

# Explanatory Memorandum - Self Managed Superannuation Funds (SMSF).

Self managed superannuation funds can now borrow to invest in real estate. Much care needs to be taken in setting up and running a self managed superannuation fund.

## Explanatory Memorandums – Self Managed Super Fund (SMSF)

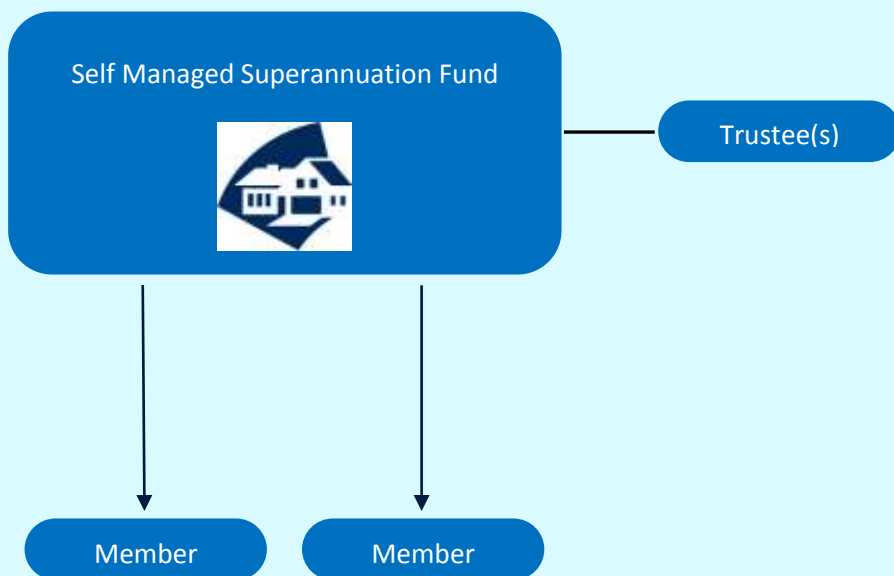
A Self-Managed Superannuation Fund (“SMSF”) is an excellent tool, both for retirees who are looking to convert their superannuation into an income stream, as well as for those who still accumulating superannuation for their retirement. SMSFs offer individuals a unique combination of flexibility and control over their superannuation affairs at a reasonable price. However, they are subject to strict rules and abiding with the legislation is critical to their effectiveness. Further, failing to comply with the relevant laws can result in significant fines and even gaol terms. As with any financial structure, it is important to get professional advice to ensure you are able to benefit from the advantages of having your own superannuation fund without suffering the potential pitfalls.

This Explanatory Memorandum is not meant to be professional advice, and is intended to merely provide a brief outline of the issues that should be considered in the establishment and future management of an SMSF.

### Important Issues

In order to be entitled to become and remain a regulated self managed superannuation fund:

- All members must be trustees or directors of a corporate trustee;
- An irrevocable election must be made to the ATO; and
- The investments of the SMSF must comply with the SIS Act and SIS Regs as well as comply with the sole purpose test.



## Legislative Framework

The main item of legislation regulating SMSFs is the *Superannuation Industry (Supervision) Act 1993* (Cth) and associated regulations (“the *SIS Act*” and “the *SIS Regulations*”).

The *SIS Act* and *Regulations* stipulate that the trustees of an SMSF must ensure that its *sole purpose* is to provide benefits to members (or, in some circumstances, their dependants) on events such as:

- retirement;
- death; and
- leaving employment.

The *SIS Act* and *Regulations* also set out a number of “covenants” which individuals are considered to have made when they agree to act as trustees of an SMSF. Those covenants may be summarised as follows:

- to act honestly in all matters;
- to exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide;
- to act in the best interests of members and their beneficiaries;
- to keep the SMSF’s money and assets separate from their own (or those of any employer contributing to the SMSF);
- not to enter into any contract or do anything which would hinder them from properly carrying out their trustee functions;
- to formulate and give effect to an appropriate investment strategy;
- to formulate and give effect to an appropriate strategy for the management of the SMSF’s reserves (if applicable); and
- to allow members and other beneficiaries access to any information prescribed under the *SIS Act* and *Regulations*.

Whenever a decision is made in relation to an SMSF (in

particular, when decisions impacting upon its investments are made), the decision-maker should ask themselves two questions:

- whether the outcome is consistent with the sole purpose of the SMSF, or are they making the decision for some other reason; and
- whether the decision will help or hinder them in abiding by their covenants.

