

SELF MANAGED SUPER FUNDS

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INTRODUCTION

By Pauline Hammer

Welcome Investors. Happy New Financial Year!

We continue with the extracts from the “Self Managed Super Solutions Phase Three — Preliminary Report” of the Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System.

In this issue, we provide the following extracts:

- SMSF Establishment - Gatekeeper Mechanism
- Independence of SMSF auditors
- Investments

Nathan Papson of DBA lawyers discusses the recent six major changes to SMSF borrowing laws.

There are over 400,000 SMSFs in Australia and in many cases these vehicles are people’s greatest asset. Annette Esposito, Bryce Figot and Dan Butler from DBA lawyers provide us with 10 steps to take to ensure that your death benefit is passed onto the beneficiary of your choice.

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SMSF ESTABLISHMENT GATEKEEPER MECHANISM

The Panel believes that the establishment of an SMSF is one of the most significant steps a person can take in relation to their retirement savings. As previously discussed, the Panel remains concerned about the number of small sized SMSFs. The Panel also believes that establishing an SMSF cannot be viewed in isolation. Establishing an SMSF is, in the vast majority of cases, linked to decisions about the transfer of balances from APRA-regulated superannuation funds and the direction of an employer's Superannuation Guarantee and other contributions. SMSFs are not just one type of superannuation product in a range of products; they are the product that has the most fundamentally different roles and responsibilities for trustee/members.

As has already been mentioned, the Panel is exploring some form of mechanism aimed at allowing new entrants to the SMSF sector to assess whether they would be suited to its unique features and responsibilities and understand the need for a certain size of fund to make an SMSF cost competitive with other types of fund. The ideas that have been considered by the Panel include:

1. minimum fund size of \$200,000;
2. all new entrants be required to get advice from a licensed adviser about the consequences of forming an SMSF. The existence of the advice could then be incorporated into the SMSF registration process and verified by the approved auditor;
3. requirement to get licensed advice if there would be less than a minimum \$500,000 fund size;
4. those in the business of providing establishment services in relation to SMSFs be required to hold an 'SMSF establishment AFSL' (ie a licence that would only authorise that activity). This would enable regulators to identify who is establishing SMSFs, but not everyone would be required to use them or to get financial advice;
5. a requirement for prospective SMSF members to complete an online module on a government website which would take them through their possible suitability to participate as a member and trustee of an SMSF.

(a) Minimum fund size of \$200,000

The Panel does not favour this option. It is an arbitrary limit and, to work properly, might need a large number of exceptions. It offends principle 1 and although the Panel readily acknowledges that small-sized SMSFs do appear to be a problem (see the Appendix), it would be a heavy-handed restriction to apply across the board.

(b) Licensed advice

This option would require a prospective SMSF member of a new SMSF to get advice from a licensed adviser to ensure they are made aware of the consequences of establishing an SMSF and leaving, or not participating as fully, in the MySuper or choice sectors. This option recognises that many prospective SMSF member/trustees already get advice before establishment (either from a financial adviser or an accountant – who in the near future may need to become AFS licensed to continue to provide advice on SMSF establishment).⁵⁶ This could be achieved by a specific legislative obligation in the Corporations Act addressing this issue. There could be an obligation to explain specific aspects of the establishment of an SMSF, including the fact that insufficient asset size would generally mean that the SMSF is not cost-effective compared to an account in an APRA-regulated fund. This could also include advice in relation to investment restrictions and other trustee obligations to ensure the prospective trustees understand their obligations and responsibilities as a superannuation trustee and be complimentary to the current trustee declaration.⁵⁷ This option could ensure that prospective SMSF member/trustees would get a minimum level of consistent and standardised advice, and it would also ensure that all members (not just the dominant party – if there was one) received that advice, thereby promoting wider engagement.

(c) Licensed advice or \$500,000 minimum fund size

An alternative to requiring every prospective member to get financial advice (option b), could be to exempt those members whose SMSF asset size at establishment would be manifestly large enough (\$500,000) to be cost-competitive with APRA-regulated funds. The figure of \$500,000 is also one of the measures of a 'wholesale client' in the Corporations Act.⁵⁶

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<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/036.htm&pageID=003&min=ceba&Year=&DocType=>.

⁵⁷ Currently, the approved forms for the registration of a new SMSF require the members to sign a declaration to the effect that they understand their obligations and responsibilities in areas such as trustee duties, investment restrictions, the sole purpose test, record-keeping and reporting obligations.

⁵⁸ Regulation 7.1.19 Corporations Regulations 2001.

(d) New SMSF establishment licence

This option would involve requiring any service provider who carried on a business of establishing SMSFs to have an AFSL, but with a specifically limited authorisation that only extended to that activity (and thereby being less onerous to obtain). Providers would also be able to obtain a more comprehensive AFSL with a higher threshold permitting them to both establish SMSFs and undertake other financial sector functions. This would not stop a person from forming their own SMSF without using a service provider, but would see a greater proportion of new SMSFs being established by licence holders so that regulators could better monitor the 'pipeline' of new SMSFs.

