



## Limited recourse borrowing arrangements explained

By Andy Nguyen

In SMSFR 2011/D1, the Commissioner of Taxation (the Commissioner) explains key concepts relevant to the application of the limited recourse borrowing arrangement (LRBA) provisions. This article covers relevant aspects of the draft ruling including the interpretation of the important term 'single acquirable asset'.

### Background

A number of provisions in the *Superannuation Industry (Supervision) Act 1993* (SISA) place restrictions on an SMSF's investment activities. Specifically, ss67(1) SISA prohibits a trustee of an SMSF from borrowing money or maintaining an existing borrowing of money.

A specific exception to the prohibition on borrowing is provided by s67A and 67B SISA, which apply from 7 July 2010.

### Section 67A

Section 67A permits a borrowing arrangement (an LRBA) if the money borrowed is applied to the acquisition of

a 'single acquirable asset' and that asset is held in a holding trust (as the legal owner). Under such an arrangement, the SMSF trustee acquires a beneficial interest in the asset and the lender's right of recourse in the event of default is limited to the acquirable asset held in the holding trust.

By making one or more payments after acquiring a beneficial interest in the asset the SMSF trustee has the right to acquire legal ownership. Additional rules apply for the treatment of a collection of identical assets having the same market value in the same way as a single acquirable asset.

*continued – page 4*

inside...

Editorial: Moving in the right direction ... unhurriedly  
Actuarial certificates  
Managing residency risk

*see overleaf for the full listing*

## A Tax Office reminder: 'Concessional contributions caps'

As part of its ongoing efforts to keep trustees and employees aware of their superannuation obligations and responsibilities the Tax Office has sought our assistance by circulating the following brief message to members entitled *Save money – keep track of your super*, to remind them of the need to adequately manage their superannuation contributions and avoid having to pay excess concessional contributions tax. Given the high incidence of excess contributions tax from exceeding concessional contributions caps you are urged to take care and manage contributions within the 'caps' regime.

### Save money – keep track of your super (Source: Australian Taxation Office)

Any time is a good time to look at your super contributions. Something like a pay rise may mean you end up paying extra tax on your super contributions.

Employer super guarantee contributions and salary sacrifice amounts are concessional contributions.



## contents

- Limited recourse borrowing arrangements explained..... 1
- Editorial: Moving in the right direction ... unhurriedly** ..... 3
- Stronger Super reforms - final details* ..... 8
- Actuarial certificates ..... 11
- The Preservation Regime ..... 15
- Managing residency risk ..... 19
- Dates for your diary..... 23

Depending on your age and the amount contributed, you may go over the concessional contributions cap and have to pay extra tax (see table below).

For more information about superannuation contributions and how they are taxed, see [www.ato.gov.au/supercaps](http://www.ato.gov.au/supercaps) ■

Age	Concessional contributions cap for 2011-12	Excess tax we will charge
If you're under 50 years of age	You will pay extra tax if your concessional contributions are more than \$25,000	31.5% of the excess
If you're 50 years of age and over	You will pay extra tax if your concessional contributions are more than \$50,000	31.5% of the excess

All information provided in this publication is of a general nature only and is not personal financial or investment advice. It does not take into account your particular objectives and circumstances. No person should act on the basis of this information without first obtaining and following the advice of a suitably qualified professional advisor. To the fullest extent permitted by law, no person involved in producing, distributing or providing the information in this publication (including Taxpayers Australia Incorporated, each of its directors, councillors, employees and contractors and the editors or authors of the information) will be liable in any way for any loss or damage suffered by any person through the use of or access to this information. The Copyright is owned exclusively by Taxpayers Australia Inc (ABN 96 075 950 284).

**NOTICE FORBIDDING UNAUTHORISED REPRODUCTION**

So long as no alterations are made unless approved, you are invited to reprint Editorials provided acknowledgment is given that the Association is the source. No other item covered by copyright may be reproduced or copied in any form (graphic, electronic or mechanical, or recorded on film or magnetic media) or placed in any computer or information transmission or retrieval system unless permission in writing is obtained from Taxpayers Australia Inc. Permission to reproduce items covered by copyright will only be extended to members financial at time of request. Permission may be obtained by email to [info@taxpayer.com.au](mailto:info@taxpayer.com.au), by phone 1300 657 572 or by downloading an Application to Reproduce Copyright Material Form from [www.taxpayer.com.au/copyrightform](http://www.taxpayer.com.au/copyrightform)

## Moving in the right direction ... unhurriedly



The recent tabling in parliament of the *Superannuation Guarantee (Administration) Amendment Bill 2011* is an important step for retirement savings in Australia. Increasing the Superannuation Guarantee (SG) rate will go some way to alleviating the significant retirement savings gap the nation

faces. If passed this legislation will, among other things, increase the annual SG contribution rate from 9% to 12% of wages as was proposed by government in the May 2010 Federal Budget. The cost to revenue is the difference between the 15% contributions tax rate and the potentially higher individual tax rate that would apply for the contributor. This will be offset by some of the revenue from the Minerals Resource Rent Tax that, according to the government, is also intended to finance the proposed company tax rate reductions.