In addition to the *SIS Act* and *Regulations*, an SMSF and any parties that contribute to it must comply with a range of other items of legislation – the *Income Tax Assessment Act 1936* (Cth), the *Income Tax Assessment Act 1997* (Cth), the *Superannuation Guarantee (Administration) Act 1992* (Cth), *Corporations Law*, etc.

It is also important to ensure that trustees act within the regulating Trust Deed.

## Membership

SMSFs can have a maximum of four members. Generally (but not always), these are members of the same family and, typically, if there were more than four family members who wanted to manage their superannuation together, more than one SMSF would need to be established.

If persons wish to have more than four members in a single superannuation fund, then the fund will no longer be classified as an SMSF, whose ongoing management will be subject to a different regime.

You should also note that it is important that no member of an SMSF may be employed by another member, unless the two members are related.

## Trusteeship

All members of an SMSF must also be its trustees, either directly (ie. as an individual trustee) or in their role as a director of a company which acts as trustee of the SMSF.

The converse is also true – all trustees of an SMSF must generally be members. There are, however, special rules for SMSFs with only one member. Single-member SMSFs must have two individual trustees, or two directors of a trustee company. In this case, the two trustees/directors must *either* be related *or* ensure that neither is an employee of the other. Alternatively, a single-member SMSF can have a corporate trustee with only one director – the member (the company may have as many or as few shareholders as is desired).

Importantly, however, not every individual is permitted to act as the trustee of an SMSF. Examples of people who cannot be trustees of SMSFs are those who:

- are bankrupt;
- have been convicted of an offence related to dishonest conduct; or
- who have previously been a trustee of a superannuation fund and a “civil penalty order” has been made against them.

It is vital, therefore, to ensure that as soon as a new person joins as a member of an SMSF, they are also appointed as a (direct or indirect) trustee. This means that they must not only complete a membership application (along the lines of the applications you completed when you first established the SMSF), but that they should also:

- sign a formal acknowledgement that they consent to act as a trustee;
- confirm that they are not a disqualified person;
- (in the case of individual trustees) have their name recorded as one of the owners of any investments, bank accounts, insurance

- policies, etc, held by the SMSF;
- have both their membership and trusteeship noted in the minutes of a trustee meeting; and
- advise the ATO (currently, the appropriate form for doing this is called “Superannuation Entities Change of Details” and it is available from the ATO’s website - [www.ato.gov.au](http://www.ato.gov.au)).

### Legislative Breaches

Trustees of SMSFs are responsible for ensuring that the fund complies with all of the relevant laws, and are personally liable for breaches. The penalties for non-compliance depend on the nature of the breach and can range from:

- having the SMSF declared “non-complying” – in this case, there would be a 47% tax levied on all the SMSF’s assets except for any “undeducted” or “non-concessional” contributions (these are essentially contributions paid by an individual for which no tax deduction has been claimed);
- fines being levied for minor offences, such as the late lodgment of returns; and
- gaol terms.

Although the regulators have hitherto only penalises those trustees who (in their view) have deliberately broken the law, you should note that the *SIS Act* and *Regulations* permit fines to be levied, even where breaches are accidental or minor. Of course, goal terms can only be imposed where criminal action has occurred.

### Investments

All superannuation funds must have a documented “Investment Strategy”.

The Investment Strategy should set out what the trustees are trying to achieve, how they intend to achieve it, and what factors they have considered in

making these decisions (such as cash-flow, risk, return, diversification and liquidity). Trustees should then ensure that all investment decisions are made in accordance with this documented strategy. Further, in some circumstances, the regulator may impose extra reporting requirements on SMSFs which use particular investments – eg. funds that invest in particular types of derivatives are required to have a “Risk Management Statement”.

Certain investments are *prohibited* in the SMSF environment. In particular, SMSFs:

- cannot borrow, except in a few limited and very particular circumstances, or where carefully executed bare trust and limited recourse arrangements are entered into. Trustees should, therefore, ensure that they do not overdraw the SMSF’s bank account, as this is a common cause of unintended borrowing;
- cannot lend money or provide any other form of financial support to members or their relatives;
- cannot, generally, buy assets from members, their relatives or their associates. There are, however, some exceptions to this rule, eg. SMSFs **can** purchase the following from members, their relatives or their associates:
  - securities listed on a recognised exchange (eg. the ASX);
  - units in widely held unit trusts (eg. managed fund units);
  - “business real property”; and
  - certain in-house assets within the restrictions applying to those assets (see below).