(e) Online module

Under this option, a prospective SMSF member would be required to complete an online module on a government website which would take them through their possible suitability to participate as a member and trustee of an SMSF on a self assessment basis. Issues dealt with could include asset size to be cost competitive, compliance obligations, experience necessary, recognition of possible costs, time commitment and so on. The existing ATO declaration could also be rolled into this process so that the new SMSF member would go through an educative, and then a declarative, process. The Panel has not yet reached a firm enough view on this issue to make any form of recommendation, but currently favours the online module option.

Independence of SMSF auditors

Given the fundamental role auditors play in the SMSF regulatory framework, true independence of auditors is crucial for the efficient and effective operation of the SMSF sector.

Independence requirements relevant to auditors are those prescribed in Accounting Professional and Ethical Standard 110 — *Code of Ethics for Professional Accountants (APES 110)*, which requires that auditors must not only be independent in action, but must also be perceived to be independent. It is difficult to see how an auditor could appear to be independent when their firm provides advice, prepares the financial statements or provides other services to SMSFs or their members.⁸³ Auditors who are members of the professional accounting bodies are professionally obliged to comply with the requirements of the Code.

⁸³ Williams Partners, Phase Three Submission, page 1.

However, approved auditors who are not members of the professional accounting bodies are not.

⁸⁴ Based on 2008 SMSF annual return data, auditors of 18 per cent of SMSFs provided some other services, such as acting as a tax agent, accountant, financial adviser or administrator. ⁸⁵

The ATO's 2009 compliance activities targeting high risk approved auditors identified 29 per cent of auditors who were an SMSF's accountant and who had prepared a material part of its financial statements. Additionally, 28 per cent of auditors exhibited evidence of a relationship or conflict of interest that might impact the auditor's ability to be independent and had no safeguards to mitigate that risk.

A number of submissions expressed the view that auditing firms should not be providing SMSFs with any other services and should be completely independent.⁸⁶ The Panel accepts this view, given the particular features of the SMSF sector. It also believes the auditor independence model

needs to be wider than just requiring auditors to have no connection with services or advice provided to the audited SMSF. The Panel prefers an independence model where the auditor or auditing firm also has no connection to services or advice provided to the individual member/trustees or their family businesses (ie wider than just in relation to the SMSF itself).

Some industry participants have questioned why there is a need to mandate audit independence, arguing that it would be singling out SMSF auditors for treatment inconsistent with international auditing standards and practice. The Panel acknowledges this, but believes that different treatment is justified, given the unique features of SMSFs and their regulation (that is there is no direct equivalent in any overseas jurisdiction that the Panel is aware of). The closely held nature of SMSFs requires both a traditional financial audit as well as a compliance audit. The compliance audit is the central component of the SMSF regulatory framework.

Requiring true independence should not result in increased audit fees (unless cross-subsidisation within the accounting industry is actually occurring). It would, however, likely result in more specialisation and this could assist to reduce audit costs. The following table illustrates that greater scale already reduces the average and median audit costs for auditors who perform a higher number of audits compared to auditors who only conduct a small number of audits.

84 CPA Australia, Phase Three Submission, page 18.

85 This figure is potentially understated. Anecdotal information from accounting professionals suggests that accounting practices are providing other services in addition to the audit service. It is thought that this is not disclosed in the SMSF annual return because those services are carried out by others in the practice. Super System Review, 'Statistical

summary of self-managed superannuation funds,' 10 December 2009.

86 William Partners, Phase Three Submission, page 1; ING Australia Limited, Phase Three Submission, page 22; D Evans, Phase Three Submission, page 21; Smartsuper Pty Ltd, Phase Three Submission, page 14.

Preliminary recommendation

The Panel recommends legislating full audit independence whereby an individual or firm providing any service in connection with an SMSF or its individual trustees or trustee directors in any capacity is to be expressly prohibited from auditing that SMSF.

Investments

The majority of submissions opposed any notion of restricting SMSF asset allocation or investments. The Panel generally supports this position. It believes that the government should not constrain superannuation trustees' options on how to invest fund assets unless there are clear prudential or retirement income policy reasons to do so.

87 A. Cummings, Phase Three Submission, page 2; Heffron Consulting Pty Ltd and Cavendish Superannuation Pty Ltd, Phase Three Submission, page 7; CBA, Phase Three Submission, page 29.

Conceptually, the Panel agrees that those within the 'self-managed' sector should have as much choice as members in the 'choice' sector. Curtailing investment options in the 'self-managed' sector that are still available in the 'choice' sector would be illogical, counterproductive and lead to inefficiencies.

Leverage

In principle, the Panel has concerns with the concept of direct borrowing within any superannuation funds, whether SMSFs or APRA-regulated funds. In principle 8, the Panel expressed the view that leverage should not be a core focus for SMSFs.

