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Self Managed Superannuation Funds — An Overview

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1 Disclaimer

These notes have been prepared as a mere guide to assist learning. They should not be relied upon and should not be considered to be advice.

2 What is an SMSF?

2.1 Introduction

The definition of an SMSF is in s 17A of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA'). Broadly, to be an SMSF, a fund must have no more than four members and all

members must be trustees (or directors of trustee company). However, this is only a general rule. There are exceptions, such as:

- funds where someone holding an enduring power of attorney in respect of a member is a trustee (or director of trustee company) in place of the member
- single member funds.

> ***Coreta Pty Ltd and Commissioner of Taxation* [2009] AATA 105**
>
> Mr Maplestone ran a business through his family trust. The trustee of the family trust employed several people including Mr Nowoweiski, Mr Hillebrand and Mr Mullins. The Commissioner of Taxation decided that the trustee of the family trust had a superannuation guarantee shortfall for the 1999 year of $5,489.82; and for the 2000 tax year of $6,338.13. In other words, the trustee of the family trust had not paid enough superannuation on behalf of the staff.
>
> Among other things, the taxpayer argued that contributions had been made. Specifically, the taxpayer argued that the contributions were made to the Maplestone Superannuation Fund (a self managed superannuation fund) on behalf of Mr Nowoweiski, Mr Hillebrand and Mr Mullins.
>
> The presiding AAT member rejected this argument. In paragraph 43, he noted that the contributions must be made to a complying superannuation and noted that there was nothing suggesting that Mr Nowoweiski, Mr Hillebrand and Mr Mullins were trustees of directors of the corporate trustee. Accordingly, he found that the payments made to the Maplestone Superannuation Fund were not payments made to a 'complying superannuation fund'.

2.2 Why are they popular?

A key reason for the popularity of SMSFs is the high level of control that 'mums and dads' can exercise over their superannuation money. For example, the following case study represents a strategy that is very appealing for many small business owners.

> Alice runs a dental practice. The trustee of the Alice Superannuation Fund purchases the real property where the business is run. The trustee of the Alice Superannuation Fund leases the property to Alice. Alice likes this arrangement because:
>
> - when she pays rent she gets a tax deduction
> - she knows the rent is not 'dead' money — rather, she knows it is being safely stored in the fund for her retirement.

Also, there is the view that SMSFs provide greater 'economies of scale' when it comes to cost. For example, an APRA-regulated fund might charge say fees of 1% pa of a member's account balance. Accordingly, if a member has a $1 million in an APRA-regulated fund, they would pay $10,000 pa in fees. However, typically the costs of running an SMSF are lower than $10,000 pa and are relatively fixed.

2.3 Just how popular are they?

According to the regulator of SMSFs, the Commissioner of Taxation, as at June 2013 there were 509,362 SMSFs and they held $495,021,000,000 worth of assets.[1]

This means that the average wealth held in an SMSF is $971,845.

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[1]Commissioner of Taxation, *Self-Managed Super Fund Statistical Report — June 2013* (accessed on 16 November 2013) <http://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-statistical-report---June-2013/?default=&page=1>.

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2.4 How do they differ to other types of superannuation funds?

Broadly, the same laws apply to all regulated superannuation funds, whether they are self managed superannuation fund, small APRA funds, corporate funds, retail funds or industry funds. However, there are several aspects that distinguish SMSFs from other types of funds.

People who are non-professional trustees (ie, mums and dads) manage the fund. On a day to day level, there is very little standing between the prudential management of monies and unauthorised access. Accordingly, the role of the SMSF auditor is vital.

However, sometimes there are different legislative rules that apply to SMSFs, as illustrated by *XPMX and Commissioner of Taxation* [2008] AATA 981.

> ***XPMX and Commissioner of Taxation* [2008] AATA 981***
>
> Mr H and his daughter Ms H were the trustees of a self managed superannuation fund. Ms H was the sole member. The fund was established with an original contribution of $12,000. There were no further contributions.
>
> The trustees did not lodge regulatory returns for the fund. The trustees only lodged income tax returns in respect of certain years. Records were not been kept in the correct manner. Fund accounts and statements had not been prepared. Member contribution statements had not been lodged. The trustees failed to appoint an approved auditor to audit the fund's accounts and statements since its establishment.
>
> As a result, the Commissioner relied on s 42(1) of the SISA and issued a notice of non-compliance.
>
> The trustees sought review of the decision in the AAT. Mr H argued that it was too costly to appoint an approved auditor to audit the fund's accounts and statements. Further, he submitted that the regulatory requirements were too onerous for small, single member SMSFs.
>
> Senior Member Dunne rejected this argument. However, he noted that s 42 applies to non-SMSF superannuation funds. Rather, s 42A applies to SMSFs. This mistake by the Commissioner could have been countered by the maxim *falsa demonstratio non nocet* (ie, an imperfect or inaccurate description will not vitiate an instrument). However, the possible application of the maxim was itself countered by the principle that a taxpayer should not be subjected to the detriment of a taxation provision unless the provision is clear and unambiguous (*Anderson v Commissioner of Taxes (Vic)* (1937) 57 CLR 233, 243). If there is any ambiguity, the matter should be resolved in favour of the taxpayer (*Liquor Administration Board (NSW) v Wolfe* (1993) 32 NSWLR 328, 329).
>
> Accordingly, the Commissioner's decision to issue a notice of non-compliance was set aside.

Finally, SMSFs are far more likely to suffer from human error because non-professional trustees are ultimately responsible for them. For example, a lost deed is almost unheard of in respect of a large fund. However, it is a common problem for SMSFs (see, for example, *Crane Distribution Limited v Recorder of Titles* [2009] TASSC 68).

