

SELF MANAGED SUPER FUNDS

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INTRODUCTION

By Pauline Hammer

How fast it has come to this time of year again, being our last newsletter for 2009. The December edition of the AIA Self Managed Super Fund newsletter is packed with lots of Christmas holiday reading.

A special thank you to AIA member Margaret Studley for her contribution – *Our Self managed Super Fund*. Margaret and her husband have been running their SMSF for 28 years.

Graeme Colley of ING provides an overview on drawing lump sums from an account based pension. For readers whom receive Centrelink benefits, this is especially an important read.

Daniel Butler of DBA Lawyers provides us with five important articles which deliver an update on binding death nominations, the benefits and pitfalls of holding various insurance covers within superannuation, tips for making the most of the small business CGT concessions, recent news from the ATO on adding to existing pensions with reserve amounts and an update on SMSF borrowing.

We would like to extend our best wishes for a safe and happy Christmas and New Year to all AIA members and, of course, a peaceful and prosperous 2010.

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OUR SMSF

By Margaret Studley

Background and Administration

My husband and I have been running our own Super Fund for 28 years since it was set up in 1981 on the recommendation of our accountants who looked after the financial aspects involved and arranged for the Trust Deed to be drawn up by a solicitor with whom they had regular contact for such purposes.

Our accountants are part of a firm with whom members of the family have dealt with for four generations so they knew our situation very well, circumstances that I think would be quite rare today. We therefore had great confidence in them which helped. They also had confidence that we could, and should, manage this ourselves. We already had a company structure set up and the company was made trustee of the Super Fund. My husband and I are the members of the Fund and directors of the trustee company.

At the directions of the accountants we personally set up all the bank accounts and since inception have paid in all the contributions, paid out all the pensions, controlled the bank accounts and done all the day to day running of the fund, including keeping all the necessary records with regards to the bank accounts, share purchases and sales, and dividends, minutes of meetings, cash book details and diary entries when necessary. We send all the relevant summaries and supporting documents to the accountant for inclusion in our tax returns.

The accountants ensure that all necessary returns are completed and lodged when necessary and arrange for auditing of the fund as prescribed. The accountants have also seen to it that all TFN and ABN and other regulatory obligations have been met as and when necessary. I occasionally contact them to check whether there have been any regulatory changes we need to know about. These events are usually triggered by an article I have read in AIA or media somewhere, but I would always do it towards the end of the financial year, especially to check that we have paid the correct pension amounts.

The annual costs are approximately \$3400 for accounting and auditing and about \$400 for statutory levies and bank fees.

Investment Services

Our first contributions totalled about \$3000 so asset allocation was not an immediate issue! Over time we acquired some managed funds (mainly for overseas and property exposure), shares, fixed interest and cash. We have continued to manage our own fund with advice from the accountants as to financial matters as above.

In the late 1990's we decided to sell the business and that was when we decided to seek advice from a financial planner. Initially we chose a well known and respected name in the field but decided not to proceed. (See comments below). By the time our business was actually sold in 2000, our accountants had set up a financial planning section as part of their business. We decided to consult with their financial planning section because we felt they knew all our financial circumstances so well and could easily liaise with the taxation and personal accounts section. At that stage we felt that they were the professionals and we did not know enough to proceed entirely without some advice as to how to structure our investments in retirement.

Excluding our home, their advice was to keep at least one third of our assets, outside the super fund. This was because of a concern that the 'powers that be' might alter the rules dramatically in the future. Although this was not as tax advantageous it provided for more flexibility. We were not confident at that point that we would manage as well as professionals so thought we would put some into managed funds. They asked us to fill in a risk profile questionnaire to determine our respective attitudes to risk and what elements of investing we were comfortable with and which not. Accordingly, they suggested placing one third of our super funds in managed funds under the umbrella of a master trust. This would give us access to overseas shares and property holdings all

of which could be sold if and when we chose to do so. They provided a very detailed and informative schedule for us at this time, pointing out the pros and cons of various actions.

Fixed interest investments had staggered redemption dates over one, two and three years. We did not have any directly held real estate investments within the fund because they were deemed by our advisers to be too illiquid for our purposes and fund size. We have some property exposure through the managed funds and listed shares.