The original default position adopted in the SIS legislation was that superannuation funds should not engage in borrowing, other than in the very short term to address cash flow issues. The rationale for this stance was simply that leverage for asset acquisition amplifies both gains and losses and this was seen as placing fund members' retirement savings at too much risk. The Panel agrees with the original default position adopted in the SIS legislation.

On 24 September 2007, the SIS Act was amended to allow all regulated superannuation funds, including SMSFs, to invest in instalment warrants. Initial interest in instalment warrants was modest, with only 0.9 per cent of the SMSF population having a derivative or instalment warrant at 30 June 2008.⁸⁸ There are, however, indications that this trend might have changed in recent times. Data from Investment Trends' surveys suggest that more than five per cent of SMSFs already invest in such instruments.⁸⁹

While the number of SMSFs has increased greatly, so also has their average asset size and, by implication, their capacity to invest in more complex assets. SMSFs are nevertheless at greater risk than APRA-regulated funds, which are required to have licensed trustees and comprehensive risk management strategies. SMSFs do not have the mandated controls and risk mitigation strategies imposed on APRA-regulated funds.

The Panel is concerned that if direct borrowing had been more widespread before the recent GFC then a substantial amount of retirement savings could have been lost. The Panel therefore believes that the 2007 amendments to the SIS Act, which relaxed the borrowing provisions, are inconsistent with Australia's retirement policy.

The majority of submissions supported the retention of leverage in SMSFs. However, there was a general theme that the existing provisions are complex, create unnecessary confusion and require clarification.⁹⁰

Some submissions suggested that recourse be restricted to the initial capital investment with no risk to a fund's assets as a whole or from personal guarantees from any SMSF trustees.⁹¹ Other submissions suggested introducing a maximum loan-to-valuation ratio.⁹²

⁸⁸ *Super System Review, 'Statistical Summary of self-managed superannuation funds,' 10 December 2009, table 18.*

⁸⁹ *Investment Trends, May 2009 Self Managed Super Fund Investor Report, August 2009.*

⁹⁰ *IFSA, Phase Three Submission, page 39; DBA Lawyers, Phase Three Submission, page 5; Taxpayers Australia page, Phase*

Three Submission, 22; Heffron Consulting Pty Ltd and Cavendish Superannuation Pty Ltd, Phase Three Submission, page 14; Multiport Pty Ltd, Phase Three Submission, page 12.

⁹¹ *CPA Australia, Phase Three Submission, page 14; ICAA, Phase Three Submission, page 23; Outlook Tax & Accounting*

Solutions, Phase Three Submission, page 11.

⁹² *ICAA, Phase Three Submission, page 23; Heffron Consulting Pty Ltd and Cavendish Superannuation Pty Ltd, Phase Three*

Submission, page 13; Multiport Pty Ltd, Phase Three Submission, page 12; Dixon Advisory, Phase Three Submission, page 24.

Related party investments

Retirement policy is that superannuation savings should be invested for the sole purpose of providing retirement savings (together with certain approved ancillary benefits) and not for providing current-day benefits. SMSFs are closely held entities and there is substantial opportunity for SMSF members to engage in behaviour that is inconsistent with government policy and the purpose of their fund. In 1997, an Insurance and Superannuation Commission survey identified that around 20 per cent of 'excluded funds' (as SMSFs were previously known) invested in related trusts and around 13 per cent of funds leased assets to related parties, raising concerns that superannuation savings were not being appropriately safeguarded.⁹⁴ Subsequent amendments to the SIS Act in 1999, generally tightening the in-house asset (IHA) test and related party rules, have (with other changes) resulted in the current reduction of these investments to less than 3 per cent of the SMSF population.⁹⁵ Nonetheless, these types of contraventions still account for 16 per cent of all the contraventions that auditors report to the ATO.⁹⁶

The Panel accepts the argument that some related party investments are made in line with government policy and acknowledges that in some instances these investments have performed well. It also acknowledges that the majority of submissions have recommended no change to the current rules. Nonetheless, the Panel believes that the current exemptions still provide an avenue for potential abuse, which is inconsistent with government policy, and whose regulatory compliance costs across the superannuation system outweigh the benefits they bring to individual funds.

The Panel believes that non-prudentially regulated, closely held retirement vehicles, such as SMSFs, should not be able to make related party investments and they should not be in a position to inappropriately benefit from acquiring or disposing of assets with related parties.

5 per cent in-house asset limit

The purpose of the IHA test is twofold. It serves to protect fund members from the risk that, in the event of the employer failing, they lose both their source of income and their retirement savings. It also limits the extent to which business funding arrangements can be distorted, particularly in the small business sector, through access to relatively cheap, tax-advantaged working capital derived from a related SMSF. The Panel believes that the 5 per cent IHA limit is appropriate within the APRA-regulated sector. Unlike SMSF members, there is generally no opportunity for APRA-regulated fund members to get direct benefits from these investments. Additionally, the 5 per cent limit enables APRA-regulated funds to have limited exposure to an employer sponsor where its exclusion could limit the capacity of the trustee to invest in, for example, index linked funds where the employer forms a significant part of the ASX 200.

