

SELF MANAGED SUPER FUNDS

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INTRODUCTION

By Pauline Hammer

Welcome to the October edition of the Self Managed Superannuation Funds Bulletin.

This month, Dan Butler and Bryce Figot shed light on the issue of income received by the SMSF which is "non-arms length." Non-arms length income was previously known as "special income". This income attracts a higher tax rate as explained in Dan & Bryce's article.

We include a regulatory update from the ATO provided to us from the Self-Managed Superannuation Fund Professional Association of Australia (SPAA). This update explains the caps that apply to super contributions and the tax payable if you exceed these caps.

A special thanks to Jenni Eason who has provided a review of the new book by Max Newman. This book is designed to be used by the trustees of SMSFs to assist them with documentation, strategies and their overall responsibilities.

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SMSF'S AND NON-ARM'S LENGTH (SPECIAL) INCOME THE KEY "MUST KNOW" ELEMENTS

By Bryce Figot and Daniel Butler

Introduction

A recent Administrative Appeals Tribunal (AAT) decision reminds us that there are several elements of non-arm's length income that all practitioners must be aware of. This is especially relevant where superannuation fund trustees have invested in related unit trusts.

(Note that prior to 1 July 2007, 'non-arm's length income' was called 'special income'.)

Background information

Superannuation fund income which is non-arm's length income is subject to income tax at 45% (not the usual 15%). Income is non-arm's length income if:

- it is derived from a scheme where the parties were not dealing at arm's length and the amount of the income is more than the amount that would have received if they were dealing at arm's length; or
- it is a private company dividend (unless the Commissioner deems the dividend not be non-arm's length income).

Facts of the AAT decision

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.

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.

For the full text of this decision, email the author at bfigot@dbalawyers.com.au.

Implications of the decision: the tainting effect

The decision suggests that if an asset is ever acquired on other than arm's length's length terms that will taint all associated income forever. Also, this principle applies to other investments that can result in non-arm's length income being derived from investments in trusts.

For example, consider a situation where an SMSF trustee purchases 500,000 units in a brand new unit trust for \$500,000 and an SMSF member also personally purchases 500,000 units for \$500,000. The unit trust trustee uses this money to acquire a \$1 million property. The property increases in value to \$1.5 million. The unit trust trustee needs further cash for repairs. The SMSF trustee wants to invest a further \$50,000 to fund the repairs. The unit trust trustee issues the SMSF trustee 50,000 units for \$50,000 each (ie, \$1 per unit). Because the real estate increased in value, \$1 per unit is no longer an arm's price for a unit. The arm's length price is now \$1.5 per unit.

Because of this, at least some of the income that the SMSF trustee now receives from the unit trust trustee (and arguably all of the income) is non-arm's length income and will be subject to income tax at 45%. This situation could have been avoided if the SMSF trustee had acquired 33,333 units instead of 50,000 in exchange for its \$50,000.

What does 'arm's length' actually mean?

There are two different definitions of 'arm's length'. One is applied for the superannuation prudential rules (eg, the arm's length requirements in s 109 of the Superannuation Industry (Supervision) Act 1993 (Cth) ('SISA')). The other is applied for income tax legislation purposes (eg, to determine whether income is special income).

For superannuation prudential rules, case law has defined arm's length as follows:

... it plainly implies a dealing that is carried out on commercial terms ... 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.

For income tax law, case law has defined arm's length as follows:

the term 'at arm's length' means, at least, that the parties to a transaction have acted severally and independently in forming their bargain ... That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.

The pension exemption

When a superannuation fund trustee commences paying a pension, typically, income derived by the assets supporting the pension become income tax free. This is referred to as the 'pension exemption'. Some have asked whether the pension exemption can be used to overcome the effects of non-arm's length income. The short answer is no because the pension exemption expressly does not apply to non-arm's length income.

Practical implications

In light of the AAT decision, practitioners should:

- Ensure that all future SMSF transactions are at arm's length.
- Check that any previous SMSF transactions that are still giving rise to income today were at arm's length.
- Ensure that sufficient evidence is retained to prove the above.
- Remember that a transaction can still not be at arm's length even if the other party is not related.

Bryce Figot is a senior associate and Daniel Butler is a director at leading SMSF law firm DBA Lawyers (www.dbalawyers.com.au). This article is general information only and should not be relied upon without first seeking advice from an appropriately qualified professional.