We have virtually controlled our own destiny since and made our own decisions from then on but consulting them on such issues as to what effect would certain actions have on our situation at any given time. These queries I would classify as accounting matters rather than financial planning as such. The managed funds are not something we would go into again (see below) but we do have ultimate control in that we have been able to swap funds within the master trust and can sell funds at any time we choose. We are not lovers of fixed interest investments so they were redeemed as they became due.

Over time we have tried to keep up to date with happenings in accounting and legal fields, particularly with regard to superannuation and have continued to educate ourselves as much as possible in matters of investment - attending seminars, joining the AIA etc. Attending some of the AIA annual conferences has been the most helpful as it has led us in many directions with its wonderful coverage of subjects. We subscribed to Stockdoctor years ago and since then to *ActVest*, *Stock Val* and *Eureka Report* (including *Business Spectator*) and Bodhi Gold charting, all of which we find helpful, together with books by Colin Nicholson and items by Roger Montgomery, among others. Over the years we have relied less on our stock broker and now do most of our trades online. We sold off most of the managed funds in September 2007 and intend redeeming the rest soon.

We prefer shares with dividend imputation credits and/or chance of capital appreciation. Usually we would have less in cash but have been re-entering the market after having sold down somewhat over the last couple of years. (In hindsight, not enough!!)

We are both now over 70 and as we each reached the statutory age we took out allocated pensions within the fund.

In order to provide for ourselves for possibly many years to come we aim to keep the fund growing as long as we can given that withdrawals have to be made by way of pension. We invest directly in shares, still have a small amount in managed funds and the rest is in cash. Normally, we like to have two years pension payment amounts in cash but over the last couple of years the percentage of cash has been higher.

We consider it of paramount importance to preserve our capital and to retain control over our assets.

We hope we have simplified our investments to the point where it is relatively easy for us to maintain our fund and we are confident that it could be relatively easily managed by busy family members in conjunction with our accountants should we become incapacitated. This latter is a very complicated situation from a legal perspective and I think everyone should seek expert advice on this. (Refer also to article in October issue of *AIA SMSF re Powers of Attorney*).

In view of our ages we do not wish to enter the field of options, warrants or other complicated structures. We wish to have flexibility and the capacity to add to, swap or liquidate holdings quickly at all times. We are trying to achieve diversity by investing in various sectors of activity with our share portfolio, including some companies with overseas interests. Our current portfolio:

Asset class	% of portfolio	Examples
Direct shares	72.5	BHP WPL CBA WBC JBH WOW and others
Managed Funds	10.5	CFS WS Property Sec. and others
Cash	17	

Brokerage fees are kept to a minimum with internet trading and bank fees are low. The managed funds fee for the services of the master trust and including trailing commission is approximately 1.9% to 2.6% but varies depending on the balance of the funds monthly.

General Comments

Anyone wishing to manage their own superannuation fund should have the ability to do so, the will and time to do it, and must keep up to date as much as possible. Getting expert advice is essential. I would suggest superannuation specialists be consulted as it is a very complicated field requiring both accounting and legal knowledge. It takes time and requires a good knowledge and understanding of financial matters.

It is imperative that you are aware of the obligations of Trustees so that you do not commit sins of omission or commission which would involve penalties that could result in your fund losing its status as a complying fund – seek expert opinion on this one.

I consider that in most cases it doesn't matter how good your advisors, accountants, solicitors etc. are they cannot be aware of all their clients circumstances on a continuing basis. It is important therefore for us to be keeping up with changes and ask the relevant questions as time goes by. For instance, AIA recently had an article on Powers of Attorney and super funds which immediately had me sending a query to our accountant and solicitor to check that our document covered all that was necessary in this regard.

Trust Deeds: We have had a number of amendments done as statutory regulations have changed over the years. The last one was organised by our accountant and done by a leading legal firm for \$395. Some solicitors will quote \$2000-3000 for the same service. Shop around. We have also been advised to keep copies of the original and all subsequent amendments. I think Daniel Butler, who has contributed articles to AIA bulletins, would be a good person to contact. If not able to do it personally he could probably refer you on.

Estate Issues: Also of importance is understanding the estate ramifications of disposal of funds on death, whether the assets are included in the will or not etc. Another area of importance relates to Binding Death Nominations. These have had to be updated every three years which can be a problem if one forgets or becomes incapable of managing their own affairs. I think they can now be considered non lapsing if your Trust Deed permits but you should seek expert advice on this.

