind the effect of inflation: drawing less than the earnings is a good idea if the real value of the investments is to be maintained.

Noelle Kelleher in her book "DIY Superannuation" suggests assets of 7.5 times the pre-retirement income as a sensible goal. This seems to be closer to the mark. Ms Kelleher stresses that you should look at your required income and then work backward to determine how much money you need to retire. Barbara Smith and Ed Koken in their book "Super Simple" suggest you need to earn 65% of your pre-retirement income, which at 7% pa means you need assets of nearly ten times the pre-retirement income.

But the sad truth is most Australians are saving nowhere near enough to be self-sufficient by the time they retire. Therefore most will live solely on the old age pension.

One thing is sure: the more the better. Hence minimizing tax during your SMSF's accumulation phase, and eliminating tax during its pension phase means more money is available for retirement. Therefore there will be less pressure to reduce lifestyle in what should be the big payback years.

If you are looking for a nice round figure, we suggest $1,500,000 plus your home. This means you will live quite comfortably, and will probably leave a sensible inheritance to the grandkids (after all the kids can look after themselves!)

How may people have this sort of money at retirement?

Not many. It's probably less than 5%. Most couples have less than $200,000 on top of their family home when they retire at age 65. Further, the tendency is to eat up capital faster in the early years to maintain the pre-retirement life style. Five or ten years later the penny drops. And so does the lifestyle. Usually by age seventy the retirees are at or below the poverty line.

In the next ten to twenty years this will become a serious social problem. As the population grays, more people will be forced to live on the pension and (relatively) fewer and fewer people will be in the workforce paying for those pensions.

There is no magic pudding. And there is no magic wand.

If you want to have a reasonable standard of living in retirement you must work on the assumption that you will have to pay for it yourself. You will have to make sure that you have got at least $1,500,000 of capital plus your home at the time you retire.

How do you accumulate this much capital?

You can be lucky and inherit it. Or you can win Tatts. But in most cases this will not happen and you will have to earn it. A realistic investment strategy must be developed and implemented. A SMSF should play a major role in this strategy.

What happens if you are age 50 (or one day might be)?

We frequently help people age 50 or more, who have 15 years or less of their working lives left, plan for their retirement. Often they have not got anywhere near enough wealth to pay for that retirement, and if they continue the way they are going they never will. These strategies are also relevant to persons aged less than fifty, but are particularly focused for those in this age group. We recommend them to all of our clients irrespective of age. These strategies include:

(i) defer your retirement. This sounds a bit obvious but it is something a lot of people do not fully consider. Do you really want to stop working completely at age 65 (or even 58, as most people do?) A more realistic time frame might be a gradual phase out between age 55 and age 70. Extending your working life by 5 years or more can add interest to your later years. It also radically changes the economics of retirement: not only are you building up capital for an extra 5 years, but you are also shortening the draw down phase by 5 years;

(ii) if you run your own business involve your spouse in the business to save on labour costs. This can be on a part-time basis. If the spouse's salary is taken as a superannuation contribution this can mean that, say, an extra $200,000 to $300,000 of superannuation can be put away over a ten-year period;

(iii) increase your superannuation contributions. Pay the maximum able to be contributed each year irrespective of your other spending desires;

(iv) look hard at your household budget and cut costs wherever possible. One area for savings is the cost of your car. A modest Magna or Commodore will do just as good a job as a SAAB. The savings in lease payments and insurance costs can be then dedicated to additional super contributions or can be used to retire debt. An extra $5,000 a year will add up to more than $100,000 in ten years time; and

(v) c

onsider rationalizing your family home. You may not need four bedrooms and three living areas once the children have gone their own way. A two-bedroom apartment closer to town may be more appropriate to your needs now (and almost certainly will be once you retire). Let's assume that your home is worth $350,000 and you still have a $100,000 mortgage on it. Selling it and moving to a smaller home will save you about $10,000 in interest a year. But since this interest has to be paid out of after tax dollars, it is really costing you $20,000 a year. Use this $20,000 a year to pay additional superannuation contributions. An extra $20,000 a year adds up to more than $400,000 in ten years' time.

Any of these suggestions can be adopted by a client aged fifty and over in order to put more money away for their retirement. Even if you are older than sixty they can still have a powerful effect on the economics of your retirement and thus the quality of your future life. They are also relevant thoughts for younger persons.

PART 2.4 WOMENS' SUPERANNUATION

The experience of women in the superannuation stakes deserves special comment.

Women are seriously under-represented in the superannuation stakes. The reasons for this are quite obvious: women spend less time in the paid workforce, due to being primarily responsible for child-care and earlier retirement ages. Women usually have lower incomes than their male counterparts. They are also less likely to regard themselves as being responsible for their own retirement planning and more likely to spend their incomes on current consumption for themselves and their families. An article in the Age dated Saturday 7 July 2001 interviewing a collection of prominent feminists stressed that most family units still regarded the female's income as "pin money" and not something to be regarded as the main stay of the family's budget or a base for future investments.

But superannuation is probably more important for women than it is for men, since women live longer, and are increasing less likely to be married or otherwise part of a family economic unit in the future. Alle McBeal needs a SMSF more than she needs a man! She just does not know it.

The 2001 study, 'Women and Superannuation in the 21st Century: Poverty or Plenty?' by the National Centre for Social and Economic Modeling at the University of Canberra, has found that unless there is complete equality in the labor force roles women's superannuation will remain lower than men's due to lower female earnings and different workforce participation.

The study found that in 1993 women's average accumulated superannuation was only $9,647, less than half of the average accumulated superannuation of men. By 2030 the average woman's superannuation nest egg will increase nine-fold to $89,591 in 1999 dollars, but it will still only be 70% of men's.

The study found that 10% of women aged 55 to 64 will have accumulated less than $27,300 in superannuation by the time they contemplate retirement in 2010. This is obviously far too little. But it is still a vast improvement over the 2000 picture, when the bottom 10% of women considering retirement had super nest eggs of less than $3,850.

These findings mean that the majority of women will live below the comfortable or 'plenty' level in retirement. While most women will have some superannuation due to the introduction of the Superannuation Guarantee Contribution in 1992, the amounts are not likely to take the average women from near 'poverty' to 'plenty'. Most people feel 60% of pre-retirement income is required to live comfortably in retirement, and the projected amounts, combined with a full or partial age pension, will still not achieve this level.

The problem is particularly pronounced for older women, say the 40 plus group. Most have little or no supern and the high costs of raising families in the next ten years or

so means for most the situation will not change before age 50. At age 50 most women have less than ten years of equivalent full time work ahead of them. By then it's usually too late to make a dint in the problem.

Phillip Smith, the AFAS CEO, is reported in the Age on 23 July 2001 as saying:

"Super rules need to take account of the broken work patterns now common for both women and men. Women are most behind the eight ball at this stage. We need to look at ways of helping them save for retirement".

It is critical that younger women do not repeat the mistakes of their predecessors. Their contributions should start as soon as possible and should be as much as possible. The earlier the snowball starts, the greater it becomes.

Women should not assume they will share someone else's super in retirement: it may work out that way, but it may not.

Under-superannuated older women will be over represented in the ranks of the poor in twenty years time, as they are now.

The above comments are a little old as at October 2010.

But they are as relevant as ever.

PART 2.5: THE ADVANTAGES OF SELF-MANAGED SUPERANNUATION

Any investment will do better in a SMSF

Where the member faces tax of 40% or 45% (which is virtually everyone) any investment will perform better in a SMSF. This is because:

(i) the tax deduction for contributions means up to 30% more cash is available for investment at the beginning of the investment's life (ie 45%, being the member's tax rate, less 15%, being the SMSF's tax rate);

(ii) because more money is invested, investment earnings are greater. A head-start is created and this lasts for the life of the investment; and

(iii) the fund's investment income is:

a. taxed at no more 15% up to age 60 (or in some cases after age 55) and realized capital gains are taxed at 10% (and sometimes 0%), so the after tax rate of return on the investment is always greater than for a 45% taxpayer, meaning there is faster compounding in a SMSF than elsewhere; and
b. is tax free after age 60 (assuming the member starts a pension at that age).

This advantage is deliberate government policy. The old age pension is being replaced by a system of private pensions. It is a mathematical certainty that an investment in a super environment will do better than and identical investment in a non-super environment.

Increased information

A SMSF means you don't have to wait for months after 30 June each year to find out how your investment is performing (or even what it is invested in). The information is always readily available. Most trustees can access information on virtually a daily basis.

The rapid growth in Internet trading is increasing the amount of information. Most e-traders provide free portfolio tracking software, which means clients get immediate reports on the state of their portfolios at any time.

Cheap software packages like Banklink make it even simpler for SMSF trustees to run their own investment portfolios with minimum effort and maximum fun.

Synergy with other investment and business strategies

SMSFs can create synergies with the member's other investment and business activities. The SMSF's investment strategy should be prepared as part of an overall investment strategy reflecting the member's attitudes and overall financial profile. The member's will and estate planning should be considered as part of this strategy.

It can make sense for a SMSF to minimize property investments if the member's family trust has invested heavily in property. Overall, the investment portfolio is balanced, even if the SMSF invests solely in shares. It's hard to see how a managed fund with thousands of members of all ages, from all walks of life and with vastly different financial profiles can be as efficient as a SMSF.

One fund cannot be all things to all people.

Tax free death benefits

In most cases eligible termination payments paid direct to a deceased member's dependants are tax-free in the dependant's hands. This applies to all superannuation funds, not just SMSFs. But as SMSFs are usually controlled by the deceased member's nearest relatives there is more tax planning potential and certainly more control.

Asset protection

SMSF assets are generally protected from bankruptcy. This means a trustee in bankruptcy cannot access the benefits and the benefits are held for the member. Benefits paid out during a bankruptcy, say, on the member reaching a specified age, or before bankruptcy may not be protected.

Capital gains tax efficiencies

Most people know most SMSF income is taxed at 15% and capital gains are taxed at no more than 10%, provided the asset has been held for less than 12 months. This gives SMSFs a significant advantage when it comes to deciding which entity should hold an asset that is expected to increase in value.

Fewer are aware SMSF income is taxed at nil % if it used to pay a pension, and that capital gains only face tax in the year the gain is realized, not in the year the gain accrues. SMSFs allow you to eliminate CGT by controlling the timing of asset disposals. This means the realization of gains (and, in many cases, other income) can be deferred to a year when the SMSF pays nil tax, ie when the members are being paid pensions from the SMSF. With planning most capital gains can be derived tax-free using this method.

And pensions can start at age 55 without having to stop work.

This significantly increases the after tax rate of capital gain, significantly increasing the return on the investment, just by deferring the disposal of the investment. Try getting a managed fund to do this for you!

Retirement planning for children

SMSFs can be used to obtain retirement benefits for spouses, children and even grand children. SMSFs are a sophisticated method of cross-generational wealth transmission.

Ethical investments

SMSFs can choose to only hold investments they believe are ethical. Trustees can structure the SMSFs' investment strategy so that no unconscionable investments are held, or so that socially advanced investments are emphasized.

It's a pleasure: SMSFs as a enjoyable way to spend your time

Each year we give this heading more and more weight. Most people who run SMSFs do so because they enjoy it. They like the control and they are genuinely interested in investing. They enjoy learning about investment opportunities.

Most people who run SMSFs enjoy it. SMSFs do not have to take up a great deal of time. Some people get by with just a few hours a year. They only buy quality blue chip shares or some other conservative investment, such as an index fund, and never sell. This strategy has worked well in recent years and has the added benefit of lower administration costs since there are fewer transactions to record and monitor. This strategy is common with younger people with smaller funds and/or larger work and family commitments.

Other people enjoy spending a few hours a week or in some cases even a few hours a day attending to their SMSF investments. They believe they can add to its performance by paying closer attention and investing. Older people who are retired from full time practice are more inclined to do this. With the low cost of e-trading, and the huge amount of information available on the Internet, we are seeing a new class of investor who works his or her SMSF hard to make extra profits.

Whether one method is better than the other is not clear. And it really depends on the ultimate choice of investments. But for many clients spending a few hours on their investments beats playing bowls. As Barbara Smith and Austin Donnelly say in "Do It Yourself Superannuation" under the heading "Psychological Benefits":

"Other benefits enjoyed by some trustee members are the interest and satisfaction from buying shares or property and watching market developments closely, particularly in relation to the share market. This process is an absorbing interest for some people."

Running a SMSF is a valid and interesting occupation: ten years ago many managed funds did not have as much in them as some SMSFs do today. Their size and cash flow means the trustees enjoy the time spent on SMSF activities.

Tax deductible life insurance premiums

Life insurance premiums paid through a SMSF can be tax deductible. This can halve the cost of the cover and is the cheapest way to arrange life insurance. Often the tax benefit connected to deductible premiums more than covers the cost of running the SMSF.

Any insurance benefits paid will be included in the SMSF's assessable income. Whether there is a tax charge or not will depend on the fund's tax profile: the worst case is a tax charge of 15%, and the best case is a tax charge of 0%, which will apply if the SMSF is paying an allocated pension at the time of the member's death.

Roll-over of taxable capital gains

Small businesses, including businesses run through companies and trusts, can roll over taxable capital gains on the sale of their businesses into their SMSF. This special rule acknowledges that businesses are often the main retirement asset for many people. Conditions apply and expert advice should always be obtained.

Reversibility

If for any reason you decide a SMSF is not for you, it's the easiest thing to reverse the decision. This can be done by paying your-self an ETP, paying tax, and then reinvesting in a non-superannuation environment or by rolling over to a managed fund. Unlike managed funds, this reversal is simple and cheap to complete, and you have not wasted thousands on entry fees and even more thousands on exit fees!

Other reasons

Other reasons for SMSFs are:

(i) increased information: you don't have to wait for months after 30 June each year to find out how your investment is performing. The information is always at hand. Most trustees can access information on a daily basis;

(ii) synergies with the member's business activities (eg ownership of business premises) or other investment activities. This means the SMSF's investment strategy makes sense as part of an overall investment strategy. For example, it can make good sense for a SMSF to minimize property investments if the member's family trust has invested heavily in property;

(iii) control over the investment. This is perhaps the most important advantage. Control and security appeal to self-employed or professional people;

(iv) tax-free death benefits. Benefits paid to a deceased member's dependants are usually tax free in the dependant's hands even if the member is not 60 years old;

(v) SMSF assets are protected from bankruptcy;

(vi) control over the timing of income: capital gains and, in many cases, other types of income, can be deferred to a year when the SMSF pays nil tax;

(vii) retirement benefits for spouses and children. SMSFs can be even used to create retirement funds for spouses and children. They can be used to help grand-children: SMSFs as a sophisticated method of cross-generational wealth creation and transmission is a growth area at the moment;

(viii) tax-effective savings. The deduction for contributions and the low rate of tax (15%, 10% or nil %) means virtually any investment will do better in a superannuation fund; and

(ix) access to unrestricted non-preserved amounts at any time without having to retire, in the same way a member can access benefits held in an ADF. In some cases a SMSF can be used as a low tax rate (or even nil tax rate) bank account.

PART 2.6: WHAT IS A "SELF-MANAGED SUPERANNUATION FUND"?

Introduction

A SMSF is a super fund with less than five members that is managed by its members. SMSFs are also known as DIY funds. The Australian Taxation Office ("the ATO") is the main SMSF regulator, and has responsibility for overseeing SMSFs in Australia.

The members, or a company owned and controlled by the members, act as the trustees. The trustees control the SMSF's investments and are generally responsible for the SMSF's administration and its compliance with the law.

A SMSF is controlled by a trust deed. The trust deed sets out the rules the SMSF has to follow. It also sets out the obligations and responsibilities of the people connected to the SMSF, ie the members and the trustees. The rules for paying contributions on retirement or death, investing assets, holding meetings, appointing trustees, paying benefits to members and the other matters affecting the SMSF are also found in the trust deed.

What is a SMSF?

A SMSF is a special type of trust. It is special because the trust assets are held and managed by a trustee for the purpose of providing retirement income and other benefits to members. This means it qualifies for special income tax concessions under the tax law.

The three essential parts of a trust are present in a SMSF. These are a trustee, trust property and beneficiaries, in this case called "members". The trust deed must have special rules if the SMSF is to be a complying superannuation fund and be eligible for tax concessions. However, it is the trustee's year-to-year conduct that ultimately determines the SMSF's eligibility for tax concessions.

To be a SMSF the fund must be a superannuation fund and must also satisfy a number of conditions set out in section 17A of the Superannuation Industry Superannuation Act ("the SISA"). These conditions are:

1. the fund must have no more than four members;

2. if the trustees of the fund are individual persons, each of them must be a trustee and if the trustee of the fund is a company, each member must be a director;

3. the members are not in an employment relationship unless they are relatives;

4. no trustee derives any benefit from providing services to the fund or for performing his/her/its duties as a trustee.

What is a member?

A person is said to be a "'member" if the trustee holds benefits on trust for them. The role is analogous to a beneficiary of a family trust, and a unit holder of a unit trust. The member is entitled to receive benefits from the SMSF on the occurrence of certain specified events, such as reaching a certain age, or dying (in which case the benefits are paid to the member's estate or dependants or a nominated person).

Most SMSFs only have two members, ie mum and dad. A minority will have children as members too. It usually makes more sense for other people to set up their own SMSF and to keep their financial arrangements separate.

Why the limit on the number of members?

The number of members is limited to four so that the SMSF cannot become too big. This rationale is not perfect, as obviously it is possible for a one member fund to hold more member benefits than a four member fund. But it does make some sense. It also means that individual SMSFs do not become too big, and that the members stay in control.

Most of the consumer protection type rules in the law do not apply to SMSFs. The rule that members must be trustees means that members will automatically have access to financial information and other information about the fund, and so a further layer of protective regulation is not necessary. This simplifies the costs of running SMSFs and makes them more accessible and workable. Increasing the number of members beyond four members would run contrary to this policy, making SMSF less workable, more expensive and more difficult to run.

There is some sense in the rule being relaxed so there can be more than four members if they are all part of the same family. This 'same surname" approach is discussed in the industry from time to time but there is nothing to suggest it will become law at present.

Single member funds

It is not possible for a person to be the trustee for himself or herself. This is because the necessary separation of equitable ownership and legal ownership, which is a fundamental to the concept of a trust, of which a SMSF is a sub-species, is missing.

This posed a problem for the legislature when section 17A of the SISA was being drafted: how can the all members be trustees rule be satisfied in the case of a single member fund? The solution was an exception to the rule which in effect says that in the case of a single member fund:

(i) a sole director/shareholder company can act as trustee, with the member as the sole director and shareholders (since this creates the necessary separation of equitable ownership and legal ownership); or

(ii) another person can be a trustee provided that other person is a relative.

A 'relative" is defined widely and goes as far as second cousins, and includes relatives by marriage or adoption, de-facto spouses, and ex-spouses. "Spouse" does not cover a same sex partner. There is some contention as to whether a special rule for single member funds is necessary. This is because the member's dependants may have a contingent interest in the fund, and in that sense may be a beneficiary under the trust deed, and/or because a SMSF is a purpose trust, and may have future members. This contention is, however, completely academic as the law is very clear regarding who must be the trustee(s) for a single member fund.

Members who are also employees

A person cannot be a member of the same fund as his or her employer, unless they are related. This rule is intended to make sure that self-managed superannuation funds do not become de-facto employer sponsored funds, but without the extensive consumer protection type rules afforded to employees in these funds.

What happens if a member/trustee dies?

This is controlled by sub-section 17A (3)(b) of the SISA. If a member dies the deceased member's legal personal representative will become the trustee of the SMSF or the director of the company that is the trustee of the SMSF. The legal personal representative will remain a trustee, and hence the fund will remain a SMSF, from the date of death until the death benefits start to be paid. Once the death benefits begin to be paid the legal personal representative must cease to be a trustee or a director of a corporate trustee.

What happens if a member comes under a legal disability?

This is controlled by sub-section 17A(3)(c) of the SISA. If a member comes under a legal disability the disabled members' legal personal representative will become the trustee of the SMSF or the director of the company that is the trustee of the SMSF for the duration of the disability.

What other laws are relevant to SMSFs?

SMSF trustees are subject to a wide range of laws. These include:

1. the general law;

2. trustee law, ie the special body of law developed over centuries that applies to trustees, including the various state Trustee Acts;

3. rules that apply specifically to SMSFs, being the Superannuation Industry (Supervision) Act and six related pieces of legislation ("the SISA"); and

4. the Tax Act. All of these laws must be complied with if the SMSF is to be eligible for tax concessions and the trustees are to avoid penalties under the SISA.

Who supervises SMSFs?

The Australian Taxation Office ("ATO") is is responsible for enforcing the SISA and other superannuation laws as they apply to SMSFs.

If the SMSF's deed is drafted properly and the trustees comply with the law, the SMSF will be eligible for tax concessions. These concessions include a deduction for contributions and concessional tax on the SMSF's income. These tax concessions drive the SMSF's enhanced investment performance. It is the tax concessions that make superannuation such an attractive investment medium and allows it to outperform alternative investment media.

Although theoretically onerous, trustees are normally able to satisfy these rules without any difficulty. The ATO is helpful not obstructive and it is on the record as saying it will follow the standards set by its predecessor, the APRA. It is important not to overstate the risk of breaching the law. In most cases SMSFs run smoothly and difficulties are not encountered. Except for cases of extreme culpability, it a SMSF that has inadvertently breached the superannuation law will be deemed to have complied with the law by the Regulator. Where there is a minor breach of these rules, the Regulator generally uses its discretion to deem the SMSF to have complied with the rules.

The Superannuation Industry (Supervision) Act

The SISA, and the regulations made under it, is the major source of regulation of SMSFs, although other laws, including the Tax Act, have to be considered. The SISA is part of a seven Act parcel of legislation. The SISA is the pivotal Act and is generally referred to the most. In this manual the term "SISA" describes the full parcel of superannuation legislation as well as the SIS Act.

Objects of the SISA

The SISA is intended to increase the security of benefits held for members and ensure the special tax concessions (ie tax rates of 15%, 10% and nil %) are only available to SMSFs that are conducted properly. The ATO ensures SMSFs comply with the SISA and other relevant laws. The SISA is a complex piece of legislation. Many of its provisions relate to non-excluded funds and are therefore outside the scope of this manual. Rather than set out an overview of the SISA we have instead referred to it in the context of the specific themes and topics covered in the manual.

Who can set up a SMSF?

There is no restriction on who can establish SMSFs. They are set up by people of all ages from all walks of life. Normally people with higher incomes or who have significant wealth set up SMSFs. Older people predominate, since they are able to pay larger contributions and are more aware of their ultimate retirement. Younger people using the SMSF's to set themselves up for later life are becoming increasingly common.

How much do you need to set up a SMSF?

Some say a person should have $200,000 of super before setting up SMSF. They say below $200,000 the costs of running SMSFs outweigh the benefits. The threshold of $200,000 is often too high. It significantly overstates the cost of setting and running a SMSF and significantly understates the various commissions and fees connected to managed funds.

We believe a more accurate figure is $100,000. Some people use SMSFs with less than $100,000, confident that over time the enhanced returns coupled with a robust contributions strategy, will make up for any cost inefficiencies in the early days.

The figure of $100,000 comes with two caveats: these are that the SMSF has a simple investment strategy and does not have a large number of small value transactions. It is the number of transactions that determines the cost of running a SMSF, not its size. One good strategy for a SMSF is to have all of its assets in an investment like an indexed fund. This is an extremely easy investment to account for and to audit and this means these costs are kept to a bare minimum.

Do you need more for a SMSF paying a pension?

The figure is closer to $200,000 for a SMSF that is paying a pension. This is because most members would be better off taking a tax free lump-sum benefit if they have any less than this. Hence the higher threshold for the SMSF to be economically viable

How does a SMSF differ from other superannuation funds?

SMSF members do not need the benefit of the consumer protection type rules applying to larger superannuation funds with hundreds or even thousands of members, and no involvement by the members in the operations of the fund. They do not need the benefit of these rules because they are both members and trustees, and therefore are actively involved in the SMSF's operation and able to access information about it at will.

Examples of this include:

(i) the equal representation rules between employers and employees do not apply;

(ii) the rules for member inquiries and complaint procedures do not apply;

(iii) there is no need to appoint a custodian or a manager to SMSF;

(iv) a wider class of persons may audit the SMSF. This is because the formal qualifications for an auditor are less rigorous;

(v) the information to be provided to members is less extensive. There is no need to provide members with details regarding income and expense allocations and the general requirements to provide formal information are more relaxed, since the members have access to this information on a daily basis; and

(vi) the trustees have nine months, rather than six months, from the end of the financial year to arrange for the audit to be completed and for the annual return to be prepared and lodged with the Regulator.

This means the costs of running SMSFs are lower than otherwise would be the case.

Documentation requirements

The SISA requires SMSFs to:

1. keep minutes of all trustee meetings, including meetings of the directors of a trustee company. This minute must be kept for at least ten years from the date of the meeting, but it is a good idea to keep them for longer;

2. keep complete accounting records. These records may be kept electronically provided they can be easily converted to paper. The accounting records must be kept for at least five years after the end of the relevant financial year;

3. keep a copy of the deed and amending deeds and similar documents; and

4. prepare annual accounts showing the financial position at the end of the year and the operating performance during the year.

Generally, these are minimum requirements. A wise trustee keeps more detailed records and retains them longer. But this is good management rather than a legal requirement.

PART 2.7: WHAT HAPPENS IF A SMSF BREACHES THE LAW?

A SMSF must be a complying superannuation fund to get the benefit of the tax concessions extended to superannuation funds as part of the Federal Government's retirement incomes strategy. If a SMSF seriously breaches the superannuation law it may become a non-complying fund and may lose the benefit of these tax concessions. It may also become liable for certain penalties, as may its advisors, particularly its auditors.