The higher SG rate will have a direct and immediate impact on raising the level of national retirement savings, but the stepped take-up means the full 12% is only reached in 2019-20. Given that significant absolute growth comes from 'time in the fund', the earlier an account is well-resourced the sooner it will grow by a meaningful amount. Neither the incremental increases in the SG rate nor the immediate impact that this has on individual account balances is likely to have a significant impact on the overall savings of members in the near term, but will have maximum impact for those who benefit for the full length of a working career.

However for others, the near term impact may be marginal and it follows that for such taxpayers they shouldn't rely on the increased rate and assume increases in their super savings would be adequate through this incremental mechanism alone. The full impact will not be seen for a long time, however as the government explains, those on average wages, receiving the 12% rate over their working life will have approximately \$108,000 more saved for retirement,

clearly a significant amount. What is difficult to quantify however is whether the targeted rate is about right, and will it lead to adequate retirement savings overall for future generations? Regardless of whether this can be answered in the affirmative, the current proposal is a great step forward for boosting taxpayers' retirement savings.

In the meantime, for those in mid-careers who cannot expect to be covered at the higher SG rate over their working life, they should consider the benefits that salary sacrifice to superannuation would have on their full accounts and not rely merely on a higher compulsory SG rate.

The recent indication from the Opposition that should it come to government at the next election it would not repeal this SG legislation, is most welcome. It ensures a degree of certainty for those making retirement savings plans and this certainty is indeed good news for all. ■

### Section 67B

Section 67B contains the specific circumstances under which a borrowing arrangement may be maintained in relation to a replacement asset rather than the asset originally acquired. The replacement asset provisions apply only to shares and units and only in narrowly defined circumstances.

### Contraventions

Section 67 SISA is a civil penalty provision and therefore, contravening, or being involved in a contravention, of s67 SISA may have civil and criminal consequences. Contravention places at risk the status of the SMSF as a complying superannuation fund under the SISA.

**Note: Sections 67A and 67B replace former ss67(4A). This provision was replaced as certain practices had developed that led to prudential concerns with the borrowing arrangements created pursuant to these provisions.**

### SMSFR 2011/D1

The Commissioner's views in relation to the application of key LRBA concepts may be summarised as follows.

### The meaning of 'acquirable asset' and 'single acquirable asset'

- **Acquirable asset:**

An asset is defined in ss10(1) SISA to mean any form of property. In the context of an LRBA, an acquirable asset is therefore any form of property, other than money, that the trustee is not otherwise prohibited from acquiring by the SISA or any other law.

- **Single acquirable asset:**

The Commissioner considers that it is necessary to consider the meaning of property in both the legal form and substance of the asset acquired to determine whether money borrowed under an LRBA has been applied to the acquisition of a 'single acquirable asset'. Having regard to both the object of the proprietary rights and the proprietary rights, it may be possible to conclude that a trustee is acquiring a single acquirable asset in the sense that the trustee is acquiring a single object of property

notwithstanding that it is comprised of two or more proprietary rights. However, this will only be so where it is reasonable to conclude that the object of the separate proprietary rights is distinctly identifiable as a single asset.

If assets can be dealt with separately, this will mean that there is more than one asset for the purposes of the LRBA provisions. It is not the acquisition of a 'single acquirable asset' merely because the vendor wants to deal with the assets as a package or the lender will only lend over a group of assets.

However, if there are laws of a State or Territory preventing assets from being dealt with separately, the Commissioner concludes that there is a single acquirable asset.

#### EXAMPLE 1 from draft ruling - two adjacent blocks of land

As part of the SMSF's investment strategy, the trustees want to acquire two adjacent blocks of land under the one LRBA. The vendor will only sell the two blocks together however, there are no physical or legal impediments to the two blocks of land being sold separately.

The two blocks of land are not a single acquirable asset. As a result, the two blocks of land cannot be acquired under one LRBA. However, each block could be acquired under a separate LRBA.

