

## SELF MANAGED SUPER FUNDS

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## INTRODUCTION

**By Pauline Hammer**

One of the main reasons people generally have for starting a SMSF is the flexibility in investment options and the control you have over these investments. However it's always important to remember that there are limitations to the type of investments you can enter into. SMSF Education outlines in detail these limitations.

Owning business premises in a SMSF can make a great deal of sense for SMSF's and business owners alike. It can provide a steady source of income and capital growth for the SMSF and also provides stability for the business owner rather than having a 3<sup>rd</sup> party landlord. Travis Allen from Hillyer Riches tells us how to go about it.

If an SMSF trustee contravenes the SIS legislation, the SMSF might be made non-complying. However, that is not necessarily the end of the story. The Commissioner might also seek to have the Federal Court order the trustee to pay a monetary penalty to the government. Bryce Figot from DBA lawyers provides an insight into how the penalty was determined in the case of *Oleson v Eddy*.

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## INVESTMENT LIMITATIONS – WHAT’S NOT ALLOWED

One of the main reasons people generally have for starting a SMSF is the flexibility in investment options and the control you have over these investments. However it's always important to remember that there are limitations to the type of investments you can enter into. Basically these limitations can come from three sources, firstly your trust deed, secondly your investment strategy and finally legislation.

The reason I mention your trust deed and investment strategy first is that regardless of what the law says, your trust deed and strategy can limit the investment powers of the trustees. Breaching these covenants is no less a compliance breach than breaking the law, so as in most cases with SMSFs, always check your deed and make the decision with reference to your strategy.

The Superannuation Industry Supervision Act (SISA) allows very broad investment powers for a super fund. Rather than try to state all the things you can invest in, they specifically state the limitations. Fundamentally these limitations are:

- a) The purpose of an investment must be for one of the sole purposes allowed under the act. Section 62 outlines what these are, but broadly speaking they are to provide retirement benefits, disability benefits or death benefits. When looking at making an investment, if there is any possibility that an alternative purpose could exist, you need to tread very carefully. An example of this is when a fund purchases a collectible. If this is stored at the home or business of a member, it is possible that they are receiving enjoyment from an asset they would not otherwise had the money to purchase and this could be seen as an alternative purpose for the decision. So you have to ensure that the decision is justifiable on commercial grounds.
- b) You cannot lend money to a member or relative of a member. Section 65 says that your fund cannot lend money or give financial assistance to a member or relative of a member. In this case it doesn't matter whether you intended that the member would pay interest or that the loan is formalised. This doesn't mean that the fund cannot lend money to a separate business entity such as a member's company, however this would be an in-house asset and subject to the 5% rule.
- c) As a general rule you cannot acquire assets from a member or related party to a member. Section 66 deals with this and it is safest to adopt a blanket ban on a purchase from a member unless you are certain that it falls under one of the exceptions also found in section 66. It is important to remember that acquiring an asset includes a contribution in specie (contributing an asset rather than cash). What are the exemptions? You can purchase an asset if it satisfies one of the following:
  - i. If the asset is a listed security AND it is acquired at market value. For example, you can purchase a share listed on the ASX from yourself rather than going to the market. Although the regulator has said that they prefer to see this type of transaction done via the market when possible. We can only assume this is because people have been playing around with the market price to suit themselves, rather than adopting the true market value. Remember, the exemption actually only applies when the market value is paid.
  - ii. For an SMSF, business real property can be acquired from a related party or member provided the market price is paid. This would generally exclude any residential property, as an investment property where rent is derived would not satisfy the definition of business real property. While this sounds simple enough, residential property may be considered business real property under certain circumstances (eg. where the property is the subject of a business operation).
  - iii. If the assets are acquired through the merger of regulated super funds. This would be unusual for a SMSF.

- iv. If the regulator determines that a particular kind of asset can be purchased by your fund. Again, this is fairly rare.
- v. You are able to purchase an asset that is an in-house asset, provided that it does not cause the fund to exceed the allowable limits for these types of assets (currently 5%).
- vi. You can also purchase an asset that would be an in-house asset except for the fact that section 71 specifically excludes it. These provisions are a bit long to be listed here, but the most widely used that haven't already been discussed are probably assets held as tenants in common, widely held unit trusts and assets specified in the regulations as not being in-house assets (for example a regulation 13.22(C) trust).
- vii. If the assets are being purchased from the related entity as part of a relationship breakdown and those assets relate to the member benefit they had in the original SMSF.