Financial Advisers: The first financial planner we consulted (well known firm) charged a fee for service and for a personal investment of my own assured me I would get the 4% commission refunded when I received my first statement. This did not happen fully. On one fund, I understand, he ended up receiving 2% of that as a trailing commission for some years until I cashed the investment in. I also had trouble with the figures projected by this adviser with regards to yields on some fixed interest investments. This may have been a staff error but we decided he was not someone we wished to deal with in the future. If getting a plan from a financial planner I would suggest it worth the money to get a second opinion if the amount in question warrants this.

Managed Funds: Although these can provide the answer for some, and access to areas that we may not so easily access directly, we are not happy with them. They are costly and in our view are not transparent enough for us. We cannot possibly know if we have received the full benefit entitlement for dividends and dividend imputation etc. and if the tax treatments are as they should be. Costs are another issue. We have done much better with our own direct investing.

Unit prices for non listed trusts are a big issue as far as I am concerned but one never hears this mentioned. Even today I am hearing the arguments about fee for service v commissions but no one mentions unit prices. Regulations may have changed but in the 1990s I contacted a firm who advertised extensively that they would only charge nil or 1% commission when others were charging 4-5%. I asked if I would have to pay the difference on exit. No. I persevered and finally was told that if I took the lower entry fee option I would pay the additional amount in the unit price on purchase!!! How can the average investor determine just what the price of units should be?

With our current holdings, the fund manager costs (which are additional to the administration costs of the master trust and trailing commission to adviser) are deducted from the unit values. We also have to be selective about when we sell. It seems that on the first day of every quarter unit prices

drop. "The current account value may be understated due to distributions owing but not yet received" and "It is important to be aware that there is usually a delay between the date that the unit price drops and the date that a distribution payment is credited to your account. This is because it takes a number of weeks before we receive the distribution from the fund manager and we are able to pass it on to you".

We therefore wait till the distributions have been credited to our account before selling. Conversely, if buying it might be worth asking if there is a window of opportunity when unit prices are down. This is a bit like ex and cum dividends but one wonders just who benefits from our distributions for a few weeks. I have to admit that I am bewildered by all the unknowns involved with managed funds and hence our preference for direct investing.

Footnote: With communications so good today we do not find it a problem to have our accountants in another part of the state. This was so even when we were in business. Although face to face meetings are advisable for major shifts it has worked well for us to use telephone, internet and postal contact. This may be helpful to those who move to a new area and try to find new advisers.

Margaret Studley is a member of the AIA.

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DRAWING LUMP SUMS FROM AN ACCOUNT BASED PENSION

By Graeme Colley

One of the great benefits of superannuation is to receive a tax free pension once you reach age 60. If you are under age 60 then the taxable part of your pension is taxed but is eligible for a 15% tax offset.

An added benefit of being in pension phase is that any income and capital gains on investments in the superannuation fund which are paying the pension are also tax free. If you leave your superannuation in accumulation phase income and capital gains in accumulation phase are taxed in the fund at 15%.

Did you know it is possible to have superannuation benefits in pension phase and be able to draw a lump sum from your pension account in the fund? It's a bit like having your cake and eating it too.

What is an account based pension?

Under the current superannuation rules there is basically only one type of pension that can commence from a superannuation fund – the account based pension. As the name suggests this type of pension is calculated on the balance in your pension account when it commences and every 1 July thereafter. You can commence an account based pension once you have retired after age 55 or from age 65, whatever comes first.

The balance in your account based pension account can go up or down depending on the investments you have selected. If your investments go well then their value and the balance in your pension account may increase. But if they don't do so well their value may decrease and so will your pension account balance. Withdrawals from your account based pension account such as pension payments, lump sums and fees will also reduce the account balance. For this reason it is worthwhile to keep an eye on the amount being withdrawn to ensure it will last as long as possible.

Taking a lump sum from your account based pension

You may not think it means a great deal once you have reached age 60 that there is any difference between drawing a pension from your fund and drawing a lump sum because they will be tax free. However, it does matter for superannuation as well as Centrelink purposes whether a lump sum or pension has been withdrawn. For superannuation purposes it is not possible to have a pension

paid as an *in specie* transfer of investments and for Centrelink purposes an amount withdrawn as a lump sum from a pension will count for assets test purposes rather than income test purposes.