94 <http://law.ato.gov.au/atoLaw/view.htm?DocID=NEM%2FEM99051%2FNAT%2FATO%2F00004>.

95 Super System Review, 'Statistical summary of self-managed superannuation funds,' 10 December 2009.

96 Super System Review, 'Statistical summary of self-managed superannuation funds,' 10 December 2009.

However, given the closely-held nature of SMSFs, the Panel believes that SMSFs should be prohibited from holding any IHA investments. For those SMSFs with existing IHA investments, grandfathering or transitional arrangements would be required. Potential options to facilitate this could include:

- Existing IHA investments under 5 per cent could be grandfathered, in a similar manner to the 1999 grandfathering rules, whereby these investments could be retained and defined so as not to constitute an IHA investment. However, no new or further IHA investments would be permissible.
- Alternatively, SMSFs with IHA investments could be provided with a transition period, say up to 30 June 2020, to dispose of their existing IHA investments. No new or further IHA investments would be permissible during or after this period.

The Panel favours the latter option. This would result in the removal of all IHA investments from SMSFs and provides sufficient time for funds to dispose of existing IHA investments. The Panel believes prohibiting these IHA investments would have minimal impact on SMSFs, as the vast majority of SMSFs do not have IHA investments and should lead to reduced compliance costs for the system overall. However, the Panel is not proposing to unwind the previous 1999 grandfathering arrangements or alter the existing IHA definition exemptions. The Panel wants it to be understood that the current extent of IHA investments is not material in the overall context of the SMSF sector, but that the continued existence of the exemption has the potential to undermine confidence in the sector as a whole and should be eliminated.

Preliminary recommendation

The Panel recommends that in relation to the self-managed sector:

- a) the 5 per cent IHA investment limit be removed so that no IHA investments would be allowed;
- b) SMSFs with existing IHA investments be provided a transitional period, up to 30 June 2020, in which to dispose of their IHA investments (no new or further IHA investments are to be permissible during this transition period); and
- c) APRA-regulated funds be exempted from these changes.

Acquisition and disposal of assets from related parties

The Panel believes that the off market acquisition and disposal of assets between related parties (where the guiding mind of both buyer and seller can effectively be the same person), does not provide transparency, is inherently risky and is open to greater abuse than non-related party transactions. The Panel believes the current provisions relating to related party acquisitions and disposals are insufficient to mitigate the potential risk of transaction date and asset value manipulation to illegally benefit the SMSF or the related party (depending on the transaction).

While the Panel debated recommending prohibiting all related party transactions (to ensure that trustee retirement decisions were in no way affected by the personal tensions that related party transactions can present) it concluded that retaining the ability to conduct limited related party transactions was still a desirable feature. As previously mentioned, the Panel is not proposing to change existing exemptions to the IHA definition, such as the lease of business real property to related parties. The Panel recognises that, unlike the removal of the 5 per cent IHA investment limit, removing the business real property exemption would have a very significant impact on the SMSF sector and on a large number of individual SMSFs.

Given the longstanding nature of the business real property exemption, the benefits it provides to business and farmers (especially as it engages them with providing for their retirement) and the lack of reports of any significant abuse in this area, the Panel believes, that with additional related party safeguards, it should remain in place.

The Panel believes that any acquisition or disposal of an asset (including in specie acquisitions and disposals) to a related party where there is an underlying formal market or exchange (for example, securities quoted for trading on ASX) must be conducted through that market. Where a market does not exist, then that acquisition or disposal must be supported by a current independent valuation from a registered valuer (for example, a business real property transaction will need to be supported by a valuation).

These changes will provide greater transparency to related party acquisitions and disposals, enabling approved auditors and the ATO to monitor this area more effectively. This will enhance the integrity of the SMSF system. While the Panel recognises these changes are likely to add to individual transaction costs, such costs will only be borne by those SMSFs that choose to engage in related party transactions.

Preliminary recommendation

The Panel recommends that the SIS legislation relating to acquisitions and disposals between related parties should be amended so that either:

- a) Where an underlying market exists, all acquisitions and disposal of assets between SMSFs and related parties must be conducted through that market; or
- b) Where an underlying market does not exist, acquisitions or disposals of assets between related parties must be supported by a current independent valuation from a registered valuer; and
- c) APRA-regulated funds are exempt from these changes.

Collectables and personal use assets

While the Panel recognises and supports the freedom of investment choice that SMSFs afford their members, it believes that there are certain types of assets that should not be regarded as investments that build retirement savings and which consequently should not be available to SMSFs. Such assets are broadly equivalent to 'collectables' and 'personal use assets' for tax purposes.⁹⁷ Examples include (but are not limited to):

- paintings, jewellery, antiques and stamp collections ; and
- wine, exotic cars, golf club memberships, race horses and boats.