A lot of misinformation surrounds the issue of SMSF's becoming non-complying funds.

We have read statements like "if a SMSF makes an investment outside of its investment strategy then it becomes non-complying and has to pay 47% of its assets to the Tax Office". These statements are just wrong. Further, they ignore the practical reality that it is virtually unheard of for the Regulator to treat a SMSF as being a non-complying superannuation fund except in the most extreme cases. For example, in the ten years to 1998, only 3 SMSFs have lost their concessional tax status in recent years (source Business Review Weekly May 18 1998). This is not much when there are more than 300,000 SMSFs in Australia.

It is virtually unheard of for a SMSF to deliberately become non-complying. It just does not happen except in the most extreme cases, and this a place few people choose to go to and one we definitely recommend you stay away from. The ATO is, sensibly, most forgiving when inadvertent errors are made leading to non-compliance. It rarely plays a hard hand provided the error is corrected and does not reoccur.

When is a SMSF a complying superannuation fund?

A SMSF is a complying fund in a particular year, and is eligible for taxation concessions, if it has received a notice of compliance from the ATO for that year.

A SMSF is not a super fund if it has not received such a notice. If a SMSF is not a complying fund it will not be eligible for tax concessions and it will be liable to a tax penalty equal to 47% of its assets, less un-deducted contributions, at the start of the year it becomes non-complying.

Sub-section 41(2) of the SISA sets out where the ATO must issue a notice of compliance to a SMSF. It says that the ATO must do this where:

- the SMSF is a complying fund under the superannuation law; and
- the ATO has not given a notice under section 40 in relation to a previous income year; or
- the ATO has not given a notice under section 40 in relation to a subsequent income year in which the SMSF is a complying fund.

The ATO does not issue annual notices that SMSFs are complying funds. Rather it issues an initial notice when the SMSF is first formed (this is usually obtained for the SMSF by McMasters'). Thereafter it only issues a notice if requested to do so by the SMSF, provided the ATO has not issued a notice under section 40 that the SMSF is no longer a complying fund and it is a non-complying fund. Therefore, once a SMSF is formed and has obtained an initial notice that it is a complying fund it continues to be a complying fund unless it receives a notice from the ATO saying it is a non-complying fund.

This means SMSF compliance is a self-assessment system. The SMSF's auditor plays a critical role. The auditor must certify that the SMSF has complied with the superannuation law and this certificate is included in the annual return lodged by the SMSF with the ATO. If this certificate is not provided the ATO will issue a notice under section 40 that the SMSF is not a complying superannuation fund. If this happens the SMSF loses its concessional tax status and becomes liable to tax equal to 47% of its assets, less un-deducted contributions. The trustees and other persons connected to the SMSF may also become liable.

In most cases where the auditor does not certify that the SMSF has complied with the superannuation law, the ATO uses its discretion to determine whether the SMSF should be treated as a complying fund despite the breach of the superannuation law. This discretion is exercised having regard to the culpability of the breach, the taxation effect of the breach, the seriousness of the breach and all other relevant circumstances.

What must the auditor audit?

The audit can be broken into two parts. The first part is a financial audit and this relates to the correctness of the financial statements and related documents. The second part is a compliance audit and this relates to the SMSF's compliance with the SISA, and particularly whether the fund has not breached the various laws applying to SMSFs, for example, has not acquired an inappropriate investment, has not paid out member benefits in circumstances that breach the SISA.

Must the auditor report breaches of the superannuation law?

This is dealt with in section 129 of the SISA.

If an auditor believes that the SISA has been breached the auditor must inform the trustee in writing of the breach. The auditor does not have to do this if the auditor honestly believes the trustee is already aware of the breach, but a wise auditor will do so anyway.

The auditor must then report the breach to the Regulator if:

1. the trustee does not comply with the auditor's request for a report regarding the proposed or actual action to be taken in respect of the breach; or

2. the auditor is not satisfied with that action.

What happens if a SMSF does breach the superannuation law?

From time to time SMSFs will breach the superannuation law. Usually these breaches are not deliberate and in effect excused by the ATO, provided they are disclosed and are rectified as soon as possible. We have not seen the ATO no use its discretion favorably.

In practice, it is important for the SMSF to be able to show that the breach was inadvertent, not deliberate, and was rectified as soon as practicable once the SMSF became aware of the breach. For example, in the year ended 30 June 2000 a client SMSF with more than $1,000,000 lent the members' daughter $20,000 on commercial terms to help buy a car. The SMSF believed this investment was valid, because the loan was less than 5% of the SMSF's assets and therefore did not breach the sole purpose test. The SMSF did not realise that the investment would breach the rule against loans and other financial assistance to members. Immediately on being informed of the breach the SMSF arranged for the loan to be repaid. The auditors did not certify that the SMSF had complied with the law and specifically brought the breach to the ATO's attention.

The ATO exercised its discretion in favor of the SMSF. It was satisfied that the breach was not deliberate and that the SMSF had done all it could to rectify the breach once it was discovered. We expect that the situation would be different if the ATO had discovered the breach or if rectification had not been made.

What if the ATO does not exercise its discretion favorably?

We have never seen the ATO do this, but it were to not exercise its discretion in favor of the SMSF and refuses to deem the SMSF to be a non-complying fund, the SMSF may seek a review of the ATO's decision by the ATO. If the ATO still does not exercise its discretion in favour of the SMSF the SMSF may apply to the Administrative Appeals Tribunal (or equivalent) for a review of the ATO's decision under the administrative law.

The request to the ATO to review its decision is made under section 344 of the SISA. The request must be in writing, must set out the reasons for making the request and usually must be made within 21 days of the ATO's original decision. If this decision is unfavorable to the SMSF any application to the AAT for a review of the ATO's decision must be made within 28 days of the decision.

Specific legal advice should be sought in writing regarding these options if the ATO treats a SMSF as not being a complying SMSF.

Common problem areas

A SMSF may breach the superannuation law in any number of ways. In a paper on SMSFs delivered to the Taxation Institute of Australia in March 2001 Chris Kestidis of Hall and Wilcox, Lawyers, identified the following problem areas:

1. special income, a situation where the SMSF derives income from related parties, such as a company or a unit trust, on a non-arms length basis;

2. in-house asset rules, particularly those for investments in geared unit trusts; and

3. sole purpose test, particularly where assets have a second purpose of being available for use by members and family and friends.

We recommend SMSF trustees steer clear of each of these areas and do not take risks by investing in anything other than traditional investments. In fact our attitude to these areas is hardening year by year: trustees should not do anything which may breach the laws in any of these areas, no matter how attractive the opposite technical arguments may be. It is just not worth taking a risk in any of these areas.

Consequences of a SMSF becoming non-complying

If a SMSF ceases to be a complying fund it loses the tax concessions extended to complying funds and become liable to a tax charge equal to 47% of the value of its assets, less un-deducted contributions. If a SMSF with $1,000,000 of assets on 1 July 2004 becomes a non-complying fund then a tax charge of $470,000 will arise at that time.

(The logic behind the tax charge being based on the value of the SMSF's assets less un-deducted contributions is that this effectively reverses the tax concessions previously applied to the contributions received by the SMSF. In most cases it will go further than this, since the contributions are taxed at 15% and are possibly subject to the 15% superannuation surcharge. There is no adjustment for this, plus the underlying assets have probably increased in value, and this increase is subject to tax at 47% even though it may not have been realized. This makes the penalties very onerous indeed.)

This is a serious penalty, and although it is rare, it explains our conservative stance on so many issues: it's just not worth taking risks with SMSFs and their complying fund status.

Consequences for advisors

Advisors involved in setting up arrangements that contravene the superannuation law may also be liable to penalties under the SISA. In fact the Regulator is more interested in pursuing advisors who set the arrangements up rather than the SMSFs who participate in them. This makes a lot of sense, and is another reason why we are so conservative!

The Courts have supported the Regulator. For example, in one recent case it was said by the Court that: "I have particular regard to the need to fix penalties of sufficient magnitude to deter each of the respondents from any further conduct contravening the SISA, and to signify to the community at large the serious consequences that may flow from contraventions of the SISA, so as to deter others who are trustees of, or advisors to, regulated superannuation funds from engaging in such conduct". [FCT v Holloway (2000) FCA 1245]

The APRA (the responsible Regulator at the time this case arose) subsequently put out a public statement saying that "…this is a clear warning to accountants who promote schemes to avoid the application of the SISA, for trustees who engage such accountants and for auditors who audit the funds. …" (APRA press release dated 9 September 2000).

It is an unwise advisor who allows SMSF clients to stray into the grey where compliance issues are involved. Our suggested motto for SMSF advisors and trustees is: "If it's grey, run away".

PART 2.8 THE ATO'S ATTITUDE TO SMSFS

For many years SMSFs were enforced by the Australian Prudential Regulation Authority ("the APRA'). Nothing much happened. Looking back it is easy to see that the APRA was probably under-staffed and under-trained for the job of administering 300,000 superannuation funds. If it could not supervise the insurance giants how could it supervise small superannuation funds?

Most people knew the APRA was not handling SMSFs well and many advisors took advantage of the lax attitude, and to be fair to the APRA, lax laws. There was no effective sanction against a SMSF not complying with the law, and many advisors encouraged their clients to abuse the system and to rort the system.

Eventually in October 1999 the enforcement role for self-managed super funds with less than five members, ie the vast bulk of SMSFs, was taken off the APRA and passed to the Australian Taxation Office. The APRA remains responsible for other super funds.

The original appointment of the ATO was heavily criticized by some industry personalities, with "it's like putting Dracula in charge of the Blood Bank" the most memorable quote of the time. But these fears were un-founded. The first few years of the ATO's responsibilities were marked by a "more of the same" approach. The ATO has taken a deliberately educative approach and has proven to be most reasonable in all its dealings with the SMSF sector. Certainly our dealings with the ATO have been more than reasonable, and this seems to be the common view amongst accountants and solicitors in the SMSF field.

We do not think this is going to change.

But what is going the change is the ATOs' attitude to SMSFs that deliberately breach the superannuation law. SMSFs that deliberately breach the superannuation law, particularly in the area of premature access of benefits or inappropriate investments can expect an uncompromising ATO. This was made clear by the Commissioner of Taxation when on 18 August 2006 he issued a press release saying, amongst other things:

"Self-managed super funds are also singled out for attention this year. Through our data-matching activities we have identified 20,000 high risk funds and will be asking them to lodge outstanding tax and regulatory returns.

About 1,000 self-managed funds can expect to be audited this year as a result of compliance work. "

A similar message was sent when in May 2003 when in its publication "Future Directions in Tax Administration (A Relationship of Mutual Dependency) the ATO wrote:

"...since these (ie compliance and reporting obligations and managing one's own superannuation fund are relatively new undertakings for the members who also have the responsibility of being trustees, the ATO includes a strong education focus in its compliance activities. We would rather sit down with the trustees and unravel instances of non-compliance and set the fund back on the straight and narrow than enforce penalties. However, when we detect instances of multiple infringements or where the non-compliance is a blatant attempt to thwart the rules we will take a much tougher approach."

This message has been repeated in the press and at industry seminars and conferences since then. It boils down to this: the ATO will be helpful with inadvertent breaches of the law, but will take appropriate action, including imposing penalties, when it encounters deliberate breaches of the law. And one can surmise that this will be particular the case where the breach involves premature access of benefits and inappropriate investments.

The trustee's attitude

A wise trustee will have exactly the same attitude as the ATO. In particular, a wise trustee will make certain that his or her SMSF does not pay benefits to members prematurely and does not hold inappropriate investments. A wise trustee will also bear in mind that the super law takes a substance approach, rather than a form approach, to the law: various anti-avoidance rules apply to nullify any attempt to get around the black letter of the law.

The auditor/advisors' attitude

A wise auditor or other SMSF advisor will have exactly the same attitude as the wise trustee. There is just no sense in getting involved in a SMSF that is breaching the law, or moving close to a breach of the law. A good motto could be "if it's grey, run away", bearing in mind the experts who proffer alternative views always cover their bets and disclaim liability, and that the superannuation law places responsibility for SMSF compliance firmly on the shoulders of the trustee's and the auditor.

What is an "inappropriate investment"?

The phrase "inappropriate investment" is not defined in the superannuation law. In the context of SMSFs it means any investment that is an in-house asset, that is, is an investment with or a loan or lease to a member or a related person, subject to certain specific exceptions, or which breaches the sole purpose test, that is, has a purpose other than pure financial return, whether it be a familial, an aesthetic or a lifestyle purpose.

Looking at it from the other direction, we believe that "appropriate investments" are investments in listed shares, properties and cash and other forms of loans, and variations thereon, both in Australia and internationally. By "variations thereon" we mean managed funds, index funds, property syndicates, options, futures and other indirect or derivative ways of investing in listed shares, properties and cash.

We believe "inappropriate investments" include:

- art;
- wine;
- residential property in holiday locations;
- agricultural schemes, such as vineyards and olives; and
- co-ownership of properties with related persons and un-related persons.

Yes, it is possible for one of these investments to be held by a SMSF. For example, it could be that a 30 year old bottle of Hermitage Grange worth $10,000 will be worth $20,000 in five years time, and is therefore a good investment. But you can understand why the ATO would look twice, thwice or even audit a SMSF that buys wine. And it is a fact that if the wine is drunk, even tasted, it is likely that the SMSF has breached the sole purpose test. This means the SMSF may lose its concessional tax status, face a tax charge equal to 47% of its assets (other than un-deducted contributions) and its trustees and auditors face other penalties.

To be blunt, it is not smart to hold assets like wine in a SMSF. The risk is too high. It makes more sense to hold an asset like wine in an individual's name or a family trust's name, where there are no risks, than it does to hold it in a SMSF.

The SMSF should only invest in assets where there is no risk that the ATO will challenge the trustees' decision. And there is no risk of penalties.

What is the sole purpose test?

The sole purpose test states that a SMSF must be run for the sole purpose of providing retirement benefits to members. This boils down to saying that the SMSF must be run for the sole purpose of achieving maximum investment returns for members, since this maximizes their retirement benefits.

This can be broken down further into two sets of purposes. These are core purposes and ancillary purposes. The core purposes all relate to retirement and include:

- paying a lump sum benefit or a pension benefit to members after retirement from gainful employment after age 55;

- paying a lump sum benefit or a pension benefit to members after attaining age 65; and

- paying a lump sum benefit or a pension benefit to dependants of a deceased member after the death of a member.

Certain ancillary purposes are permitted. These purposes to some extent conflict with the core purposes, but have been permitted because of an over ring public interest. The permitted ancillary purposes are:

- disability benefits on a member being either permanently or temporarily disabled, in the sense of not being able to do their normal work;

- severe financial hardship (very limited); and
- welfare and compassionate grounds, such as a terminal illness.

The sole purpose test is invariably discussed in the context of SMSF investments. A concern may arise that the SMSF trustees have a purpose other than the members' retirement for acquiring or retaining an investment. The issue is best considered using a series of examples. Each of these examples is based on situations that have been described to us by potential clients. In each case we chose not to act for the SMSF.

Example 1

The Mum and Dad Fund buys an apartment in Melbourne close to RMIT. They lease the apartment to a friend of their daughter, who then sub-leases a room to the daughter. Both the daughter and the friend pay an arms length rent.

Analysis

At least one purpose of buying the apartment was to provide the trustees' daughter with a nice and safe home close to RMIT. This breaches the sole purpose test and the MDSF is now a non-complying fund. The lease/sub-lease arrangement will be seen by the ATO as a deliberate contrivance, and will increase the chances of heavier penalties applying.

The MDSF has also breached the in-house asset test. Mum and dad should have used the Mum and Dad Family Trust to buy the apartment.

Example 2

The Connorsores Fund buys $20,000 of wine, as an investment. The wine is stored in the trustees' home and is "occasionally" sampled in the company of good friends to make sure it is "compounding nicely as an investment". The purchase was based on advice received from a recognized expert, Ken Mevans, though his weekly column in the Wine Lovers Gazzette.

The auditor, a trusted friend and occasional dining companion, Fred Foody, had signed the audit report each year, and had suggested the wine be described as "Other Liquid Investments" in the CSFs' balance sheet.

Analysis

The CSF has breached the sole purpose test and is a non-complying fund. The CSG faces serious tax penalties. Fred Foody, auditor, also faces penalties. The trustees should have bought the wine in their own name using their own money and should not have involved the CSF. The auditor should have known better.

Example 3

The Lazy Daze Fund buys a three bedroom apartment on the beach at Lorne. The trustees never use the apartment for personal reasons. But check it regularly in

January each year, and odd weekends during the year, to make sure it is being maintained properly and is performing well as an investment. Because of the distance from home they have to stay overnight, sometimes with friends and family who help with maintenance.

The LDSF has breached the sole purpose test. The facts show that the apartment was bought for at least a secondary purpose of enjoying a holiday, and this means the sole purpose test is not satisfied.

Hiding a secondary purpose

We are sometimes asked what can be done to proposed arrangements like these three examples to make sure they are seen as passing the sole purpose test while still allowing the trustees to enjoy the secondary purpose. Our response is always "nothing, and if you try to do this you only make the breach worse, and invite stiffer penalties: the contrivance highlights the intention of the breach".

We instead suggest that these investments be made in the trustees' personal names (ie not in their capacity as SMSF trustees) using their own money or that a family trust be set up to acquire and hold the investment.

Case law on the sole purpose test

There is not much case law available dealing with the sole purpose test. The only major case involved a McDonald's franchisee using the store's staff fund to buy a Swiss ski chalet, a beach house at Sorrento on Victoria's Mornington Peninsula and a golf club membership. The court held that the fund was not maintained for the sole purpose of providing retirement benefits to members and had another purpose of providing fringe benefits to the trustees, their family and friends.

The importance of the investment strategy

When asked to opine on intention, or purpose, the courts will give little weight to statements from the person who claims to have had the requisite intention. Instead, the court will give weight to facts including documents that existed at the time the relevant act took place. For example, if a SMSF bought $50,000 shares in Coles Myer for the purpose of receiving dividends and enjoying an increase in their value then the trustees' use of the shareholders' discount card would not be a problem. This is particularly since the value of the shares held far exceeds the minimum holding for the discount card. But if the trustees bought say $1,000 of Coles Myer shares so they could get the shareholders discount card, there will be a problem with the sole purpose test.

It is critical that all investments be made in line with the investment strategy, and if necessary the investments strategy be adapted if an unusual investment is contemplated.

A more expansive commentary on the investment strategy is provided part 5.4.

The ATO's likely approach to investment strategies

If an SMSF is selected for audit it the ATO will certainly look at its investment strategy.

The trustees must be able to show the ATO that a written investment strategy has been formulated, observed and up-dated if necessary, reflecting the changing investment environment and the changing circumstances of the members.

Formulating the investment strategy

Some SMSF trustees see the preparation of the investment strategy as being a more formality. It is not a mere formality and will be critical part of any ATO audit. The age and circumstances of the members need to be considered, as do their risk preferences. There is no doubt SMSF trustees can prepare an investment strategy themselves following the precedents and commentary in this manual, and similar materials that are available elsewhere. But for larger SMSFs or SMSFs where the trustees have less confidence in their investment abilities it can make sense to use an investment advisor.

The key points of interest for the ATO will be:

- to sight the investment strategy and to ensure it has been properly documented in the SMSF's record of the trustees' meetings; and

- to ensure it has been disclosed to members: bearing in mind that the trustees are also the members it seems an odd requirement. But an appropriate choice of words in the minute of the meeting of the trustees to adopt the investment strategy should be sufficient to prove this point.

The standard minutes of a meeting of the trustees to adopt the investment strategy included elsewhere in this manual are sufficient to satisfy these requirements.

Observing the investment strategy

The ATO will not only check that the investment strategy has been formulated correctly and provided to members. It will also examine whether the investment strategy has been followed by the trustees.

The actual investments must be consistent with the investments described in the investments strategy, subject to common sense tolerance limits. For example, if the investment strategy says that at least 80% of the SMFS's assets should be invested in Australian shares paying at least 70% franked dividends, and it turned out that the average for the year was 78% and the franking percentage was 65%, there is probably not a problem. But if the trustees had simply ignored the SMSF's investment strategy and invested 100% in a commercial property, there probably is a problem.

However, we are reluctant to say that the ATO will impose penalties in this situation. It may. But its May 2003 statement, reproduced in part above, suggests it is more likely to sit down with the trustees and "help them unravel" the problem, and "put

them back on the straight and narrow". Perhaps a warning is more appropriate, coupled with a direction to correct the written investment strategy, or the perhaps the actual investment strategy, so that the policy objective of ensuring trustees consider what they are doing is satisfied.

Up-dating the investment strategy

This brings us naturally to the final point, has the investment strategy been up-dated?

Members' circumstances change. So do investment conditions. Whereas an un-hedged international investment may not have made sense in 2006, given the then low Australian dollar against the US dollar, it may make sense in early 2004. The SMSF's investment strategy will ideally show that the trustees considered this, even if they did not act on it.

PART 3.1: SUPERVISION BY AUDIT AND THE PENALTY MECHANISM

Audit requirements

All SMSFs must be audited each year. This is a critical part of the control function, since auditors are under a duty to report breaches of the SISA to the Regulator. It is preferable to use an auditor who specializes in SMSFs, since this lowers costs and ensures a more thorough job is done.

Who can be an auditor?

The auditor must be any one of the following:

(i) a registered company auditor under the Corporations Law;
(ii) a member of the Australian Association of Certified Practicing Accountants;
(iii) a member of the Institute of Chartered Accountants in Australia;
(iv) a member of the National Association of Tax and Management Accountants;
(v) a member of the National Institute of Accountants; or
(vi) a fellow of the National Tax and Accountants Association Ltd.

Supervision by audit

The auditor must report breaches of the SISA to the trustees under special "whistle blowing' rules. If the trustees do not fix the problem the auditor must report the breach to the Regulator: this combined audit and reporting role provides the key to the government's supervision of SMSFs. It is supplemented by regular audits.

Annual returns

All SMSFs must lodge a return with the Regulator each year. This return includes a signed certificate from the auditor advising that the fund has complied with the superannuation law during the year. The return must be lodged within nine months of the end of the financial year. In most cases this is 31 March in the following year, but can be up to May under a tax agents' lodgment program.
The supervisory mechanism: management by exception

The Regulator uses the annual return, and the attached audit certificate, to decide if a SMSF has complied with the SISA. This certificate is also used to determine if further information regarding the fund is needed before a decision can be made. Only complying funds are eligible for tax concessions. These concessions are the carrot driving the regulation of SMSFs: if the auditor is not able to certify the trustees have complied with the SISA then the SMSF will not be eligible for tax concessions. The stick is the 47% tax on the opening value of assets (less un-deducted contributions) and the risk of civil or criminal penalties for the trustees.

Trustee penalties

The Regulator may apply penalties other than the issue of a certificate of non-compliance. Depending on the nature of the breach:

(i) the SMSF may be liable to a penalty;
(ii) the trustee may be liable to the members for losses suffered by the SMSF; or
(iii) third persons, such as auditors, may be liable for losses.

There are five types of SISA breach. These are breaches of the statutory covenants, the strict liability provisions, the fault liability provisions, the civil liability provisions and the criminal liability provisions. The classification of a breach depends on the particular SISA provision. The penalties for a breach depend on the nature of the breach. Briefly:

(i) a breach of a statutory covenant does not in strictness expose a trustee to penalties but gives aggrieved persons a right of recovery;
(ii) strict liability provisions. The state of mind of the trustee is not relevant here. Examples include acquiring an asset from a member or making a false statement to the Regulator. The penalty is a fine and, in extreme cases, gaol;
(iii) fault liability provisions. The trustee must "knowingly, intentionally or recklessly" breach the law. Most are administrative in nature. The penalties are usually fines;
(iv) civil liability provisions. The Regulator may prove a breach of the SISA on the balance of probabilities. Examples include a breach of the sole purpose test. The penalties include fines of up to $200,000 and compensation orders; and
(v) criminal liability provisions. This is the most serious breach and requires an intention to deceive or defraud. The penalty can be gaol for up to five years.

PART 3.2: TRUST DEEDS

Introduction

The simplest and cheapest way to obtain a trust deed for your SMSF is to order one from from McMasters'.

What documents are required?

The specific documents required to start a SMSF are:

1. a trust deed. This controls the SMSF;
2. a minute recording the resolution of the trustee to create the SMSF;
3. members' application forms;
4. employer sponsor application forms;
5. ATO notice, including:

    - the date the SMSF was created,
    - the full name of the SMSF,
    - the full address of the SMSF,
    - the details of the contact person, and
    - the full details of the type of SMSF;

6. election to become a regulated fund to be lodged with the ATO;
7. tax file number application forms;
8. an Australian Business Number application; and
9. a bank account "kit" including documents needed to open a bank account.

Trust deeds

The deed sets out the rules governing the SMSF. These include rules that:

(i) control who can be a trustee and who cannot be a trustee, what the trustee can do, what the trustee can't do, how the trustee can retire and a new trustee be appointed, what the trustee can be paid and so on;
(ii) describe who can be a member;
(iii) describe what contributions can be accepted, and from whom;
(iv) describe the lump sum and pension benefits, and how they are calculated, on retirement, on death or permanent disability, or on serious financial hardship;
(v) describe how the decisions of the trustee should be made;
(vi) facilitate the preparation and implementation of an investment strategy; and
(vii) allow members access to all relevant fund documents.

Relationship between the trust deed and SISA

A good trust deed will include a general rule saying the SISA (and other relevant superannuation and taxation laws) is deemed to be included in the deed. In the event

of conflict with the specific provisions of the deed, the deemed provisions will have priority. Further, the specific powers of the trustee will be limited by a general rule that the trustee is not permitted to do any act or thing or omit to do any act or thing that may breach the SISA (and other relevant laws).