How do you make a lump sum withdrawal?

A lump sum, unlike a pension, can be paid either as an amount of money or as an *in-specie* transfer of assets. Before paying a lump sum the fund's trust deed should ensure it is possible to pay lump sums from the pension. Conversion of a pension, in whole or in part, to a lump sum is referred to as a commutation of the pension.

Before the lump sum is paid the superannuation legislation requires the pensioner to notify the superannuation fund that the next payment they wish to receive from their account based pension is to be treated as a lump sum. This should be documented in the minutes of the superannuation fund to ensure that the superannuation law and Centrelink requirements are being met.

Taxation consequences of a lump sum withdrawal

Lump sum withdrawals may be taxable depending upon the age of the recipient and the components of the payment. Lump sum withdrawals are based upon superannuation components using the proportioning rules. These components are split into taxable and tax free percentages and are calculated when an account based pension commences.

Lump sum payments are tax free for those above 60 years of age. There is no requirement to include the payment in your assessable income. Tax may be payable on lump sum withdrawals for people between 55 and 60. The tax free component is not included in assessable income, however, tax may be payable on the taxable component and the whole amount is included in assessable income.

If you are between 55 and 60 it is possible to withdraw a lump sum from your account based pension which includes a taxable component and it can also be exempt from tax. The rules provide that the first \$150,000 (indexed) of your taxable component you receive as a lump sum is tax free. Lump sum withdrawals above the cap received prior to age 60 are taxed at 15%.

Case study: Cooper is a 58 year old retiree who would like to receive \$50,000 as a lump sum by commuting part of his account based pension. The taxable and tax free component of his account based pension is 75% taxable and 25% tax free.

Cooper will not be liable to pay any tax on the lump sum withdrawal of \$50,000. This is because \$37,500 ($\$50,000 \times 75\%$) of the lump sum which represents the taxable component of the lump sum is tax free because he has not withdrawn any lump sums previous and it is within the \$150,000 tax free cap that applies.

Centrelink consequences of a lump sum withdrawal

Generally, Centrelink does not assess a lump sum withdrawal from an account based pension as income. However, any withdrawal of a lump sum will have an effect on the amount of the account based pension that is assessed by Centrelink for income and asset test purposes.

Centrelink assess income from an income stream, such as an account based pension as the gross pension payment less the deductible amount. The deductible amount is calculated as the amount used to commence the pension divided by your life expectancy at the time the pension commenced. Because the deductible amount is required to be recalculated when the account based pension is partially commuted the result may be a greater amount being counted for income test purposes. If this is the case then it may result in a reduction in the amount of age pension being received.

Minimum pension payment

Prior to withdrawing a lump sum from an account based pension it should be ensured that the fund is able to meet the minimum pension requirements under the superannuation legislation. The minimum amount is calculated by multiplying the account balance at commencement or at any subsequent 1 July by a percentage factor set in the legislation. For example, the percentage factor for anyone under age 65 is 2% for the 2009/10 financial year. If the account based pension

commences during the year the rules permit a pro-rated minimum to be paid based on the number of days the pension will be paid for that year.

Case Study: Carly, who is 58 year old retiree would like to calculate the minimum pension amount of her account based pension. At 1 July 2009 Carly was 58 and the value of his pension was \$260,000. Her minimum payment factor is 2% for 2009/10.

To calculate the minimum annual payment for 2009/10 the account balance as at 1 July is multiplied by the percentage factor. Carly's minimum pension payment amount for 2009/10 is \$5,200 (\$260,000 x 2%).

Summary

The super rules provide a range of flexible options which allow you to access tax free incomes depending on your age. In addition to receiving an income stream from the pension it is possible to draw a lump sum from the amount supporting the pension and use the rules to your advantage for taxation and Centrelink purposes.

Graeme Colley is the National Technical Manager, ING Australia.

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BINDING DEATH BENEFICIARY NOMINATIONS & SMSF WILLS

By Daniel Butler & Claire Malone

Superannuation is a significant asset for many of our clients. Not surprisingly, they increasingly want to achieve certainty about how their benefits will be paid on death. Some may also want to plan who will be trustee of their SMSF on death. What is the best way to tie this down? There are now numerous options available to SMSF members, such as binding death benefit nominations ('BDBNs') and SMSF Wills. Advisers will be well positioned to assist their clients if they have a sound understanding of exactly what these options entail.