The Panel accepts that some of these types of assets may appreciate in value over time and that investors with the appropriate specialist knowledge can profit out of them. However, the Panel points out that people who want to own such assets are free to do so outside the SMSF environment in a way that does not involve special concessions from the tax system. Again, the Panel accepts that the proportion of SMSF sector assets invested in collectables and personal use assets is modest. While there will be some SMSFs where the concentration of such assets is quite pronounced, this is not the core issue. The principal concern is that the cumulative regulatory and compliance complexities outweigh the potential benefits of allowing such a liberal investment menu to a sector that is not directly prudentially regulated.

Preliminary recommendation

The Panel recommends that:

- a) the acquisition of collectables and personal use assets by SMSF trustees be prohibited;
- b) SMSFs that own collectables or personal use assets be provided a transitional period, up to 30 June 2020, in which to dispose of those assets; and
- c) APRA-regulated funds be exempted from these changes.

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NEW SMSF BORROWING LAWS — THE NEW ‘MUST KNOW’ CHANGES

By Nathan Papson and Bryce Figot

The old legislation (s 67(4A) of the SIS Act) under which super fund trustees engaged in ‘instalment warrant’-style borrowings has been recently repealed. It has been replaced with the new ss 67A and 67B.

The new legislation implements six major changes.

Change 1 — don’t say ‘instalment warrants’

The new legislation has essentially scrapped the term ‘instalment warrants’. The replacement legislation refers to ‘limited recourse borrowing arrangements’. Advisers and practitioners should become used to the new terminology, because soon referring to a super fund trustee borrowing as an ‘instalment warrant’ borrowing will be like referring to a train ticket as costing 3 pounds and 2 shillings!

Change 2 — definition of single acquirable asset

Arguably the biggest change is the clarification of what asset(s) can be acquired. Only a ‘single acquirable asset’ can be acquired. The definition of single acquirable asset is an asset that is not money, and is not prohibited by the SIS Act or any other law from being acquired. A *single* acquirable asset includes a collection of assets that are identical and have the same market value.

For example, if a super fund trustee wanted to borrow to fund the purchase of 1,000 ordinary BHP shares, this would be allowable under the new legislation. The shares have the same market value and are identical. If the super fund trustee were to purchase 500 BHP and 500 Rio Tinto shares, this would not be allowed under a single borrowing transaction. However, the super fund trustee could still borrow for these purchases if it entered into two limited recourse borrowing arrangements.

This raises the question: what about real estate spread over more than one title? This is very relevant for farms and for apartments that have car parks. Until clarification otherwise is received, the conservative view is that multiple borrowing arrangements are needed: one arrangement for each title.

Change 3 — refinancing

Refinancing is now expressly allowable under the new legislation.

This is very good news. Until the ATO clarified otherwise in May 2010, the conservative view had been that no refinancing was allowed. This had meant that once a super fund trustee entered into a borrowing arrangement, it was at the mercy of the lender.

Change 4 — repairs are allowable, but improvements are not

The new legislation allows for borrowed moneys to be used to pay for repairs and maintenance, but not improvements.

For example, consider a super fund trustee that wants to borrow to buy a house but discovers that the house is infested with termites. Here, the borrowings could also be used to pay to restore the property to a state in which it is suitable for occupation by tenant.

The new legislation prohibits borrowed moneys to be spent on improvements. So, for example, consider a super fund trustee looking to buy a house that has an old, leaky ceiling. The super fund trustee might want to 'overhaul' the ceiling and replace it with a new ceiling made from better, more durable materials. This would be considered an improvement and not a repair. As such, a borrowing made under the new legislation could not be used to pay for the new ceiling.

Whether ongoing repairs can be the subject of a borrowing is a contentious issue. The new legislation talks about money spent 'maintaining or repairing' an asset, however, in the past the ATO has been of the view that money applied for maintenance of an asset which is the subject of SMSF borrowing will result in a new drawdown. Whilst the ATO's view has softened, there is still some clarification needed. An objective reading of the legislation would suggest that ongoing repairs could be the subject of the borrowing. How the ATO would view the additional drawdowns associated with ongoing repairs is where the issue lies.

Change 5 —guarantees

A lingering question under the old legislation was whether personal guarantees were allowed. The Commissioner of Taxation expressed this concern in ATO Taxpayer Alert TA 2008/5 that he had concerns as to:

whether ... a personal guarantee ... may result in recourse being made to the assets of the SMSF other than the asset acquired (or any replacement) in the event that the guarantee is enforced against the trustee as the principal debtor, contrary to the intent that the exception in subsection 67(4A) of the SIS Act only applies to limited recourse borrowings ...

The new legislation clarifies that personal guarantees are allowable provided certain criteria are met.

