



Tax traps for SMSFs

The flexibility offered with Self Managed Funds in terms of investment choice and structure can be appealing for superannuants and their investment advisors. However, the law regulating Self Managed Superannuation Funds is quite complex. The intricacy of the legislation has resulted in a number of 'tax traps', which can catch out the unwary.

In this month's newsletter, we will briefly overview a few (of the many) traps to look out for:

Segregated Pension Assets

A common strategy undertaken within a SMSF is the segregation of assets between the members of the fund. Contrary to the conventional 'pooled' asset structure in a superannuation fund, segregation means that a particular member's balance comprises of a selection of assets, which may be a totally different selection of assets to the other members, albeit within the same fund.

This is a popular strategy with a SMSF that has one member in pension phase, and one in accumulation phase. Assets which have high unrealised capital gains, or potential for significant growth, are segregated to the pension member. This takes full advantage of the pension-backed assets tax concession – this is that income derived from pension assets are generally tax free, and capital gains on segregated pension assets are disregarded for tax purposes.

If executed properly, this strategy can be extremely tax effective. If the segregated pension asset's capital grows at the anticipated rates, potential reasonable benefit limit (RBL) issues for the accumulation member can be avoided (the RBL value for the pension member has already been 'locked in', regardless of future capital growth). Importantly, when the asset is sold, there should be no capital gains tax payable.

On the other hand, this strategy can be extremely tax ineffective. Should the segregated pension assets capital value decline steeply rather than grow, this will create a large unrealised capital loss. If the assets are then sold when still a segregated pension asset, the capital loss will be disregarded, just as the gain would have been disregarded. What this means is that if a capital gain is made on the accumulation member's segregated assets, the loss on the segregated pension assets will still be disregarded, and is not able to be used to offset the gain.

Residency

There are complex rules relating to when a SMSF is considered a 'resident' or a 'non resident' fund. A non resident fund is considered to be a non-complying fund, hence subject to a 47% tax rate.

The residency provisions really only come into play with a fund whose members and trustees spend prolonged periods overseas – in these cases, these provisions are surprisingly often overlooked.

Firstly, a SMSF must maintain 'central management and control' in Australia to remain a resident fund. Generally speaking, the trustees must spend less than 2 years overseas to retain the central management and control in Australia. If the trustees return to Australia for more than 28 days at one time, the 2 year period starts again.

One suggested solution to this (for trustees spending over 2 years overseas) could be to appoint an APRA approved trustee, which will retain the management and control in Australia. Keep in mind, that this may incur significant costs. Another possibility could be to appoint a resident corporate trustee with a resident family member as director of the company (this will generally only satisfy the central management and control test for a single member fund where you can have another resident family member as director of the trustee company).

Secondly, 'active resident members' must have over 50% of the 'total active member's balance' in the SMSF. Generally, an active member is a member who makes contributions to the fund in a financial year.

Therefore, if a SMSF has non resident members, yet they continue to contribute (and assuming their combined balance is in excess of 50% of the total fund balance), the fund will be a non-resident fund for the particular financial year and subject to a 47% tax rate.

It is worth considering whether a SMSF is the best option for people residing overseas.

Shares in private companies

Subject to certain conditions being satisfied (generally relating to transactions being made on arms length terms), superannuation funds may purchase shares in private companies. On the outset, this may seem a tax effective decision to make for clients who are the directors and shareholders of a private company. To sell the shares to a SMSF and funnel dividends through the superannuation fund, should theoretically provide the benefit of a 15% tax rate on the dividends paid, and consequently, a large refund of franking credits. An ideal result? Not the case.

'Special income' provisions prevent this. ALL dividends received by a SMSF from a private company must be treated as 'special income', and taxed at 47%. Even if the assets are pension assets, these dividends are still taxed at 47%.

However, a request can be made for exemption from the special income provisions. The Commissioner of Taxation can exercise discretion and deem the income from the private companies not as special income. Generally, for the Commissioner to exercise discretion, all transactions between the company and the SMSF must be made on arms length basis, and the private company should have characteristics similar to that of a public company. The process of obtaining discretion from the Commissioner can be a long and complex process.

Unless discretion is granted, the 47% tax rate applies – there is no self assessment in this case.

Minutes and SMSFs

SMSF trustees are required by law to formally document or minute all decisions made concerning the operation of their fund.

The ATO have now confirmed that individual transactions within an investment category do not need to be documented in detail, providing they are in accordance with the SMSF's investment strategy. Where new categories of investments occur, as opposed to ongoing transactions within an existing investment category, the ATO does expect such decisions to be documented and the investment strategy to be updated to reflect the reasons behind the change.

For example, if a SMSF's investment strategy includes investments in listed Australian shares, the trustees would not be expected to formally minute each purchase or sale of shares in company XYZ Australia. However, if they were to vary their investment strategy to include investments in unlisted property trusts, they would be expected to formally minute that decision and revise their Investment Strategy.

The ATO has also advised the '**Keep Proper Records**' section of the publication '**DIY Super - It's your money... but not yet!**', will be updated when the publication is next printed to better reflect these requirements. To obtain a copy, please contact **Kimberly Costa** on **1300 787 576**.



Recent Changes

Government has recently passed legislation that allows access to non-commutable income streams once preservation age has been reached, regardless of retirement. The changes are due to take effect from 1 July 2005. Coinciding with the change is the introduction of a non-commutable Allocated Pension (believe it or not!). We will cover these changes in more detail in next month's newsletter.

Advisors - Take your SMSF Advice to the Next Level

The **Certificate in Applied Self Managed Super Fund Advice** equips Advisors who are PS146 compliant to meet the practical challenges of giving advice on Self Managed Super Funds.

In a one day intensive training program, you can learn about:

- The SMSF SIS Act and trust law essentials
- The essential features of a SMSF trust deed
- The tax treatment of special income
- The tax deductibility of typical SMSF expenses
- How to apply SMSF skills to generate client wealth
- How to determine whether a SMSF is the right option for your client
- How to prepare your business for SMSF advice.

The Certificate focuses exclusively on skills for providing specialised SMSF advice, and aims to build on, rather than repeat, participants' existing knowledge.

Sessions will be held:

Sydney	Thursday	19 May
Brisbane	Friday	20 May
Adelaide	Tuesday	24 May
Perth	Thursday	26 May
Melbourne	Thursday	2 June

The Certificate is accredited by SPAA, the Self-Managed Super Fund Professionals' Association of Australia.

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