These provisions may make the deed harder to read, since the trustee has to be familiar with both the superannuation law and the trust deed to make sense of the deed. But this is a small price to pay to avoid an inadvertent breach of the law and constant changes to the deed as the law changes.

Are different deeds required for different funds?

The answer to this question is normally "no". The exception arises in large funds but, since this manual only deals with SMSFs, this exception is not relevant here. A well-drafted deed permits the SMSF to in effect operate as:

(i) an employer sponsored fund;
(ii) a self-employed fund;
(iii) an allocated pension fund;
(iv) a superannuation fund paying lump sum benefits; or
(v) a superannuation fund paying pension benefits.

This creates flexibility and means frequent deed amendments are not required.

How is the deed formally adopted?

The deed must be executed (ie signed) by the trustee and by any employer sponsor. If the trustee is a company it must execute the deed by having the directors sign the deed. An appropriate minute of a meeting of directors should be filed to record this and an appropriate entry must be made in the company's minute book. An independent person should witness the signature of each individual trustee or the application of a corporate trustee' seal.

Often a company trustee will also seal the deed. But this is no longer a Corporations Law requirement. The directors' signatures will suffice.

PART 3.3: THE TRUSTEE

The trustee

The trustee is responsible for making sure the SMSF is conducted according to its deed and the SISA and all the other relevant laws are observed. The trustee must comply with a number of minimum requirements under the law. These require the trustee to show utmost good faith to the members. This is the highest duty imposed by the law. It means the trustee must put the interests of the member ahead of its own interests. This requires the trustee to act with a very high degree of honesty, prudence and probity at all times.

A person should not be a trustee unless they understand the duty of utmost good faith and are prepared to abide by it.

The general duties of a trustee

The general duties of a trustee include the duty to:

(i) act honestly at all times in all matters relating to the SMSF;
(ii) allow members access to all materials concerning the SMSF;
(iii) keep the SMSF's assets separate to other assets;
(iv) prepare and implement an investment strategy; and
(v) abide by the terms of the trust deed.

The particular duties of a trustee

More particularly, the duties include the duty to:

(i) lodge the annual return with the Regulator;
(ii) arrange for the appointment of an auditor;
(iii) treat each member fairly and impartially;
(iv) ensure the SMSF operates for the sole purpose of providing retirement benefits to members, that is, to make sure the sole purpose test is observed. This includes only investing on an arms length basis;
(v) to abide by the law and the general law and to obey any directions given by the ATO or a court and to rectify any breach as soon as possible;
(vi) to not borrow money except in the limited circumstances permitted by the law;
(vii) to ensure there are no in-house assets above the prescribed limits;
(viii) keep records of all financial transactions and members' benefits and maintain minutes and other documents relating to all decisions made by the trustee;
(ix) not to acquire assets from members or relatives of members or from certain companies and trusts except as permitted by the law;
(x) provide all appropriate reports and statements to members on joining the fund, each year and on members leaving the SMSF;
(xi) only accept contributions for persons who are members of the SMSF;
(xii) prepare and implement an investment strategy dealing with risk, expected returns, liquidity and diversity of investments;

(xiii) to not profit directly or indirectly from dealing with the SMSF or its assets; and
(xiv) to exercise the skill and judgment an ordinary person exercises when dealing with assets belonging to another person to whom a fiduciary duty is owed.

Who cannot be a trustee?

A person cannot be a trustee if they have been convicted of a crime involving dishonesty,
penalised under the civil rules contained in the SISA, or are currently "under administration": the best example of this is bankruptcy.

A corporate trustee may not have such a person as a director. A trustee must resign if any of the events, noted above, occurs. The Regulator may remove a trustee if any of the events noted above occur.

The Regulator may remove or suspend a person as a trustee if it believes the person may breach the SISA or may do something to prejudice the financial position of the SMSF. The Regulator may give special permission for a person, excluded from being a trustee under items (I) to (iii) above, to be a trustee in some cases.

SISA penalties

Trustees face heavy penalties if they intentionally breach the SISA: this is not as fearful as it first sounds. These penalty rules are really only triggered if there is a deliberate intention to misuse the assets of the SMSF against the interests of the members. The Regulator virtually never uses them.

When do you need a corporate trustee?

If the sole or dominant purpose of the SMSF is providing pension benefits the trustee can be either two individuals or a company. If the sole or dominant purpose is providing lump sum benefits the trustee must be a company. It's hard to see the logic behind this rule. This is because there really isn't any: the rule is there because of constitutional limits on the power of the Federal Government to regulate superannuation unless either a corporation or a pension is involved. The Federal Government does not have any power over superannuation as such, but it does have power over corporations and pensions. It controls superannuation indirectly through its powers over corporations and pensions. Unless this rule is in place the SISA would be invalid. In practice nothing much turns on this. Almost all SMSFs have a dominant purpose of providing pensions. This is a standard drafting technique designed to avoid technical problems. In most cases two individuals, typically “Mum and Dad” are the trustee of the SMSF.

Which is best, an individual trustees or a corporate trustee?

The solicitor's answer should be "a dedicated corporate trustee that does nothing other than act as the trustee of the SMSF". This helps keep the SMSFs assets separate from other assets and ensures they are protected at all times. It avoids problems of having to prove the individual trustees own the assets in their capacity of trustees of the SMSF rather than in their personal capacities.

But most SMSFs have individual trustees, typically "Mum and Dad". The percentage is more than 95%. This appears to be because of the cost of setting up and maintaining a corporate trustee (about $1,000 to set up and at least $500 a year to run). But individual trustees are will not the best option if they are at risk of getting into financial trouble. Perhaps the best approach is to keep an eye on things and be ready to replace individual trustees with a corporate trustee should the need arise, for example, if an individual trustee gets into financial difficulty.

Can one person be the sole trustee and member?

This is a common question. The answer to it is "no". This is because there is no separation of legal and beneficial ownership, which is an essential requirement of trust law. This means there is no trust at general law. If there is no trust at general law, there cannot be a superannuation fund. This is a general rule that applies to all trusts, including SMSFs. It reflects a basic concept of trust law: legal ownership and beneficial ownership must be separate for a trust to exist. This is not the case if the same person is the sole trustee and the sole member.

Sometimes a person will want to set up a SMSF for just that person. That person cannot be the sole trustee if that person is also the sole member. The solution is to use a corporate trustee owned by the member, or to have a relative act as a second individual trustee. The new rules from 1 July 1999 allow an extra person to be a trustee of a SMSF with only one member provided they have a family or business link to the member.

Can a corporate trustee do other things?

The answer to this question is "yes, but we do not recommend it". A corporate trustee can wear more than one hat. For example, it may also be the employer of the members or the trustee of another trust in the employer's group.

If the company is in trouble with its other cap this can have adverse implications for the SMSF. Hence we recommend the corporate trustee does not wear another hat. The corporate trustee should be a dedicated trustee and not be involved in other matters.

PART 3.4: CHECKLIST - STARTING A SMSF

In most cases McMasters' attends to these matters for the trustees, but they are still the responsibility of the trustees. This list is not in chronological order.

1 Determine who will be the members and who will be the trustees.

2 Execute a trust deed. A solicitor must prepare the deed. To execute the trust deed the trustees must sign and date the deed.

3 The member completes a member's application form.

4 If there is an employer sponsor, the employer sponsor signs the deed and completes an application to become an employer sponsor.

5 The employer contributes to the SMSF, the member contributes to the SMSF or existing benefits held in another fund are rolled over into the SMSF. The SMSF does not commence until one of these three events has occurred (since without trust property there cannot be a trust).

6 A tax file number request and an ABN application is lodged with the ATO and an application to register as a regulated fund is lodged with the ATO within 60 days.

7 The trustees open a bank account in the name of the SMSF. This may be, for example, something like "Joe Smith as trustees of the Smith Superannuation Fund". The trustees will need to provide a signed copy of the deed and pass a "100" point identity check. A corporate trustee will also have to show a copy of its constitution and prove the identity of its directors.

8 A register is created to record the minutes of meetings of the trustees. This is normally a ring binder that includes copies of the trust deed, and all other documents to run the SMSF and a copy of all trustee minutes and the accounts of the SMSF.

9 An administration system is created to record the financial position of the SMSF and the details of member's benefits. This need be nothing more than the correct completion of all cheque butts and the filing of all documents relating to the SMSF, eg the CHESS records for the purchases and sales of shares.

10 The trustees provide members with certain information regarding the SMSF.

11 The Trustee signs a statement saying he or she understands the duties of a SMSF trustee.

PART 3.5 SAMPLE COVERING LETTER TO A NEW SMSF CLIENT

18 May 2010

Dr Smith
9 Smith Street
Smithsville Vic 1111

Dear Dr Smith

THE SMITH SUPERANNUATION FUND ("THE FUND")

Thank you for your instructions to set up the Fund.

Signing of documents

The documents to set up the Fund are attached. Could you please peruse them and, if satisfied the details are correct, sign where indicated and return the documents to us as soon as possible. Once we have them back we will file them on the Fund's files or forward them to the Commissioner of Taxation as appropriate.

You should keep one copy of the deed. You will need this to open the bank account.

Please do not hesitate to contact us should these documents be unclear or should you wish to discuss them in any way.

The documents

The documents are as follows:

1 two copies of the Fund's trust deed;
2 a minute to record the acceptance of the trusteeship by the trustees;
3 a minute recording the membership applications and the adoption of an investment strategy by the trustees;
4 a consent by the trustees to administer the Fund in accordance with the superannuation law and the trust deed;
5 applications for membership forms to be signed by each member;
6 death benefit nomination forms;
7 letters to be signed by a trustee confirming the acceptance of the members;
8 a minute recording the preparation of an investment strategy;
9 a draft investment strategy;
10 a tax file number application;
12 an election to become a regulated superannuation fund; and
13 an application for an ABN.

Tax file number, ABN and registration number

We will forward details of the Fund's tax file number, ABN and its registration number to you as soon as we receive them.

Bank account

You will need to open a bank account or cash management trust account (or a similar account) for the Fund. Most clients opt for a cash management trust account because of the higher interest rate. You should make sure the account has a cheque book because this makes its administration easier. The account should as far as possible be used as a primary record and all receipts should be banked into it and all payments made out of it. Special accounts like brokers' accounts are an exception, and can be used to handle all share transfers without involving the main bank account.

To open an account each trustee should provide the bank with 100 points of identification for each trustee (or director, if the trustee is a company), a copy of the Fund's trust deed and, if the trustee is a company, a copy of its constitution. The name of the account should be the names of the trustee followed by exactly the name of the Fund. As an example for a fictitious fund, the name could be:

(i) in the case of individual trustees, "Bill Smith and Betty Smith as trustees of the Smith Superannuation Fund"; or
(ii) in the case of company trustees, "Smith Holdings Pty Ltd as trustee of the Smith Superannuation Fund".

A tax file number is not required to open the account. However, tax will be withheld from any interest payments until the tax file number is provided, so it is a good idea to provide the tax file number to the bank as soon as it is available.

Purchase of investments

The Fund's investments should show the name of the Fund exactly as it appears on the bank account. This is not strictly required under the superannuation law, but is recommended by the Regulator to help keep the Fund's affairs in order. It is a constant reminder that the investments belong to the Fund and not to the members.

This means if you place an order to buy shares the name of the shareholder should be "Bill Smith and Betty Smith as trustees of the Smith Superannuation Fund". Sometimes there are insufficient spaces on the form to include all the letters in the Fund's name and here an abbreviation such as "B&B Smith atf the Smith Super Fund" or similar is acceptable. Getting the name right is very important and you should never acquire an asset for the Fund in your own name.

Investment Strategy

The Fund must adopt an investment strategy if it is to comply with the law and be eligible for income tax concessions. A draft investment strategy and related documents are attached. Please complete it and return it to us for retention on the Fund's files. Alternatively, leave it blank and we will complete it for you based on the actual investments of the Fund at 30 June.

Transfer of other superannuation monies to the Fund

If you are transferring existing superannuation benefits to the Fund you should:

(i) contact the other fund and ask for benefit transfer forms to be sent to you;

(ii) complete the forms specifying the Fund as the transferee fund;

(iii) return the forms to the other superannuation fund; and

(iv) once the cheque is received, bank it into the Fund's bank account.

The other fund may require proof the Fund is a complying fund before transferring the benefits to the Fund. This can often mean you have to provide a copy of the Fund's trust deed, a letter from the solicitor who set up the Fund or similar documents before the payment is approved. requirements differ from fund to fund. In exceptional cases a copy of the Fund's certificate of compliance may be required.

Some managed super products include life insurance. You may need to make alternative insurance arrangements before transferring any such benefits to the Fund. We suggest you speak to Adrian McMaster to arrange alternative cover should you wish to maintain the life insurance.

Please contact us should you have any difficulties in completing the transfer of benefits to your Fund. In some cases the other fund may require proof that your fund has been set up as a complying fund. In this case please provide me with the name and address, including fax number, of your contact at the other fund. I will write to them direct by fax advising that I set the Fund up as a complying fund and that it is in order for the other fund to transfer your benefits to the Fund.

Annual accounts, audit and tax return

We will contact you after 1 July to advise what information is required to be provided to us to complete the annual accounts, audit and tax return.

Nominated consultants

The consultant handling your file is Brett Rose. Please contact Brett regarding the day-to-day questions regarding the Fund and what it can and cannot do. Obviously I am available at all times but contacting Brett in the first instance will help ease my work flow and keep the costs of running the fund down.

Please contact us should you wish to discuss any aspect of the Fund's operations.

Yours faithfully

Terry McMaster
Solicitor & Consultant

PART 4.1: THE SOLE PURPOSE TEST

What is the sole purpose test?

A SMSF must be run for the sole purpose of providing retirement benefits to members. A "superannuation fund" is not a superannuation fund if it isn't run for the sole purpose of providing retirement benefits to members. It will be a trust, and it will exist at general law as a trust, but it will not be a superannuation fund.

Contributions to a SMSF that fails the sole purpose test will not be tax deductible to the payer. The SMSF's income will be taxed at 47%, not the concessional rate of tax of 15% generally applying to SMSF income and 10% generally applying to capital gains. The SMSF's assets, less un-deducted contributions, will be taxed at 47%.

In other words, a SMSF that fails the sole purpose test faces a risk of heavy tax penalties. These are discussed in part 2.6 of this manual.

What is the regulator's view?

The APRA described the sole purpose test as:

"The principle underlying the respective sole purpose tests requires that any investment is undertaken for the sole purpose of providing retirement or retirement related benefits for members or dependents and that any other benefits or advantages are merely incidental or ancillary to achieving this sole purpose. This is a test of purpose and therefore is a matter best assessed by the trustees. However, where identified external circumstances suggest that the purpose of an investment may not be solely for provision of retirement related benefits APRA will closely examine the activities of the trustees. An example of such circumstances could be an investment proposed by, or to suit the circumstances of a member or employer."

(Para 34 of APRA circular dated November 1993 "Investments by Super Funds")

In other words, a SMSF should be run for the sole purpose of providing retirement benefits. Any other purpose should be only incidental or ancillary to this dominant purpose. The test is subjective, and is best applied by the trustees. But if it appears that there may be a purpose other than providing member retirement benefits, particularly one that produces other benefits for members, the Regulator will investigate the SMSF.

Section 62 of the SISA

Section 62 of the SISA takes the concept of the Sole Purpose Test further. It provides that the trustees of a SMSF must ensure that the fund is maintained solely for one or more of the "core purposes" and one or more of the "ancillary purposes".

In summary, section 62 says that the SMSF's core purpose must be to provide retirement benefits, specified age benefits and pre-retirement death benefits. In certain situations ancillary benefits are permitted including resignation/retrenchment benefits, disability benefits, welfare benefits and post retirement death benefits.

Purpose of producing tax benefits

A problem occurs where a secondary purpose of establishing a SMSF is to obtain a tax benefit on contributions. Given the deliberate tax incentives extended to SMSFs, it is artificial and unconvincing to say that a SMSF is been set up for, literally, the sole purpose of providing retirement benefits and there was no purpose connected to tax benefits. The courts have found that the sole purpose test merely requires the provision of retirement benefits to be the dominant (compared to "the only") purpose. Therefore a secondary purpose of obtaining tax benefits does not breach the sole purpose test.

Further, when applying the sole purpose test one must examine the conduct of the SMSF, not the conduct of the person contributing to the SMSF. Hence an employer's tax driven contributions will not prejudice the SMSF's compliance with the sole purpose test. It is the SMSF that must satisfy the sole purpose test, not the member or the employer.

The sole purpose test is a subjective test that requires an examination of the trustees' purpose as evidenced by their acts and statements. Problems typically arise where the SMSF has another relationship with the member or a related party, for example, owns business premises leased to the member, or buys assets from a member. Here wise trustees will carefully document their actions to ensure they can prove the sole purpose test was observed and that no other purpose influenced their actions.

Lifestyle assets are also a problem. Residential properties in holiday areas, jewellery, wine, art, collectibles etc are all problem areas. Our standard recommendation is "Do not own them in your SMSF. It's just not worth the risk. If a particular lifestyle asset has a particular investment value, then great, buy it in your own name, or in your family trust's name. Just don't involve your SMSF."

The arms length test

The arms length test is not a statutory test in the sense the sole purpose test is. It does not have a statutory basis in the SISA or elsewhere. But it is often spoken of in the same breath as the sole purpose test. This is because where a SMSF deals with a member it will often break the sole purpose test if the transaction is not made on an arm's length basis.

This test has been described by the APRA as follows:

"Both the OSSA (the predecessor to the SISA) and the SISA legislation require that all fund investments are to be made on an arm's length basis (ie on normal commercial terms). The purchase or sale price of an investment should be at full market value and the income received from that investment should also reflect a true market rate of return.

While especially important for small funds where employers and members are related, this provision does not prohibit commercial transactions between associated parties. That is because the arms length requirement relates to the terms of the investment not the relationship between the parties involved. Accordingly, provided a commercial rental is paid, there is nothing to prevent a fund's investment strategy from including the acquisition of an asset from an arms length third party and subsequent lease of such an asset to an employer, employer sponsor or member.

Neither would the rule prevent the commercial rate lease back to an employer or a member of an asset acquired from an associated party. However, the sole purpose and the prohibition on acquisition from members outlined above may impose specific restrictions on certain transactions with employers and members.

Where it is considered appropriate, APRA may call for evidence to substantiate that such arrangements have been entered into on a commercial basis."

(Para 19 to 22 of APRA circular November 1993 "Investments by Super Funds").

In other words, the Regulator says:

(i) transactions between a member and a SMSF or an employer and a SMSF, (ie "related party transactions") are possible and do not necessarily breach the sole purpose test;

(ii) related party transactions must be at arm's length. This means, for example:

(a) if a SMSF buys shares from a member or a related party the price paid must be the market value, and in particular must not be above the market value of the shares;
(b) if a SMSF sells a property to an employer, the price paid must be the market value of the property and in particular must not be below the market value of the property;
(c) if a SMSF rents a property to a member, the rents paid must reflect market prices and, in particular, must not be below market prices; and
(d) if a SMSF leases equipment to an employer the lease rentals should reflect the market rate of interest, the lease term and any residual payment (legal advice should be sought before doing this); and

(iii) evidence should be created and kept by the trustees to prove the related party transactions were made on an arms length basis. This is because in appropriate cases the Regulator will require this evidence before it accepts the transactions are at arm's length and do not breach the sole purpose test.

What ground rules should be followed?

Following some basic ground rules helps ensure related party transactions do not breach the sole purpose test. Trustees should assume their conduct will be examined by the Regulator and make sure all aspects are documented properly so observance can be proven at a later date if necessary.

External evidence for the sole purpose test

Before an asset is sold to or bought from a SMSF make sure the price can be shown to be market value. Market value is the price a willing but not anxious (and unrelated) vendor and seller would agree on if they were the parties to the deal. The best proof of market value is a formal offer to buy from an unrelated party. Written valuations from appropriate professionals are useful too. At the least ensure comparable sale information or rental yield information is on record to support the transaction price. The same rules apply for leases. But the records should be up-dated for each year the transaction is on foot. (SMSFs must comply with s66 of the SISA. This section prevents SMSFs from acquiring assets from members unless they are listed shares and other securities or "business real property". Section 66 of the SISA is discussed in part 5.1 of this manual.)

Internal evidence

As indicated above, the trustees should make sure their decisions, and the reasons for them, are minuted and filed. The investment strategy should be consistent with the decisions made by the trustees. We recommend clients fax these records to McMasters' so a back up copy is kept. This means the trustees can prove the minutes were created at the appropriate times and places.

PART 4.2 THE VESTING RULES AND THE PRESERVATION RULES

The vesting rules

"Vesting" describes the process by which a member becomes legally entitled to receive a benefit either now or some time in the future. The SISA requires trust deeds to meet minimum vesting requirements if the SMSF is to be a complying fund. Since the members control the SMSF and are normally also the trustees, there is very rarely a problem with vesting rules. In virtually all cases all contributions and roll over amounts vest fully in the member. The member is entitled to the benefit. Full stop.

The preservation rules

The preservation rules regulate the time at which benefits can be paid, in the case of lump sum benefits, or the time that benefits can start to be paid in the case of pension benefits.

Trustees must comply with rules for the preservation of member benefits. These rules are set out in the SISA. A trustee who breaches these rules may be penalized under the SISA and the SMSF will lose its complying fund status and be exposed to tax penalties.

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There are three classes of benefits for preservation purposes. These are: preserved benefits; restricted non-preserved benefits; and unrestricted non-preserved benefits.

The importance of records

The creation and retention of records to verify preserved benefits at 30.6.99 is important. These typically include the SMSF's own records and the rollover notification forms provided to the SMSF/member when rolling benefits into the SMSF from other entities.

Under SIS Regulation 6.15, contributions are presumed to be preserved unless the SMSF can show they are not preserved, ie, are not within the above seven categories of benefits.

Schemes to circumvent the preservation rules

The preservation rules are intended to ensure that SMSF members only access their superannuation benefits when a 'condition of release' is met, such as retirement, permanent incapacity or severe financial hardship.

Recently a number of schemes emerged which attempt to allow SMSF members access to their benefits before an appropriate condition of release has occurred. The ATO is aware of these schemes and has warned SMSFs that breaches of the preservation rules will lead to the SMSF becoming a non-complying fund and penalties against the trustees and any advisor who encourages or facilitates the breach of these rules.

The consequences of a SMSF becoming a non-complying fund are set out in detail in other parts of this manual. The law gives the ATO a range of enforcement options against the SMSF's trustees, which ultimately include heavy fines and gaol sentences.

At what age must benefits begin to be paid?

There is now no mandatory age for starting benefits. Members can leave their benefits in the SMSF for as long as they like and do not have to start drawing pensions at age 65, or up to age 75 if still in the workforce.

We expect in most cases people will start drawing their benefits at age 60, since this means the fund's earnings and the pension income is tax free.

Members can also start a transition to retirement pension at age 55.

Specific legal advice should be sought before starting a pension.

PART 4.3: THE SUPERANNUATION GUARANTEE LEVY

Introduction

The Superannuation Guarantee Assessment Act started on 1 July 1992. This Act is a major part of the Government's retirement savings policy. Under this Act employers are required to provide a minimum level of superannuation support for each employee. This is known as the "Superannuation Guarantee Levy" ("SGL"). If employers fail to do this they are liable to penalties. The penalties reflect the benefits not provided plus administration costs and an allowance for lost earnings.

SGL contributions are generally deductible. SGL penalties are not deductible.

Many employers voluntarily pay contributions exceeding the prescribed minimums, ie now 9% of "salary and wages", as defined. These voluntary contributions count for the SGL and no further contributions are required. For this reason we keep our comments brief. The SGL is a topic that rarely produces problems.

What is "salary and wages"?

"Salary and wages" includes commissions and director's fees. The definition covers any payment made to or for the benefit of an employee by an employer. The definition of "salary and wages" includes fringe benefits.

Who isn't subject to the SGL?

The SGL applies to all employers but some employees are exempt. These are:

(i) employees paid less than $450 a month;
(ii) employees less than age eighteen who are not in full time employment;
(iii) employees more than age sixty-five
(iv) certain non-residents in Australia for a short period of time;
(v) Community Development Employment Program workers;
(vi) resident employees employed by non-residents outside Australia; and
(vii) non-resident employees working outside Australia.

Vesting

SGL Contributions made after 1 July 1994 must vest in the member. The trustees will breach the SISA if the trust deed does not provide that this is the case.

When do contributions have to be paid by?

Employers have had to pay SGL contributions quarterly. The due dates are 28 October, 28 January, 28 April and 28 July each year, for the quarter ended 28 days earlier. Employers are liable for penalties if they have not paid the SGL contributions by the correct date.

Self-assessment and SGL shortfall payments

The SGL works on a self-assessment basis. The employer must assess the SGL amount and lodge an SGL return, together with a cheque for any shortfall by the due date (see above). Interest and a small penalty must be paid on any late payments.

The ATO is responsible for the SGL. It has wide enforcement powers including the power to audit employers and demand wage records and other documents.

Interaction with the rules for deductions for contributions

Contributions must be paid by 30 June each year to be deductible in that year.

This means the June quarter SGL contributions must be paid by 30 June to be deductible in that year, even thought they are not due to be paid under the SGL rules until 28 July.

PART 5.1: SMSF INVESTMENTS

A brief summary

SMSF investments are an area where myths abound. The basic rule is the trustees may invest as they wish provided they are satisfied the investment is in the members' long term interests, in the sense of enhancing retirement benefits. This is subject to some specific rules concerning investments with related parties and acquiring assets from related parties. These rules were announced in the 1998 Federal Budget, but changed significantly before they were finally introduced.

