DBA Butler Pty Ltd Lawyers

NEWS

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Double tax on the value of SMSF assets!

With an ever-increasing globalisation of the work force, it is not uncommon for employees to be seconded overseas on short-term assignments. Moreover, families may relocate to an overseas destination for one reason or another. However, what may initially be intended as a 12 month posting could, in fact, blow-out to 2 years or more. The risk facing SMSFs is that they may unintentionally become non-resident funds and lose their concessional tax status.

To be a resident fund, an SMSF must satisfy both the central management and control ('CMC') test (or two year test) and the active member test. The CMC test requires that the central management and control of the SMSF is in Australia. That is, the strategic and important decisions of the trustees must be made in Australia.

The two year test, on the other hand, allows the trustees to be *temporarily* absent from Australia for a period of less than two years. Returning to Australia for 29 days or more within this two year period will restart the two years again. However, if the initial two year period is extended, this may give rise to concerns as to whether the trustees are in fact 'temporarily' absent from Australia.

The CMC test and the two year test are alternative tests. Therefore, in some circumstances, it may be possible for the SMSF to remain a resident fund even though a member is overseas for two or more years. Note, where the SMSF has a corporate trustee, the company must have at least one Australian resident director.

The SMSF must also satisfy the active member test if there are any active members. Broadly, this requires that 50% of the account balances of members who are in receipt of contributions or roll-overs (ie, active members) are Australian residents (as a proportion of all active resident and active non-resident members). An SMSF with mum, dad and the two kids could still satisfy this test if, eg, dad who has 60% of the fund's balance was overseas but there were no contributions or roll-overs in respect of dad while he was overseas (ie, dad is an inactive member). Contributions could still be received for mum and the kids who were still residents of Australia and therefore active members.

Failure to satisfy the residency test will automatically result in the SMSF becoming a non-resident and non-complying fund. Broadly, this means that in the first full fiscal year in which the fund is a non-resident fund, it will be hit with tax at 47% on the opening market value of the fund's assets (less any undeducted contributions).

Care must also be taken to ensure that a non-resident SMSF does not subsequently become a resident fund, without carefully considering its tax status. This is because the SMSF could be taxed heavily again on becoming a resident SMSF. Broadly, tax is imposed in that fiscal year on the opening market value of the fund's assets (less any undeducted contributions). The tax rate imposed depends on whether the SMSF is a complying fund, in which case a 15% rate generally applies, or a non-complying fund, in which case a 47% rate applies.

Hence, the SMSF will be hit with tax on the value of its assets at 47% in the first full fiscal year in which the fund is a non-resident fund and at either 47% or 15% in the year it becomes a resident fund again! At worst, this could result in 47% tax on departure and another 47% tax on resumption of Australian residency on the bulk of an SMSF's assets.

We understand that the ATO is taking a strict line on the residency test, and there is currently no discretion to waive the tax levied when an Australian superannuation fund is rendered non-resident. Accordingly, advisers must ensure they are pro-active in managing their clients that travel overseas for extended periods.

Recent ATO determination and draft ruling

The ATO has just released its finalised version of TD 2004/D82 as TD 2005/29. TD 2004/D82 was issued following the AAT's decision in Ryan's case, and the final determination is substantially the same as the draft. Broadly, TD 2005/29 provides that Part IVA of the ITAA 1936 will not apply to a case where a company, trust, partnership or individual conducting a personal services business pays superannuation contributions up to the age-based limits in respect of the associate of the main service provider (even if the superannuation contribution is much greater than the salary paid to the employee or the value of the employee's services). However, the presumption that Part IVA does not apply is subject to the provision of personal services through the entity or as a sole trader being commercially justified or the existence of other 'unusual circumstances'. Further, a genuine employee relationship must exist and the personal services income or PSI rules in Part 2-42 of the *Income Tax Assessment Act 1997* (Cth) will still need to be considered.

The ATO has also released draft taxation ruling TR 2005/D15. This outlines the ATO's position in relation to trust cloning on the requirement that 'the beneficiaries and terms of both trusts are the same'. In particular, the ATO confirms that in relation to a trust where beneficiaries have interests in the income and corpus of the trust, each beneficiary must have the same percentage interest in the income and corpus of the cloned trust as they did in the original trust.

Update – payment of ETPs from SMSFs

In the September 2005 edition of DBA News, we looked at whether SMSFs with individual trustees can pay eligible termination payments. This article was prepared on the basis of a written opinion DBA received from the ATO.

Broadly, the ATO requires that if an SMSF has individual trustees (and therefore has as its sole or primary purpose the provision of old-age pensions) and a pension is paid before being commuted shortly after, the pension must actually be paid in accordance with the law.

This means that even if, eg, an allocated pension is paid for only 1–2 days and then commuted, the minimum amount of the pension for that financial year (or the pro-rated amount in the case of a fully commuted allocated pension) must still be paid. Furthermore, the normal documentation required to establish the pension must be completed and the relevant forms lodged with the ATO. This is regardless of any wording in the trust deed that may permit elections to be made to commute a pension from the outset.

We note that this recent position taken by the ATO is different from prior practice and may represent a possible change in policy at the ATO. This matter is now being pursued by a number of professional bodies and we will keep you informed of any further developments in this area.

Why Pensions Must Be Properly Documented

Now more than ever, it is essential that advisers and trustees of SMSFs take seriously their responsibility to document pensions thoroughly and accurately! **Consider:** Dad has a defined benefit pension ('DBP') and Mum is the reversionary beneficiary. Mum dies. Dad makes his son the reversionary beneficiary instead. In the ATO's opinion, this creates a new pension — this can mean a loss of transitional relief for a DBP and other adverse consequences!

DBA can help

DBA offers a comprehensive range of services to facilitate the documentation of **allocated**, **complying lifetime**, **complying term** (or life expectancy) and the new **market linked** (or term allocated) pensions. Volume discounts apply. See www.dbabutler.com/index.php?p=pensions.

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