#### EXAMPLE 2 from draft ruling - a factory on more than one title

An SMSF trustee wants to enter into an LRBA to acquire a factory. The entire factory covers three separate legal titles. The factory is a single acquirable asset and can be acquired under one LRBA.

#### EXAMPLE 6 from draft ruling - apartment with separate car park

The trustee of an SMSF wants to enter into an LRBA to purchase an apartment with a separate car park. The apartment and car park are each on a separate legal title. The laws of the State in which the apartment is located do not allow the two titles to be disposed of separately.

As the two titles cannot be assigned or transferred separately, the apartment together with the car park is a single acquirable asset.

---

## Borrowings applied in maintaining or repairing but not improving the asset

The Commissioner considers that money borrowed under the LRBA (and secured by the single acquirable asset) may be applied not only to acquire the acquirable asset but also in carrying out repairs and maintenance to the asset whether necessary at the time of its acquisition or at a later time.

No amount that has been borrowed by the SMSF trustees under the LRBA may be applied to improve the single acquirable asset. Where this is the case, the exception in s67A SISA will cease to apply to the LRBA and, if the borrowing is maintained, the trustee will contravene s67 SISA.

## Distinguishing between maintaining, repairing and improving a single acquirable asset

The Commissioner importantly notes that while the views on the meaning of repair and improvement in Taxation Ruling TR 97/23 *Income tax : deduction for repairs* are informative they are not determinative in the LRBA context as the ruling focuses on whether expenditure is of a revenue or capital nature.

The meaning of **'maintaining'**, **'repairing'** and **'improving'** the acquirable asset for the purposes of the draft ruling are as follows:

- **Maintaining:**

The word 'maintaining' ordinarily means work done to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration provided that it merely ensures the functional efficiency of the asset is maintained in its present state.

- **Repairing:**

The word 'repairing' ordinarily means remedying or making good defects in, damage to, or deterioration of, an asset and contemplates the continued existence of the asset. A repair is usually occasional and partial (rather than the whole).

In terms of whether the repair is partial, it is the entire asset that is held under an LRBA that is relevant. For example, if the asset is a house and land, in determining if the asset is maintained

or repaired or whether it has been improved, it is necessary to consider the overall effect of the work (or expenditure) on both the house and the land (refer table 1 below).

An asset may be acquired in a state in which a part of the asset is defective, damaged or suffering some deterioration from what would be considered to be its normal level of functional efficiency. Restoration of that part of the asset to its functional efficiency would typically be a repair for LRBA purposes.

- **Improving:**

An asset is improved if the functional efficiency of the asset or the value of the asset is substantially increased through:

- the addition of new and substantial features or rights, or
- bringing a thing or structure into a more valuable or desirable form, state or condition than a mere repair would do.

Determining if the functional efficiency of the asset is merely restored, or whether it is substantially increased, is a question of fact and degree. Minor or trifling increases in functional efficiency or value as compared with the acquirable asset as a whole will not amount to an improvement.

An 'improved' asset which is fundamentally altered in character is considered to be a different asset, which would result in a breach of s67A if an LRBA was maintained.

Table 1 on page 6 extracted from the draft ruling illustrates repairs compared to improvements.

### EXAMPLE 9 from draft ruling – renovation of property using borrowings

An SMSF enters into an LRBA where the single acquirable asset is a three bedroom residential property. The SMSF renovates the property adding a bathroom using borrowings under the LRBA.

The addition of the bathroom using LRBA funding improves the asset compared with the asset as it was at the time when the LRBA was entered into. The arrangement will no longer satisfy the requirements of s67A as money borrowed under the LRBA has been applied to improve the asset in contravention of subparagraph 67A(1)(a)(i).

### Subsequent draw downs for repairs

According to the draft ruling, subsequent draw downs under an LRBA may be made for the purposes of maintaining or repairing an asset.

If draw downs for the purposes of maintaining or repairing an acquirable asset are provided for as part of an LRBA, each draw down is a borrowing under an arrangement that is an LRBA if the arrangement as a whole continues to satisfy the LRBA provisions.

### Repairs to an asset already owned by an SMSF

If an asset is already owned by an SMSF, and thus not subject to an LRBA, a borrowing to fund repairs

or maintenance for that asset would not satisfy the requirements of the LRBA provisions.

### Money other than borrowings used to improve an asset

Although borrowings under an LRBA cannot be used to improve a single acquirable asset that is the subject of the LRBA, money from other sources could be used to improve that asset. However, the Commissioner makes it clear that any improvements must not result in the acquirable asset becoming a different asset due to there being a fundamental change in the character of the asset (refer to Table 1 below).