Naturally, any transaction between the SMSF and a member, their relative or their associate must be at market-value.

Other investments are *restricted*, in that they must constitute no more than 5% of the market-value as an SMSF’s assets (known as “in-house assets”). In-house assets are essentially any assets which are:

- loans to and/or investments in “related parties”;
- investments in related trusts (eg. a family unit trust); or
- assets which are subject to a lease between the trustee and a “related party” of the SMSF.

In this regard, “related party” is defined extremely broadly, and can include family members, employers who contribute to the fund, business partners, etc.

Once again, there are exceptions to these rules, eg. business real property can be leased-back to related parties of the SMSF), and there are transitional arrangements for SMSFs which had arrangements in place before 11 August 1999. Nevertheless, trustees should always be mindful of the sole purpose of the SMSF and their covenants as trustees, whenever they are considering any financial arrangements which involve dealing with a “related party.”

Within these restrictions, a Trust Deed establishing an SMSF provided by Macquarie Group Services gives trustees very broad powers in relation to the SMSF’s investments. In particular, the trustees can:

- have different investment strategies for different members;
- allow members to choose their own investment strategy;
- specifically allocate certain investments to particular members; and
- establish reserves to “smooth” investment earnings credited to members’ accounts.

### Contributions

Under a Trust Deed establishing an SMSF provided by Macquarie Group Services, anyone can contribute to the SMSF, provided that they are permitted to do so by the *SIS Act* and *Regulations*. Currently, this includes:

- members who make contributions in their own names;
- individuals who contribute for their spouse who is a member (whether or not the individual is also a member of the SMSF); and

- employers of members.

Contributions may be in cash or by the “in-specie” transfer of assets. As an example of an “in-specie” contribution, trustees could transfer personal shareholdings into the SMSF, by transferring ownership from their own name to that of the SMSF. Note, however, that there are Capital Gains Tax and other consequences associated with doing so, and advice should be sought where parties wish to execute this type of transaction.

As a general rule, personal contributions can only be made by a person who is under age 65, or by their spouse (if the member is under age 65). Where a person is age 65 or older, but has not yet reached age 75, they may still make personal contributions, but only if they:

- have been “gainfully employed on at least a part-time basis” during the relevant financial year, ie. they have worked at least 40 hours in a period of not more than 30 consecutive days in the year; or
- the contributions are being made by their spouse, they are age 65 or older but have not yet reached age 70, and they have been “gainfully employed on at least a part-time basis” during the relevant financial year.

However, SMSFs cannot accept personal contributions from persons who have not quoted their Tax File Number to the SMSF, or where the person has reached age 75.

Importantly, there are essentially two types of superannuation contribution that can be made:

- “non-concessional contributions” for which no tax deduction is claimed by the contributor. As a general rule, unless a person is self-employed, any contributions they make to an SMSF from their personal savings or from their after-tax income will not entitle them to a deduction; and
- “concessional contributions”, which are contributions that have been claimed as a tax deduction by whoever made them. Unless a person is self-employed, only their employer’s

contributions will be deductible. If a person has a “salary sacrifice” arrangement with their employer, they are effectively exchanging higher employer superannuation contributions for a lower cash salary. These extra employer contributions are classified as “concessional contributions”, as the employer will still be entitled to a deduction for the full amount of the employee’s remuneration “package.” If a person is self-employed, however, they are able to claim all of the contributions they make as a tax deduction, provided that the deduction cannot be greater than the amount that reduces the individual’s taxable income to nil, ie. the deduction cannot create a loss.

Although there is no limit on the tax deduction employers and self-employed people who make deductible contributions can claim, there are limits on the amounts of “concessional” contributions that can be made before the relevant member becomes liable to excess contributions tax.

Currently, the limits are as follows:

**Maximum Concessional Superannuation Contributions**

2008/09	2009/10
\$50,000	\$25,000

An Excess Contributions Tax of 31.5% is payable by the member, if their concessional contributions for a year exceed these caps. Notably, a transitional concessional contributions cap of \$100 000 applies in the years 2007/08 to 2011/12 for individuals aged 50 and over.

There are also currently limits on the amount of “non-concessional” contributions that can be made, before a liability to Excess Contributions Tax arises. Those limits are as follows:

### Maximum Non-Concessional Superannuation Contributions

2008/09	2009/10
\$150 000	\$150 000

An Excess Contributions Tax of 46.5% is payable by the member, if their non-concessional contributions for a year exceed these caps. Notably, persons who are aged under 65 in a year can bring-forward the next two years' entitlements to make non-concessional contributions, ie. they can make total non-concessional contributions of \$450 000 at any time over three financial years without exceeding their non-concessional contributions cap.