3 Section 52B — the covenants

The covenants in s 52B often receive lip service in the SMSF context, however, practically, little ever turns on them. Nevertheless, they should still be met, especially s 52B(2)(f) (ie, the investment strategy requirements) as s 55 provides that:

> (3) … a person who suffers loss or damage as a result of conduct of another person that was engaged in in [sic] contravention of [the contraventions] may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention.
>
> ...
>
> (5) It is a defence to an action for loss or damage suffered by a person as a result of the making of an investment by or on behalf of a trustee of a superannuation entity if the defendant establishes that

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> the defendant has complied with all of the covenants referred to in sections 52 to 53 and prescribed under section 54A, and all of the obligations referred to in sections 29VN and 29VO, that apply to the defendant in relation to each act, or failure to act, that resulted in the loss or damage.

4 Section 62 — the sole purpose test

Section 62 can broadly be thought of as the general anti-avoidance provision of the SISA. In other words, in the same way that pt IVA hangs over the head of all questionable income tax transactions, s 62 hangs over the head of all questionable superannuation transactions.

Broadly, the test provides that trustees of each regulated fund must ensure that the fund is maintained for certain purposes. Naturally, such purposes are things like the provision of retirement benefits.

But, how should the ‘purpose’ in the sole purpose test be measured? What if someone genuinely believes that their SMSF investing in a Swiss chalet is a great way to generate funds for retirement benefits? Further, what if that someone also believes that getting their family and friends to stay there is a great way to achieve that goal because family and friends can be trusted to pay rent on time and to take care of the chalet?

That actual purpose inside that person’s head — their *subjective* purpose — may well be to provide retirement benefits.

However, does a person’s subjective purpose matter?

The short answer is no. The AAT state in *Montgomery Wools Pty Ltd ATF Montgomery Wools Pty Ltd Super Fund and Commissioner of Taxation* [2012] AATA 61:

> Whether a fund complies [with the sole purpose test] will depend on the facts of each case and will be assessed by the **OBJECTIVE** facts, not the subjective views of trustees or, in the case of the corporate trustees, the directors. [Emphasis added]

In short, you work out someone’s purpose by looking at the concrete facts and seeing what those facts suggest their purpose is.

It is easy to say that purpose should be worked out objectively, but what does this mean in ‘hands on’ practical terms?

Here’s where I get a bit controversial.

I think that the most important fact is whether all dealings are at arm’s length.

I have conducted what I believe is an exhaustive search of every court case and AAT decision considering the sole purpose test or its predecessors. (I won’t list them all here, but if anyone’s interested, email me at bfigot@dbalawyers.com.au and I’ll send the list to you.)

Without exception, in every court case and AAT decision where dealings were not at arm’s length, the sole purpose test was held to be contravened. The flip side is also true: where dealings were at arm’s length, the sole purpose test was held to have been complied with.

If anyone has an instance where dealings were at arm’s length but the sole purpose test was held to have been contravened, please let me know. However, to the best of my knowledge such an instance does not exist.

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Consider the following real life examples.

> ***Montgomery Wools Pty Ltd ATF Montgomery Wools Pty Ltd Super Fund and Commissioner of Taxation* [2012] AATA 61**
>
> In Montgomery Wools [2012] AATA 61, an SMSF bought all the units in a unit trust. The unit trust used the SMSF's money to acquire real estate and then the unit trust allowed the real estate to be used as security in respect of a related business' loans. The real estate was sold and the proceeds used to repay the related business' debts. The unit trust, and therefore the SMSF indirectly, was left with a loan investment that existed on paper but realistically it had lost its money.
>
> Naturally, in allowing its assets to be used as security, the unit trust was not acting at arm's length. The ATO held that the SMSF failed the sole purpose test and the AAT agreed.
>
> On an interesting side note, the SMSF met the arm's length rules in the SIS Act as the SMSF itself had not engaged in the non-arm's length dealings. Rather, the unit trust had had the non-arm's length dealings and the unit trust is not regulated by the SIS Act. That being said, the ATO in their decision impact statement said that they might dispute this point if it ever arises again.

I use Montgomery Wools to illustrate that when I say all dealings should be at arm's length, I do mean all dealings. Consideration should be given not just to the SMSF's dealings but to the dealings of all parties who directly or indirectly have involvement with the SMSF.

> ***AAT Case 6059* (1990) 21 ATR 3477**
>
> A small super fund was by run by Mr D. Mr D had a 'penchant, indeed [a] positive zeal for investing a considerable part of the trust funds in a manner not normally adopted by trustees'. This included investing in a real estate development unit trust. Once the fund was invested in these investments, the fund felt compelled to make a number of interest free loans to the investment entities (eg, the unit trust). The ATO took issue and said that the fund failed the then equivalent of the sole purpose test.
>
> However, the AAT ultimately found that 'the non-payment of interest on monies loaned in all these instances, arose from practical commercial considerations in each case and not from any desire … of benefiting the entities to whom the funds were loaned'. That is, at the risk of putting words in the AAT's mouth, the interest free loans were held to be at arm's length and the then sole purpose test equivalent was met.

The sole purpose test is crucial and funds that do not comply with it can risk serious penalties. However, so long as care is taken to ensure that dealings are at arm's length, I dare say there is an extremely strong chance that the sole purpose test will be complied with.

5 Section 65 — no financial assistance

Section 65 broadly prohibits the provision of financial assistance to fund members and their relatives. This raises the question of what constitutes financial assistance. Consider the following passage (*Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [1986] BCLC 1, 10):

> There is no definition of giving financial assistance ... The words have no technical meaning and their frame of reference is in my judgment the language of ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the section is a penal one and should not be strained to cover transactions which are not fairly within it.