If a SMSF acquires or holds an asset that is not permitted under the law it becomes a non-complying fund. This means the SMSF is exposed to a potential tax penalty equal to 47% of its assets, less un-deducted contributions. It also means the trustees are exposed to civil and criminal penalties, including, in (very) extreme cases, a risk of a gaol sentence.

For this reason trustees will be wise to invest conservatively by sticking with the traditional choices of shares, cash and property, and variations thereon, and to avoid non-traditional choices. Certainly assets that have lifestyle advantages (e.g. art, jewellery or residential properties in holiday areas) should be dealt with very carefully, and preferably not at all. Assets or asset strategies that seek to circumvent the rules against borrowing, and loans to or investments with related persons, should also be avoided.

If the SMSF trustees stick with the traditional choices of shares, cash and property there will be no problems. The problems are invariably caused by non-traditional investments. Having said this, the number of SMSFs that have non-traditional investments is actually quite small: we estimate it is less than 1%. This estimate conflicts with newspaper reports of the ATO's 2006/3 pilot audit program, which suggest up to 30% have problem assets.

In general terms a SMSF must:

(i) have a written investment strategy. This is discussed in part 4 of this manual;

(ii) always deal with other persons on a strictly arms length basis;

(iii) not borrow, except in very limited circumstances;

(iv) not acquire assets from members and related parties unless they are certain listed shares and other securities, bank deposits, cash, life insurance policies or business real property;

(v) not lend money or provide financial assistance to members or related parties; and

(vi) not invest in in-house assets except in very limited circumstances.

Special rules for unusual investments such as art

A wise trustee adds a further basic rule: they must be able to prove the investment is in the members' long term interests and that they considered all aspects of its expected performance before proceeding with it. This rule is not found in the SISA. It is a common sense rule we add to help keep trustees out of trouble with the Regulator.

We stress this rule applies to all investments undertaken by a SMSF. In the following paragraphs we consider it in the context of an investment in art. But any other lifestyle asset could also have been used. Lifestyle assets include holiday homes and ski lodges. Lifestyle assets and SMSFs is a difficult area and we recommend SMSFs steer well clear of such assets. But using a difficult example helps illustrate the importance of the investment strategy and of trustee's recording their reasons for holding an investment.

If the trustees decide to invest in art or some other unusual investment they should:

(i) log detailed reasons for doing so in the minutes of the trustees' meetings. These reasons should be limited to investment reasons and should not include non-financial or personal reasons: this is because trustees are not supposed to have non-financial or personal reasons for owning such investments;

(ii) obtain and retain information regarding the likely investment performance of art compared to traditional investments. This should include expert opinions on the value of the art and its prospects for capital gain (remember, the return is generally limited to capital gains since art does not produce income in the way a property produces rent or a share produces dividends. Often people, particularly art sales consultants, speak of a "corporate leasing market" but corporate leasing is rarely encountered in practice);

(iii) ensure the SMSF's investment strategy and trust deed permit investments in art; and

(iv) be able to show the art was purchased solely for investment reasons and not to please someone's aesthetic senses or to grace a lounge room wall.

The sole purpose test, which is discussed in more detail below, is an absolute test. The art must be acquired for the sole purpose of enhancing the members' retirement benefits. Any admission of a non-investment purpose, no matter how incidental or minor, breaches the sole purpose test and make the SMSF a non-complying fund. This exposes the SMSF to a tax penalty equal to 47% of the opening value of a SMSF's assets, less any un-deducted contributions. If a SMSF has assets of $1,000,000, this means the tax penalty is $470,000. That makes it a very expensive piece of art!

Any auditor or other SMSF advisor should think seriously about their legal liability and duty of care to the trustees and the members before recommending (or acquiescing to?) art as a SMSF investment. They should also think about the heavy penalties that can be visited on an auditor of a SMSF that breaches these rules.

Some commentators have understated the significance of the sole purpose test, and on occasions even the Regulator understates them. For example, in Superannuation Circular No. III.A.4 - The Sole Purpose Test, the Regulator indicates that incidental use by members paying a commercial rent of a holiday property normally rented on a commercial basis to third parties may not breach the sole purpose test. These comments have been taken by many as a green light for holiday houses in SMSFs.

This is not the case. The light is still red.

We have never seen a holiday home bought by anyone, let alone a SMSF, solely for investment purposes and without any thought to the pleasure of staying in it. The prospects of a SMSF's trustees being able to prove to a court there was no intention of member use, except for "incidental" member use, are slim, at best. Given that the penalties are so serious, why take a risk? If the trustees really believe that the best investment for the SMSF having regard to income, capital gains and risk, is a particular holiday house, then they should buy it. They should then make sure that the members never stay in it. The risk of something going wrong if they do is just too great.

But it makes much better sense to buy an asset like this in a family trust, which can own lifestyle assets and which can borrow to acquire and hold assets. There is no sole purpose test for family trusts, and there is no other reason why a trust should not hold such an asset. So if for any reason a particular lifestyle asset seems irresistible, buy it by all means. Just do not buy it in your SMSF. It's just not worth the risk.

One tip, if despite these concerns a SMSF's trustees wish to acquire a lifestyle asset, consider setting up a separate special purpose SMSF to do this. For example, if the existing SMSF has $1,000,000, and the trustees wish to acquire art costing $100,000, then they should consider rolling $100,000 to a new SMSF and having the new SMSF buy the art. This way if the art breaches the sole purpose test only $100,000 of assets will be taxed at 47%, not $1,000,000, and the other assets are quarantined from penalties.

Thankfully problems with investments and the sole purpose test are not that common. Most SMSFs function very happily and stay well away from art and other lifestyle assets. The above discussion will not apply to most SMSFs and its use is more as an illustration of what can go wrong than anything else.

Trustees usually have a more conservative investment philosophy based on:

(i) listed company shares, particularly blue chips;

(ii) bank accounts and other interest bearing investments;

(iii) real estate; and

(iv) similar investments.

The bulk of SMSF investments are Australian shares and interest bearing deposits. Properties come next, but these are surprisingly few in number, presumably because

of the higher entry price, the lack of liquidity, the inability to borrow, and because the tax benefits attached to property are worth less to a SMSF than they are to its members.

Probably less than one per cent of SMSFs have risky or unusual investments.

What are the exceptions to the basic rule?

The basic rule is the trustees may invest in any asset they believe is appropriate. This is provided they are satisfied the investment is in the members' long-term financial interests, in the sense of having the sole purpose of enhancing their retirement benefits. The exceptions relate to lending to members, acquisition of assets from members, borrowing, non-arm's length assets, in-house assets and the sole purpose test.

Each of these exceptions is discussed in turn in the following paragraphs.

Lending to members

Under section 65 of the SISA SMSFs cannot lend money or provide other financial assistance to members or to relatives of members. Here "relative" means in relation to a person the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the person or the spouse of the person or any other person previously listed. "Providing other financial assistance" is not defined but is thought to include activities like guaranteeing a third party's debts or other financial obligations.

(In strictness, section 65 does not prohibit a loan to a related party who is not a relative, as defined, for example, a private company that the member owns shares in. But such a loan is likely to breach the sole purpose test, the in-house asset test and/or the arms length test, and hence is otherwise prohibited under the superannuation law. Therefore we recommend SMSF trustees do not lend to these persons.)

A loan or other financial assistance cannot be made indirectly either. For example, a SMSF cannot place money with a financier on the condition the financier lend the money to the member's spouse at the same interest rate. The SISA prohibits back-to-back loan arrangements designed to get around the rule against lending to members. (See APRA Superannuation circular No. II. D. 2 "Lending and provision of financial assistance to members and unit holders".)

In 2000 an Adelaide accountant was convicted and fined for facilitating arrangements to breach the rule against member loans. The accountant arranged for SMSF clients to lend money to entities related to each other on an apparently arms length basis. But in truth the loans were made on the understanding that the borrower's SMSF would make a loan to the members of the lender SMSF, or a related party. The court had no trouble concluding that this breached the superannuation law. This case highlights the need to avoid strategies that are intended to circumvent prohibited practices. In most cases these strategies trigger anti-avoidance rules and do not achieve the intended result.

Acquisition of assets from members

Section 66 of the SISA prohibits SMSF trustees from intentionally acquiring assets (other than cash) from members or related parties, such as family trusts. This is known as the rule against self-dealing or "the member asset rule". There are three exceptions to the member asset rule. These are:

(i) "business real property" (basically real estate used in a business, such as a person's premises) from a member. Once the business had to be connected to the member, but this is no longer the case;

(ii) listed securities (ie shares, units, bonds, debentures, options, rights). The listing does not have to be on an Australian stock exchange; and

(iii) in-house assets provided the acquisition does not result in the SMSF breaching the in-house asset rule. This rule is discussed in detail below.

Care needs to be taken with non-cash un-deducted contributions. These can comprise the acquisition of an asset from a member and can breach section 66. Specific legal advice should be sought before transferring assets from a member or a related entity to a SMSF. All assets acquired from members must be acquired at market value.

A "related party" means members of the SMSF and their associates and employer sponsors of the SMSF and their associates. An "associate" of a member includes the member's relatives, business partners and any trust or company that they control, and an associate of an employer sponsor has a similar meaning.

What is "business real property?"

"Business real property" means any freehold or leasehold interest used in a business. The business real property must be used wholly and exclusively in the business (except for certain dwellings on farming properties). "Business real property" is widely defined to include a profession, trade, employment or profit making activity carried on by or connected to a member. The definition excludes any interest held in the capacity of a beneficiary of a trust estate. Hence it does not include units in a unit hybrid trust where the trustee owns the relevant property.

Prior to 12 May 1998 there was a limit on the amount of business real property able to be acquired from members. No more than 40% of the SMSF's assets can be used to acquire business real property from members. However, this cap was removed in 12 May 1998 and now there is no limit. All of the SMSF's assets now can be used to acquire business real property from members if the SMSF wishes to do so.

Since 11 August 1999 it has not been necessary for the business real property to be used in a business owned by the member or a related party. It is sufficient for the property to be "used wholly and exclusively in one or more businesses (whether carried on by the entity or not)…". "Wholly and exclusively" means just that. Therefore, for example, a GP's surgery that is also used as a home is not able to be transferred to the GP's SMSF. Homes on farms will be treated as wholly and exclusively used in a business of primary production provided an area of no more than

two hectares is used for private purposes and the private purposes do not comprise the predominant use of the whole property. (This cuts out hobby farms: the farm must be a genuine primary production business.)

Arm's length investments

Under section 109 of the SISA SMSFs may only invest on an arms length basis. This does not mean that trustees cannot deal with related persons, such as members and employers of members. It does mean that if trustees deal with related persons they must do so on ordinary commercial terms. For example, if a SMSF trustee sells an asset to a member's trust the sale price must be market value. If a SMSF trustee rents a factory to a member's employer the rent must be a market rent and, in particular, must be no more favorable than would reasonably be expected if the parties were not related.

In other words:

(i) the parties must be at arms length; or

(ii) they must deal with each on an arms length basis.

What does "arms length" mean? There is no definition in the superannuation law so we are forced back to general principles. Osborne's Concise Law Dictionary (7th edition, Sweet and Maxwell, London 1983) defines the phrase "at arms length" as:

"the relationship that exists between parties who are strangers to each other and who bear no special duty, obligation, or relation to each other..."

The superannuation law does not stop persons, who are not at arm's length, from dealing with each other. However, it does require the terms on which they deal with each other to be the terms that people who are at arm's length deal with each other. Contract terms must always be commercial.

A wise trustee takes great care to show related party transactions are carefully documented to prove they occurred on an arms length basis. This means, for example, valuations will be obtained before selling an asset to a member's family trust and real estate agents will be asked to advise in writing on market rents at regular intervals. If, for example, a related party tenant in a factory owned by a SMSF defaults then the SMSF trustees should commence all normal recovery actions, including eviction if need be. All trustee decisions will be carefully minuted and copies faxed to McMasters' at the time they are created. The records should be kept for at least ten years and made available to the Regulator should it wish to examine the transaction in any way.

In-house assets: the definition

A SMSF cannot have in house assets of more than 5% of the value of all of its assets.

Up 11 August 1999 an "in-house asset" is a loan or an investment by a SMSF in an employer sponsor or an associate. The definition of "employer sponsor" was wide. It

included associates of the employer sponsor and includes related companies and trusts.

However, since 11 August 1999 the concept of an "in-house asset" has been extended greatly. Under section 72 of the SISA the definition of an in-house asset now covers:

(i) a loan to or an investment in a related party;

(ii) an investment in a related trust; and

(iii) an asset of the fund that is subject to a lease or lease arrangement between the SMSF trustees and a related party.

A "related party" in relation to an SMSF includes a member, a standard employer sponsor, and "Part 8 associates" ie controlled persons.

These terms are broadly defined and have a wide meaning. A wise trustee looks to the intention of the legislation, which is to prevent the SMSF from lending money to or investing in related entities, and ensure the SMSF did not do any of these things, and did not adopt an aggressively narrow view of these terms and hence the scope of section 72.

SMSF trustees should stay well away from any investment that is connected to a member, an employer sponsor or a related party. Even if the value of these investments is less than 5% of the SMSF's total assets, there is a serious risk that they may breach the sole purpose test. There is just no point in having a SMSF hold such investments.

Exceptions to the in-house asset definition

Some investments made before the current form of section 72 was enacted are not in-house assets even though they would be if made after 11 August 1999. The best example of this is units in related unit trusts that have borrowed money to acquire property. In summary, these are not in-house assets if acquired before 11 August 1999, but will be in house assets if acquired after 11 August 1999 (except in limited circumstances).

The in-house assets rule: limits on in-house assets

The in-house asset limits are:

(i) up to 30 June 1998 : 10% of historical cost

(ii) from 1 July 1998 to 30 June 2000 : 10% of market value

(iii) after 1 July 2000 : 5% of market value

If a SMSF breaches these limits it will be a non-complying superannuation fund. This means it will be charged tax equal to 47% of the SMSF's assets, less un-deducted

contributions, and the SMSF and its trustees will be liable for other civil and criminal penalties, depending on the degree of culpability.

The purposes of the in-house asset rules is make sure employee members' interests are protected from the risk of the employer's business failing and from the risk of an employer deliberately defrauding a member. The Government is concerned that because of the connection between the SMSF and the related parties, the special tax concessions provided to SMSFs will be exploited. For this reason it has limited the extent of these transactions even though they may have been permitted under the other investment rules such as the sole purpose test and the arms length test.

There are a number of exceptions to the in-house asset rules. However, these are not relevant to SMSFs so we do not discuss them here.

There are anti-avoidance rules to stop trustees circumventing the in-house assets rule. Generally, if an arrangement is entered into for the purpose of circumventing the in-house asset rule the Regulator may ignore the arrangement and declare the underlying asset to be an in-house asset.

Transitional rules

The in-house asset test has been progressively widened and tightened since August 1999. Transitional rules are in place to ensure that this widening and tightening does not have a retrospective effect. The potential application of these rules should be considered before concluding that a particular investment is an in-house asset.

Related rules

The in-house asset rule is reinforced by the rule that taxes a SMSF at 47% on all income derived from non-arms length sources. A SMSF that breaches the in-house assets test is also likely to be in breach of the sole purpose test and the arms length rule. The sole purpose test is discussed briefly in the following paragraphs.

The sole purpose test

This is a general rule regarding the overall conduct of SMSFs. It is discussed earlier in this manual. Investments must be made for the sole purpose of providing retirement benefits to members. This sounds like a simple rule but in practice it can lead to difficulties. We believe SMSF trustees should not take any chances here and should not acquire or hold any investments that may breach the sole purpose test.

Borrowing to invest

SMSFs can now borrow to invest and this is discussed in detail in part 5.2 of this manual.

Part 5.2 SMSFs and limited recourse borrowing arrangements

Introduction

This part of the manual considers the background and history of self-managed superannuation funds (SMSFs) borrowing to invest, and looks at the restrictions created by changes introduced to Parliament in May 2010 and passed as law in early July 2010. It considers some of the practical problems, suggests alternatives, and settles on one (very) simple strategy that could work very well for a large number of clients of average age and financial circumstances.

The guide is current as at 1 September 2010. No responsibility is taken for any error or omission in it and it should not be acted on without specific legal advice from the McMasters' legal team.

Executive summary

The law regarding SMSF borrowings changed on 7 July 2010. Arrangements entered into before this date are controlled by the former sub-section 67(4A) of the Superannuation Industry (Supervision) Act 1993, and arrangements entered into after this date are controlled by the new sections 67A and 67B of this Act. Borrowings may be refinanced, and a refinancing may, depending on its detail, create a new borrowing that brings the arrangement within the new rules.

Instalment trust arrangements are now known as "limited recourse borrowing arrangements".

First, some perspective

Anecdotally there is only a very low incidence of SMSFs investing in instalment warrants. The Cooper Review observed that:

"Initial interest in instalment warrants was modest with only 0.9% of the SMSF population having a derivative or instalment warrant at 30 June 2008. There are, however, indications that this trend might have changed in recent times. Data from Investment Trends' survey suggest more than five per cent of SMSFs already invest in such instruments[1]."

Assuming there are 350,000 SMSFs in Australia this translates to about 17,500 incidents of SMSFs borrowing through instalment trust arrangements. Dover's experience suggests most of these will involve packaged arrangements to buy shares, facilitated by large financial institutions, and few will involve property transactions.

[1] Australian Government, Self-Managed Super Solutions A preliminary report of the Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System http://www.supersystemreview.gov.au/content/downloads/self_managed_solutions/self_managed_super_solutions.pdf

This is not a significant incidence and readers should keep perspective: SMSF borrowing is not common and is unlikely to become common in the short to medium term future.

Second, some background

SMSFs have always had a limited ability to borrow. However, the power to borrow was so limited that most SMSF advisors have never encountered it. Section 67 of the Superannuation Industry (Supervision) Act 1993[2] (SISA) allows SMSFs to borrow in certain limited circumstances; that is:

(i) where the borrowing is necessary to pay a member an amount due under the law, provided the borrowing is for a period of no more than 90 days and the borrowing is not more than 10% of the market value of the assets of the fund;
(ii) where the borrowing is necessary to allow the SMSF to pay the (now defunct) surcharge, provided the borrowing is for a period of no more than 90 days and the borrowing is not more than 10% of the market value of the assets of the fund;
(iii) where the borrowing is necessary to settle the purchase of shares and similar securities, provided the borrowing is for a period of no more than 7 days and the borrowing is not more than 10% of the market value of the assets of the fund, and provided that at the time the purchase contract was signed it was likely that the borrowing was not needed.

Section 67 did not allow borrowing to fund investments.

The policy behind this situation is clear: the government considered SMSF borrowing to be risky, and contrary to the conservative long term interests of Australia's retirement incomes policy.

Creative advisors sought to circumvent these rules. Up to August 1999 it was easy for a SMSF to set up a controlled unit trust to effectively circumvent section 67. The practice was widespread at the time, and ended with the government extending the definition of an in-house asset to include most controlled trusts (subject to a 10 year moratorium for existing controlled trusts).

Never underestimate the ingenuity of the financial planning profession, because before long new arrangements sprung up which appeared to neatly side-step the 1999 controlled trust rules.

Instalment warrant arrangements were introduced, based on shares and other financial securities marketed by large product providers, which claimed to not be a borrowing for SMSF purposes. The position was very confusing: the arrangements looked like debt, and used the language of debt, including words like "borrowing", "interest" and 'principal", but the promoters produced ATO rulings saying they were not debt, and that SMSFs could invest in them.

[2] Section 67 of the SISA

In 2006 the ATO and APRA got together and decided that instalment warrants were in fact a form of borrowing not permitted by section 67 and that therefore SMSFs could not invest in them.

Never underestimate the political punch of the financial planning profession. Eventually the government decided that since the (illegal) instalment warrants had become quite common, the law should be changed to allow them, and that existing (illegal) arrangements could continue until the new laws saw the light of day. Evidently the non-recourse aspect of instalment warrants nullified concerns about default, and the risk this creates for Australia's retirement income policy.

(It is also interesting to see what happens to a law if enough people break it...but let's leave that there for now.)

In summary, the Government decided SMSF debt was OK after all.

This crystallised on 24 September 2007, when a new sub-section 67(4A) headed "Exception – Instalment Warrants" came into play. This exception legitimised the instalment warrant arrangements on the market, but also surprised all concerned by not being limited to instalment warrants, despite the tag "Exception - Instalment Warrants". The exception goes well beyond what most regarded to be an "instalment warrant" and allows other types of borrowing as well, provided certain conditions are met. Evidently Treasury formed the view, against ATO submissions, that there was no logical reason to limit the exception to the narrow class of assets found in traditional instalment trust arrangements, and assets like property should also be included.

Many predicted that the new sub-section 67(4A) would trigger a boom in SMSF borrowing. Some people even set up websites dealing specifically with the issue, and some solicitors tried to charge as much as $20,000 a go for their standardised (and often plagiarised) SMSF borrowing "kit".

The SMSF borrowing boom never came.

September 2007, and the following months, saw world finance markets freeze as the GFC spread from the burst bubble of the USA residential property market to contaminate virtually all world markets. Credit disappeared, and asset values fell. The ASX dropped as much as 50%. SMSF investors had no appetite for debt, which was just as well because the banks had none to offer, unless it was at rip-off rates as high as 12% per annum, with LVRs limited to 50%, at a time when standard home loan rates were just 6% or even less.

The ATO made it clear it disagreed with Treasury, and would take a hard line on technical breaches of the law, which caused many advisors to prudently steer clear of the new rules until they had settled down and further guidance was available.

A few clever advisors realised the idea was not as attractive as it first sounded, anyway. SMSF borrowing can be very tax inefficient. Gearing strategies, particular for residential property, rely on tax benefits for a significant part of their return. With SMSF borrowings the tax rate is never more than 15%, and may be less due to the one

third exemption on capital gains while the member is in accumulation mode, and the 100% exemption once the member is in pension mode.

It's important to appreciate that sub-section 67(1) of the SISA general prohibits SMSFs from borrowing, unless the limited exceptions set out in the following sub-sections apply. The ATO will take a restrictive view of the scope of these exceptions, in order to give effect to what it sees as the proper construction of section 67.

Uncertainties in the law

Since September 2007 practitioners have encountered uncertainties in both the application of the law, and the ATO's view of the law. These uncertainties contributed to the low incidence, or take-up, of geared SMSF arrangements. The Government also believed that some interpretations of section 67 of the SISA were creating undue risk for SMSFs, particularly:

- personal guarantees by SMSF trustees;
- borrowing arrangements extending to other assets, to achieve increased security for the lender, and hence create greater risk for the borrower (ie the SMSF); and
- borrowing arrangements extending to replacement assets.

On 26 May 2010 The Government introduced into Parliament the Superannuation Industry (Supervision) Bill 2010 to, as the explanatory memorandum said:

(i) make sure SMSF assets are protected against the consequences of a default under the borrowing contract; and
(ii) resolve "uncertainties" in the operation of section 67, by:

a. introducing the concept of a single "acquirable asset", or a collection of identical assets that have the same market value and are treated as one asset;
b. prohibiting borrowing to improve properties;
c. ensuring the recourse of lenders does not cover other SMSF assets and only the specific asset can be charged; and
d. ensuring the specific asset can only be replaced in limited specified circumstances.

You can read the Bills Digest for this Bill here: Bills Digest Superannuation Industry (Supervision) Amendment Bill 2010.

On 27 May 2010, one day later, the ATO expressed its own views on the operation of the SMSF borrowing rules, when it published "Limited recourse borrowing arrangements by self-managed super funds - questions and answers[3]" which has since

[3] Limited recourse borrowing arrangements by self-managed super funds

been up dated for the new effect of the new SISA provisions concerning SMSF borrowings.

The current state of the law

The Superannuation Industry (Supervision) Amendment Bill 2010 became law on 7 July 2010. You can read the amended SISA provisions here: section 67A of the SISA and section 67B of the SISA. And you can read the ATO's summary of the new rules here: Limited recourse borrowing arrangements by self-managed superannuation funds.

The old rules (ie section 67(4A)) apply to borrowings entered into before 7 July 2010.

The new rules (ie section 67A and 67B) apply to borrowings entered into after 7 July 2010, to restrict the form of the borrowings as follows:

(i) **single acquirable asset**. Only one asset, or set of identical assets (example a parcel of shares in a listed company, listed trust, or other assets that have economically identical qualities) is permitted in each instalment trust arrangement, and which must be dealt with as if they are one asset (for example, that parcel of shares cannot be sold gradually over time, and if sold all must be sold; it's all or nothing). This rule is very restrictive for shares and similar securities but of no real effect for real estate;

(ii) **capital improvements.** Borrowings cannot improve the asset, but can be used to maintain or repair the asset to maintain its functional value. This is particularly relevant to real estate and, for example, an SMSF cannot borrow to buy an old run down building and then borrow again to knock it down and build a new one. But a SMSF can borrow to repair or maintain a property to maintain its functional value;

(iii) **lender's recourse**. This is limited to the particular asset. Other assets cannot be charged in any way. In summary, a charge may be given over an asset acquired through a borrowing arrangement to secure that borrowing, but no other charge is permitted. This effects both shares and similar assets, and real estate;

(iv) **replacement assets**. Replacement is limited to where instalment receipts are replaced with shares or units under a takeover, merger, demerger or a similar reconstruction; and

(v) **refinancing**. Loans may be refinanced, and where the loan is re-financed such that a new loan is effectively created, the new loan will be brought within the new rules. "Lesser" refinances may not be new loans and will not be brought within the new rules, but advice is needed each time to make sure the refinancing has not created a new loan. Particular care is needed when

refinancing old borrowings for more than one asset, such as a parcel of shares in listed companies. The refinancing may create a new borrowing, and therefore breach the single acquirable asset rule.