Even when an asset can be acquired by your SMSF from a related party, it is important to remember that this is meant to be a commercial transaction. If the transaction is not undertaken at arm's length, then it should be treated as though it is at arm's length. At the very least, it should not be on terms that disadvantage the SMSF. Beware however, if it is on terms that benefit the SMSF, the benefit derived may be considered a contribution and so allowance needs to be made to your contribution strategy to ensure you don't exceed the caps.

Your SMSF cannot borrow or maintain a borrowing and this includes having a charge over its assets. While this is possible if strict limited recourse requirements are met (these are beyond the scope of this article) you cannot generally borrow to invest, nor allow the assets to act as security for a borrowing. So if you are purchasing an asset that may have had a charge against it at some time, for example a business property owned by a member, you need to make sure that the mortgage has in fact been released by the bank.

Investing within an SMSF is relatively straight forward when you are talking about un-gearred mainstream assets being purchased from non-related parties. You really only need to check your trust deed and investment strategy, but you are unlikely to find any trouble within the legislation. When you step away from those simple parameters, the rules become far more complicated. This doesn't mean that you shouldn't go there, it just means that your level of caution needs to increase so that you ensure your fund's compliance. Using an appropriately qualified adviser could be money well spent.

*This article was provided by SMSF Education [www.smsfeducation.com.au](http://www.smsfeducation.com.au).*

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# ADDING VALUE TO YOUR SMSF WITH BUSINESS PREMISES

By Travis Allen

Owning business premises in a SMSF can make a great deal of sense for SMSF's and business owners alike. It can provide a steady source of income and capital growth for the SMSF and also provides stability for the business owner rather than having a 3<sup>rd</sup> party landlord. At the same time, having your business premises in a SMSF rather than holding it personally or in a company can offer significant tax savings on disposal. Finally, SMSF's also offer one of the most robust structures to protect assets from creditors in bankruptcy.

## How can the SMSF legally purchase business premises from the business owners?

Unlike residential properties, 'business real property' can be purchased from related parties by a SMSF without breaching section 66 of the SIS Act. The property is required to be business real property that is used exclusively in a business (e.g. it can't be a retail shop with a residential premise above it). In addition, the acquisition needs to be at market value (i.e. independently valued).

The sole purpose of the transaction must be to provide a retirement benefit for the members (i.e. consistent with the investment strategy of the SMSF). You should consult with your financial advisor if appropriate to ensure it is a good fit with your portfolio.

## Can the property be transferred for nil consideration?

Business premises can also be transferred into an SMSF without cash (in-specie). The transfer is considered a contribution for the SMSF members and subject to the contribution cap limits. Non-Concessional Personal Contributions of \$150k per annum is the contributions limit each year (subject to the age and work status of the member). However, for those members under the age of 65 non-concessional contributions of \$450k per member can be utilized using the 'bring-forward' rule. Concessional employer or concessional personal contributions can be made of \$50k for those over 50 years of age, or \$25k for those under 50.

Most SMSF's have commonly two members (with a maximum of four members), and therefore most small businesses commercial properties being under 1 million dollars in value can typically be transferred in without breaching contribution limits and incurring excess contributions tax. Care needs to be taken when making contributions in the following two years if you trigger the 'bring forward' provisions. A combination of cash/in-specie payments could also be done to transfer the property in.

## What about gearing if the SMSF does not have sufficient funds to purchase outright?

Yes, this is possible but it is vital that the transaction is completed in the correct manner and properly documented.

Business real property can be purchased by the SMSF from a related party providing any existing mortgage has first been discharged. The existing gearing must be extinguished before being transferred into the SMSF and a new gearing arrangement can be established through a limited recourse borrowing arrangement. It is critical that an independent valuation is used to determine the purchase price.