Although this passage is from a UK case, it has been cited with approval in subsequent Australian cases, such as *Dempster v National Companies And Securities Commission* (1993) 10 ACSR 297, 352–3 and *Milburn v Pivot Ltd* (1997) 149 ALR 439, 466.

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The commercial realities of essentially all transactions with related parties is that the related party is given financial assistance. However, construing s 65 in the context of the entire SISA, it is clear that related party transactions can be allowable (hence the existence of s 109, discussed under heading 9 below). Accordingly, the generally accepted practice is that if a transaction is at arm's length and complies with all the other investment rules in the SISA, s 65 has not been contravened. Consider the following example from the Commissioner.[2]

> ***Example 4 - acquiring services on arm's length terms - not financial assistance***
>
> Sam is a member and trustee of an SMSF. Sam has a nephew, Peter, who is an accountant and specialises in providing accountancy services to SMSFs. Sam engages Peter to provide accountancy services to the SMSF. Peter provides the services for arm's length consideration and all the services provided by Peter are reasonably necessary to ensure good administration of the SMSF.
>
> On the facts there is no contravention of paragraph 65(1)(b). Peter has not been remunerated in excess of arm's length consideration and has not provided excessive services to the SMSF. Sam, in employing the services of Peter, has not provided Peter with financial assistance using the resources of the SMSF.
>
> If, however, the amount charged by Peter for the services was greater than an arm's length amount, or the services provided by Peter were excessive, Sam as trustee would be giving financial assistance to Peter (a relative of a member) using the resources of the SMSF and would therefore contravene paragraph 65(1)(b).

Further, the Commissioner provides the following example:[3]

> ***Example 24 - investment in new family company to establish business - not financial assistance***
>
> Les and Merle are members and trustees of an SMSF. Les and Merle are equal shareholders in a newly incorporated company. The company, a related party of the SMSF, is to carry on business as a furniture manufacturer.
>
> Les and Merle as trustees of the SMSF lend $500,000 to the company at a commercial rate of interest with the capital to be repaid to the SMSF in 5 years. The $500,000 is used by the company to acquire the equipment and premises. (The loan is an in-house asset of the SMSF and therefore subject to the provisions in Part 8, including the 5% limit on the market value ratio of the SMSF's in-house assets.)
>
> SMSF funds have been used to finance the establishment of the company's business and therefore the SMSF has provided financial assistance to the company using SMSF resources. However, the mere fact that Les and Merle are shareholders of the company is not sufficient to reach the conclusion that Les and Merle are indirectly provided with financial assistance. If there were other factors present, for example, the company used part of the $500,000 to satisfy a debt owed to a third party by Les and Merle, then financial assistance using SMSF resources would be indirectly provided to Les and Merle and would therefore contravene paragraph 65(1)(b).

6 Section 66 — no acquisitions from related parties

Section 66(1) broadly prohibits trustees of regulated superannuation funds from acquiring assets from related parties (eg, members). The policy behind this was explained by Mr Pooley, the then

[2] Australian Taxation Office, *Self Managed Superannuation Funds: giving financial assistance using the resources of a self managed superannuation fund to a member or relative of a member that is prohibited for the purposes of paragraph 65(1)(b) of the Superannuation Industry (Supervision) Act 1993*, SMSFR 2008/1 (16 July 2008) [105]-[07].

[3] Australian Taxation Office, *Self Managed Superannuation Funds: giving financial assistance using the resources of a self managed superannuation fund to a member or relative of a member that is prohibited for the purposes of paragraph 65(1)(b) of the Superannuation Industry (Supervision) Act 1993*, SMSFR 2008/1 (16 July 2008) [214]-[216].

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Commissioner of the Insurance and Superannuation Commission, at the Senate Select Committee on Superannuation when the SISA was still a bill:[4]

> Clause 62 [enacted as section 66] of the SIS bill prohibits a trustee or investment manager from intentionally acquiring an asset from a member or relative of a member. There is also an anti-avoidance provision relating to the acquisition of assets through schemes that are designed to stop circumvention of the intent of the provisions. This clause is intended to prohibit members selling their private assets to their fund in order to obtain cash or contributing in specie assets which do not necessarily increase members' retirement income. It should be noted that clause 62 does not preclude cash contributions.
>
> The above transactions are not consistent with the government's aim of giving tax concessions to superannuation to increase retirement income. For example, where a member's or relative's assets is sold to the fund to release cash from the funds this often avoids the intent of the preservation requirements through swapping an illiquid asset outside of the fund, say an investment property or the member's house, for cash in the fund which need not be used for retirement income purposes. The second example is: where a contribution of the member's or relatives in specie asset is made to move an asset into the concessionally taxed superannuation environment, the transaction may not result in an increase in overall retirement income.

Schemes to avoid the operation of s 66(1) are also prohibited. See s 66(3). Section 66 is noteworthy because, in addition to the usual risks of non-compliance, s 66(4) expressly states that a person who contravenes s 66(1) or s 66(3) is guilty of an offence punishable on conviction by imprisonment for a term not exceeding one year.

> ***Lock v Commissioner of Taxation*** **(2003) 129 FCR 1***
>
> Mr and Mrs Lock transferred land to the trustee of the Lock Property Trust in early June 1995. The Lock Superannuation Fund No 2 was established on 23 February 1995. The trustee of the Lock Superannuation Fund No 2 acquired units in the Lock Property Trust.
>
> Even though the trustee of the fund never acquired the land itself, the Commissioner nevertheless considered this to be a scheme and a contravention of s 66(3). This decision was appealed to the Federal Court where Goldberg J dismissed the appeal.