Change 6 — replacement assets

The new legislation clarifies the circumstances in which an asset that is the subject of a borrowing can be replaced with another asset. Generally, it is only shares in a company or units in a unit trust that can be replaced. Further, they can only be replaced with shares or units in the same company or the same unit trust.

One important implication of this change is that super fund trustees cannot effectively have 'margin loan'-style share trading facilities.

A Final Note – Application of s 67A

The new legislation will apply to borrowings entered into after 6 July.

Borrowing arrangements entered into between 24 September 2007 and 6 July 2010 inclusive will be governed by the old s 67(4A). However, if super fund trustees choose to refinance, they may do so and by doing so will adopt the rules under ss 67A and 67B.

Where a super fund trustee signed all the relevant documents before 7 July but does not draw down the loan until afterwards, the new legislation will apply.

Going forward

Practitioners should take note of the new legislation. As discussed, there are still some areas needing clarification, notably where real estate is spread over multiple titles. Overall though the new legislation is a welcome change as it provides a clearer picture on how a super fund trustee should go about borrowing.

Nathan Papson is a lawyer and Bryce Figot is a senior associate at SMSF firm DBA lawyers. This article is for general information only and should not be relied upon without first seeking advice from an appropriately qualified professional.

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INTEGRATED SMSF SUCCESSION PLANNING

By Annette Esposito lawyer, Bryce Figot senior associate, and Daniel Butler director, DBA Lawyers

Today the wealth held in self managed superannuation funds ('SMSF') has increasingly become people's greatest asset surpassing the family home.

There are currently over 420,000 SMSFs in Australia. Given that the wealth held in SMSFs is increasing and that Australia's population is aging, succession planning for SMSFs is vital for people nearing retirement. Furthermore, taking appropriate steps now and implementing succession planning now ensures superannuation will pass to the right beneficiaries.

Integrated SMSF succession planning is often best explained with a case study.

Consider the scenario of Denny and Donna, Denny is aged 60 and Donna is aged 59, they are married and have three adult children David, Daniela and Daisy. Daisy was left disabled after a tragic motor accident. Denny and Donna have \$4million in their SMSF and upon the death of both of them they want firstly the SMSF to benefit David, Daniela and Daisy equally and secondly want David and Daniela to take care of Daisy's finances.

In order to achieve their objectives Denny and Donna can take the following steps:

1. Identify the rules that govern the SMSF

Denny and Donna should identify the most recent governing rules of their SMSF and it is vital they can answer the following questions positively:

- Do you know where the original copy of the deed establishing the SMSF and any deeds of variation are located? The full 'document trail' is necessary to prove the most recent deed is valid.
- Have all of the deeds been properly executed? In most Australian jurisdictions, where an individual must sign a deed, proper execution includes being signed by at least one witness who is not a party to the deed.
- Do you also know where all documentation evidencing any change of trustee is located?

If Denny and Donna cannot locate the full 'document trail', they can do nothing but need to be made aware that this creates significant risk. Secondly, they can prepare a deed of variation with as many relevant parties as possible signing the deed including all contributing employers and beneficiaries^[1]. Beneficiaries include members' children and grandchildren^[2]. This is not a perfect solution. Thirdly, Denny and Donna can roll benefits to a newly created SMSF and terminate their existing SMSF. This could give rise to CGT and stamp duty liabilities. However depending on the assets in the SMSF, section 66 of *Superannuation Industry Supervision Act 1993* ('SISA') might make this option illegal. Fourthly, seek a Court order^[3]. This could cure lost governing rules however it is expensive and there is uncertainty in litigation.

Let's now consider that Denny and Donna's SMSF has a corporate trustee as corporate trustees provide far greater flexibility in respect to planning for succession.

2. If the SMSF has a corporate trustee, ensure that the shareholding distributes voting power appropriately

In Denny and Donna's situation, it is appropriate that each of Denny and Donna personally own half the shares each. If either Denny or Donna have children from a previous relationship, Denny and Donna should nominate their executors as their successor directors.

^[1] *Re Bowmill Nominees Pty Ltd* [2004] NSWSC 61

^[2] *Kafataris v Deputy Commissioner of Taxation* (2008) 172 FCR 242

^[3] *Crane Distribution Limited v Recorder of Titles* [2009] TASSC 68

Now consider the scenario where Denny and Donna have prepared enduring powers of attorney appointing each other and then appointing David and Daniela as their attorneys.

3. Ensure that an enduring power of attorney is in place in respect of each member

In this situation, it is usually appropriate that if this is Denny's first marriage/relationship Donna should act as attorney and if Donna is unable to act then all of Denny's children (ie, David and Daniela) jointly and severally could act as attorneys subject to the law of the relevant jurisdiction allowing this.

If this is Denny's second marriage and he has children from a first marriage, all of the children jointly and severally could act as attorneys (ie, David and Daniela and any children from the first marriage).