The new rules do not use the phrase "Instalment Warrants", which makes sense because the old section 67(4A), which did use the phrase "Instalment Warrants" in its caption, was not limited to instalment warrants and covered all types of borrowings.

Possible planning options

One can expect some great minds to devote a lot of time and thought to how to best use these new rules. Preliminary ideas from a lesser mind include:

(i) consider whether a SMSF borrowing is the best way to proceed. Is it possible that the asset can be acquired through some other less restrictive mode, perhaps in the client's own name, or in a trust based structure? This basic test is our preferred option: the consequences of a SMSF becoming non-compliant are very serious and we believe it is wisest to stay away from complicated areas with a high probability of causing problems;

(ii) commercial banks will introduce/emphasise gearing strategies based on derivatives, and/ diversified assets such as a listed investment companies and index funds, where the single acquirable asset rule will be less of a problem;

(iii) consider an uncontrolled unit trust, with the client's share of the units (less than 50% and no deemed control) owned by the SMSF and the debt held at the unit trust level (specific legal advice should be sought before proceeding here);

(iv) if a geared SMSF property redevelopment is contemplated, consider a higher debt to equity ratio, and preserve existing cash balances and future contributions (concessional and non-concessional) for the redevelopment phase. Joint venture arrangements may also be considered, although these can be very messy;

(v) consider gearing into certain unit trusts which acquire the property and then borrow at the trust level to complete the renovation/redevelopment (specific legal advice should be sought before proceeding here);

(vi) consider whether SMSFs may be better off gearing in large geared share trusts where the trust borrows, and is not subject to the restrictive SMSF borrowing rules; and

(vii) expect to see slick arrangements where the one document creates two or more loans and trusts, to allow SMSFs to create geared portfolios with more than one share without breaching the single acquirable asset rule.

Quarantined SMSFs

It is always a good idea to consider using a separate, special purpose SMSF for a specific transaction, such as buying a property using debt. The SMSF only holds the minimum amount of benefits needed to complete the transaction, and the clients' other benefits are held in another super fund.

Doing this limits risk, and means any non-compliance penalties are less than otherwise may have been the case.

Guarantees

There were concerns that rights of subrogation, ie the right of a guarantor to recover all or part of any amount paid under the guarantee from the debtor/SMSF, could extend to other fund assets.

The new provisions make it clear this cannot happen.

Any payment under a guarantee may be treated as contribution, and this may create its own issues.

Capitalised interest and related party borrowings

The new rules do not impact capitalised interest arrangements, or related party borrowings. Both are permitted, provided all relevant rules are observed.

However, we strongly recommend interest be paid when it is due and not capitalised, particularly with related party borrowings, to preserve the commerciality of the arrangement and to maintain an arm's length quality at all times. This arm's length quality will be needed to comply with other aspects of the SMSF law, and is consistent with the ATO's views as expressed in TA 2008/5.

A warning

The new rules are particularly restrictive for shares, and do not allow a parcel of shares in different companies to be held under the one instalment arrangement, and do not allow a progressive sell down of shares. For obvious reasons the "single acquirable asset" rule is less of a problem with real estate assets, which tend to be bought singularly, with far few properties owned relative to shares.

Bear in mind that most clients will shy away from complex matters and do not want to be guinea pigs for some bright spark's great idea to get around these rules. It's perfectly OK to say to your clients "this is too complicated, risky and limited, and you are better off not using your SMSF in this transaction". Sometimes it is best to say "no".

And if it's a good investment for a SMSF it's probably a good investment for the client himself. So there is no burning reason to involve a SMSF in the investment, with the attendant compliance risks.

Investment strategies

The SMSF's investment strategy must include borrowing to acquire investments.

A particularly simple application

One simple application has merit. Consider a forty-five year old couple with, say, $200,000 in superannuation. They are concerned about their long term retirement prospects and, although they are in the 37% tax bracket and have statistically high incomes, they are cash poor because of the high costs of feeding, housing, educating and "holidaying" their family.

It can make sense to set up a SMSF, transfer the existing $200,000 of benefits in, pay future contributions in, and then borrow say $400,000 to complete the purchase of a $600,000 home. The property is then rented out, with the rent income covering the outgoings and the interest, with a bit of help from their contributions. The expected capital gains drive this investment, and the trick is to not realize the capital gains until the SMSF is in pension mode, ie until say age 60 in 15 years time, so that the bulk of the return is capital gains tax free.

This advantage overwhelms the disadvantage of low debt deductibility in the SMSF.

This is a simple application of the rules and is unlikely to run into any problems.
If the Reserve Bank predictions on future home prices eventuate, then this will be a very good investment strategy too.

Business premises

This simple strategy can also be a tax effective way to own business premises, which are bought using a geared SMSF arrangement and then leased back on an arm's length basis to the business.

However, here the loss of the active asset exemption for business premises held by a SMSF has to be considered, which makes the arrangement less attractive from a tax point of view than may have been first thought: SMSFs are not eligible for this exemption.

Stamp duty on transfer from the trustee to the SMSF

The transfer of real estate from the trustee to the SMSF at the end of the borrowing contract should not be a stamp dutiable event, since there is no change in beneficial ownership. But care is needed, particularly in South Australia where contrary views have been suggested.

(This is general advice only and is not personal financial advice and it should not be acted on without specific advice in written form from a qualified advisor.)

Appendix: What is an instalment warrant?

Generally an instalment warrant is a financial product that derives its value from the underlying asset, typically a share or a similar security, under which the instalment warrant owner may acquire full rights to the underlying asset (ie the share) by paying instalments.

The ATO defined an instalment warrant as:

"... a form of derivative or financial product that entails borrowing to invest in an asset, such as a share or real property (the underlying asset) with limited recourse to the investor...the underlying asset is held on trust during the life of the loan to provide limited security for the lender[4]."

The new sections 67A and 67B do not refer to "instalment warrants" but the former sub-section 67(4A) included this phrase in its heading, despite having a much broader application than just instalment warrants.

The former sub-section 67(4A) did not explicitly define "instalment warrant", despite using this phrase as a caption, but it did set out conditions which in effect defined instalment warrant for these purposes. The conditions for a SMSF borrowing to be permitted under sub-section 67(4A) were:

- the borrowing was used to acquire an asset held on trust for the SMSF by a trustee, often called an "instalment trust";
- the SMSF owned the beneficial interest in the asset and a right but not an obligation to acquire legal ownership of the asset by paying instalments (ie repaying the borrowings);
- the lender's recourse (ie right of recovery) was limited to the asset, which means other SMSF assets cannot be charged/secured in any way; and
- the asset was otherwise able to be owned directly by a SMSF, and for example was not an in-house asset and is not an asset that has been acquired from a related party (except as permitted by section 66 of the SISA).

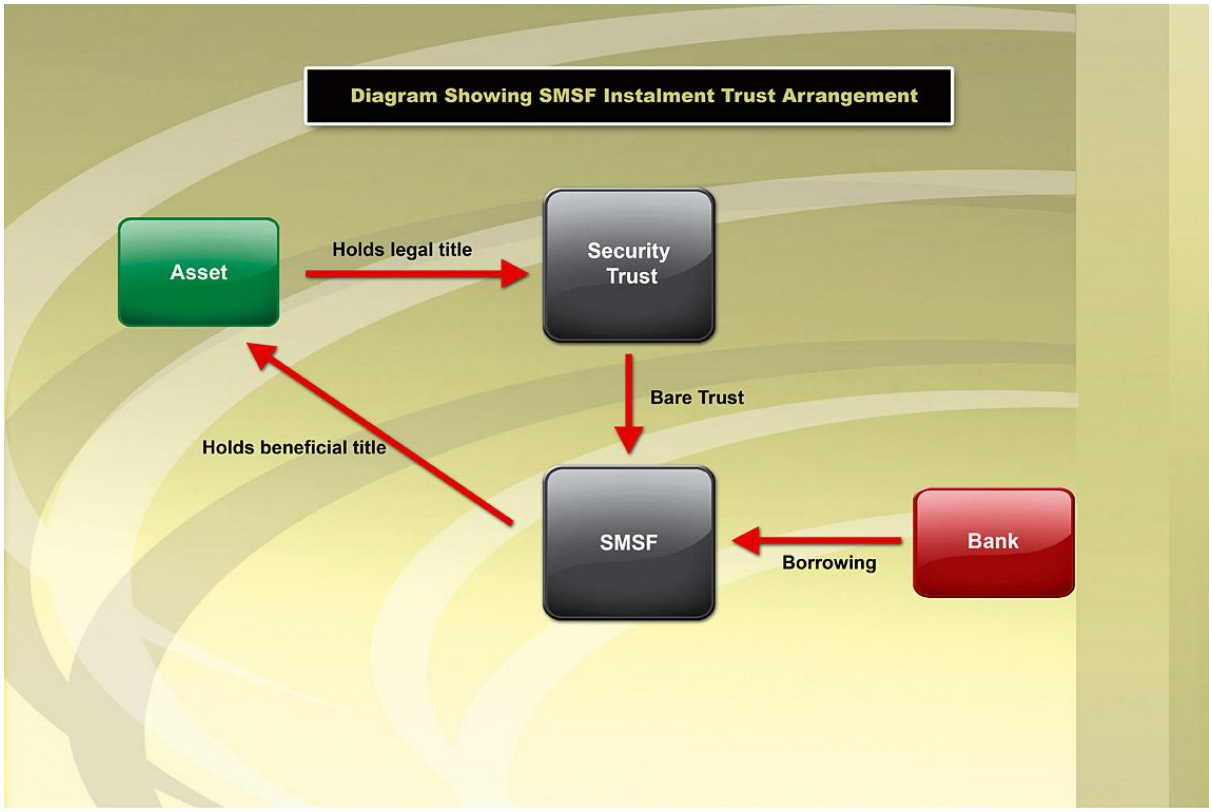
The instalment trust was often described as a bare trust, which is the thinnest form of trust recognised at law, and requires the trustee to act in accordance with the directions of the beneficiary and, in particular, to transfer full ownership to the beneficiary when requested to do so. The instalment trust is actually more complex than a bare trust, as conditions must be met before full ownership is transferred to the beneficiary. But this is an academic point only and thinking of the instalment trust as a bare trust is an effective way of understanding the relationship between the trustee of the "instalment trust" and the SMSF, ie the beneficiary of the instalment trust.

The SMSF is the borrower under the loan agreement, and is beneficially entitled to the asset (subject to conditions) and the instalment trustee holds legal title to the asset

[4] Limited recourse borrowing arrangements by self-managed super funds

until all payments are made and other conditions are met, at which time it must transfer legal title to the SMSF.

The relationship is depicted as follows:



PART 5.3: SMSFS AND SHARES

Introduction

The most common investments for SMSFs are share in Australian public companies. One major reason is their underlying investment performance: Australian shares have performed well over the last ten years. SMSF trustees are more likely to know about Australian shares than international shares, and until recently Australian shares have been a lot easier to access than international shares. Another major reason is the treatment of franking credits. Excess franking credits are refunded as a cash payment by the ATO. This means SMSFs often get two "dividend cheques": one from the company and one from the ATO.

SMSFs and fully franked dividends

Public company shares paying franked dividends are attractive investments for SMSFs. This is because the franking credits come at up to 30%, being the current company tax rate, but SMSF generally only pay tax on them at 15% (and 10% on any capital gains on the shares provide they are held for more than 12 months). This means there is an excess credit of up to 25%. This excess credit reduces the tax payable on other income, including contribution income and any excess franking credits are refunded to the SMSF.

A simple example may help. Assume a SMSF received franked dividends of $10,000 and assessable contributions of $10,000 in the year ending 30 June 2006. Assume the SMSF has no deductions and no net capital gains.

The SMSF's tax position will look like this:

Cash Dividend	**$10,000**
Imputation Credit ($10,000 times 30 divided by 70)	**$4,285**
Contributions	**$10,000**
Taxable Income	**$24,285**
Tax on Taxable Income	**$3,642**
Less: Franking Rebate	**$4,285**
Tax Payable (Refunded)	**($643)**

In other words, the franking credit attached to the cash dividend of $10,000 has sheltered all the SMSF's income from tax, including its contributions income, and has generated a refund of $643. Further un-franked income other than capital gains of $4,286 (ie $643 divided by 15%) could have been derived without a further tax charge arising, or a capital gain of $6,430 (ie $643 divided by 10%) could have been derived without a further tax charge arising.

This is a great result. It sharply lifts the equivalent after tax rate of return on listed company shares compared to other investments available to trustees. This result is particularly great for SMSFs paying allocated pensions and complying pensions

because the franking credits received will be refunded in full, making franked shares and other franked investments (ie franked shares and managed funds that include franked shares in their portfolio) attractive investments.

Private company shares

Normally a SMSF will only invest in listed company shares and will not invest in private company shares. This is because dividends from private companies comprise "special component" income that is taxed at 47% in the hands of the SMSF. Even if the dividends are fully franked they will be unattractive for SMSFs. Trustees need good reasons to invest in private company shares. If the trustee doesn't expect significant dividends and the private company is related to the employer or a member the question of whether the sole purpose test is satisfied and the in-house asset test is satisfied will be very relevant.

Can a SMSF buy shares from a member?

A SMSF can buy listed shares (and similar securities) from a member or a relative of a member. The securities can be listed on any Australian or international exchange. This is one of the exceptions to the usual rule against a SMSF buying assets from members. A SMSF cannot buy other shares (ie private company shares or international shares) from a member or a relative of a member. Readers interested in transferring shares to their SMSF should get specific legal advice on their circumstances before doing so.

What stamp duty is payable on a share transfer?

From 1 July 2001 there is no stamp duty paid on share transfers. This is part of the New Tax System and is part of the trade-off for the new 10% GST applying from 1 July 2000.

Capital gains on transfers to SMSFs

A transfer of shares to a SMSF is a disposal under the capital gains rules, and this disposal gives rise to a capital gains tax computation. Whether there is a CGT liability will depend on the SMSF's overall tax profile. The CGT implications should be considered before any shares are transferred.

PART 5.4: SMSFS AND INVESTMENTS OTHER THAN SHARES

This part of the manual looks at SMSFs and investments other than shares, principally cash and bank deposits, properties, and indexed funds and managed funds. Instalment warrants are briefly considered. It does not provide an overview of how these investments work or how they have performed over time: this information is available from a variety of other sources and does not need to be duplicated here. These materials focus on these investments as they relate to SMSFs.

Cash and bank deposits

Virtually all SMSFs have at least one investment in cash, being the amount of cash at bank at any time. Most SMSFs hold this investment in a cash management trust account, due to the higher interest rates paid. It is important to have a higher interest rate because from time to time there can be a sizeable bank balance, as amounts are transferred into the SMSF, as investments are sold and as dividends are received.

It is a good idea to have just one bank account or CMT account, and to use this account as a primary record of all transactions. This simplifies the paper work and minimizes accounting fees. Some times this cannot be done. For example, a SMSF may have to use a particular account to buy shares through a particular share broker. Here the tail should not wag the dog, and the SMSF should use two bank accounts or change over completely to the broker's account. But generally multiple bank accounts should be avoided.

Most investment advisors believe that SMSFs tend to have too much money invested in bank deposits and similar interest bearing facilities. They are probably right: history shows that higher returns are generated in shares and properties rather than in cash based investments. Timing can be important, since these markets can fall as well as rise, but in the longer term it is probable that most SMSFs will be better off minimizing their investments in cash and maximizing their investments in shares and property.

Direct property investments

Direct property investments are not popular with SMSFs. This seems to be due to:

(i) the high entry price for a quality property: the average SMSF has about $300,000 in it, and an average house in Melbourne or Sydney can cost this much or more, and a quality industrial property will cost more again;

(ii) properties are illiquid assets, and SMSFs cannot borrow;

(iii) properties are generally bought using a mix of equity and debt, but SMSFs cannot do this because, again, they are generally not permitted to borrow;

(iv) the tax benefits connected to property (ie interest, depreciation of plant and equipment and the 2.5%/4% building allowance) are worth less to SMSFs than to high rate tax-payers, such as the members;

(v) in the case of residential property at least, the return tends to be in the form of a capital gain. Capital gains are taxed concessionally for individuals and may be planned for, so often there is little if any tax benefit connected to the capital gain being taxed at no more than 10% in a SMSF;

(vi) an investment strategy for a SMSF paying an allocated pension or a complying pension will need a cash return of between 5% and 10% each year to pay the pension to the member. This can be hard if the SMSF has invested all or most of its money in, say, a low income (but hopefully high growth) residential property (bear in mind income yields can be as low as 3%, and less once outgoings are considered).

Business real property is the most common property investments for SMSFs. This may be for example, a person's surgery or a factory. But these investments are less common since the changes to the in-house assets rules were made.

Managed Investments

There are literally thousands of managed investment options to choose from. Publications such as Personal Investor and Money and books by Paul Clitheroe and various others are a good start for someone interested in this investments sector. These information sources can be easily accessed at your local shopping centre (assuming it has a good bookstore) and through numerous sites on the Internet.

Managed investments usually do not feature in the investment portfolios of SMSFs. We expect this is because:

(i) most SMSF trustees tend to be interested in investing directly, particularly in shares, and not investing through a fund manager. This is why they have chosen the self-managed option in the first place;

(ii) there are costs connected to SMSFs and there are costs connected to managed investments, in the form of initial commissions and trailer commissions, as well as management fees charged by the manager each year. If a SMSF invests in a managed investment then the underlying investment is subject to two tiers of fees, one at the SMSF level and one at the managed fund level; and

(iii) Most types of managed funds can be accessed in a managed superannuation format. For example, if a SMSF member is interested in investing in managed Australian equities fund, then there are dozens of appropriate managed superannuation funds that could fit the bill, and the member is probably better off transferring out of the SMSF and investing directly into the managed superannuation fund.

One advantage of investing in managed funds is the lower accounting and audit costs. The number of transactions determines the accounting and audit costs. If the SMSF

invests in just a few managed investments then the number of transactions falls considerably and therefore the accounting and audit fees fall considerably.

Managed funds have the advantage of simplicity. Some advisors believe that a professional fund manager is probably going to get a better rate of return than a lay investor. This is not always the case, but it can be a valid reason for a SMSF to select managed funds.

However, it is unusual for SMSFs to have significant investments in managed funds. We expect this is because most SMSF trustees are interested in investing directly, and this is why the SMSF has been set up. SMSFs that invest heavily in just a small number of indexed funds tend to have very low accounting and audit fees.

Index funds can be attractive for small SMSFs. They create a simple, passive, highly diversified and low cost method of investing that may well outperform other alternatives.

PART 6.1: INVESTMENT STRATEGIES

Introduction

All SMSFs must have an investment strategy. This is set out in section 52 of the SISA and SIS Regulation 4.09. This part of the manual discusses the SISA's requirements for an investment strategy.

The requirement for an investment strategy was introduced in 1996. It appears that this was the result of lobbying by the investment advisory industry, which presumed that it would lead to a flood of work from SMSFs. The flood did not follow, as most SMSFs prepared the investment strategies themselves. The requirement was in a sense unnecessary as most SMSFs dealt with this issue well without any need for a specific legislative requirement. However, on balance, investment strategies are good for SMSFs as they formalize the investing process and compel trustees to consider what they are doing and what they might be doing with their SMSF investments.

What is an investment strategy?

An investment strategy is a document setting out the SMSF's approach to its investments. Interestingly, SMSFs are only required to "formulate and give effect to" an investment strategy. There is no formal requirement for it to be in writing. However, as a practical matter we recommend all SMSFs should put investment strategies in writing, as this is the simplest way to prove the requirements of section 52 of the SISA have been met.

The strategy must consider all the circumstances of the SMSF. In the CCH publication "The SIS handbook" this is said to include:

(i) the risk and the likely return from the investments, having regard to the SMSF's objectives and its expected cash flow requirements;

(ii) the composition of the investments as a whole, including the extent to which they are diverse or involve the entity in being exposed to risks from inadequate diversification;

(iii) the liquidity of the investments, having regard to the SMSF's expected cash flow requirements; and

(iv) the ability of the SMSF to discharge its existing and prospective liabilities (we assume this refers to member liabilities).

These words are quite similar to the words used in section 52 of the SISA.

A common misunderstanding

There are no qualitative or quantitative restrictions on the investments a SMSF may invest in, except for limits on in-house assets, loans to members, acquisition of assets from members and the sole purpose test. For example, there is nothing to stop a SMSF from investing all of its monies in, say, a foreign listed company that owns a Mexican berry farm (assuming the other rules are complied with.) This may be a very risky investment, and it may be a case of all the berries in one basket: but there is nothing in the law to prevent it. The law does not prescribe risk return criteria or asset diversification criteria. Whether the shares in the berry farm are a good investment is another thing. But there is nothing in the law to stop a SMSF from investing in them.

Diversification

The investment strategy is required to consider diversification. This is the extent to which the SMSF has spread its investments across a range of asset classes and holds a number of investments within each asset class. There is no requirement that a SMSF diversify its investments. A SMSF may invest all of its assets in one investment or one class of investments. It is quite common, for example, for a SMSF to have all or the bulk of its investments in one asset class, say, Australian shares, or even one asset, say, the person's surgery. Whether this is a wise strategy or not is a different issue, but there is nothing in the law to stop a SMSF doing this.

Liquidity

The investment strategy is required to consider liquidity. There is no requirement that a SMSF must only invest in liquid or near liquid investments or must hold any percentage of its investments as liquid investments. There is no requirement for a SMSF to keep any part of its portfolio in cash or near cash assets. A SMSF may invest in illiquid assets. Again, whether this is a wise strategy or not is a different issue, but there is nothing in the law to stop a SMSF doing this.

Investment objectives

The investment strategy should state the SMSF's investment objectives. For example, the investment objective may be to "obtain a rate of return at least equal to the average return on the Australian share market over the next three years". The specific investments would then be chosen to make sure this objective is attained. Here, one would expect a bias to Australian shares and a bias away from cash, if the objective is to be achieved. But this is really a decision for the SMSF trustees.

Other documents

A wise trustee will not limit the records kept to an investment strategy. This is particularly so where the investments are unusual or have a connection with persons who are related to the SMSF, such as premises leased to an employer sponsor.

Other documents should be used to support the investment strategy and to verify the trustee's reasons for acquiring and holding the assets. These records include:

(i) copies of investment consultants and financial planners' advices, and other materials relied on when deciding to acquire, hold or dispose of an investment;

(ii) valuations of similar properties and evidence of their value; and

(iii) minutes of meetings of the trustees, linked to the overriding investment strategy of the SMSF supporting the reasons for acquiring and holding the investments and showing that alternative investments are considered on a regular basis.

An on-going process

Formulating and implementing an investment strategy is an on-going process. The idea is to show the trustees consider the SMSF's investment profile, and alternative profiles, in terms of risk, expected return, diversification and liquidity, on a regular basis. Any document that evidences this should be retained and filed by the trustees.

The investment strategy is an on going process, not a once a year formality. Once the investment strategy is determined the SMSF is not bound to follow it. The investment strategy is a servant, not a master. But if there is a significant deviation from the investment strategy the SMSF should change the strategy, and should record the reasons for the change. For example, a client's SMSF recently decided to invest in land near a major European city. Previously its investment strategy had stressed Australian shares. There was no reason why the SMSF could not acquire the land, but we stressed that its investment strategy should be changed to record this decision.

Directions from members

The SISA contemplates trustees accepting a direction from a member as to how the member's investments should be invested. This is obviously needed if the idea of self-managed superannuation is to work. Most trust deeds permit the trustees to accept a direction like this. In the context of SMSFs the concept of member direction is artificial, since the members are almost always the same people as the trustees and obviously set the investment agenda. That's why they have SMSFs. This reinforces the practical result of the members directing their own investments.

The need for advice

SMSF trustees tend to like doing things for themselves. For this reason most do not seek advice on their specific investment options. Those interested in obtaining investment advice often become frustrated at the perceived lack of independent advisors with the required skill, objectivity and empathy to work with SMSFs.

Despite having reservations about the skill level and objectivity of many investment advisors, we constantly recommend that SMSF trustees seek help in this area if they feel it is needed. This may be more on asset classes and future investment directions, rather than advice on specific investment options. The advisor should be retained on a time-spent basis and should be someone who understands the SMSF environment and mentality. The advisor should not be involved in the placement of the investments as this may create a conflict of interest.

Can a SMSF have all its benefits in one asset or one asset class?

This question has been tacked on to this part of the manual because it is easily the most commonly asked investment strategy question.

The answer to this question is "Yes. A SMSF can have all of its benefits in one asset or one asset class provided this is consistent with the SMSF's investment strategy." This is so even though the asset or asset class may be illiquid and undiversified, for example, just one property. The investment strategy rules do not say that a SMSF's investments must be liquid or diversified. They just say that liquidity and diversity must be considered when preparing the investment strategy. (Refer to sub-section 52(2)(f) of the SISA).

APRA and ATO statements are consistent with this answer. For example, APRA circular No II.D.1 – Managing Investments and Investment Choice accepts that a trustee may invest all of a SMSF's benefits in one asset class, or even one asset. The Circular states that this would be unusual, and inconsistent with modern investment theory. But it is still possible. In fact the government has implicitly accepted this by increasing the percentage of a SMSF"S investments that may be "business real property" (ie basically property other than residential property) to 100%. Up to 12 May 1998 this was limited to 40%.

Many commentators will say that the liquidity requirements of say, funding a member's pension mean that a SMSF with older members should move to a more diversified and more liquid investment strategy. It is not clear that this is correct. There is no legal requirement for it. The commentators are mixing up what they think is a good investment strategy with what the law says a SMSF can and cannot do.

From an investment perspective it may make sense for a SMSF with older members to migrate from say an investment strategy based on one or two commercial properties, for more diversified and liquid strategy. But it may not too. For example, the trustees may not be able to identify an alternative investment with a better income yield, in terms of both height and security, and better capital gains prospects. It does not make good investment sense to switch from a secure 10% per annum on one commercial property to a less secure 5.5% pa on a parcel of 20 Australian shares.