The doctrine of fixtures can lead to a contravention of s 66(1), as the Commissioner sets out:[5]

> ***Example 6 - performance of a service - goods not insignificant in value and function***
>
> The following examples illustrate the performance of a service for the SMSF along with the provision of assets that are not insignificant in value and function.
>
> (a) A member of an SMSF buys and installs ducted air-conditioning in a rental property owned by the SMSF. An asset is acquired as the ducted air-conditioning components are not insignificant in value and function.
>
> (b) A member of an SMSF buys all necessary building materials and builds a house in situ on land owned by the SMSF. The member does some of the building work and also pays contractors to do some of the building work. A service is performed for the SMSF and assets are acquired from the member as the building materials are not insignificant in value and function.
>
> Subsection 66(1) is contravened in each of the above circumstances

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[4] Senate Select Committee on Superannuation Hansard, Public Hearings Thursday 23 September and Friday 24 September 1993, 174–5.

[5] Australian Taxation Office, *Self Managed Superannuation Funds: the application of subsection 66(1) of the Superannuation Industry (Supervision) Act 1993 to the acquisition of an asset by a self managed superannuation fund from a related party*, SMSFR 2010/1 [59–90]

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There are also a number of exceptions for to s 66(1). Some of the key exceptions are for money (s 66(5)), listed securities (s 66(2)(a)), 'business real property' (s 66(2)(b)). The rationale for the exception for 'business real property' has been explained as follows:[6]

> The rules concerning the acquisition of assets from related parties and leasing assets to related parties have exceptions for business real property. While there are risks involved in providing exceptions to the general rules, these exceptions have the benefit of allowing small business owners to use their superannuation savings to invest in their own business premises. The exceptions recognise that land and buildings generally have an underlying value independent of the employer-sponsor's business.

There are other exceptions

7 Section 67 — prohibition on borrowings

Section 67(1) prohibits the trustees of regulated superannuation funds from borrowing money or maintain an existing borrowing of money.

However, in the 1990s and early 2000s, trustees of many regulated superannuation funds began investing in instalment warrants. Instalment warrants in many ways can be viewed as substantially the same as a borrowing.

The Commissioner of Taxation and APRA both announced in 2006 that they considered instalment warrants to be borrowings and thus contraventions of s 67(1). The government then announced it would provide a legislative fix. The 'fix' was s 67(4A) (since repealed and replaced with ss 67A and 67B). This fix turned out to be very broad and essentially allows the trustee of a regulated superannuation fund to borrow to acquire assets, including real estate.

There are various conditions that must be satisfied in order for s 67(1) not to apply. They are set out in ss 67A and 67B. The key requirements are in s 67A(1), which provides as follows.

> Subsection 67(1) does not prohibit a trustee of a regulated superannuation fund (the *RSF trustee*) from borrowing money, or maintaining a borrowing of money, under an arrangement under which:
>
> (a) the money is or has been applied for the acquisition of a single acquirable asset, including:
>
> (i) expenses incurred in connection with the borrowing or acquisition, or in maintaining or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset); and
>
> (ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and
>
> (b) the acquirable asset is held on trust so that the RSF trustee acquires a beneficial interest in the acquirable asset; and
>
> (c) the RSF trustee has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and
>
> (d) the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) default on:
>
> (i) the borrowing; or
>
> (ii) the sum of the borrowing and charges related to the borrowing;
>
> are limited to rights relating to the acquirable asset; and
>
> (e) if, under the arrangement, the RSF trustee has a right relating to the acquirable asset (other than a right described in paragraph (c))—the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the acquirable asset; and
>
> (f) the acquirable asset is not subject to any charge (including a mortgage, lien or other encumbrance) except as provided for in paragraph (d) or (e).

[6]Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth), 7–8.

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There are a number of issues which SMSF trustees must be particularly mindful of when engaging in a limited recourse borrowing arrangement pursuant to s 67A, such as:

- When the limited recourse borrowing arrangement finishes and the asset is transfer from the 'holding' trustee to the SMSF trustee, on its face this often will give rise to a duty for liability calculated on an ad valorem basis. SMSF trustees must receive jurisdiction specific advice regarding how the purchaser is described on the initial purchase contract and how the deposit is paid, etc, to ensure that the minimum legal amount of stamp duty liability arises.

- Do an apartment and a car park (each on a separate title) constitute a single title or would two limited recourse borrowing arrangements be required?

- Are off-the-plan developments allowed?

The ATO has released a ruling clarifying certain aspects of these questions.[7]

8 Part 8 — in-house asset rules

There are restrictions on the level of Fund assets that may be invested in in-house assets (SISA s 82(2)). An in-house asset is broadly any of the following (SISA s 71(1)):

- an investment in a related trust or a related party;

- a loan to a related party; and

- an asset that is leased to a related party.

The restriction on investments in in-house assets originally was 'designed to protect members' benefits by encouraging superannuation funds to restrict the level of their investments in sponsoring employers' (second reading speech to the Taxation Laws Amendment Bill (No. 2) 1985 (Cth)). This was intended to avoid the situation where, in the event of the failure of that sponsoring employers' business, members 'lose both their jobs and also their superannuation entitlements' (*Case 73/96* [1996] ATC 653, 661).

However, in the late 1990s, the definition of in-house asset was expanded to cover another situation.

In 1998, the government had grown concerned because the trustees of about 20% of all of small superannuation funds were investing in unit trusts that were effectively controlled by the fund members. Around one half of these unit trusts were undertaking geared investments (that is, gearing up money received from the superannuation funds). Naturally, trustees of regulated superannuation funds are not allowed to engage in such activities directly (SISA s 67(1)). Therefore, the government felt that these practices were undermining the effectiveness of the existing investment rules that were designed to reduce the risks of superannuation investments and ensure that superannuation savings are preserved for retirement purposes. The government considered extending the prudential rules of the SISA to also apply to related trusts in the same way that the SISA regulates regulated superannuation funds. However, this was ultimately decided against.