4. Identify who will be running the fund upon the member's loss of capacity

Consider further that if Denny suffers a stroke and Donna becomes appointed as Denny's attorney, who will act as the trustees of the SMSF or in this case the directors of the corporate trustee of the SMSF. This is determined by the specific fund's governing rules and, if applicable, the constitution of the corporate trustee.

5. Ensure that a will has been made

Denny and Donna have been considering revisiting their wills which were prepared some years ago. When drafting their wills, Denny and Donna will need to consider that the people they appoint as executors of their wills often play an important role in running their SMSF upon their death. If Denny and Donna have a family trust of which they are the appointors, their executors also invariably become the appointors on their passing. However if Denny and Donna want to appoint different successor appointors, they can execute a deed to do so or nominate successor appointors via their Wills.

Denny and Donna's superannuation benefits might be paid to their executors (and thus be subject to the terms of their wills). Accordingly, their wills should deal with this possibility. A good will generally caters for the following:

- an equalisation (or a 'hotchpot') provision to ensure overall equality between children especially where some children receive moneys directly from an SMSF, some receive family trust distributions and some may be given money during their lifetime;
- superannuation benefits are kept separate from other assets in the estate. This helps to ensure maximum asset protection and tax efficiency; and
- paying superannuation benefits received to the children.

Consider that Denny and Donna have a corporate trustee of their SMSF, although the corporate trustee will continue to operate, upon the death of either Denny or Donna as a director, they will need to turn their minds as to who will act in their place as a director of the corporate trustee.

6. Identify who will be running the SMSF upon the member's death

Denny and Donna can determine this by looking at the specific fund's governing rules and, if applicable, the constitution of the trustee company to their SMSF. Denny and Donna will need to ensure that if either of them ceases to be a director upon death that they have nominated a successor director. The nominated director then becomes a director in their place subject to the nominating director consenting. Alternately, if either Denny or Donna dies, the shareholders of the corporate trustee can appoint their executor(s) in his or her place to exercise the voting power on his or her behalf. Upon the death of either Denny or Donna, the SMSF must be back within the normal 'trustee-member' rules no later than six months after the date the death benefits became payable in order to remain a SMSF.

As discussed earlier, upon the death of both Denny and Donna, they want firstly the SMSF to benefit David, Daniela and Daisy equally and secondly want David and Daniela to take care of Daisy's finances.

7. Identify what the member wishes to happen to their superannuation benefits upon death

The options available to them are as follows:

- leave to the discretion of the people running their SMSF upon death;
- This is appropriate where Denny and Donna trust the people who will be running their SMSF upon their death. Further this is appropriate for those who are very concerned with tax efficiency and asset protection.
- lump sum to the executors to be dealt with in accordance with the terms of their will;
- If Denny and Donna want to 'rule from the grave' they might consider this option as they can exert a high level of control over the benefits upon their death or if they seek to benefit a person who is not a dependant (ie, grandchildren, charities etc).
- Further if benefits go directly to Denny and Donna's children and David is married, if Denny and Donna are concerned about the stability of David's marriage to ensure that David's former spouse will not benefit. Keeping the benefits in their estate can protect against this somewhat, but there would be greater certainty if David entered into a binding financial agreement with his wife (which can be entered into prior to, during or after the marriage).
- lump sum to a dependant;
- This is often appropriate where Denny and Donna are concerned that their estate will be challenged.
- pension to a dependant (other than adult child) ie, Daisy could receive the superannuation benefits and rely on a 'hotchpot' clause in their wills and David and Daniela could receive a greater share of the estate assets. If David and Daniela are appointed the executors of Denny and Donna's wills, subject to the governing rules of the SMSF will be able to control the finances for Daisy;
- This is often appropriate when there is a surviving spouse ie, Donna and no children from a prior relationship.
- a non-commutable pension to a spouse but upon spouse's death the capital supporting the pension is paid to the member's children from a previous relationship; or

If Denny and Donna want to take this option, they should be aware that it is impossible to have 100% certainty achieved. Rather, they will be exchanging certainty in favour of the tax efficiency of keeping moneys in the concessional taxed superannuation environment.

A simpler method of achieving certainty (albeit at the cost of tax efficiency) is to pay superannuation benefits upon death as a lump sum to their executors and the terms of the will provide a life interest to the survivor of them and the capital to their children. Naturally, even this option is risky as the estate can be challenged under a testator family maintenance claim. An even more certain option, which is even less tax efficient, is to withdraw their superannuation benefits during their lifetime and then put those moneys in a newly established family discretionary trust with an independent trustee.

An alternate strategy is the 'kiss it goodbye strategy'. Under this strategy, during life, for instance, Denny could split his superannuation benefits into two funds. One fund is ear-marked for Donna and upon death/loss of capacity of Denny, Donna would be controlling this fund. The other fund is ear-marked for David, Daniela and Daisy and upon the death/loss of capacity of Denny, the children would be controlling this fund.

- A combination of the above.