And there is nothing in the law to make SMSF trustees do this.

Appendix 1: Draft letter: Investment strategy

Date

Name of Trustee
Address of Trustee

Dear Name of Trustee

Investment Strategy

The Fund must formulate and record an investment strategy it is to comply with the superannuation law and be eligible for income tax concessions after that date.

We attach the Fund's investment strategy. This has been prepared in conjunction with the trustees and other advisors as appropriate. Could you please complete the section at the top of Pages 1 and 2, sign where indicated at the bottom of Page 2 and then return the document to us for retention on the Fund's register.

Could you also please complete, sign and return the attached minute of a meeting of trustees to record the adoption of the investment strategy. You will note the minute refers to an annual review of the Fund's investment strategy: we will approach you next year to organise this meeting.

The Fund's investment strategy is an on-going process that requires you to monitor the investments and the alternative investments. Risk, expected return, diversity and liquidity should be considered having regard to the member's retirement benefits and requirements.

We trust you find the attached strategy and trustees' minute to be satisfactory. Please do not hesitate to contact us should you wish to discuss it or require further information regarding this matter.

Yours faithfully

Name of Accountant

Appendix 2: Minutes of a meeting of the trustees

Minutes of a meeting of the trustees of the (name) superannuation fund (the fund") held at its registered office on the day of June

Present
Names of persons attending and capacity

Chairperson
Name of first trustee

Capacity
The Chairperson noted the trustees were meeting in connection with the Fund

Previous Meeting
The Chairman read the minutes of the previous meeting and affirmed them as correct

Investment Strategy
The Chairperson reported that the Fund is required to formulate and record an investment strategy if it is to comply with the superannuation law and be eligible for income tax concessions after that date.

Preparation of Investment Strategy
The Chairperson advised the meeting that, after discussing the matter with the Fund's accountants, investment advisor and solicitor an investment strategy had been determined which took account of the member's retirement requirements and which the trustees believed maximized the retirement benefits able to be paid to the members. This involved a consideration of the ability of the Fund to diversify its investments and the relative expected returns from all investments undertaken or able to be undertaken by the Fund.
The trustees considered expected cash flow, the expected risk, the expected return and the suitability of the investment including its liquidity. They need also consider the time for expected payments of benefits to members and the preferences of members to accept the transfer of an asset in lieu of a cash payment when a benefits required to be paid.

Diversification of Investments
The trustees determined it is not advisable to diversify the Fund's investments beyond the current range of investments.

Resolution
The Trustees resolved to adopt the attached investment strategy and to review the strategy each year based on the Fund's circumstances and prevailing investment conditions. The Trustees also confirmed that a copy of the investment strategy has been provided to each member.

Closed
There being no further business the meeting closed.

Chairperson

Appendix 3: Draft investment strategy

1 Details of Fund

Name of Fund:
Date Fund Set Up:
Name(s) and Addresses of Trustees:
Name and Address of Auditor:
Type of Superannuation Fund:
Date and Location of Trust Deed

2 Investment Objectives

The Trustee aims to obtain the greatest rate of return possible on the fund's assets while keeping risk within controlled boundaries.

The Trustee will ensure all investments are authorised by the trust deed.

The Trustee will ensure no more than and no less than the percentages stated below of the investments are invested in any one of the following assets or groups of assets:

		Minimum Percentage	Maximum Percentage
(i)	Fixed Interest		
(ii)	Australian Shares		
(iii)	International Shares		
(iv)	Property		
(v)	Life Insurance Policies		
(vi)	Managed Trusts		
(vii)	Other		

The specific investment return objectives for each class of investment are:

		Objective
(i)	Fixed Interest:	NAB prime deposit rate
(ii)	Australian Shares:	15% or more
(iii)	International Shares:	15% or more
(iv)	Property:	12% or more
(vii)	Managed Trusts:	10% or more
(viii)	Other:	

3 Review Procedure

The Trustees will meet at no less than quarterly intervals to consider the performance of the investment portfolio. The Trustees will obtain expert assistance as required.

4 Benchmark for Investment Performance

The Trustees will use the following investment measures as a benchmarks to measure investment performance.

(i) Fixed Interest: Equal to or more than NAB prime deposit rate
(ii) Australian Shares: 15% or more
(iii) International Shares: 15% or more
(iv) Property: 12% or more
(v) Life Insurance Policies: 8% or more
(vi) Managed Trusts: 10% or more
(vii) Other: X% or more

5 Reserves

The Trustees will create and maintain reserves using investment earnings greater than the investment objective for each class of investment.

6 Liquidity

The Trustees will maintain cash and near cash reserves to allow the trustees to pay all expected assessments, benefit transfers and member benefits. The Trustees will use their best efforts to maintain adequate life insurance policies on the lives of the members.

7 Manager

The Trustees will conduct all investments personally.

8 Investment objective questionnaire

The attached completed investment objective questionnaire is part of this strategy.

Confirmation

Agreed by the Trustees of the DIY Superannuation Fund on 29 June 2010

Signed.....

Signed

PART 6.2 COORDINATING THE SMSF'S INVESTMENT STRATEGY WITH THE OTHER PARTS OF A FINANCIAL PLAN

Introduction

A SMSF is a separate entity to its members and it must always be treated as such. However, a functional exception may be made when the SMSF's investment strategy is being considered. Here there is a need to integrate the SMSF's specific investment strategy with the member's general financial strategies and goals. After all, the purpose of the SMSF is to provide retirement benefits to the member, and this can hardly be done without considering the overall position of the member and the member's retirement prospects and aspirations.

For example, an aggressive investment strategy focusing on potentially high growth but low dividend small cap shares may not be appropriate for a SMSF paying an allocated pension to a seventy year old. This is particularly if the member has no other assets, no other income, and no prospects of acquiring either. Yet that strategy could be perfect for a forty-year old GP with a virtually guaranteed life income and significant cash deposits and property investments outside of the SMSF.

Nothing happens in a vacuum, and this should include the formulation of the SMSF's investment strategy. The SMSF is just the vehicle by which certain investments are held by the member, and the member's other assets and financial circumstances should be considered in detail when setting the SMSF's investment strategy.

What should a SMSF invest in?

Anyone who is dogmatic here is probably a salesman. Property, direct shares, cash, managed funds and indexed funds all have their place. Which is best? It depends, and it's too simple to assert that one class of investment will always outperform another. It's more a question of which investment within that class.

For example, consider the oft-asked question "do shares outperform property?" It's amazing the emotion this question generates. But it is really a question that cannot be answered. If you bought News Limited 12 years ago, rather than a one bedroom flat in a rural town, you will say "shares". But if you bought an Inner Bayside four-bedroom home 12 years ago rather than HIH, you will swear it is property. The more sensible answer is "it depends" or even "it's a question of balance". And the member's overall financial profile must be considered before making a decision.

Should you negatively gear a property investment or should you make extra superannuation contributions?

This is another question without a real answer. To say for sure one needs to know the future. And again the choice of which property you gear, and which investment by is ultimately made by the SMSF, will be critical to the outcome.

One suggested strategy

We generally suggest that clients should have both property and share investments, and should invest in both the SMSF and outside the SMSF.

If this suggestion is accepted then it is a likely next step to suggest that:

(i) property should be owned by the member personally and not the SMSF; and

(iii) shares should be owned by the SMSF, not the member personally.

This is because the particular characteristics of shares makes them better suited to SMSFs and the particular characteristics of property makes it better suited to a member personally or, possibly, a controlled trust.

The average SMSF has about $300,000 of assets. The average house price in Sydney is about twice this, and the average house price in Melbourne is about $400,000. Most SMSF's do not have enough assets to acquire a house in Sydney or Melbourne, at least without sacrificing diversity and liquidity. Remember, SMSFs cannot borrow to acquire assets. This makes property a difficult investment for most SMSFs.

On the other hand, members can borrow to acquire assets, and properties are usually acquired using at least some borrowed money. Even if a member can buy a property without borrowing, it is comforting to know that the property can be borrowed against if circumstances change. And the tax benefits attached to negative gearing are worth more if the owner is paying tax at 47%.

Franked shares are particularly attractive to SMSFs since franking credits are refunded or offset against tax due on other taxable income. And these refunds will become greater once the SMSF starts to pay an allocated pension.

Hence a common strategy, that integrates the investment profile of the SMSF and the member, is to negatively gear properties in the name of the member and to buy franked shares in the name of the SMSF. But the question of which property and which shares we must leave to you!

PART 6.3 SMSFS AND INVESTMENTS IN UNIT TRUSTS

What is a unit trust?

A unit trust is a special type of trust where the beneficial ownership of the trust property is allocated between the owners, or unit holders, based on the number and type of units that they hold. A detailed explanation of a unit trust, and its cousin, a hybrid trust, is outside the scope of this manual. We have prepared detailed memoranda explaining each of these trusts and these manuals are available on request.

How do unit trusts work with SMSFs?

Up to 11 August 1999 it was quite common for a SMSF to use some or all of its benefits to acquire units in a unit trust. This trust would then borrow and the total monies, the capital and the debt, would be used to buy a property or some other geared investment.

This strategy allowed the SMSF to circumvent the rule against SMSFs borrowing.

The courts found that these arrangements were effective and did not comprise an in-house asset as the term was then defined. This was good news to the many SMSF that had used this strategy to gear up property investments from the early 90's on. Their timing was impeccable and coincided with a boom in Australian property prices, which translated to excellent returns for the SMSFs.

The managed fund industry did not like this strategy as it drew money away from the traditional superannuation and insurance businesses: their bread and butter.

In August 1999 the Federal Government responded to lobbying from the managed fund industry and changed the law to treat new investments in units in geared related unit trusts as in-house assets. We still get regular complaints from clients about this change. But there is nothing that can be done about it and the fact is new SMSF investments into geared private trusts disappeared on that date.

Trust investments in place at 11 August 1999

Trust investments in place at 11 August 1999 are not in-house assets and can continue to be held by a SMSF. This is so even where the trust has borrowed to acquire or retain assets. This rule is set out in sub-section 71A of the SISA.

This rule, as usual, is subject to some exceptions and extensions. Briefly, and in simplified terms, these are:

(i) if the SMSF holds partly paid units then it can pay up those units and the paid up amount will not be an in-house asset until 30 June 2009. It is very rare for private trust units to be issued on a part paid basis, and this exception is of limited practical significance; and

(ii) two special rules applied to allow excessive levels of debt held at 11 August 1999 to be discharged. These rules are mutually exclusive and are:

(a) the SMSF could elect to acquire additional units up to 23 December 2000 (section 71E); or

(b) the SMSF could elect to convert distributions of net income to additional units (section 71D)

We counsel great caution in dealing with trust investments in place at 11 August 1999. The ATO does not like them and it is unlikely that a SMSF will get sympathetic treatment if there is an inadvertent breach of these rules.

SMSF trustees with these investments should seriously consider un-winding them.

Trust investments after 11 August 1999

A SMSF may now only invest in a unit trust after 11 August 1999 if:

(i) the trust is not geared, ie has no debt; or

(ii) the trust is not related to the SMSF (in which case it can have debt).

Whether or not these restrictions make investment sense is not the point. It is quite arguable that geared unit trusts have been excellent investments for SMSFs and the gearing has lifted investment returns considerably. But the point is that the law changed on 11 August 1999 and investments in related geared unit trusts are now in-house assets.

A SMSF can only acquire units in a geared unit trust after 12 August 1999 where the trustee is either not a related party or the units do not breach the 5% in-house asset limit.

A SMSF can acquire units in a geared unit trust where the trustee is not a related party. As to what sort of circumstances will satisfy the rule that the trustee not be related, we can only say that the issue is very difficult and we generally recommend that SMSFs do not go down this road, as the piftfalls are many. Daniel Butler, a respected authority on SMSFs, writing in the papers for the National Tax & Accountants Association September 2003 seminar observes that at least three criteria must be met. These are:

(i) each investor (ie unit holder) should generally hold less than 50% of the investment (ie the issued units), since there is a view that here no one party controls the trust;

(ii) the trust should not make related party investments (since this means the trust could be seen as a device to get around the other in-house asset rules, and so attract anti-avoidance rules); and

(iii) do not allow a related part to take a charge over an asset owned by the unit trust.

A SMSF can acquire units in a related unit trust provided the trust is not geared, ie has no debt. The units are prima facie an in-house asset but provided some special rules are observed they come within an exception. The special rules are set out in sub-section 71(1)(j) of the SISA and regulations 13.22A to 13.22D and say that:

(i) the unit trust must not lease assets (other than business real property) to related parties or make a loan to another person (other than hold a bank deposit or a similar facility);

(ii) the trust's assets are not assets which, if acquired or held directly by the SMSF, would breach the superannuation law;

(iii) the unit trust's assets should not be charged in any way; and

(iv) all transactions are conducted on an arms length basis.

As indicated above, we recommend that SMSFs do not go down this road and avoid investing in unit trusts. The pitfalls are many, and the consequences of getting it wrong severe: the SMSF may lose its complying fund status and be liable for large tax penalties.

What are the pitfalls with non-geared trusts?

The pitfalls are many and include:

(i) un-presented cheques exceeding the bank balance, and hence creating an overdraft, ie a borrowing;

(ii) inadvertent charges over the property. We have encountered cases where another unit holder has borrowed against the property or created a charge over the property without the knowledge or consent of the SMST unit holder. This is a problematic area and, to say the least, there is a possibility that this breaches a number of rules that must be observed if the SMSF is to stay as a complying fund. This is a big problem area: on day one everyone knows the score and respects the position of the SMSF. But three years on most have forgotten, and just do what they want to do without any regard to these complications.

Building contracts are another cause of concern. Sometimes these contracts create a charge in favor of the builder for un-paid building fees. Signing a contract like this breaches the superannuation law.

(iii) loans to other persons, except a bank, are not permitted; and

(iv) the trustee of the unit trust should not be the same trustee as the SMSF, and in the case of corporate trustees, the same person should not be a director of each corporate trustee. This is because to do so automatically makes the unit trust a

related party and breaches the in-house asset rule even if the SMSF cannot exercise voting control over the unit trust.

Can a SMSF invest in a hybrid trust?

No. A hybrid trust is a non-fixed trust and this means distributions of net income from a hybrid trust comprise special income in the hands of a SMSF. Special income is taxed at 47%. So SMSFs should not acquire or hold units in hybrid trusts.

Can the special income rules apply to a unit trust?

Yes they can. If the unit trust derives special income from another source, then the distribution of net income from that unit trust will be special income in the hands of a SMSF. Another reason for clients to not go down these roads.

Unpaid trust distributions

It is not uncommon for a unit holder in a unit trust to receive cash from the trust more than the amount of net income the unit holder is presently entitled to under the trust deed. Accountants frequently show this in the accounts of the trust and the unit holder as an amount owed by the unit holder to the trust. Or, if you like, a loan to the unit holder, this is a problem where the unit holder is a SMSF, since SMSFs cannot borrow.

But it is actually not a problem at all. It is a misnomer. The technical analysis is that the amount is not a loan at all. But rather it is a benefit held under a separate trust for the unit holder that must be paid on demand, ie an amount held under a bare trust. The SMSF has not borrowed: rather, the accountant has called something a borrowing when in truth it is not a borrowing at all, the common sense solution is obvious: call it "an amount held on trust" in the SMSFs' accounts, and avoid the problem altogether.

PART 7: CONTRIBUTIONS

Introduction

Most trust deeds provide that the SMSF can accept contributions from any person provided that doing so does not breach the superannuation law. This is a sensible approach to take because it avoids the need for frequent amendments to the fund's trust deed. But it does make it hard for readers to work out who can contributions and for whom. This part of the manual aims to answer this question.

It is important that SMSF trustees are fully aware of the minimum standards relating to the acceptance of contributions prescribed under

Who can contribute to a superannuation fund?

From 1 July 2007 the rules for who can contribute to super are very simple.

Under age 65

Anyone under age 65 can contribute to super. This is so even if they are not working: there is no work test for persons under age 65.

Age 65 to 75

Once you reach age 65 you can contribute to super if you pass the work test. The work requires you to have worked for at least 40 hours over 30 consecutive days at the time the contribution is paid. "Work" is defined broadly to in effect include time spent administering investments and also includes paid work where the payer cannot claim a tax deduction for the payment, such as baby sitting or private gardening.

Age 75

After age 75 you cannot contribute to super (although you can pay a spouse contribution on behalf of your spouse if the spouse is under age 65.) However, a fund can still accepted mandated contributions made under an industrial award that does not specify an upper age limit.

Children under age 18

Contributions can be paid for a child under the age of 18. However, the child must derive eligible employment income or business income before they can claim a tax deduction for the contributions paid for them.

Summary table

Member's Age	Conditions to be met before a fund can accept contributions
Under age 65	No conditions. All contributions can be accepted
Age 65 to age 75	The fund may accept: (i) mandated employer contributions; (ii) employer contributions other than mandated contributions; (iii) member contributions
Age 75	Only mandated contributions can be accepted over age 75

What contributions are deductible?

Contributions by self-employed persons and employers are deductible in the year they are paid to the fund up to the member's deduction limit. From 1 July 2007 100% of the contributions paid by a self-employed person are deductible, whereas previously only the first $5,000 plus 75% of the excess were deductible.

An employer that is a company, including a company that is a trustee of a trust, can superannuate persons who are general law employees and can also superannuate persons who are not general law employees but who are directors. This is because directors are deemed to be employees for superannuation purposes. This is the law and the ATO has recently issued a public ruling accepting that this is the law.

The deduction limits are now $25,000 per member, subject to a special transitional rule that allows persons age 50 and over to claim $50,000 a year until June 2012. The government has announced changes that, if passed by parliament, will permanently increase the concessional contributions cap to $50,000 for individuals who have total super balances below $500,000 and are 50 years old or over. Progress of this change and the deduction rules generally can be checked at the ATO website at: ATO website contribution rules.

The deduction limit used to apply on a per employer basis. This was great news for doctors and dentists because it meant they could have double or even triple the normal age based deduction limits. But from 1 July 2007 the deduction limit applies on a per member basis, which takes away the opportunity for double or even triple contributions.

What contributions are not deductible?

Employee contributions are not deductible. However, there is a special concession originally intended for doctors and dentists who are substantially self-employed but who derive limited salary income from hospital appointments and other part time appointments. This concession is colloquially known as "the 10% rule". Briefly, provided no more than 10% of a doctor's assessable income is salary from an

employer who is required to superannuate them under the law, such as a public hospital, the salary is ignored and the doctor is treated as a self-employed person for super purposes.

When is interest on amounts borrowed to pay contributions deductible?

Interest incurred by an employer on a loan to pay employee contributions is deductible.

Otherwise interest incurred on a loan to pay contributions is not deductible.

This means care is needed when paying contributions other than employer contributions to ensure that borrowings are not directly used to pay contributions. Instead, borrowings should be used for other purposes where the interest on the borrowing is clearly deductible, and debt free cash flow from the practice used to pay the contributions. For example, a dentist practising in her own name may choose to borrow to pay the 30% management fee due to the host practice, rather than pay cash, and to use the cash flow freed up by doing this to pay her contributions.

What are the tax benefits of large deductible contributions?

Super contributions are tax deductible. This means the Government rewards you for providing for your own financial future. $100,000 of contributions for a couple over age 50 can generate an immediate and certain return of up to $36,500 cash. This makes super the ultimate tax-planning scheme.

The savings depend on the member's age, and hence the maximum amount they are able to contribute, and the member's marginal tax rate.

Single people under age 50 will be at least $8,250 better off in cash, and married doctors and dentists under age 50 can be as much as $31,500 better off in cash as a result of paying $50,000 of deductible contributions.

Single people over age 50 will be at least $16,500 better off in cash, and married doctors and dentists over age 50 can be as much as $63,000 better off in cash as a result of paying $50,000 of deductible contributions.

The results are summarized in the following table:

Member's Age	Member's age based deduction limit	Member's net tax rate (plus Medicare Levy)	Maximum tax benefit single person	Maximum tax benefit couple
0 to 50	$25,000	31.5% less 15%	$4,125	$8,250
		41.5% less 15%	$6,625	$13,250
		46.5% less 15%	$7,785	$15,750
50 plus	$50,000	31.5% less 15%	$8,250	$16,500
		41.5% less 15%	$13,250	$26,500
		46.5% less 15%	$15,750	$31,500

Bear in mind tax benefits are cash benefits: you have to (up to) almost double it to calculate the effective pre-tax equivalent income. For example, $63,000 tax-free is the same as $114,545 in pre-tax taxable income, with a marginal tax rate of 45%.

Figures for couples are included because most doctors and dentists are able to effectively superannuate their spouse out of the practice's pre-tax income. Another reason why super is so good. And this is just the beginning. The tax benefits go on and on, making sure that super is the most tax efficient investment vehicle available.

How are fund earnings taxed?

Once the contributions are received by the fund they are invested in deposits, shares and properties, and derivatives thereof. The interest, dividends and rents from these investments and re-invested again, creating a compound effect over time.

These are taxed very concessionally, which means the after tax rate of return on a given investment will usually be greater in a super fund than otherwise, due to the concessional tax rules. These rules can be summarized in tabular form as follows:

Income component	Tax rate in accumulation mode	Tax rate once pension starts
Income (ie rents, dividends and interest)	15%	0%
Realized capital gains on assets held less than 12 months	15%	0%
Realized capital gains on assets held more than 12 months	10%	0%
Unrealized capital gains	0%	0%

These tax rates compare favorably with the personal tax rates and are particularly good for unrealized capital gains: capital gains are only taxed when and if the underlying asset is sold, ie on realization. This means buy and hold strategies are very tax efficient for SMSFs. If you hold long enough, ie until a pension starts, there will be no tax at all.

Non-arms length investment income

Special rules apply to non-arms length investment income. This income, for example, private company dividends and distributions from related trusts, is taxed at 47%. This means, as a practical matter, very few SMSFs derive non-arms length income.

Contributions income

Contributions are taxed at one of three rates:

(i) concessional contributions are taxed at 15%;

(ii) non-concessional contributions are taxed at nil%; and

(iii) concessional contributions above the member's age based limit (Ie $25,000 under age 50 and $50,000 over age 50) are taxed at 47%, and non-concessional contributions above the member's limit (ie $150,000 in a year or $450,000 in a three year period) are taxed at 47%.

A snow ball effect

The concessional rules for taxing contributions and fund earnings mean there is more to invest, and that the amount invested grows faster than otherwise would be the case. We like to think of a bigger snowball and a steeper slope, so that at the end of the slope, ie at the end of a given period of time, the snowball will much bigger than otherwise will be the case. It's a double whammy effect: more at the start plus higher after tax earnings along the way combine to create a much better investment result over time.

PART 8: BENEFITS

Introduction

Most funds pay two types of benefits, being lump sum benefits and pension benefits.

For technical reasons, most trust deeds are drafted with an emphasis on paying pension benefits, with lump sum benefits added in almost as an afterthought. This emphasis is a little duplicitous. It's really there to satisfy various constitutional rules relating to the Federal Government's power to legislate for superannuation funds. The constitution does not allow the government to legislate for superannuation as such, but it does allow it to legislate for pensions. The government therefore made the superannuation tax benefits dependant on whether a fund was set up for the primary purpose of providing members with pensions. Because the fund wants to get these tax benefits, its deed is drafted to reflect a primary purpose of providing members with pensions. This is the case even when the trustees/members never had any intention of drawing a pension and always intended to draw a lump sum benefit.

Lump sum benefits

A lump sum benefit is a simple enough concept to understand. It is a lump sum benefit, ie a benefit paid to a member in one single lump sum. Superannuation lump sum benefits are eligible termination payments ("ETPs") and are taxed under the rules applying to ETPs, which are discussed in the next section.

Pension benefits

A pension benefit is really a superannuation benefit other than a lump sum benefit. The word "pension" is really a misnomer in this context. A pension is traditionally a series of income payments paid to a person over the life of that person or for a defined period of time. Hence we think of old age pensions, state government super pensions and private life pensions paid by life offices and similar organizations.

But from 1 July 2007, and particularly from 20 September 2007, a pension benefit can be paid to a member over just one year, or an even shorter period of time, and the only real tax condition is that a minimum amount be withdrawn each year, and there is no upper limit. There is no requirement that the pension last for a member's life, expected life or for a defined period of time.

Different types of pension benefits

Pension benefits can be further divided into a bewildering array of different types of pensions. These include complying pensions, allocated pensions, transition to retirement pensions, growth pensions, market linked pensions and so on and so on.

Thankfully, a detailed study of the pensions that were once available is no longer a sensible use of time. This is because from 20 September 2007 only one type of pension can be started, and this pension is already being described as a "Simple Pension".

In tabular form:

Type of pension	Where used?	Start date	End date	Comments
Allocated pension	To access tax benefits, (ie fund income and pension income both exempt from tax)	Many years ago	30 June 2007	May apply to some clients between age 55 and 60 where tax benefits justify an early pension
Market linked pension (aka "TAP")	To access tax benefits, and to access old age pension benefits (ie 50% exemption from assets test)	20 September 2004	20 September 2007 (effectively)	Will only be used by clients who have low assets and are interested in securing the old age pension.
New simple pension	To access tax benefits	1 July 2007	On-going	Automatic for clients age 60 or more at 30 June 2007 May also apply to some clients between age 55 and 60 where tax benefits justify an early pension

Simplicity, simplicity, simplicity

The new rules make super pensions much simpler than before. For pensions started before 20 September 2007 the rules are actually a bit more complicated than previously. The simplest way to get a handle on the new rules is look at what the position will be come 21 September 2007, ie the position most people will be in, and to then jump back and look at what the position is between now and 30 June 2007, and at what the position will be between 30 June 2007 and 20 September 2007. That is, let's examine the general rule and then consider two minor, and time limited exceptions. This keeps the examination as simple as possible and avoids unnecessary complications.