[7] Australian Taxation Office, *Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts*, SMSFR 2012/1, 23 May 2012.

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Instead, the government concluded it was administratively easier to expand the definition of in-house assets to include investments in related trusts. (For more background information, see the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth).)

Therefore, it is not the activities of the trustee of the related trust that are tested. Rather, the key test is whether the related trust is actually a related trust (ie, an in-house asset).

Broadly, trustees of regulated superannuation funds should ensure that no more than 5% of funds are invested in in-house assets.

Practical experience suggests that failure to comply with the in-house asset rules is seen as a particularly grave contravention and may well lead to non-compliance.

> ***JNVQ and Commissioner of Taxation* [2009] AATA 522***
>
> A husband and wife were the trustees of a self managed superannuation fund. They also ran a business through a related party. In August 2004 the business required emergency working capital in order to 'trade through current difficulties'. Accordingly, between 12 August 2004 and 5 May 2005 the trustees of the fund lent the business a total of $126,000. This represented over 95% of the fund's assets. There was a loan agreement and interest was to charge at a rate of 10% and the loan was to be repaid within five years. The related party paid the nominated 10% interest on 30 June 2005.
>
> On 23 July 2007, the fund's auditor lodged a contravention report advising the Commissioner that the trustees had contravened the in-house asset rules. After receiving this information, the Commissioner asked for further detail.
>
> In February 2008, the trustees offered an enforceable undertaking to the Commissioner to pay $20,000 and then a further $20,000 by 30 June 2008, followed by monthly payments of $3,600 until loan fully paid. The Commissioner rejected this because he considered the timeframes were set too far into the future.
>
> Then in June 2008, new enforceable undertaking was offered. The related party had by then repaid $40,000 and the proposed arrangement was to pay further $10,000 by end of June 2008, with loan to be fully repaid by 30 November 2008. The Commissioner also rejected this because he again considered the timeframes were set too far into the future.
>
> The Commissioner exercised his discretion to issue a notice of non-compliance.
>
> The trustees sought review of this decision in the AAT. Senior Member Carstairs weighed up the factors and was satisfied that it was the correct decision to issue the notice of non-compliance. Accordingly, the AAT affirmed the decision.

Accordingly, contraventions of the in-house asset rules do not necessarily lead to non-compliance, but must be addressed as soon as possible.

There are a number of exceptions to the definition of what is an in-house asset. One common exception contained in div 13.3A of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') (s 71(j)(ii)). Broadly, it provides that an investment in a trust or company that would usually be an in-house asset is not an in-house asset if:

> (a) the superannuation fund has fewer than 5 members; and
>
> (b) the company, or a trustee of the unit trust, is not a party to a lease with a related party of the superannuation fund, unless the lease relates to business real property; and
>
> (c) the company, or a trustee of the unit trust, is not a party to a lease arrangement with a related party of the superannuation fund, unless the lease arrangement:
>
> (i) is legally binding; and
>
> (ii) relates to business real property; and
>
> (d) the company, or a trustee of the unit trust, is not a party to a lease, or lease arrangement, with another party in relation to an asset that is the subject of another lease or lease arrangement

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between any party and a related party of the superannuation fund (unless the asset is business real property); and

(e) the company, or a trustee of the unit trust, does not have outstanding borrowings; and

(f) the assets of the company or unit trust do not include:

(i) an interest in another entity; or

(ii) a loan to another entity, unless the loan is a deposit with an authorised deposit taking institution within the meaning of the Banking Act 1959; or

(iii) an asset over, or in relation to, which there is a charge; or

(iv) an asset that was acquired from a related party of the superannuation fund after 11 August 1999, unless the asset was business real property acquired at market value; or

(v) an asset that had been at any time (unless it was business real property acquired by the company, or a trustee of the unit trust, at market value) an asset of a related party of the superannuation fund since the later of:

(A) the end of 11 August 1999; and

(B) the day 3 years before the day on which the fund first acquired an interest in the company or unit trust.

9 Section 109 — dealings at arm's length

Section 109 broadly provides that if the trustee of regulated superannuation fund invests where the other party is not at arm's length the terms of the transaction must be no more favourable than to the other party than if it had been at arm's length. The key case considering the meaning of the expression 'arm's length' in the context of the SISA provides that (*APRA v Derstepanian* (2005) 60 ATR 518, 524 [18]):

> [t]he term 'at arm's length' is not defined in the SISA Act. Nonetheless, it plainly implies a dealing that is carried out on commercial terms. As counsel for the respondents submitted, a useful test to apply is whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment.

Section 109 is particularly relevant where related parties lend to SMSF trustees as part of a limited recourse borrowing arrangement.

10 Regulation 13.14 — no charges

Regulation 13.14 of the SISR broadly provides that trustees of regulated superannuation funds must not give a charge over, in relation to, an asset of the fund. A 'charge' includes a mortgage, lien or other encumbrance (reg 13.11). However, there are exceptions to this prohibition where the charge is permitted, expressly or by necessary implication, by the SISA or the SISR (reg 13.15). The two most common exceptions are:

- where the charge is pursuant to a limited recourse borrowing arrangement;
- where the charge is pursuant to an investment in certain derivates (see reg 13.15A).

11 Income tax law

11.1 Introduction

In return for being supervised under the SISA and the SISR, the funds may become eligible for concessional taxation treatment (SISA s 3(2)).

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If you are 60 years or over when you receive a superannuation benefit, the benefit is not assessable income and is not exempt income (*Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') s 301-10). In other words, you receive it income tax free.