However in distributing their superannuation benefits in one of the ways outlined above in step 7, Denny and Donna will also need to consider the taxation consequences that follow.

- Calculate the approximate tax payable if the wish in 7 occurs
- Upon death, there are two levels of taxing points:

- Level 1 — taxes payable at the fund level when an asset leaves the fund. This is relevant where lump sums will be paid and so the ‘pension exemption’ will not apply. When assets leave the fund this can give rise to a CGT event, a stamp duty liability and possibly a GST liability^[4]. Naturally, an anti-detriment deduction strategy can play an important role in minimising an income tax (including CGT) liability.
- Level 2 — income tax payable by the recipient
- Pensions are received income tax free if any of the following are true: (i) the deceased attained age 60 before death; (ii) if the recipient has attained age 60; or (iii) to the extent the pension is comprised of the tax free component.
- Lump sums received are always received tax free by spouses, minors or dependent children, or other people who are dependent upon the deceased. To the extent that lump sums are comprised of the taxable component, generally only adult independent children and executors pay income tax on their receipt.

After considering the manner in which superannuation is to be distributed and the relevant taxation consequences, Denny and Donna will need to consider the manner in which they wish to ensure their wishes in relation to their superannuation benefits are carried out.

8. Identify to what extent the member wants to try and ‘lock in’ their wish in step 7

Broadly Donna and Denny have the following options (in order of ascending cost and certainty):

- ensure that he or she trusts whomever will be running the fund upon his or her death;
Whoever is running the fund appears to have complete discretion as to whom and how to pay death benefits, subject to the options below being implemented. However, the law always requires this decision to be made in good faith, upon real and genuine consideration and in accordance with the sole purpose test and not for some ulterior purpose^[5].
- make a binding death benefit nomination specifying to whom and how benefits are to be paid;
DBA Lawyers and the Commissioner of Taxation believe that a (‘BDBN’) can last indefinitely (ie, non-lapsing) provided the governing rules are appropriately drafted^[6]. However, case law has left the door open to a small amount of ambiguity as to whether this is correct or whether an SMSF BDBN can only last for a maximum of three years^[7]. Best practice is to ensure that a BDBN is expressly drafted to last indefinitely and then ensure that they re-execute them every three years.
- vary the fund’s governing rules to ‘hardwire’ a provision into them incorporating the wish. This is sometimes referred to as a ‘death benefit rule’.
If Denny and Donna wish to pursue this option properly, it is important to put a ‘clog’ on the trustee’s ability to vary this aspect of the governing rules. As part of this clog, it is prudent to have a guardian-type role under which the rules cannot be varied unless the guardian permits it.
- make a mutual wills agreement.

^[4] GSTD 2009/1

^[5] Karger v Paul [1984] VR 161, 164

^[6] SMSFD 2008/3

^[7] Donovan v Donovan [2009] QSC 26

This is particularly important if Denny and Donna want a non-commutable pension paid to the surviving spouse and they enter into their second marriage, ie if Denny dies and Donna remarries but upon Donna's death the capital supporting the pension should be paid to David, Daniela and Daisy.

Upon Denny's death his superannuation benefits would commence to be paid to Donna and would become Donna's benefits. Further, upon the death of Denny, if Denny had children from a previous marriage, those children would cease to be Donna's children^[8]. Therefore, upon Donna's death, superannuation law precludes those benefits from being paid to Denny's three children (ie, because these children are not Donna's children at the time of Denny's death).

Accordingly, the only way for the superannuation benefits supporting the pension to reach Denny's children from his first marriage upon the death of Donna is for the superannuation benefits to be paid to Donna's executors and for the terms of Donna's will to stipulate that those benefits must be paid to Denny's three children. Naturally, there is a risk that after Denny dies, Donna might seek to change her will to exclude Denny's three children. A mutual wills agreement seeks to protect against this risk.

Denny and Donna have a great deal to consider and have made an appointment to see their accountant who understands their financial circumstances and to point them in the right direction.

9. Instruct a lawyer to advise upon and draft the relevant documents.

Accountants and financial planners can add great value in collecting instructions, making strategic input and investment recommendations. However, accountants and financial planners must ensure they do not prepare documents affecting the rights of a person as these would constitute the provision of legal services. The punishment for a non-qualified person engaging in legal practice can be severe, including imprisonment. Accordingly, the ultimate advice and drafting of documentation should always be done by a lawyer. (Legal Profession Act 2004 (Vic) s 2.2.2(1)).

Conclusion

When considering superannuation benefits and ensuring that they pass to the intended beneficiaries, it is essential to consider succession planning holistically. This requires not just looking at the fund's governing rules but also who is to succeed to the role of trustee. Finally, it is important to ensure that an appropriate will has been drafted that expressly covers the superannuation benefits and appropriate powers of attorney are also executed.

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^[8] Re Cook Maxwell; Ex Parte C (1985) 156 CLR 249, 263

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