

SMSFs & Artwork

The ATO recently issued four Interpretative Decisions, ID 2004/248, 249, 250 & 251 on artwork investments by SMSFs. SMSFs that invest in artwork must satisfy a range of tests, especially if the artwork is used by the members.

First of all, artwork owned by a SMSF and displayed in a member's home or office is an in-house asset ('IHA'). An IHA includes a lease of a fund's asset to a member or related party ('RP'). A lease is deemed to arise where any asset is *used* by a member or RP even though no rent is paid. ATO ID 2004/250 confirms this point.

The level of IHAs must not exceed 5% of the market value of a fund's total assets. Therefore, leasing of artwork (or any other fund asset) to a member or RP is generally only permitted if all of the fund's IHAs fall below the 5% limit.

A trustee must regularly monitor its IHAs to ensure they remain below the 5% limit, and take prompt action to dispose of excess IHAs if they exceed this limit.

If an artist dies, for example, and the value of their work sky-rockets, then the 5% limit could be breached. The trustee must prepare a written plan and reduce the level of IHAs in the next financial year of income (if the 5% limit is exceeded by growth in existing IHAs).

In addition to the IHA test, trustees must also satisfy the sole purpose test ('SPT'), arm's length test ('ALT') and the prudent person test ('PPT'). A breach of any of these tests can result in significant penalties.

The SPT requires each investment to be made for the sole purpose of providing retirement benefits to the fund's members. The trustee should have selected the artwork after due consideration of alternative investments and charge an arm's length rental. ATO ID 2004/249 confirms that the SPT is breached if a fund's asset is used by a member at no cost.

The ALT requires each transaction to be made and maintained on an arm's length basis, eg, the lease rental should reflect an arm's length rental and be supported by an independent valuation. ATO ID 2004/251 confirms that the ALT is breached if a fund's asset is used by a member for a cost which is below the prevailing market value.

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The PPT requires that each investment is prudent and the best amongst other alternatives. The *Trustee Act 1958* (Vic) requires at least 15 factors to be considered before making an investment for a trust unless they are expressly excluded.

ATO ID 2004/248 confirms that artwork can constitute a suitable SMSF investment. The ATO expects that expert advice will be obtained due to the additional issues and costs that arise when investing in 'alternative assets'. The ATO would, in our opinion, generally expect that an arm's length rent is charged, a written lease exists and there is appropriate security and insurance. The fund's trust deed and investment strategy must also allow for investments in artwork.

The ATO will closely scrutinise funds that do not comply with these matters and take appropriate action, including the imposition of penalties, as they determine appropriate.

James Shattock

New Power of Attorney - Vic

DBA can prepare a Enduring Power of Attorney (Financial) ('Enduring Power') in accordance with the new requirements that took effect from 1 April 2004. Visit DBA's web site at www.dbabutler.com for details on this new power and the other powers available, namely:

General Power of Attorney - this is useful where the Enduring Power is considered too complicated and/or time consuming. Note, a general power ceases to have effect on the incapacity of the donor. This is the strength of an Enduring Power.

Medical Power of Attorney - this allows someone to appoint an agent (and alternate agent) for the making of their medical decisions, eg, whether to be placed on life support if the donor is injured.

Enduring Power of Guardianship which allows someone to appoint an attorney to make lifestyle and similar decisions, eg, where to live. This power is generally made by those about to retire or who suffer declining mental capacity.

Reduced Tax on Excess ETPs

The maximum tax rate on an excess lump sum eligible termination payment ('ETP') was recently decreased to 38% on the post-June 1983 taxed component (formerly 47%). This change applies from 1 July 2002 even though the law was only passed in late 2003.

The 47% tax rate on an excessive component ('EC') is reduced to 38% to the extent that the EC reflects the taxed element of a post-June 1983 component. This component is determined by a process that produces the amount that is taxed at 38%. The remainder of the EC, eg, the pre-July 1983 and the untaxed post-June 1983 components, continue to be taxed at 47%.

To illustrate how the new rules work, we will apply them to a death benefit ETP with an EC. For the sake of simplicity, we will ignore the Medicare levy.

Ray has a \$2m benefit that is 25% pre-July 1983 and 75% post-June 1983. He has \$300,000 of undeducted contributions ('UCs'). All the post-June 1983 component is a taxed element.

Therefore, the EC is (\$2 million - \$300,000 - \$1,176,106) = \$523,894. The pension RBL applies on death, and Ray's pension RBL is \$1,176,106 for 2003/04.

The taxed element of the retained amount of the post-June 1983 component (given the EC) is calculated as follows:

Pre-July 1983 component
\$2m - \$523,894 = \$1,476,106
\$1,476,106 x 25% = \$369,027

Post-June 1983 component
\$2m - \$523,894 - \$300,000 - \$369,027 = \$807,079

The taxed element of the retained amount of the post-June 1983 component (assuming there is no EC) is calculated as follows:

Pre-July 1983 component
\$2m x 25% = \$500,000

Post-June 1983 component
\$2 million - \$500,000 - \$300,000 = \$1,200,000

The amount taxed at 38% equals the difference between the post-June 1983 component assuming

Forthcoming Seminar

The *DBA Network* will be holding a ½ day workshop at the Savoy Hotel, Melbourne on the morning of **21 May 2004** covering SMSFs & reserving, SMSFs making joint investments and the new Enduring Powers of Attorney in Victoria.

there is no EC compared to the same component taking into account the EC, namely:
\$1,200,000 - \$807,079 = \$392,921

EC tax calculation:
\$392,921 x 38% = \$149,310

The remainder of the EC is taxed at 47%:
\$523,894 - \$392,921 = \$130,973
\$130,973 x 47% = \$61,557

Therefore, the total tax on the EC is:
\$149,310 + \$61,557 = \$210,867

Note that not all of the post-June 1983 component paid as an ETP from a superannuation fund will be a taxed element, eg, a death benefit funded partly by life insurance that is paid to someone who is not a dependant for tax purposes (eg, an adult child who is not financially dependent), then a certain amount of the ETP will be an untaxed element. The formula is in s 27AB(3) of the *Income Tax Assessment Act 1936* (Cth) which broadly calculates the future service period component of the ETP.

Thus, only a portion of the taxed element of the post-June 1983 component of the ETP (assuming there is no EC), is taxed at 38%. The remainder, including the proportion of the EC that would have been the pre-July 1983 component and the untaxed element of the post-June 1983 component and any other component continue to be taxed at the 47% rate.

John Sudano

Family Trust Election - Amnesty

The ATO are allowing certain taxpayers the ability to include a family trust or interposed entity election in their 2004 tax returns to clear up past oversights. This is the last opportunity to ensure these elections have been properly handled. DBA can assist in ensuring the elections have been properly handled especially in relation to discretionary, unit and testamentary trusts and SMSFs with related trusts.

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