Broadly, to the extent that superannuation fund assets are being used to meet current pension liabilities, the income (including net capital gains) is exempt from income tax (ITAA 1997 sub-div 295-F).

This can lead to very tax effective structures.

> Joe retires at age 65 and has $5 million in a self managed superannuation fund. The trustee of the fund commences to pay him a pension using the assets of the fund. Joe receives pension payments totalling $250,000. The trustee of the fund receives dividends and realises capital gains totalling $1 million. Neither the trustee of the fund nor Joe pay any income tax. In fact, the trustee fund will probably receive a cheque from the Australian Taxation Office (due to franking credits).

The tax concessions afforded to superannuation can lead to people wanting to manipulate superannuation in certain ways, such as:

- Taxpayers 'pumping' profits into the concessionally tax superannuation environment pursuant to non arm's length arrangements to avoid those profits being taxed at non-superannuation rates; and
- structures that are not 'Australian superannuation funds' seeking to benefit from the tax concessions.

There are rules that seek to deal with each of these issues.

11.2 Non-arm's length income

Broadly, income derived on a non-arm's length basis is taxed at the highest marginal tax rate.

> ***FFWX and Commissioner of Taxation* [2009] AATA 657 (affirmed on appeal in *Darrelen Pty Ltd v Commissioner of Taxation* [2010] FCAFC 35)***
>
> In 1995 a superannuation fund trustee acquired 4% of the shares in a private company from Mrs C. There was a 'relationship' between the director of the superannuation fund trustee and Mrs C's husband who controlled the private company. The acquisition price was only 10% of the shares' market value. The superannuation fund trustee conceded that the price at which it acquired the shares was not an arm's length price.
>
> The private company was a passive holding company that held shares in a listed public company. Over the years, the listed public company paid dividends to its shareholders, including the private company. The private company then paid these dividends to its shareholders, including the superannuation fund trustee. All of the dividends paid by the public listed company and the private company were proportional to the shares held.
>
> Specifically, the superannuation fund trustee paid $51,218 for the shares in 1995, which had a market value of around $594,136. The dividends from the shares were as follows:
>
> year ending 30 June 1996 — the amount of $26,400;
> year ending 30 June 1997 — the amount of $208,136;
> year ending 30 June 1998 — the amount of $140,000;
> year ending 30 June 1999 — the amount of $125,200
> year ending 30 June 2000 — the amount of $143,720;
> year ending 30 June 2001 — the amount of $143,720;
> year ending 30 June 2002 — the amount of $86,320; and
> year ending 30 June 2003 — the amount of $76,640.

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The superannuation fund's investment in the private company was recouped in a short time frame and as can be seen above, substantial dividends flowed.

As these facts arose prior to 1 July 2007, the relevant legislation referred to special income. If the facts arose today, the relevant legislation would refer to non-arm's length income.

As the dividends were from a private company, the dividends received by the superannuation fund trustee constituted special income. However, the Commissioner of Taxation may determine otherwise, having regard to certain factors. Those factors include:

factor (a): the value of the shares; and

factor (f): any other matters that the Commissioner considers relevant.

The Commissioner declined to exclude the dividends from being special income. The superannuation fund trustee objected to the AAT.

The Commissioner had stated in a taxation ruling that 'value' in factor (a) means 'market value'. A major argument by the superannuation fund trustee was that the Commissioner was wrong to state in his tax ruling that 'value' in factor (a) means 'market value'. The superannuation fund trustee won on this point, with the AAT stating 'the Ruling is in this particular regard incorrect'. However, market value was still relevant for factor (f).

The superannuation fund trustee argued that if the AAT decided the matter in favour of the Commissioner, the 'tainting effect' arising from the acquisition of assets for less than market value would endure indefinitely, and that this consequence could not have been intended. However, the AAT rejected this argument. They found that the underlying transaction that gave rise to the relevant income could not be divorced from the income itself.

Accordingly, the AAT affirmed the Commissioner's decision and the dividends constituted special income.

11.3 Australian superannuation fund

(a) Introduction

Broadly, in order for an SMSF to be a complying superannuation fund and thus receive tax concessions, it must be — among other things — an Australian superannuation fund as defined under the ITAA 1997.

Section 295-95(2) provides three tests, all of which must be passed, in order for a fund to be an Australian superannuation fund. They can be broadly summarised as:

- the fund was established in Australia, or any asset of the fund is situated in Australia at that time
- the central management and control of the fund is ordinarily in Australia
- the active member test is met.

The Commissioner sets out his views relating to this in Tax Ruling 2008/9.[8]

SMSF trustees often forget about meeting these tests.

[8]Australian Taxation Office, *Income tax: meaning of 'Australian superannuation fund' in subsection 295-95(2) of the Income Tax Assessment Act 1997*, TR 2008/6, 10 December 2008.

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CBNP Superannuation Fund and Commissioner of Taxation* [2009] AATA 709

There was a self managed superannuation fund with only one member, Ms M. Ms M was also the only director of the fund's corporate trustee. Ms M ceased to be a resident of Australia for income tax purposes, moving to New Zealand. Ms M installed her brother, Mr M, as a fellow director of the fund's corporate trustee. Nevertheless, all decisions in relation to the management and control of the fund from then onwards were made by Ms M in New Zealand.

Ms M personally borrowed about $118,000 from fund assets. This loan could give rise to many different contraventions, including:

- a contravention of the limit on investments in in-house assets
- a contravention of the prohibition on loans to fund members
- a contravention that the fund only be maintained for certain core and ancillary purposes (ie, the sole purpose test).

The fund's auditor focused on the first contravention and reported it to the Commissioner of Taxation. The Commissioner then audited the fund. Upon auditing the fund, the Commissioner realised that the fund failed the residency rules. The Commissioner issued a notice of non-compliance. The fund's total assets were approximately $273,768. The notice of non-compliance resulted in a tax bill for the fund of approximately $146,000.