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TAX IMPLICATIONS OF EXCEEDING CONTRIBUTION CAPS

**Regulatory Update – ATO
Sourced from SPAA**

Super contributions - too much super can mean extra tax

Caps apply to contributions made to your super fund for a financial year. Any super contributed over the cap amount is subject to extra tax. The cap amount and how much extra tax you pay once you exceed it, depends upon whether the contributions are:

concessional - which are generally made to a super fund for or by you in a financial year and are included in the assessable income of the super fund (for example super guarantee, salary sacrificed amounts and any amount you are allowed as a personal super deduction in your income tax return).

non-concessional - which are generally made to a super fund by or for you in a financial year and are not included in the super fund's assessable income (for example, personal contributions you make from your after-tax income).

Summary of contribution caps

	Concessional cap *	Transitional concessional cap*	Non-concessional cap
2009-10 financial year	\$25,000	\$50,000	\$150,000
2008-09 and 2007-08 financial year	\$50,000	\$100,000	\$150,000
Tax on amounts over the cap	31.5% (in addition to the 15% paid by the super fund)	31.5% (in addition to the 15% paid by the super fund)	46.5%
Other information	Any concessional contributions in excess of the cap will also count towards the non-concessional contributions cap	Any concessional contributions in excess of the cap will also count towards the non-concessional contributions cap	If you are under age 65 at any time during the financial year the contribution is made, you can bring forward two years of contributions, effectively allowing you to contribute up to three times the cap at once, or at any time during the three financial years.

*The \$25,000 concessional cap will be indexed annually from 2010-11 onwards to average weekly ordinary time earnings (AWOTE) and rounded down to the nearest multiple of \$5,000.

*The transitional concessional contributions cap is for those aged 50 years or older and is available until 30 June 2012.

If you are considering making extra contributions to super, ensure you understand all the implications by reading this document.

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SELF MANAGED SUPERANNUATION FUNDS BOOK REVIEW

Author: Max Newnham ISBN: 9781 742 169 262
RRP: \$34.95 Publisher: Wiley Australia, Brisbane, 2009
Reviewer: Jenni Eason, AIA Treasurer and Secretary

Max Newnham is a Melbourne based Chartered Accountant who writes for *The Age* and *The Sydney Morning Herald* and is the author of a number of other books. He has over 25 years experience in the SMSF area.

This book is designed to be used by trustees of SMSFs to assist them with the array of duties and responsibilities. To this end, it is probably one of the better books available in this arena. The book is structured as follows:

- a history of superannuation and the types of super funds;
- some technical and taxation stuff;
- the rules of the SMSF game, how to set up and run a fund;
- documentation requirements;
- SMSF strategies and making good investments; and
- questions and answers.

In the preface Max mentions that the books release was delayed due to the Budget and that Budget changes are reflected in the book. Unfortunately, there are a number of instances where the Budget changes have not been included, particularly in the Q&A chapter.

The first two chapters provide an overview of the super system and the types of super funds. The chapters on technical issues and taxation cover each topic moderately well, although I thought some of the personal views were unnecessary and the space would have been better used discussing issues in more detail or other issues. The next few chapters regarding the rules, setting up and running a SMSF provide a basic introduction to the topics, although some rules are not mentioned eg who is eligible to be a trustee.

The chapter on documentation requirements is probably the best I have seen. For each of the topics covered Max provides examples of the content of minutes, letters, etc. Unfortunately the chapter only covers a few areas and does not include some common strategies eg recontributions, rollover and recommencement of pension, etc.

The SMSF strategies chapter is pretty comprehensive with details of the most common strategies including salary sacrificing, recontributions, in specie transfers and worked examples are provided where relevant.

The chapter on 'Making Good Investments' includes a little more information on the requirements of an Investment Strategy, but I don't think that this issue is well covered. The remainder of the chapter focuses on risk profiles and asset allocation, a topic not unique to SMSFs. He does have one interesting idea – the concept that direct property investing as a "Defensive Growth Asset" on the basis that it produces regular income and may produce a capital gain. I'm not sure that this is any different from an investment in a first rate company which makes regular dividend payments. It is also curious why over five pages was devoted to Alternative Assets, most of which was about managed investment schemes and how good they are (he does acknowledge some of the risks). To me, the Q&A chapter was a waste of time – all these questions, had/should have been answered in the book.

As the book is only about 200 pages (excluding the Q&A chapter and appendixes, etc) many of the topics are necessarily not dealt with in depth. The book would have been better structured by deleting some of the less useful information eg history of superannuation and making good investments (this is not unique to superannuation) and expanding on some of the technical areas which were not well covered eg the Fund's investment strategy, binding death benefit nominations, segregation of assets and some more record-keeping/documentation issues. That said, it is still probably the best of the SMSF books available and is written in an easy to read style.

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