What is the difference between a BDBN and an SMSF Will?

A BDBN is a nomination made by a member during their lifetime which directs the trustee how to pay their benefits after death. If drafted correctly, the deed should allow members to make BDBNs and should also provide that the trustee is bound to follow any valid BDBN in place when the member dies. An SMSF Will is also a set of directions by the member given to the trustee, but works differently. (Note that, depending on what the member chooses, some SMSF Wills are actually death benefit nominations). However, some choose for their SMSF Will to be what is known as a death benefit rule ('DBR'). In this case, the member's directions vary and become 'embedded' into the SMSF's deed (ie, the DBR becomes part of the SMSF's rules).

It's all in the implementation

Ultimately, both BDBNs and DBRs require careful implementation and neither will be 100% foolproof.

Certainty about how benefits will be paid

Achieving certainty about what will happen to death benefits is of the utmost importance. If the trustee has a right not to follow a member's BDBN or DBR when they die because, in the trustee's opinion, this might create cash flow problems for the SMSF, this could possibly be exploited by an aggrieved party as an excuse not to follow the deceased's wishes.

These kinds of loopholes that create an 'out' for the trustee are best avoided if members want to maximise certainty. Similarly, if the trustee has a choice whether or not to accept a direction when it is given to them by the member, this could also create uncertainty. Giving a trustee a discretion not to accept a direction detracts from the objective that it should be 'binding' on the trustee. It may

also give rise to evidentiary disputes about what happened (eg, claims that “so-and-so verbally accepted (or rejected) the direction”, etc).

A more certain approach is to compel the trustee to follow any direction that is given to them, provided of course that the BDBN or DBR is made validly (ie, in accordance with the deed and any applicable laws) and has not been revoked prior to death. Having a trustee counter-sign a direction will serve as good evidence it was in fact received by the trustee.

Amending the deed

If using a DBR (which amends the deed to ‘embed’ the member’s directions), bear in mind this could be overridden if the deed is amended. Unless there is a restriction on the variation power that prevents the DBR itself from being amended, this could be an exposure (especially if other parties can out-vote the particular member and therefore vary the deed).

An alternative might be to make a BDBN and enter into a mutual agreement (eg, between spouses) which includes an agreement not to revoke a BDBN.

Succession to the trustee role

Some DBRs also seek to set up trustee succession by providing that, eg, on the member’s death their Executor will become trustee of the SMSF. This is a good idea but the implementation is the key. Firstly, a person cannot become a trustee of a fund without consenting in writing, so this cannot happen automatically. For a corporate trustee, a person also needs to be appointed as a director in accordance with the constitution and of course there are ASIC/corporations law requirements to comply with. If the trustee has not been validly appointed, its decisions (including about payment of benefits) could be void.

Further, if the deceased’s Executors are two or more persons, what are the implications for voting power under the SMSF deed or constitution? Unfortunately, many simply give all trustees equal voting power. This means the deceased’s Executors could out-vote everyone else, even if the deceased had a small account balance! Thus, the SMSF’s deed (or company’s constitution) should make provision for this, eg, an adjustment mechanism if multiple executors stand in for the one person.

The latest on BDBNs

When deciding what path to take, advisers should ensure they are up-to-date with the latest on BDBNs. For example, we now have ATO confirmation that BDBNs can last indefinitely for SMSF members (provided the deed allows indefinite BDBNs): see SMSFD 2008/3. A BDBN is also able to specify the form of benefits (ie, whether as pension or lump sum), provided the deed expressly gives this power.

Daniel Butler and Claire Malone are lawyers with DBA Lawyers Pty Ltd.

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INSURANCE INSIDE OR OUTSIDE A FUND?

By Daniel Butler

There are several reasons why having insurance in a super fund may make good sense. Firstly, the premium for death and total and permanent disability ('TPD') risk cover is tax deductible and proceeds are exempt from capital gains tax ('CGT'). Members incurring such premiums outside the fund are not entitled to a deduction but do get a CGT exemption.