The fund appealed the notice of non-compliance to the Administrative Appeals Tribunal. The Tribunal found that it was 'most unfortunate that Ms M will suffer a significant reduction in her self-managed superannuation fund benefits. The Tribunal sympathises with her and the position in which she finds herself, but has no greater power than the respondent under the SIS Act to assist her.' Accordingly, the tax liability stood.

Whenever an adviser has a client who is moving overseas, alarm bells should ring and the adviser should ask: does the client have an SMSF? If the client does, specific steps must be taken.

Failure to take the specific steps can result in a hefty and unnecessary tax bill as well as little avenue for successful appeal.

(b) Specific steps

There are three key steps to ensure that an self managed superannuation fund with overseas member meets the residency rules.

(c) First step

Either the fund must have been established in Australia, or any asset of the fund must be situated in Australia. This step is invariably met.

(d) Second step

The central management and control of the fund must ordinarily remain in Australia. The Commissioner believes that this means the strategic and high level decision making processes and activities of the fund must ordinarily remain in Australia. He believes that the strategic and high level decision making processes includes:

- formulating the investment strategy for the fund
- reviewing and updating or varying the fund's investment strategy as well as monitoring and reviewing the performance of the fund's investments
- if the fund has reserves - the formulation of a strategy for their prudential management and
- determining how the assets of the fund are to be used to fund member benefits.

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The Commissioner further believes that formalistic or administrative activities do not constitute central management and control. Examples of formalistic or administrative activities include the actual investment of the fund's assets pursuant to a pre-existing investment strategy.

Accordingly, one way to try to meet this rule is to ensure that the fund's trustees ordinarily only make the strategic and high level decision while in Australia. However, this is not the preferred course of action for a number of reason. One reason is that factually proving where the trustees ordinarily make the strategic and high level decision is easier said than done.

The preferred way to meet this rule is to transfer trusteeship (or directorship if a company is the trustee) to a trusted Australian family member or friend. This should happen before the client leaves Australia. The trusted Australian family member or friend should then make centrally manage and control the fund. On its face this poses a problem: the fund no longer appears to a self managed superannuation fund as the members are no longer the trustees (or directors of the corporate trustee). However, provided that the trusted Australian family member or friend holds an enduring power of attorney in respect of the members, the fund will still be an self managed superannuation fund. The Commissioner has set out his views on the uses of enduring powers of attorney in Self Managed Superannuation Fund Ruling SMSFR 2010/2.

(e) Third and final step

Finally, no contributions or roll-overs whatsoever should be made to the self managed superannuation fund while its members are overseas. This is a slight over simplification of the actual rule, but if clients follow this simplified version, they will never go wrong.

If superannuation contributions must be made while clients are overseas, they should be made to a large fund. Then once the clients have resumed being Australian residents again, they can roll benefits from the large fund to the self managed superannuation fund.

(f) What if the client has already gone overseas?

These three rules work well where the adviser has the opportunity to plan in advance. However, often work constraints mean clients must leave the country quickly and with little time to properly consult with their adviser. Accordingly, ah adviser might find him or herself in the tricky position of having an overseas client who has an self managed superannuation fund where the three rules might not have been followed. Advisers should act quickly in this situation and consult an expert for tailored to determine whether the fund still meets the residency rules and whether any other avenues exist.

12 Death benefit disputes

12.1 Introduction

Many superannuation fund members are shocked to learn that their will does not cover any interests they might have in a superannuation fund (*McFadden v Public Trustee for Victoria* [1981] 1 NSWLR 15, 22). Many fail to arrange for wills. Even more fail to properly plan for the wealth in an SMSF upon death.

A key tool in planning for the wealth in an SMSF upon death is the 'BDBN'. It is effectively a will that covers superannuation interests.

There is a long standing debate in SMSF law: how long can a BDBN last for? Many incorrectly think the ATO definitely answered this question in SMSFD 2008/3. However, case law suggests

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that advisers need to dig a little deeper to achieve the best result for clients. The bottom line is: it depends on how the deed is worded and how the deed links itself to superannuation law.

12.2 Background: what is a BDBN?

A BDBN (ie, a 'binding death benefit nomination') is a nomination by a member of a superannuation fund in respect of whether their benefit on death is paid to one or more of their dependants or legal personal representative. The term BDBN is not used in the superannuation legislation anywhere. Its exact meaning depends on the fund's specific governing rules. Generally, a fund's governing rules define a BDBN to mean a nomination that a member makes that binds the fund's trustee as to how to pay any death benefit upon the member's death. BDBNs are increasing important because:

- Upon death, a member's will typically does not govern their interests in a fund (*McFadden v Public Trustee For Victoria* [1981] 1 NSWLR 15). Therefore a BDBN is often necessary to have certainty as to whom the fund's trustee will pay the deceased's death benefits.

- Members often have large amounts in their funds upon death. This is for due to two reasons. Firstly, many are contributing more and more to funds and retaining money in the concessionally taxed superannuation environment as long as possible. Secondly, due to life insurance policies held via superannuation, a nominal account balances during life often equates to a death benefit of several hundreds of thousands of dollars. See, for example, *Edwards v Postsuper Pty Ltd* [2006] FCA 1380, where the deceased was 25 years old and died suddenly in a motor vehicle accident. Due to insurance, his superannuation death benefit was $221,509.65.

12.3 Background: Why does the controversy exist?

Section 59(1) of the *Superannuation Industry (Supervision) Act 1993* (Cth) provides that generally only a trustee can exercise discretions under a fund's governing rules. Therefore, a BDBN appears to be not allowed because it involves someone other than a trustee (ie, the member) exercising a discretion (ie, to whom a death benefit will be paid upon death). It must be noted that s 59(1) expressly only apples to superannuation entities other than SMSFs.