Unlike an ordinary borrowing arrangement, a limited recourse loan is established through a bare trust to gear the property legally in an SMSF. It is generally recommended that the level of borrowing does not exceed 60% of the value of the property. The reason for this is that generally the investment will be cash flow positive and not require additional funding from outside the SMSF. Defaulting on repayments in these arrangements may trigger a personal guarantee payment demanded by your bank, and that payment would be considered a contribution by the member, potentially giving rise to excess contribution tax if the contribution limits are exceeded.

The limited recourse borrowing arrangement can be an ideal opportunity to give the SMSF members the ability to purchase a property they would not otherwise have the resources to afford. It is critical to seek expert tax and legal guidance to benefit from these structures.

## **Commercial Lease Arrangements**

Once the property is within the SMSF, a legally enforceable lease arrangement between the trustee of the SMSF and the related party (sec 71 SIS) must be drawn up. We would recommend a solicitor to be engaged to draw up a commercial, fully documented, lease agreement between the SMSF trustees and the business. Rent should be specified in the contract to be payable at a market value from the business to the SMSF and also, for example, outlining the consequences of not paying rent on time. Rent should also be adjusted regularly in future years to ensure that rent paid is always at market value.

## **Capital Gains Tax**

Capital Gains Tax may not be payable on the sale or transfer into the SMSF of an existing property dependant on whether the business premise is used in the related parties business and if they pass the Small Business CGT Concessions. The Capital Gain may also be reduced in certain circumstances by the member making a concessional contribution into the SMSF and claiming a deduction to offset the gain.

Once the members' of the SMSF turn 55, they can also commence a pension (transition to retirement income stream), and may not be subject to capital gains tax on the subsequent sale of the property. This is a major benefit to business taxpayers that cannot access the small business capital gains tax concessions. Because the tax on the gain is not apportioned between the years the property is increasing in value whilst they are in accumulation phase and the years in pension phase, once a pension has commenced the capital gains on sales of assets within the SMSF become tax free.

If the property is disposed of by the SMSF before pension phase has commenced, and the building has been held for longer than 12 months, the tax on any capital gain is still concessionally taxed in the SMSF at only 10%.

## **Stamp Duty**

Stamp duty may also be payable in some states when the property is transferred to the SMSF and dependant on how the transaction is structured.

## **Income Tax**

Rental income less outgoings are taxed in the SMSF at 15 cents in the dollar. The rental expense in the business if it is a corporate taxpayer receives a tax refund of 30%, saving 15 cents in every dollar of tax paid by the family overall. This saving rises to 30 cents in the dollar once the members commence pension phase.

## **Other Issues**

The property should also be valued in the SMSF each year on a reasonable basis. An annual independent valuation is not required, and normally a curb side valuation by a real estate agent is sufficient. If the SMSF is in pension mode, the property and the SMSF assets need to be valued at market value each year to continue to qualify for the generous taxation concessions for SMSF's in pension mode. To continue to qualify for these concessions, a market valuation by a formal valuer every three years would be best practice with curbside valuations in between. The value should always be compared to the Council rates notice. If the SMSF is not valued at market value, then the SMSF may not qualify for the pension concessions and all income will be taxed at 15%.

Having the property in a SMSF also forms an excellent barrier for asset protection purposes, removing exposure of the property to creditors and other inherent business risks. However, there are claw back provisions in the Bankruptcy Act for contributions made to defeat creditors.

SMSF's lead both industry and retail funds because of the investments that only these funds can purchase. Although trustees take on more responsibility, they will continue to be the

superannuation structure of choice in the future. Trustees need to seek advice prior to a final decision to pursue the strategy to insure that any pitfalls are identified and can be provisioned.

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## **SMSFS AND COURT-IMPOSED PENALTIES – WHEN NON-COMPLIANCE IS NOT PUNISHMENT ENOUGH**

**By Bryce Figot**

### **Introduction**

If an SMSF trustee contravenes the SIS legislation, the SMSF might be made non-complying. However, that is not necessarily the end of the story. The Commissioner might also seek to have the Federal Court order the trustee to pay a monetary penalty to the government.

The recent case of *Oleson v Eddy* [2011] FCA 13 provides valuable insights as to how such a penalty is determined. The full text of this case can be found at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2011/13.html>.