The premium for income protection cover is also tax deductible but the proceeds are assessable to the fund. This is the same tax treatment as having this type of insurance outside a fund. Where premiums are claimed on the above insurance in a super fund, then an untaxed element can arise in relation to a lump sum payment which can result in more tax being payable on the benefit. For example, a death benefit lump sum that is paid to a non – dependant such as an adult child may be exposed to a 31.5% tax rate based on the formula in s 307-290 of the *Income Tax Assessment Act 1997* (Cth); this is one downside to claiming insurance in a fund.

Having a fund pay for insurance however assists with cash flow. Many have reduced their non-essential expenditure and may therefore be without adequate insurance (as revealed by the recent Victorian bushfires). So, while it generally makes good sense to have insurance in an SMSF, there can often be hurdles, eg, complex application forms and medical tests. One option may be to seek to obtain cover in a public offer/industry super fund that offers automatic acceptance. Moreover, such funds may offer better premium rates due to their bulk purchasing power. Naturally, having insurance in another fund may minimise the impact of the untaxed element (ie, the 31.5% tax discussed above). There have also been some recent developments impacting on insurance that clarify certain grey areas. The first relates to deductibility of premiums for TPD. Amending legislation will shortly be issued providing a deduction for premiums that cover own occupation (typically higher premiums as it relates to ability to perform a specific role, eg, an adviser) compared to general occupation. A general occupation policy has a lower premium and a broader definition of TPD (eg, unable to undertake work the person is capable of doing by education, training or experience). This change will relate to the periods 1 July 2004 to 30 June 2011. From 1 July 2011, deductions for TPD will only apply to the extent of a general occupation premium so the excess will not be deductible.

Hopefully, when the legislation issues the condition of release ('COR') will also be amended to allow funds to pay out occupation-specific TPD proceeds even though they have not satisfied a general occupation definition under SIS.

The ATO have generally argued that trauma insurance is not consistent with the sole purpose test.

However, the ATO's draft SMSFD 2009/D1 clarifies that trauma insurance can be held in a fund provided the proceeds are received and form part of the fund's assets until a relevant COR occurs. (An event such as cancer, stroke or heart attack, by itself, may not satisfy a COR, eg, a 40 year old may suffer a heart attack and re-enter the workforce after a short spell.) The ATO have therefore confirmed that trauma insurance can be held in a fund and that this can be consistent with the sole purpose test. However, the ATO do state that the size of the premium may be a relevant factor and also whether taking out the policy may be providing a benefit to someone outside the fund, (eg, if the policy taken in the fund lowers the premium on a policy outside the fund). Insurance can also be very helpful where an SMSF enters into a borrowing arrangement and to provide funding for an anti-detriment payment. However, the SMSF's trust deed needs to have flexibility for managing insurance. Thus, now is an ideal time to review the appropriateness and adequacy of insurance for everyone and your SMSF deeds!

Daniel Butler is a lawyer with DBA Lawyers Pty Ltd.

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SMALL BUSINESS CGT CONCESSIONS & SUPER

By Daniel Butler & Claire Malone

The CGT small business concessions allow members to get an extra \$1.1 million each into super. This can be a great way to boost retirement savings given the contribution limits now in place.

Furthermore, these concessions can also be used in conjunction with an asset protection strategy. For example, transferring business real property ('BRP') to an SMSF can allow business owners to take advantage of the CGT concessions and boost their retirement savings with the further advantage of long-term asset protection offered by SMSFs.

15 year v retirement exemption

Advisers should think carefully about which of the concessions are available to their clients. For example, will they qualify for the 15 year or retirement exemptions, and what are the advantages of each?

15 year exemption	retirement exemption
<i>capital proceeds</i> can be contributed into super	only the <i>net capital gain</i> may be contributed
up to \$1.1m proceeds can be contributed	up to \$500,000 net gain can be contributed
entire capital gain can be disregarded	up to \$500,000 net gain can be disregarded
only available to those aged 55 years or over (unless permanently incapacitated)	potentially available to those under 55 years
must be in connection with 'retirement' (unless permanently incapacitated)	no need to retire (despite the name 'retirement exemption'!)
asset must have been continuously owned for at least 15 years	no requirement as to period of ownership
if asset owned by a company or trust, must have had a 'significant individual' for a total of at least 15 years	if asset owned by a company or trust, must have had a 'significant individual' but only at time of the CGT event
can apply to a pre-CGT asset	only applies to post-CGT assets

Daniel Butler and Claire Malone are lawyers with DBA Lawyers Pty Ltd.