There is an exception to s 59(1), which is contained in s 59(1A). Section 59(1A) provides that a fund's governing rules can allow a discretion to be exercised by someone other than the trustee in respect of paying out of death benefits, *provided that the applicable regulation is complied with.*

The applicable regulation is reg 6.17A of the *Superannuation Industry (Supervision) Regulations 1994* (Cth). This contains a number of conditions in order for someone other than the trustee to exercise discretion in respect of death benefits. One condition is that any such notice (eg, a BDBN) can only last for a maximum of three years (reg 6.17A(7)).

Therefore, for all non-SMSF superannuation funds they can generally only have BDBNs that last for a maximum of three years. However, many argue that because reg 6.17A(7) applies to s 59(1A) and because s 59(1A) is an exception that applies to s 59(1) and because s 59(1) never applied to SMSFs, therefore reg 6.17A has no application to SMSFs.

12.4 The ATO position

The ATO have released SMSFD 2008/3. This states that (SMSFD 2008/3 [1]):

> Section 59 ... and regulation 6.17A ... do not apply to ... SMSFs. This means that the governing rules of an SMSF may permit members to make death benefit nominations that are binding on the trustee, whether or not in circumstances that accord with the rules in regulation 6.17A

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Many incorrectly believe that SMSFD 2008/3 settled the debate, with the conclusion being that reg 6.17A has no application to SMSFs and therefore that SMSF governing rules can allow members to make BDBNs that last for more than three years (eg, indefinitely).

However, it must be remembered that an SMSFD is not law. It does not bind the courts, tribunals, fund trustees, members, or anyone else. In fact, as each SMSFD warns in its preamble, an SMSFD does not even bind the Commissioner.

Accordingly, the importance of SMSFD 2008/3 is limited to being authority for the following proposition: the Commissioner is unlikely to view an SMSF trustee as having breached s 59 if the trustee treats a BDBN that does not comply with reg 6.17A as being valid.

12.5 The legal position

The case of *Donovan v Donovan* [2009] QSC 26 considered three questions. Relevantly, the first question was whether s 59(1A) and reg 6.17A applies to SMSFs.

The case involved an SMSF and its governing rules provided that a member may make a BDBN 'in the form required to satisfy the Statutory Requirements'. A member wrote a letter to the trustee stating:

> I hereby advise that it is my wish that the balance of any amounts standing in my name in the above named superannuation fund, on my demise, be paid to my Legal Personal Representative for inclusion in my estate assets.

The final question that the court was to consider was whether the letter constituted a BDBN. The judge answered this final question first and found that the letter did not manifest the requisite intention and accordingly was not a BDBN. Accordingly, he did not find it necessary to answer the other questions.

However, the judge nevertheless made some relevant passing comments (ie, *obiter dicta*). It must be noted that because these comments were not his reason of deciding (ie, *ratio decidendi*) and therefore the doctrine of *stare decisis* (ie, future judges being bound by prior decisions) does not apply, these comments do not form part of the law. Nevertheless, these comments are likely to be influential if another judge ever does consider similar questions.

The judge stated that the SMSF's specific governing rules — by using the phrase 'in the form required to satisfy the Statutory Requirements' — caused reg 6.17A to apply to the SMSF. One reason he stated this was that:

> It is very easy for trustees and members to make a mistake about the requirements applicable in their particular case. It is very understandable that a deed should specify a requirement in effect to comply with the form described in regulation 6.17A(6) out of an abundance of caution. The alternative would be to require the trustees or the member to take legal advice about the answer to the first question posed to me, and to run the risk that their advice might turn out to be incorrect. Such an approach is uncommercial and unlikely.

Accordingly, the judgement suggests that there is still uncertainty as to whether s 59(1A) and reg 6.17A applies to SMSFs. The Commissioner's SMSFD 2008/3 definitely did not settle the debate. In fact, part of the evidence provided to the judge was the draft version of SMSFD 2008/3 and the judge essentially ignored it. Hopefully, in the near future a case will be decided that clarifies whether s 59(1A) and reg 6.17A applies to SMSFs.

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12.6 Practical implications

There are several practical implications for those who decide that a BDBN is appropriate for their interests in an SMSF:

- The specific provisions of the SMSF's governing rules are absolutely vital. If the governing rules include reg 6.17A (or if there is any ambiguity as to whether they include reg 6.17A), a court will probably deem reg 6.17A to apply 'out of an abundance of caution'. Therefore, for those who want SMSF BDBNs that last for more than three years, the governing rules should be very clear that reg 6.17A (or at least the three year rule contained in reg 6.17A(7)) is not to apply.

- The best practice is to SMSF governing rules to expressly allow for indefinite BDBNs, yet for members to make a new BDBN every three years anyway. That way, if when the three year period expires the member is unable to make a new BDBN because they are say in a coma (cf *D07-08/030*), at least their BDBN still has a 'leg to stand on'. In contrast, if the SMSF governing rules were ambiguous as to how long a BDBN can last for, or they referred the three year period, this could place the member's estate planning at risk.

- Drafting a BDBN must be done correctly. Like a will, specific wording should be used in order to ensure that — unlike *Donovan* — the requisite intention is manifested. However, many people overlook the importance of the actual wording of a BDBN whereas the wording is as important as that in a will.

However, most importantly, it is critical to ensure that the right people are controlling an SMSF. If the wrong people are controlling the SMSF, in a practical sense, a BDBN might be ignored for spurious reasons leaving the intended recipient(s) with a very difficult and expensive legal battle to fight.

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