### **The key law**

Section 196 of the *Superannuation Industry (Supervision) Act 1993* (Cth) considers the situation where a person has contravened certain superannuation laws. It provides that the Federal Court may order the person to pay up to \$220,000 in respect of a contravention.

### **General principles in determining size of penalties**

*Oleson v Eddy* articulates the following principles in determining penalties:

Those that take advantage of the utilisation of an SMSF have a responsibility to manage that fund in accordance with the terms of the deed and the legislation.

A penalty for contravention of that obligation needs to be sufficiently high to deter contravention by others, but not so high as to be oppressive.

General deterrence is a very significant factor. Other objectives include denunciation and punishment. Contravening conduct may be difficult to detect and its investigation can be complex and expensive.

The total penalty must not exceed what is proper with regard to the conduct of the person in respect of all the contraventions.

Relevant factors in determining an appropriate penalty include:

- the nature and extent of the contravening conduct;
- the amount of any loss or damage caused;
- the size of the organisation;
- the deliberateness or otherwise of the contravention(s);
- the period over which the contravention(s) extended;
- the degree of cooperation of the person concerned, either in the investigation or the subsequent hearing;
- the past record of the person;
- the person's financial position;

- any amounts already paid by way of compensation or legal costs; and
- contrition.

## **Facts of the case**

The case considered the size of the monetary penalty to impose against the respondent.

The respondent was educated to Year 10 level. He had continuous employment since the age of 15, with a variety of employers. Initially he worked as a chef and then in the businesses of food catering or supplies.

The respondent married and then divorced. He has two young children. The birth of his second child involved complications. His wife consequently suffered severe post-natal depression requiring prolonged hospitalisation. The relationship became strained, and he and his wife were divorced in 2004. His wife was given custody of the children. In the period 2002 to 2004 he was under considerable strain. He was dealing with his wife's illness, largely caring for his children, and working a full-time and demanding job.

In 2005, at age 41, the respondent established an SMSF and approximately \$60,000 was rolled in from other superannuation funds. He was under financial pressure. He was meeting the mortgage on the matrimonial home and paying child support. He did not have enough to live on. He did not establish the SMSF with the intention of using it as a financial resource. However, the coincidence of its establishment and his financial pressures presented too much of a temptation.

Almost right from its commencement, he started to withdraw SMSF money to pay for various expenses.

The first misappropriation of \$5,500 was to repay a debt to his wife. Thereafter, various withdrawals were made to meet relatively minor bills or liabilities, or to meet his daily living expenses.

In the period from 2005, he also started drinking heavily and gambling. This was partly due to loneliness and an attempt to relieve his financial pressures.

By 30 June 2006, 98% of the SMSF assets has been withdrawn by the respondent. The auditor of the SMSF alerted the Commissioner accordingly. The Commissioner notified the respondent on 21 January 2008 that he was to immediately to repay the loans. However, the respondent did not and withdrew the remaining assets. As at the date of the judgement, he had still not replenished the SMSF.

None of the withdrawals were authorised by the governing rules of the SMSF or the SIS legislation.

The respondent has since stopped his heavy drinking and gambling. He has a good prognosis. In the judge's view it is now unlikely that he would contravene the SIS legislation again.

His financial position is just comfortable. He has a good income, but it is committed to mortgage payments, child support payments and school fees and debt repayments. Notably the debt repayments include tax debts arising from the withdrawals. His only significant asset is his home, which is heavily mortgaged. When his commitment to school fees ends, he intends to replenish the SMSF.

## **The appropriate penalty**

The judge accepted that the respondent was genuinely remorseful for what he did. He also declared that the respondent's actions had contravened:

- the sole purpose test; and
- the prohibition on the provision of financial assistance to a member from fund resources.

In total a penalty of \$15,000 was deemed appropriate with regards to all the circumstances. The respondent was allowed to pay this in weekly instalments of \$192.31.

## Conclusion

The court emphasized the seriousness of the respondent's conduct because the withdrawals were done deliberately and deprived the SMSF of its total assets. This case serves as a reminder to trustees to consistently maintain their SMSFs in compliance with their governing rules and the legislation.

Trustees must adhere to the legislation, especially the sole purpose test, which is to ensure that the SMSF is maintained for certain purposes (eg, the provision of retirement benefits).

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