### Benefits

Generally, the benefits received by a person upon their retirement, death, becoming disabled or leave an SMSF for any other reason, will be the amount held in their account balance at that time. Under some circumstances (eg. death or disablement), a person may have arranged for insurance to supplement their benefit and, if this is the case, the proceeds of the insurance policy will be paid in addition to their account balance.

A person's benefit can be paid to them either in the form of a pension or lump-sum, or as a combination of the two. The Trust Deed establishing an SMSF provided by Macquarie Group Services gives trustees very broad powers to pay benefits in a number of forms – essentially anything permitted by the *SIS Act* and *Regulations* can be accommodated.

Most superannuation benefits are “preserved”, which means that they generally cannot be paid to the member until they “retire” or reach their preservation age. To “retire”, a person must either:

- have worked at some point in the past, reached a particular age and decided that they never intend to work again for more than ten hours per week. A person's “preservation age” depends on when they were born – for people born before 1 July 1960 it is 55, and

for people born after 30 June 1964 it is 60. For people born in between, it is between 55 and 60; or

- reach 60 and leave their current job (even if they fully intend to work again in the future).

There are also other circumstances when preserved benefits can be paid – eg. upon death, disability or hardship. Further, it is possible for a person to access their benefits when they have reached their preservation age, without having to “retire” from gainful employment, in the form of a Transition to Retirement Pension. Such a pension is an account-based income stream with the total amount of payments in any year being limited to no greater than 10% of the account balance at the start of the year.

Notably, there are NO rules governing when a person's benefits *must* be paid. That is, a person is permitted to indefinitely leave their superannuation accumulating in an SMSF, irrespective of their age and/or whether or not they are gainfully employed.

### Taxation

Superannuation is taxed at three different points:

- when contributions into the system are made;
- when investment income within the system is derived; and
- when benefits are paid out of the system.

### Contributions tax

Because *non-concessional contributions* come from funds which have already been taxed (ie. a person's personal savings or after-tax income), they are not taxed when they are paid into an SMSF.

*Concessional contributions*, however, are taxed at 15% on receipt by an SMSF.

Investment income tax

Investment income in most SMSFs is taxed at 15%. This means that even if there is no direct tax concession involved in contributing money to the SMSF (eg. There is no tax deduction available for non-concessional contributions), it is still may be worth doing, because the future investment earnings on that money will be concessionally taxed. As always, professional advice should be sought in these circumstances.

If an SMSF starts paying a pension, at least part of its income is *completely tax-free*. This is an extremely valuable tax benefit, as it effectively allows a person to invest their retirement savings in a completely tax-free environment.

Superannuation benefits tax

The way in which a superannuation benefit is taxed depends on whether it is taken as a “lump-sum” benefit or as a superannuation pension, the age of the recipient and whether the taxable component of the benefit includes an element “taxed in the fund” or an element “untaxed in the fund”.

The taxation treatment of superannuation benefits is complex, but the key points are as follows:

- “non-concessional contributions” are not taxed when they are drawn out as a benefit in any manner, as they were originally paid in from money on which the member had already paid income tax; and
- the rest of a person’s benefit (ie. their “concessional contributions” and any income derived from the investment of their funds) is taxed.

Age	Lump-Sum	Income Stream
60 and over	Tax-free	Tax-free
Preservation age to age 59	0% up to the low rate cap amount \$145 000 in 2008/09). Greater amounts subject to tax up to maximum rate of 15%	Marginal rates and tax offset of 15% of the taxable component.
Below preservation age	Subject to tax up to maximum rate of 20%	Marginal tax rates and no offset.

Different rules apply if the benefit is paid as a result of death or disability.

**Statutory Reporting and Record Keeping**

Each year, trustees will need to ensure that a number of tasks are completed (either by themselves, their accountant or another advisor). These include preparation of the SMSF’s:

- accounts (including an external audit by an approved auditor);
- income tax and regulatory returns;
- Instalment Activity Statements (IASs) and Business Activity Statements (BASs), if relevant; and
- (if there is a corporate trustee) annual returns to the ASIC.

In addition, particular paper work needs to be completed whenever a benefit is paid from the SMSF and when a pension starts.

There are strict deadlines for the preparation of all these documents and, in many cases, fines are imposed if the deadlines are breached.

All SMSF records should be kept for a minimum of 10 years.



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