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CAN RESERVES BE ADDED TO PENSIONS?

By Daniel Butler & Claire Malone

The ATO has recently commented on allocations from reserves, providing greater certainty for those who wish to top up existing pensions. (Refer to NTLG Superannuation Sub-Committee minutes of 8/9/09.)

Broadly, the ATO confirms that it is possible to add to an existing pension by way of allocation from reserves. This is possible since an allocation from reserves is not a 'contribution' or a 'roll-over' for SIS purposes (once a pension has commenced, the capital supporting the pension cannot be added to by way of 'contribution or roll-over'). However, although it is not a 'contribution', an allocation of reserves can count towards a member's concessional contribution cap for tax purposes due to the operation of the tax legislation (see below).

The 'fair and reasonable' 5% test

Generally, allocations from a reserve will count towards the receiving member's concessional contributions cap, unless an exception applies (reg 292-25.01(4) of the 1997 tax regulations). One exception that can apply is where:

the amount is allocated, in a *fair and reasonable* manner, to an account for every member (or if the reserve amount relates only to a particular class of members, to an account for every member of the class); and the amount allocated for the financial year is less than 5% of the value of the member's interest.

Assuming an allocation is within the 5% limit, the question then arises: if one member has an accumulation account and also a pension (eg, account-based pension ('ABP')), does the trustee have to split the allocation between the two interests in order for it to be 'fair and reasonable'?

The ATO confirms that, to be fair and reasonable, the trustee cannot necessarily just allocate the amount all to one interest (eg, all to the ABP and nothing to the accumulation account). It must be 'fair and reasonable' between the two interests. DBA's view is that 'fair and reasonable' generally means on a proportionate basis, but there may be grounds to allocate on a disproportionate basis if this is fair and reasonable, eg, if there are special circumstances.

How does the allocation affect the component mix?

The ATO confirms that an allocation from reserves to an *accumulation* interest adds to the taxable component. This is because the 'taxable' component of an accumulation balance is, by definition, anything that is not tax free.

On the other hand, an allocation from a reserve to a *pension* account will simply add to the pension in the same tax free/taxable proportions as the pension itself. This is because the proportions of a pension are 'locked in' forever on the commencement day of the pension. Therefore, if the pension is 40% tax free, this means an allocation from reserves would also become 40% tax free.

Daniel Butler and Claire Malone are lawyers with DBA Lawyers Pty Ltd.

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SMSF BORROWING UPDATE

By Daniel Butler & Claire Malone

Instalment warrant-style borrowings by SMSF trustees have experienced a surge in interest in recent months. These arrangements appear to have now become 'mainstream' strategies for many advisers, both direct bank and related party loans.

Advisers should stay tuned for developments in this area as we expect there will be further announcements about borrowing in 2010. Our members will recall that the ATO's draft ruling on 'contributions' (TR 2009/D3) stated that amounts paid pursuant to a guarantee that supports an SMSF loan may be treated as a deemed contribution to the fund in some cases (refer to our June 2009 newsletter). This was part of a broader view expressed by the ATO that a contribution includes anything that increases the capital of the fund.

This ruling is due to be finalised early in 2010 and we understand the ATO may scale back its approach to what amounts to a 'contribution'. This could in turn lead to a revised ATO view on guarantees.

More broadly, with the recommendations of the Cooper review into superannuation due to be handed down in 2010, it is expected that the appropriateness of the borrowing laws will be examined in some form. The borrowing laws have attracted much attention since they were enacted in late 2007 and the Cooper review may focus on SMSFs specifically and whether it is appropriate for SMSFs to be allowed to borrow.

While we cannot speculate, those SMSF clients who are thinking about implementing an SMSF borrowing strategy might consider the possibility of future changes in 2010. Those who have decided to borrow may therefore benefit by locking in a borrowing arrangement prior to any announcement and ensuring they plan with flexibility in mind. Further, some flexibility may exist under a related party borrowing to allow the related party to refinance its borrowings without impacting the SMSF's loan.

DBA provides documentation for both direct bank and related party loans. Please visit our website or contact our office for pricing and information.

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DBA Lawyers Pty Ltd are based in Melbourne and do SMSF seminars on a quarterly basis around Australia at 7 locations. Further information on DBA Lawyers services and seminars can be obtained from www.dbalawyers.com.au.

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