After 20 September 2007

The position for super pensions after 20 September 2007 is remarkably simple. In summary, allocated pensions and market linked pensions cannot be started after that date and a member can only start a new simple pension.

The new simple pensions must satisfy five basic rules. These are that:

(i) at least one annual payment must be made each year;

(ii) there is no maximum amount that must be paid, but there is a minimum amount. This minimum amounts are aged based as follows:

Age	**% of account balance**
55 - 64	4%
65 - 74	5%
75 - 84	6%
85 - 94	10%
95 +	14%

(The minimum amounts have been halved for the 2010/11 year as part of the Federal Government's response to the Global Financial Crisis);

(iii) the pension cannot be transferred, except on death;

(iv) the pension's capital value and income stream cannot be used by the member for borrowing (ie the member cannot borrow against the security of the future income stream); and

(v) the pension can only be commuted in certain circumstances.

What are the tax benefits of a pension?

Once a pension starts, the income on the assets used to pay the pension is tax free in the fund's hands. The pension income is usually tax free in the member's hands provided the member is age 60 or over.

This creates significant tax planning advantages. It makes sense for doctors and dentists to move as much of their wealth as possible to the super fund before the pension starts to get the maximum benefit from these advantages.

A summary of the new rules for pensions

From 1 July 2007 only two tax components are relevant: the taxable component and the tax exempt (non-taxable) component.

The tax exempt component includes any un-deducted contributions, CGT exempt amounts and the old pre-1983 service component.

The taxable component is the total benefit less the tax exempt component.

Proportioning rule

When a lump sum is taken, the components of the lump sum are determined by the relative proportions of each of the exempt component and the taxable component at the date of withdrawal. This is known as the 'proportioning rule'. For pension payments and lump sums from a pension account, the proportions are fixed at the date the pension starts and this fixed proportion applies to all later pension payments.

Proportioning rule for members under age 60

For members under age 60 the exempt proportion of a withdrawal/pension payment is tax free but the taxable component is taxed in line with the member's tax profile. The rate of tax and the tax offsets depend on whether the withdrawal is a lump sum or pension.

If the pension is a 'pre-retirement' pension or a "transition to retirement" pension, ie where the pensioner is between age 55 and 65 and has not retired, the maximum amount be drawn each year is limited to 10%.

Proportioning Rules for members over 60

The proportioning rules are less important for members over age 60 as all lump sum benefits and pension benefits are tax free irrespective of the relative proportions of the exempt component and the taxable component.

But the proportions still need to be calculated and recorded as they will become relevant if the member dies. This is because benefits to dependants are taxed if paid from the taxable component (but not from the tax exempt component)

Proportioning rules for those under 60

The new proportioning rules do not apply to existing pensions being paid to members under age 60 at 1 July 2007. These members may stay under the old pre-30 June 2007 rules. However, if there is a major change in the pension's format, for example if the pension is commuted, is partly commuted or the member turns age 60 the new proportioning rules start automatically.

So the old rules are theoretically still relevant until 1 July 20012, if five years after the start of the new rules by which time all pensioners aged 55 at 1 July 2007 will have turned age 60.

Existing Complying Pensions

The old style "complying pensions" such as "term allocated pensions" (or "TAPs") and defined benefit pensions cannot be converted to the new style of pensions. This is because conversion in effect requires commutation, and non-commutation was a pre-condition to these old complying pensions receiving their tax benefits and Centrelink old age pension benefits.

How are superannuation benefits taxed?

Lump sum benefits

The taxation of lump sum benefits depends on the composition of the benefit and the age of the person receiving the benefits. Any lump sum benefits received after 1 July 2007 by a person age 60 or more are tax free. If the person is under age 60 it becomes more complex. Basically the pre-1 July 2007 rules apply and these are summarized in the following table:

Component	Description of component	Tax Payable
Tax-free component	The tax free component at 1 July 2007 plus any non-concessional (ie un-deducted) contributions after 1 July 2007	*Nil%*
Taxable component	Taxable component (ie the benefit paid less the tax-free component, if any)	*Age 60 or older: nil%* Between age 55 and preservation age: nil % on the first $140,000 and 16.5% on the remained Age less than preservation age: 21.5%

Pension benefits

The taxation of pension benefits also depends on the composition of the benefit and the age of the person receiving the benefits.

Any pension benefits received after 1 July 2007 by a person age 60 or more are tax free.

As is the case with lump sum benefits, if the person is under age 60 it becomes more complex. Basically the pre-1 July 2007 rules apply. These rules are summarized in the following table:

Component	**Age/disability status**	**Tax payable (plus Medicare levy of 1.5%)**
Taxable component paid by a taxed fund (ie virtually all funds with doctors and dentists as members)	Under age 55 and no disability	Marginal tax rates apply to the whole amount
	Between age 55 and 60 or under a disability	Marginal tax rates apply to the whole amount, less a 15% offset on the whole amount
	Age 60 and above	Tax free
Taxable component paid by an untaxed fund (rare for doctors and dentists)	Under age 55	Marginal tax rates apply to the whole amount
	Between age 55 and 60	Marginal tax rates apply to the whole amount
	Age 60 and above	Marginal tax rates apply to the whole amount, less a 15% offset on the whole amount
Tax-free component	Any age	Always tax free

PART 9: DIVORCE AND SUPERANNUATION BENEFITS

Historically the superannuation law has not coped well with divorce.

The Family Law Court lacked the power to order the division of a member's benefits with the member's spouse, the SISA did not contemplate such an order in event, and difficult valuation problems arose, particularly with defined benefit funds.

The Family Law Act treated superannuation as a financial resource to be taken account of when dividing assets, but not as an item of property able to be divided by the parties. The vesting and preservation rules meant that benefits could not be divided between a member and a spouse. This meant, for example, if the Family Law Court ordered a fifty-fifty division of assets, and the assets are jointly owned home $500,000, cash $100,000 and the husband's superannuation $500,000, the husband had to take the superannuation of $500,000 and, probably, $50,000 of cash. She gets the house, he gets the super. Because of the SISA vesting and preservation rules there was no other way to do it.

It was generally accepted that the superannuation law and the family law did not sit well together. Sometimes there were flagrant contradictions. For example, the Family Law Court could order a division of property which, if acted on, would breach the superannuation laws concerning the vesting and preservation of member benefits.

The Australian Master Superannuation Guide attributes this to three factors. These are:

(i) the rapid growth of superannuation and the complexity of its rules;

(ii) the provisions of the Family Law Act provide little guidance and virtually no specific reference to superannuation; and

(iii) there was no mechanism to allow a spouse's superannuation to be divided or transferred to the other spouse and the Family Law Court had no jurisdiction to make an order that binded a third party, such as a superannuation fund trustee.

In May 1998 the Federal Government released as discussion paper called "Superannuation and Family Law". The paper proposed the Government:

- allow superannuation benefits to be divided between divorcing parties;
- allow the divorcing parties to apply equitable strategies; and, ultimately;
- if the parties cannot agree, to allow the Court to make a binding order.

The Family Law Legislation Amendment (Superannuation) (Consequential Provisions) Bill 2001 was introduced into Parliament in July 2001. The Bill amends

the tax laws to ensure that appropriate tax treatment is applied to superannuation interests that have been split under the dividing superannuation on marriage breakdown reforms contained in the Family Law Legislation Amendment (Superannuation) Act 2001.

The Consequential Bill amends the tax law so that:

- the non-member's entitlement is treated as a separate ETP;
- the un-deducted contributions, concessional, post-June 1994 invalidity, capital gains tax exempt components and the untaxed element of the post-June 1983 component are split on a proportionate basis to the overall split;
- the non-member spouse's benefit is assessed separately against their own RBL;
- capital gains or losses that may arise from the creation or forgoing of rights when spouses enter into a binding superannuation agreement or where the agreement comes to an end will be disregarded;
- the current capital gains tax exemption for payments made from a superannuation fund or an approved deposit fund will be extended to non-member spouses; and
- capital gains tax rollover relief will apply to in-specie transfers between funds with fewer than five members.

The Consequential Bill also amended the superannuation law to ensure that:

- accounts held in the Superannuation Holding Accounts Reserve can be split;
- if a surcharge assessment is issued after a split but in respect of a period prior to the split, then the fund that holds those surchargable contributions for the member spouse will be liable to pay the surcharge. If no fund holds those surchargable contributions for the member spouse, then the member spouse will be liable to pay the surcharge; and
- the same protection and rights apply to the non-member spouse that are currently given to the member spouse.

De facto couples

The rules for splitting benefits on a marriage break-down do not apply to de facto couples. This is because property settlements arising from the break down of de-facto relationships are not covered by the Family Law Act and are subject to state laws.

The state of play now

A full and complete coverage of the rules for superannuation and marriage breakdown are beyond the scope of this manual. Indeed, separate books have been written on the subject and there is no point in reinventing those wheels here.

Specific legal advice should be sought if a client has a particular concern regarding his or her marriage and his or her superannuation benefits and or those of a spouse. But the bottom line in superannuation and marriage breakdown is that superannuation benefits are now treated as property for family law purposes and that:

(i) the parties to a marriage can enter into a superannuation agreement that sets out how their superannuation benefits are to be dealt with. A number of conditions must be satisfied before the agreement is effective and these are that:

  (a) the agreement must be in writing and must be signed by both parties;

  (b) the agreement must be accompanied by a statement that each party received legal advice about the effect of the agreement on each party's rights, whether the agreement was to their advantage, whether the agreement was prudent, and whether the agreement was fair and reasonable in the light of all the reasonably foreseeable circumstances; and

  (c) the agreement must be accompanied by a statement from a solicitor confirming that the advice referred to in sub-paragraph (b) was provided;

  (d) the agreement must not have been set aside by a court; and

  (e) each party must have a copy of the agreement;

(ii) the Family Law Court may make an order splitting a member's superannuation with the member's spouse; and

(iii) the Family Law Court may make an order flagging a member's superannuation benefits so that the superannuation fund trustee has to notify the member's spouse in writing a specified period before the benefit is paid to the member.

PART 10: BINDING DEATH BENEFIT NOTICES

For many years super funds were not bound to follow the directions of a member regarding who should be paid the member's death benefits if the member died prematurely. In most cases the member's written preferences would be followed. But the trustees were not bound to do this and complications could arise where the member was not in a traditional nuclear family arrangement.

These problems were rarely encountered in SMSFs. This is because the surviving trustee was usually the deceased member's legal personal representative and the beneficiary of their estate. But they are even rarer now because the law has been amended to allow members to sign binding death benefit notices. These are controlled by s 59(1A) of the SISA and Reg 6.17A and 6.17B.

What conditions apply to binding death benefit notices?

Under Regulation 6.17A binding death benefit notices must:

- Be in writing;
- Specify the dependant or the legal personal representative;
- Specify the proportion of the benefit that must be paid to each beneficiary or legal personal representative;
- Be signed and dated by two unrelated witnesses, both of who must be over age 18 and neither of whom must not be specified in the notice; and
- Contain a declaration that the member signed the notice in the presence of the witnesses**.**

The notice lasts for 3 years, or for such shorter period as may be specified in the deed, and can be revoked by the member at any time. Any revocation should be in writing and should be communicated to the SMSF's trustees and the witnesses of the original binding death benefit notice. If one of the persons specified in the notice dies before the member, then the entire binding death benefit notice will be ineffective. This is because to be valid every person who is specified in the notice must be a dependant, and a deceased person cannot be a dependant.

Binding death benefit notices are subject to SIS Regulation 6.22. This regulation sets out the class of persons who may receive a death benefit. These are:

- The member's spouse, whether married or de facto;
- The member's children, whether natural, adopted, or step children, of all ages and irrespective of whether they are actually financially dependant on the member at the time of death; and
- Persons actually financially dependant on the member at the time of death

If a person is not within one of the above classes of dependants then they cannot receive a death benefit irrespective of whether they are nominated in a binding death benefit notice. If a binding death benefit notice purports to nominate a person outside one of these classes of dependants then the entire notice will be ineffectual. A binding death benefit notice may leave all or part of the deceased member's benefits to the deceased member's legal personal representative. If this happens the amount of benefits left to the legal personal representative will be received on trust and will be subject to the deceased member's will and last testament. It is possible that a deceased member's will may be challenged and overturned. A discussion of what happens in this situation is outside the context of this manual.

A Practical application

In most cases when one member passes away, the surviving trustee will be the deceased member's widow or widower. In most cases the surviving trustee will resolve to pay the deceased member's death benefits to herself or himself as a tax free amount in her or his capacity as the deceased member's spouse. Here there is little advantage in the deceased member having signed an irrevocable death benefit notice directing that 100% of the benefits go the spouse, as this is what would have happened anyway.

Benefits do not automatically form part of the deceased member's estate. The trustees have a discretion as to whom the benefits are paid. This applies to large funds as well as SMSFs. Where the surviving trustee is also the deceased member's widow or widower this is straight forward: mum pays the money to mum, and that's the end of it.

However, in some cases this is not appropriate. These cases usually involve second or third marriages where there are legitimate and complicated competing claims on the deceased member's superannuation benefits. For example, the deceased member and his spouse may have married later in life and have separate financial arrangements. These arrangements may mean that each spouse's assets go to their respective children on death. The problem is, the widow or widower may not adhere to these arrangements and may instead determine to send the benefits to herself or himself.

The irrevocable death benefit notice, properly executed, can overcome these concerns and ensure that the correct person or persons receive the deceased member's benefits.

Appendix: Sample binding death benefit notice form

The Trustees of the SMSF
Address
Date

I, Joe Sample, of address give notice that if I die the benefits held for me in the SMSF are to be paid to the following persons in the following proportions:

Name and address	**Proportions**
List names and addresses of dependants or Legal personal representative under will	state proportions

Signed
Name
Dated

Witnessed by

Witness One
Signed
Name
Address

Witness Two
Signed
Name
Address

Each of whom is unrelated to the member, cannot benefit under this notice, has witnessed the member sign this notice and believes the member understands the contents and effect of this notice.

This notice is only effective for three years from the date of the notice.

PART 11: CAPITAL GAINS ROLL OVER BENEFITS

Superannuation benefits can be created by rolling over all or part of the capital gain realized on the sale of a small business.

A capital gain on the sale of a small business asset will be exempt from tax if it is rolled over into a SMSF (or other rollover entity) or, if the individual is over age 55, used for retirement purposes such as the purchase of an eligible annuity. This rule is intended to equalize the tax treatment of those people whose "superannuation is their business" and those people with traditional superannuation. For the capital gain exemption to apply the net value of assets of the individual and related parties including partners must not exceed $5,000,000. No exemption is available if the net value of assets is more than $5,000,000.

A lifetime ceiling of $500,000 applies to the exemption.

The exemption applies to so called "active assets", such as plant and equipment, furniture and fittings and goodwill used in connection with the business. The exemption does not apply to passive assets such as shares, real estate and intellectual property unless the asset is inherently connected to the business. The exemption also applies to companies, unit trusts and discretionary trusts that are "connected to the taxpayer". This means people who have run their businesses through various legal entities are not prejudiced under these rules.

"Connected to the taxpayer" means, in the case of a company or trust:

(i) the taxpayer controls at least half the voting power; or

(ii) the taxpayer controls between 40% and 50% of the voting power and no other person controls at least half the voting power.

"Connected to the taxpayer" means, in the case of a discretionary trust:

(i) the taxpayer controls the trust, ie controls its income and capital distributions; and

(ii) the taxpayer is a beneficiary capable of receiving more than half the trust's income or capital**.**

A rollover election must be made before the taxpayer's tax return for the year of disposal is lodged. A sample notice is attached as an appendix.

The amount of the rolled over capital gain will be reduced by any carried forward capital losses. The rolled over amount is not taxed in the hands of the SMSF but it does count towards the member's RBL. The amount of the ETP is deemed to be the lesser of the actual consideration received and the CGT exempt amount.

PART 12: ACCOUNTING REQUIREMENTS

Introduction

The accounting requirements for a SMSF are quite straightforward. Technically these requirements are the responsibility of the trustees. However, in practice, the accountant takes care of these matters. The comments set out below are general comments only. They are intended to give a broad overview of the accounting requirements for a SMSF.

Sometimes people considering starting a SMSF are daunted by what they are expect are onerous record keeping obligations. They should not be daunted. The record keeping tasks are very basic, not much more than simple filing, and take little time to complete. It boils down to filing all records for rollovers, contributions and benefit payments, and most importantly, for the SMSFs' investments. And never throw anything out.

Very few SMSF trustees encounter problems with the accounting and record keeping requirements. If anything, it is the opposite: some are prone to over account and record. But you will not hear us complaining about this. One tip can save a lot of bother: make sure the SMSF's bank account and other investment records clearly shows its name, and that this name include the words "Superannuation Fund". This means each cheque, tax invoice, distribution advice, sale note or any other document will always be flagged as belonging to the SMSF, and not to the trustee personally.

Banklink

We cannot say enough about Banklink.

Banklink seriously reduces the time and cost connected to accounting and auditing SMSFs and is strongly encouraged for all clients. Banklink, coupled with McMasters's SMSF filing system is the simplest and easiest way to administer your SMSF.

What records must be kept?

The superannuation law requires the trustees to keep records to fully explain the financial position of the SMSF and all underlying transactions. These records must be kept in a way that allows the trustees to prepare financial statements (profit and loss statement and balance sheet) and the annual return. The records must also be kept in a way that allows the accounts, statements and returns to be conveniently and properly audited.

Since most SMSFs have to pay tax the provisions of the Tax Act regarding the retention of source documents and the preparation of accounts to allow taxable income and tax payable to be calculated are also relevant. These provisions reinforce

similar provisions in the superannuation law. Corporate trustees will also be required to comply with the Corporations Law rules regarding the keeping of financial records.

What form do the financial statements have to take?

Most SMSFs are not reporting entities. This means the onerous reporting requirements set out in the accounting standards do not need to be followed. This gives the trustees some leeway with how the financial statements are prepared and means the more onerous and expensive aspects of preparing detailed financial statements can be ignored. For example, the need to revalue investment assets each year and recognize any uplift in value as income in the fund's accounts is avoided. This can be an expensive and time-consuming exercise and does not add anything to the understanding of the two members who are also the trustees.

Most trustees prepare financial statements in the familiar profit and loss and balance sheet format. This is partly because of convention and partly because of ease of interpretation. And because the standard accounting packages do it this way.

What is a reporting entity?

Briefly, a reporting entity is an accounting entity where its reasonable to expect there are people with an interest in the entity who depend on accounting information about the entity for making decisions and these people cannot otherwise get this information. Since SMSFs cannot have more than four members, and these members normally run the SMSF and have full access to financial information on a daily basis, most SMSFs are not reporting entities.

Can a SMSF report income on a cash received basis?

The answer to this question is "yes, a SMSF can report income on a cash received basis and in many cases this will be very appropriate". This simplifies the accounting and auditing requirements and makes the accounts meaningful. This is provided any major matters not reflected in cash are reported by way of notes to the accounts.

The ATO generally accepts cash receipts as a basis of measuring taxable income of SMSFs. This is provided it is consistently applied from year to year and there is no suggestion that this is being used just to secure a tax benefit.

Day to day accounting requirements

The accounting and audit costs are largely determined by the correctness and completeness of the records maintained by the trustee. The better the record keeping the lower the accounting and audit fee will be. Missing records are particularly problematic as they can take a lot of time to track down and complicate the audit process. Basic requirements include:

(i) all bank statements for the bank account should be retained in chronological order (it is simpler to have just one bank account. Multiple bank accounts are possible but do lead to higher costs);

(ii) details should be kept of all amounts deposited into the bank account, reconciled and cross referenced to the fund's bank statements. All cheques should be deposited into the bank account within a day or so of receipt.

(iii) all payments should be by cheque and full details should be written on the cheque butt, including the date, the payee's name, the amount, the source document (eg the tax invoice and the nature of the payment;

(iv) retain and file all documents relating to payments, receipts and assets in a sensible way. For example, you may choose to have a file for all BHP shares. On this file you should include your share scrip (or CHESS equivalents), copies of dividend advices including details of franking credits, copies of share purchase documents, copies of dividend reinvestment election forms and details of any bonus shares, share splits or similar transactions**.**

Contact us if there is any doubt as to what the trustee's record keeping requirements are. As a general rule: "if in doubt, file it". And we would add “never throw it out”.

SMSF record keeping is surprisingly simple. At its base level it is no more than a simple filing of all records received by the trustees in connection with the fund. If all records are filed properly there should be no problems complying with the law.

The n law requires trustees to keep records for certain periods of time. The tax law also has requirements in this area. These requirements should be seen as minimums and we recommend the SMSF’s record be kept forever. They usually do not take up much space and it is not hard to file them away just in case they are needed one day.

In “DIY Super” Noelle Kelleher provides the following guide for the retention of records:

Type of document	**Minimum period to be kept**
Trustee consents to act	10 years
Trustee minutes	10 years
Changes to trustees	10 years
Reports to members	10 years
Accounting records	5 years
Accounts and statements	5 years
Income tax return and related documents	5 years
Surcharge return and related documents	5 years

Records relating to the cost base of assets are more problematic: they must be kept for at least 5 years after the year of disposal. If an asset was acquired in 1990 and disposed of in 2000, this means the records relating to its acquisition must be kept for at least 15 years from the date of acquisition, ie to 2005. But we recommend they be kept for longer.

We prefer clients to keep all records forever. This is the safest approach.

Accounting records

The minimum records consist of the cheque butts, the bank statements and all records for the purchase and sale of assets and the expenses and income of the funds. These documents should be stored neatly in time order. Records for the purchase and sale of assets should be stored in alphabetical order with a separate division for each asset.

Details of the composition of any benefits rolled into the fund also need to be kept. This boils down to filing and retaining the statement of benefits from the old superannuation fund that comes with the cheque when the benefits are rolled into your fund. This statement should show details like the start of the eligible service period, the amount of pre-83 service, the amount of any un-deducted contribution and so on.

Some clients go to more trouble than this: one even has a "worm" on his computer screen measuring hourly movements in his share portfolio. Interesting, but highly unlikely to increase the value of the portfolio. There is no need for the transactions to be entered into a software program like MYOB, Quickbooks or the equivalent. These are useful for internal management purposes but cannot be used for audit purpose or for preparing the SMSF's annual accounts and related reports. The cheapest and easiest way to prepare the SMSF's annual accounts, tax returns and related documents is for McMasters' to input the transactions directly on to its system as part of the year-end process.

Rollover documents

This requires a specific mention. It is critical that the SMSF retain all documents received from other superannuation funds detailing the composition of the member's benefits. The member's benefits retain these characteristics when they are paid out to members, particularly as lump sums. This may be years later. Without the benefit transfer forms received from the other superannuation funds the SMSF will not be able to work out how much tax should be paid on the benefits. Rollover documents should be retained forever.

PART 13 THE TAXATION OF FUND INCOME

The taxation of SMSF income is a complex area and advice should always be sought before entering into any major transactions. A complete treatise on the taxation of SMSFs is outside the scope of this manual. Instead we explain the basic concepts involved in computing a SMSF's tax liability.

The basic idea

A SMSF is a taxpayer. It must lodge a tax return each year with the ATO. This return shows assessable income, allowable deductions and, therefore, taxable income. It also shows any tax credits or rebates available and tax payable. The tax is payable at the same time as tax is payable by companies. An instalment system applies. The ATO deems an assessment to be raised on lodgment of the SMSF's annual tax return.

The various general provisions in the tax law apply to SMSFs unless specifically excluded. These include rules regarding objections, penalties, amendment of returns, self assessment, dividend imputation, foreign tax credits, the derivation of income, capital gains and so on.

The computation of fund income

Assessable income is calculated according to ordinary concepts. It also includes specific amounts deemed to be included in assessable income by the Tax Act, such as a net capital gain and franking credits. The assessable income of a SMSF normally comprises interest, dividends (including imputation credits), rents, and net capital gains. The rules are largely the same as for other taxpayers.

Contributions that are deductible to the payer, and certain other contributions, are specifically included in a SMSF's assessable income.

Special rules apply for capital gain rollovers on mergers of funds, the cost base of assets on hand at 30.6.88, pre-30.6.88 funding credits, and transfers of taxable contributions to life offices, friendly societies and pooled superannuation trusts.

Allowable deductions

The general rules of deductibility of losses and outgoings applying to most taxpayers apply to SMSFs This essentially means any losses or outgoings incurred in production of assessable income will be allowable deductions unless they are capital in nature. If the loss or outgoing is capital and comprises depreciable plant and equipment a depreciation claim will be available. This is unusual for a SMSF unless it owns real estate or it has leased plant and equipment to lessees.

The cost of providing certain life insurance and disability benefits is deductible.

Benefits paid are not tax-deductible losses and outgoings in the fund's hands.

The ATO says the following are deductible in the hands of a SMSF:

(i) actuarial costs and fees;

(ii) accounting and audit costs;

(iii) trustee fees and indemnity insurances;

(iv) investment advice; and

(v) costs incurred in paying benefits and recording member entitlements.

Costs may need to be allocated between special component income, standard component income and exempt current pension income. These concepts are discussed in the following paragraphs.

SMSFs do not usually experience significant allowable deductions, either in frequency or value. Normally there are just a few small items like bank charges and accounting and audit fees. We are often asked how items like computers and investment magazine subscriptions should be paid for, ie should the SMSF pay for them or should the trustee pay for them. The answer is usually the trustee, assuming that they are deductible in his or her hands, since the trustee will usually face a higher tax rate than the SMSF. This means the after tax cost of the outgoing is minimized.

The calculation of income tax payable

The rate of tax depends on the type of income. There are three possibilities:

(i) 15%, which is payable on standard component income, being income other than special component income and exempt current pension income;

(ii) nil %, which is payable on exempt current pension income, being income attributable to assets used to pay allocated pensions and complying pensions to retired members; and

(iii) 47%, which is payable on special component income, being private company shares and other non-arms length income where the income is greater than would have been the case had the parties been dealing with each other at arms length.

Deductions incurred directly in earning a particular class of income will be allocated to that class of income. For example, losses and outgoings incurred by the trustee in earning private company dividends will be effectively deductible at 47%. Other deductions generally will be allocated to each class of income on a pro-rata basis.

Are distributions from discretionary trusts arms length income?

On 25 November 1997 the Treasurer Peter Costello announced changes to the law to make it clear that distributions from discretionary trusts to related SMSFs will be treated as non-arms length income and will be taxed at 47%. (Source: Treasurer's Press Release No 123 25 November 1997). Previously there had been debate as to whether this is so.

Discretionary distributions from hybrid trusts are also special income in a SMSF's hands.

Private company dividends and the Commissioner's discretion

The ATO has a discretion to treat private company dividends as being taxable at 15% in certain circumstances. The matters to be considered by the ATO are:

(i) the paid up value of the shares;

(ii) the cost of the shares;

(iii) the dividends paid on the shares; and

(iv) other matters relating to the value, cost and dividends paid on the shares.

We are not aware the ATO exercising this discretion in favor of a trustee.

Pricing related party transactions

Care is needed regarding the prices set in transactions with the fund and related entities. For example, if the ATO determines the rent paid for a property rented to an employer sponsor is excessive, that rent will be assessed at 47% rather than 15%. Any costs incurred by the trustee in deriving the income (for example, depreciation on plant and equipment and building allowances) will be deductible against the rent.

A wise trustee will make sure the rent paid to a SMSF can be proven to be a market rent. If it is below a market rent there can be problems with the sole purpose test. If it is above a market rent there can be a problem with non-arms length income.

PART 14: SMSFS, GST AND THE NEW TAX SYSTEM

Introduction

This part of the manual looks at how the goods and services tax ("GST") applies to self-managed superannuation funds ("SMSFs") and what trustees should do to make sure they comply with the GST rules. This is covered in Part 9.1. The manual also looks at how the new "pay as you go instalments system" ("PAYGIS") and the new "pay as you go withholding system" ("PAYGWS") apply to SMSFs from 1 July 2000 on. These topics are covered in Part 9.2 of the manual.

Executive Summary

SMSFs do not have to register for the GST unless turnover from non-residential properties and similar assets is more than $50,000 a year. This means most SMSFs do not have to register for GST. SMSFs that are not registered for GST cannot claim GST credits for the GST included in the cost of their inputs. SMSFs that are registered for GST can only claim GST credits for costs connected their non-input taxed services (mainly non-commercial properties and leased plant and equipment).

SMSFs will normally only have to register for the GST if they have income from commercial property and/or leased plant and equipment and their turnover from these activities is more than $50,000 a year. Problem areas include sales of non-residential properties or leased plant and equipment, leases agreements for non-residential properties and renovations and repairs of non-residential properties.

Special rules apply for claiming reduced input tax credits but in most cases the cost of complying with these rules will exceed the benefits.

SMSFs are subject to the same instalment and withholding rules as most other taxpayers, with a number of minor special rules applying as well.

SMSFs and the Australian Business Number

All new SMSFs have to register for the Australian Business Number "ABN". This is so whether or not the SMSF has to register for the GST. The requirement for SMSFs to register for the ABN comes from a special rule for SMSFs: the Government appears to have realised that most SMSFs would not have to register for the GST and therefore statistical information connected to SMSFs, and intended to be collected via the ABN system, would not be available to it. Hence a special rule was introduced to the effect that all new SMSFs have to register for an ABN irrespective of whether they are registered for the GST.

The question of whether a SMSF has to register for the GST is a separate question. This question is dealt with in the following paragraphs.

The same ATO form is used to register for the ABN and the GST (but as explained above this does not mean all SMSFs have to register for the GST).

SMSFs and the GST

The GST applies to all entities that are "enterprises" for GST purposes. SMSFs are deemed to be entities and are therefore liable to GST on services provided to members and others unless those services are exempt from GST or are input taxed. In practice, most services provided by SMSFs to members and others are input taxed. This means the SMSF is not required to pay GST on these services. Examples of input tax services are:

(i) member services, such as:
- employer contributions;
- member contributions;
- death benefits
- pension benefits
- ancillary benefits
- payment of an eligible termination payments; and

(ii) non-member services, such as:
- interest income;
- dividend income;
- residential property rent;
- sale of residential property;
- trust distributions
- gains on the sale of securities including shares; and
- gains on the sale of residential property.

What SMSF services are not input taxed services?

The simplest approach is to ask "what SMSF services are not input taxed services?" The answer is "services other than those listed above where the annual turnover (or expected annual turnover) is more than the GST threshold of $50,000". This means non-input taxed services will be subject to GST if the SMSF's total turnover from non-input taxed services is more than $50,000. Common examples of non-input taxed services include:

- non-residential property rent (ie rent from shops, factories and offices);
- plant and equipment leases including motor vehicle leases;
- proceeds from the sale of non-residential property; and
- salary continuance insurance premiums.

The $50,000 registration turnover threshold

The $50,000 registration turnover threshold deserves special mention. This threshold includes all income from non-input taxed services. In most cases this will comprise income from non-residential property and leases of equipment. The rules refer to the entity's "projected annual turnover", so vigilance is required where the SMSF's

turnover may exceed $50,000 in the next twelve month period, determined on a "rolling' basis.

Including proceeds from the sale of non-residential property in non-input taxed services deserves special reference. Usually the proceeds from a sale will exceed the $50,000 threshold on their own, and the SMSF will be required to register for GST in the year the sale occurs. This means trustees have to take care if they are considering the sale of such a property. It's wise to register for GST and charge GST on all non-input taxed services provided by the SMSF if a sale of such a property is being contemplated. If the SMSF does not do this it may be liable for GST and unable to recover the GST from the tenant.

Special rules apply for non-residential properties constructed before 1 July 2000.

The tenant will usually not mind being charged GST on rent because the tenant will receive a GST credit on lodging its Business Activity Statement. Leases can be problematic and as a general comment the lease should allow the SMSF as landlord to charge GST even if turnover is currently less than $50,000. This is to make sure the SMSF is not left with an unrecoverable GST liability on rent in the year the $50,000 turnover was exceeded due to the sale of the property.

Input taxed services

The SMSF does not pay GST on the input taxed services listed above. But the SMSF does have to pay GST on the goods and services it use to supply input taxed services. Common examples of such inputs are income tax return preparation fees; legal fees; repairs and renovations to residential properties; residential property management fees; auditors' fees and investment advice fees.

The SMSF cannot claim a GST credit for the GST included in the cost of these inputs. For most SMSFs this is not really a problem. It is unlikely that the GST included in these inputs will be more than, say, a few hundred dollars a year and usually this will be less than the cost of complying with the GST credit rules.

An exception relates to residential property renovations and repairs. The GST on these amounts can be significant. This needs to be considered by the SMSF trustees when considering acquiring, retaining, repairing or renovating a residential property.

If GST is not creditable it is usually tax-deductible in the SMSF's hands at 15% (assuming the SMSF pays income tax).

When can a SMSF claim a GST credit?

A SMSF can claim a GST credit for the GST included in the cost of inputs that are not connected to input taxed services provided the SMSF is registered for GST. For example, a SMSF can claim a GST credit for GST included in costs connected to non-residential property or leased plant and equipment. This includes:

- GST on management fees, commissions, insurances and legal fees for non-residential property or leased plant and equipment;

- GST on repairs and renovations for non-residential property; and
- GST on repairs of leased plant and equipment.

In many cases non-residential property lease agreement will state that the tenant is liable for the cost of minor repairs and renovations on the property.

A SMSF can only claim a GST credit if it is registered for GST.

What if the SMSF is contemplating renovating a non-residential property?

A SMSF may be contemplating renovating a factory, office or shop. If it is already registered for the GST there is no problem: the SMSF will get a GST credit for the GST included in the costs. But what if the SMSF is not registered for GST? In this instance it may be worth to registering for GST before the renovation starts, so the SMSF may claim a credit for the GST included in the costs.

Reduced input tax credits

SMSFs that are not providing GST chargeable services and are only providing input taxed services can register for GST in order to claim a reduced input tax credit equal to 75% of $1/11^{th}$ of the SMSF's administration fees (other than income tax return fees) and certain investment costs. In most cases this credit will be a relatively small amount that is likely to be outweighed by the additional compliance costs.

We recommend that SMSFs do not register for GST here, unless there are unusual circumstances, for example, if the SMSF is constructing a building on vacant land.

PART 15: SMSFS AND THE PAY AS YOU GO INSTALMENT SYSTEM

What is the pay as you go instalment system ("PAYGIS")?

The PAYGIS is part of the new tax system that started on 1 July 2000. The PAYGIS replaces the instalment system that applied until 1 July 2000. It requires SMSFs with investment or business income to pay tax on a quarterly basis during the tax year.

If the SMSF has to pay income tax of more than $8,000 per annum the PAYGIS instalments are notified and paid to the ATO in the SMSF's quarterly Business Activity Statement. The amount of $8,000 tax expands to a taxable income of $53,333 per annum (ie $8,000 divided by 15%). This taxable income includes both taxable superannuation contributions plus taxable investment income.

If the SMSF has to pay income tax of less than $8,000 per annum it may elect to pay one annual instalment of tax rather than four quarterly instalments of tax.

When are the instalments payable?

The payment is made on the due date for lodging the SMSF's Business Activity Statement ("BAS"). This is usually 28 days after the end of the relevant quarter, being December, March, June and September.

How is the instalment calculated?

The instalment is equal to "instalment income" times its "instalment rate".

What is "Instalment Income"?

"Instalment income" is the SMSF's assessable income for the quarter. Assessable income is gross income, ie the SMSF's income before deductions, not its taxable income, ie its income after deductions. Instalment income includes interest, rents, dividends and other types of investment income including net capital gains. Instalment income also includes employer taxable contributions and self-employed persons' taxable contributions.

Instalment income also includes any partnership net income and any trust net income.

What is the "Instalment Rate"?

The instalment rate is the rate of tax paid on the SMSF's assessable income for the previous year. The effective tax rate reflects deductions, so the higher the deductions the lower the instalment rate. The "instalment rate" is advised by the ATO in a notice sent out each quarter. This notice is kept on our files. The instalment rate will appear on the pre-printed BAS forms sent to the SMSF by the ATO before the end of each quarter.

The instalment rate is almost always something like 14.75%, ie a rate near the SMSF's tax rate but not quite at it. This reflects the low operating costs achieved by most SMSFs.

The instalment amount will be added to any withholdings due on member's benefits and any GST paid on items such as lease rentals or non-residential property rents.

A SMSF that has been notified of the instalment rate must lodge a BAS.

What does the instalment represent?

The instalment will be credited against the SMSF's tax liability for the preceding year, in the same way superannuation funds instalments were credited in previous years. The SMSF's final tax liability will not be known until its next tax return is lodged.

Some examples

What if you expect the SMSF to pay less tax this year?

If you expect the SMSF will pay less tax this year you may reduce its instalment rate. But be careful, as there are significant penalties for getting it wrong. A SMSF will expect to pay less tax if it has lower taxable contributions, net capital gains, interest, rents or dividends than in early years.

What if you expect to pay more tax this year

If you expect the SMSF to pay more tax this year you may increase the instalment rate. We generally recommend SMSFs do not do this.

Can you elect to pay annual instalments?

The SMSF can elect to pay annual instalments if its total tax is expected to be less than $8,000. The SMSF should advise the ATO of this election at the time its first instalment is due each year.

Withholdings on member benefits

SMSFs have to withhold tax from payments made to members, whether as lump sum payments (ie eligible termination payments or "ETPs") and both allocated pension payments and complying pension payments. This is because these payments comprise salary for income tax purposes. Tax must also be withheld from ancillary payments made to members, although these are very unusual and are not relevant to most SMSFs.

The ATO publishes the withholding rates in various schedule and regulations. They are based on the individual tax rates at the time of the payment.

What type of withholder?

Withholders are classified as small, medium or large. Small withholders are SMSFs which withhold less than $25,000 a year, medium withholders are SMSFs that withhold more than $25,000 but less than $1,000,000 a year and large withholders are those than withhold more than $1,000,000 a year.

Small withholders must complete the PAYGWS section of the SMSF's Business Activity Statement ("BAS") and forward the appropriate amount of tax to the Commissioner of Taxation each quarter. Medium withholders must do this each month. Large withholders must do so within eight days of making each payment.

Most SMSFs are small withholders and pay withholding tax on a quarterly basis.

Occasionally a SMSF pays more than $25,000 withholding tax each year (whether because of a large ETP or a large pension payment). Where this happens a monthly BAS is required, but the monthly BAS only relates to the withholding payment and does note affect its other PAYG obligations, ie its PAYGIS stay on a quarterly basis.

Can SMSFs be subject to other withholding obligations?

Yes. SMSF can be subject to other withholding obligations under the general rules applying to all taxpayers. For example, if a SMSF is supplied with services without an ABN on the supplier's invoice, the SMSF must withhold an amount from the payment of that invoice at the top marginal rate plus the Medicare levy. This is currently 48.5%.

The ATO publishes the withholding rates in various schedule and regulations. They are based on the individual tax rates at the time of the payment.

GLOSSARY — SUPERANNUATION

This glossary is reproduced from the Australian Tax Office website.

Allowances	Allowances are amounts paid by employers to cover anticipated costs or as compensation for conditions of employment.
Annuities	A series of payments purchased with a lump sum, usually from a life insurance company.
Assessable income	Gross income including salary and wages, dividends, interest and rent before any deductions are allowed. Assessable income also includes net capital gains, ETP and other amounts that are not ordinarily classed as income.
ATO	Australian Taxation Office
Australian Prudential Regulation Authority (APRA)	One of the Federal Government agencies which regulates superannuation funds, and other bodies in the financial sector, ensuring they operate within the requirements of retirement income legislation.
Australian Securities and Investment Commission (ASIC)	ASIC is the Australian government organisation which collects information on public and private companies and other corporate bodies registered under the Corporations Law in Australia.
Authorise	To permit some other person or organisation to do something official for you.
Beneficiary	A person entitled to or in receipt of a benefit under a fund, which is normally the member and/or his/her financial dependants.
Benefit	The amount of a member's entitlement in the fund to which the estate and/or dependants are entitled.
Bona fide redundancy	Bona fide redundancy has the following characteristics: The employee must have been dismissed from a job, not have left voluntarily; The employee must have been made redundant (their work has ceased or workplace has been relocated); and The dismissal must have been made before the employee had to retire
Complying superannuation funds	A superannuation fund that has elected to be regulated under the Superannuation Industry (Supervision) Act 1993.
Contract workers	Independent contractors or contract workers generally provide for their own income tax liability by paying PAYG instalments. Individual contract workers can, if they meet certain conditions enter into a voluntary agreement to have an amount withheld, with their payers. Payments subject to withholding under a PAYG voluntary agreement are not included in PAYG instalment income for paying PAYG instalments.
Electronic Lodgement System (ELS)	The ELS allows participating agents to lodge their clients' tax returns and other tax forms with the ATO electronically via modem.
Eligible termination payment (ETP)	An ETP is a lump sum superannuation benefit or similar payment made to a person because they, or another person, were a member of a superannuation fund, ADF or a depositor with a Retirement avings Account (RSA). ETPs also include payments made to an employee, in consequence of termination of employment. ETPs can be rolled over into another superannuation fund, ADF or RSA.
Employee	A person who receives salary or wages.
Employer	A person (or group) who pays people salary or wages.

Entity	An entity is an individual (for example a sole trader), a body corporate (a company), a corporation sole (an ongoing paid office, for example a bishopric), a body politic, a partnership, an unincorporated association or body of persons, a trust, or a superannuation fund.
Financial year	The period from 1 July to 30 June.
General Interest Charge (GIC)	The General Interest Charge (GIC) is a regime for calculating and imposing penalties including the penalty for late payment of all outstanding Australian Taxation Office (ATO) related debts. The GIC is a commercially linked interest rate that compounds daily and varies every quarter with changes in the money market.
Income	The amount of money earned from personal exertion and investments.
Interest	Money earned from investments in financial institutions.
Invest	Apply assets (money) for the purpose of gaining interest, profit or gain.
Labour Hire	Labour hire arrangements commonly involve at least two contracts. A user of labour (the client) typically contracts with a labour hire firm for the provision of labour of a specified kind. The labour hire firm does not contract to perform the work; it merely contracts with the worker and pays the worker. The worker is not an employee of the client and there is no contract between the worker and the client. The worker may or may not be an employee of the labour hire firm.
Liability	A debt or financial obligation incurred.
Lost Members Register (LMR)	The LMR is a central register of lost superannuation fund members and RSA holders administered by the ATO.
Lump sum	A capital amount payable as a single lump sum amount or by instalments, for example, an ETP. This can be contrasted with a pension or annuity which is a series of payments and are in the nature of income rather than capital.
NAT Number	A unique, four digit 'national number', that is allocated to each ATO form and publication.
Negative Gearing	Borrowing money to make an investment, where the interest and allowable deductions exceed the investment income and can be claimed as a deduction against other types of income.
Payee	The person who receives a payment.
Payer	The person who makes a payment.
Payment Advice	Payment advice (slips) are preprinted stationery provided to the client to enable them to make a payment to the ATO using EFT, Australia Post Bill Pay or Bpay. Details on the advice are also used internally by the ATO to identify a client and credit the amount of the payment onto the clients account. Payment advice stationary must be to ATO specification.
Payment Summary	Is received at the end of the financial year from your employer showing your earnings during the year.
roll	The amount of money an employer pays in wages to their employees.
Penalties	Penalties can be imposed by the ATO on offences in relation to the Income Tax Assessment Act.
Pension	A series of regular payments made as an income stream which, for example, may be provided by a superannuation fund or RSA (excludes "age pension").
Preserved benefits	Generally, preserved benefits must be retained in a superannuation fund, ADF or RSA until the member has met a condition of release under the Superannuation Industry (Supervision) Act 1993 . A condition of release is satisfied when a member has reached at least age 55 and retired from all employment prior to age 65. At age 65 there is no restriction on the payment of the benefit. If a member has not attained their preservation age and permanently retired, the benefit can be paid where it is as a result of the

	member's death, disablement, severe financial hardship or because of compassionate reasons.
Privacy Act	An Act of Parliament which among other things protects Tax File Numbers against misuse.
Reasonable Benefit Limits (RBLs)	RBLs are the maximum amount of retirement and termination of employment benefits that individuals can receive over their lifetime at concessional (reduced) tax rates. Benefits greater than a person's RBL limit are taxed at the highest personal income tax rate. There are two types of RBLs - a lump sum RBL and a pension RBL.
Retirement Savings Accounts (RSAs)	An RSA is an account that provides low cost and low risk savings. It is offered by banks, building societies, credit unions, life insurance companies and prescribed financial institutions (RSA providers). It is used for retirement savings.
Rollover	A rollover is the transfer of all or part of an ETP into a complying superannuation fund, complying ADF, RSA or towards purchase of an annuity from a life insurance company or registered organisation.
Self-assessment	The ATO issues a notice of assessment based on the information provided in your income tax return. You have an obligation under the law to make sure you have shown all your income and only claimed legal deductions and tax offsets.
Self-managed superannuation funds (SMSFs)	A self-managed superannuation fund (SMSF) is a complying superannuation fund under the Superannuation Industry (Supervision) Act 1993 which has: fewer than five members; each individual trustee of the fund is a fund member; each member of the fund is a trustee; no member of the fund is an employee of another member of a fund, unless those members are related; If the trustee of the fund is a body corporate each director of the body corporate is a member of the fund. There are also conditions for single member SMSFs and funds in which a member is unable to act as trustee because of death, disability etc.
Superannuation	A system where money is placed in a fund to provide for a person's retirement.
Superannuation fund	A fund which invests member's funds to provide for their retirement.
Superannuation guarantee (SG)	A prescribed minimum level of superannuation required under the Superannuation Guarantee (Administration) Act 1992 that an employer must contribute for employees. The employer can avoid paying the Superannuation Guarantee Charge if sufficient superannuation contributions are made to a complying superannuation fund or RSA.
Superannuation Guarantee Charge (SGC)	A charge imposed under the Superannuation Guarantee Charge Act 1992 on employers who do not meet the minimum superannuation guarantee requirements on behalf of employees.
Superannuation Holding Accounts Reserve (SHAR)	A reserve administered by the ATO whereby employers may make superannuation contributions for their employees, in instances where the employer is unable to locate a superannuation fund account or RSA for the employee.
Superannuation Industry (Supervision) Act 1993	The legislation providing prudential standards for superannuation funds. The legislation is administered by three regulators, the ATO, Australian Securities Investment Commission (ASIC) and APRA. The ATO is responsible solely for the administration of SMSFs.

Superannuation surcharge	A surcharge (tax) of up to 15% is imposed on certain superannuation contributions, specified rollover amounts, and termination payments.
Tax File Number (TFN)	A unique number issued by the ATO to individuals and organisations to increase the efficiency in administering tax and other Commonwealth Government systems such as Income Support payments.
Tax offset	An entitlement which reduces the amount of income tax to be paid.

Part 16 Summary of major changes to superannuation in 2005 and 2006

9th May 2006 Federal Budget 2006

The 9th May 2006 Federal Budget announced significant changes to the superannuation laws. After a consultation process the Government has made further changes to the proposals and clarified some of the proposals previously announced.

A brief summary of the major changes includes:

- the removal of all benefit taxes for benefits paid to members aged 60 and over from a taxed source either as a lump-sum benefit or a pension benefit;

- the Reasonable Benefit Limits (RBLs) have been abolished;

- self-employed members may claim a full deduction for contributions to age 75, where previously only the first $5,000 plus 75% of the excess was deductible;

- self-employed members will be eligible for the Government co-contribution scheme for personal (after-tax) contributions;

- age-based limits on employer deductible contributions, per employer, will be replaced by a one size fits all deductible contribution limit of $25,000 per member per annum. These contributions will be taxed at 15%. The same rules will apply to self-employed persons. A transitional arrangement will be in place for members aged 50 years or over between 1 July 2007 and 30 June 2012 to allow deductible contributions of $50,000 (this has since been extended indefinitely for members with superannuation balances less than $500,000);

- contributions above the deductible contribution limits of $25,000 ($50,000 if over age 50) are taxed at the top tax rate plus Medicare, payable by the member. The member may arrange for their SMSF to release benefits to pay the liability;

- from 1 July 2007, un-deducted contributions have been limited to $150,000 a year or $450,000 averaged over three years (under age 65) on a "bring forward" basis. Until 30 June 2007 once off un-deducted contributions of up to $1 million per member were possible, provided relevant work tests were satisfied;

- increased flexibility for those wanting to leave money in a SMSF, with members no longer being compelled to start drawing benefits. Members will

be able to leave their benefits in their SMSF as long as they like and will no longer have to start drawing benefits at age 65 (75 subject to work tests);

- employer ETPs may no longer be rolled over into a SMSF. Transitional arrangements will apply for members with employer ETPs specified in an employment contract at 9 May 2006, provided the payment is made before 1 July 2012. These employer ETPs can be rolled over into a SMSF until 1 July 2012;

- the rules relating to pensions to be simplified so that minimum standards are set for all pensions. Where the pension meets the new minimum standards, fund earnings in respect of those pensions to be tax free. Existing pensions that meet current requirements are deemed to meet the new minimum standards. Where an individual takes a pension from 1 July 2007 payments of a minimum amount must be made at least annually. No maximum amount will be prescribed, with the exception of transition to retirement pensions where no more than 10 percent of the account balance (at the start of each year) can be withdrawn in any one year;

- The 50% assets test exemption for social security purposes (Centrelink payments) was removed for new complying pensions from 20 September 2007; and

- the age pension assets taper will be halved from 20 September 2007 so pensioners would only lose $1.50 per fortnight (rather than $3) for every $1,000 of assets above the relevant threshold.

Superannuation benefit splitting for spouses

The Government introduced new laws to permit members i\to split their super contributions with their spouse under certain circumstances. Contributions made on or after 1 January, 2006 may be split with a spouse. The maximum amount able to be split is 85% of taxed splittable contributions and 100% of untaxed splittable contributions.

Where one spouse is significantly older than the other, it can make sense to split the younger spouse's contributions to the older spouse. This lessens the time to wait until the contributions can be accessed and increases the amount of time the benefits can be invested tax free in the hands of the fund (since the older spouse will turn age 60 earlier).

More detailed information on superannuation contribution splitting is available at www.ato.gov.au/super

Transition to Retirement Pensions

The new Transition to Retirement rules allow members to receive regular payments in the form of a non-commutable income stream from a SMSF of they are aged between 55 and 60, depending on your date of birth. This means people can scale down part

time work, using a SMSF pension to top up their income, without reducing their total income.

Despite a lot of press coverage, transition to retirement pensions are not very common.

The 2006 Federal Budget proposals indicate that a transition to retirement pension members will not be able to withdraw more than 10% of the member's benefits at 1 July each year. Further information on the Transition to retirement pension rules can be accessed from www.ato.gov.au/super

Same-sex partners and other close persons can receive tax free death benefits

The class of persons who may receive tax-free death benefits has been expanded to include same sex partners and other persons in an "interdependency relationship".

The phrase "interdependency relationship" is defined as a "close personal relationship between two people who live together, where one or both provides for the financial support, domestic support and personal care of the other". This is a very broad definition that covers most people who live together in a domestic relationship including same-sex partners, siblings and adult children caring for elderly parents.