<b>Table 1: Repair or improvement</b>		
<b>#</b>	<b>Repair or maintenance example</b>	<b>Improvement example (but not resulting in a different asset)</b>
1.	A fire damages a part of the kitchen (cook top, benches, walls and ceiling). Restoration of the damaged part of the kitchen would constitute repair of what is a subsidiary part of the asset being the house and land.	If the kitchen was also extended by extension of the house this extension would be an improvement.
2.	The guttering on the house is replaced and the house is repainted. A fence is replaced. A fire alarm is installed to comply with new council requirements. This would be repair or maintenance.	The addition of a new pool or a new garage would be an improvement.
3.	A cyclone damages the roof of the house. Replacement of the roof in its entirety is a repair.	The addition of a second storey to the house at the time of also replacing the roof would be an improvement.
<b><i>A farm (on a single title) is the single acquirable asset under an LRBA. At the time of entering into the LRBA the farm includes one set of cattle yards, four bores including windmills, tanks and troughs and three kilometres of fencing.</i></b>		
4.	Replacing a section of the cattle yards or the existing fencing is a repair. Ensuring the bores, windmills, tanks and troughs continue working is repair or maintenance. This would include laying new pipes between the tank and trough.	Each of the following additions is an improvement: <ul style="list-style-type: none"> <li>• a new set of cattle yards</li> <li>• a new bore, tank, windmill and trough</li> <li>• a dam, and</li> <li>• a further two kilometres of fencing.</li> </ul>
<b><i>Note: The draft ruling indicates that the improvements described in column 3 above would not result in a different asset as the changes do not fundamentally alter the character of the asset. It should therefore follow that those improvements could be carried out using the funds own monies without breaching an LRBA which related to the asset.</i></b>		

## Whether an asset is the same asset or a different asset

The Commissioner states that consideration must be given to whether any improvements or other changes to an acquirable asset result in a different asset being held on trust under the LRBA in circumstances not covered by s67B SISA.

Section 67B SISA allows for the replacement of a single acquirable asset that is a share, a unit in a unit trust or an instalment receipt (or a collection thereof) in the circumstances set out in ss67B(3) to (8) SISA.

Leaving aside the particular circumstances covered by ss67B(3) to (8) SISA, to determine if the asset presently held on trust is the acquirable asset that was subject to the LRBA at the time when the LRBA was entered into, it is necessary to consider both the physical object (assuming it is not an intangible asset) and the proprietary rights comprising the asset, to determine if the character of the asset as a whole has fundamentally changed.

If the acquirable asset is changed (including by way of improvements) to such an extent that it fundamentally changes the character of the asset such that it becomes

a different asset, the exception in s67A will cease to apply to the LRBA. If the borrowing is maintained the trustee will contravene ss67(1).

Table 2 (below) from the Ruling includes examples of situations where improvements result in a different asset.

## Operative date

When the final Ruling is issued, it is proposed to apply to arrangements entered into on or after 7 July 2010 (including an arrangement that is a refinancing of a borrowing of money entered into before, on or after that time). ■

Table 2: Whether it is a different asset		
#	Single acquirable asset	Whether it is a different asset(s)
1.	Vacant block of land on single title	The vacant block of land is subsequently subdivided resulting in multiple titles. One asset has been replaced by several different assets as a result of the subdivision.
2.	Vacant block of land on single title	A residential house is built on that vacant land (still single title). The character of the asset has fundamentally changed from vacant land to residential premises. This is a different asset.
3.	A house and land	The house is demolished and is replaced by three strata titled units. The character of the asset has fundamentally changed along with the underlying proprietary rights. This has created three different assets.
4.	A house and land	Rezoning of the land is granted and the house is renovated and is now commercial premises. The character of the asset has fundamentally changed from residential premises to commercial premises. This is a different asset.
5.	A four bedroom house and land	A fire destroys the four bedroom house and a four bedroom house is constructed using insurance proceeds. Rebuilding a four bedroom house does not fundamentally change the character of the asset held under the LRBA. Rebuilding the house restores the asset to a house and land.

# Stronger Super reforms - final details

By Michael Perry

The government released a *Stronger Super* Information Pack in September 2011 outlining certain recent decisions it had taken. The *Stronger Super* reforms contain four key initiatives. *MySuper* and *SuperStream* relate to the large and retail superannuation providers – those administered by APRA. The former is intended to create a high quality, lower cost and default\* superannuation product while *SuperStream* introduces modern technology to support the operational aspects of superannuation. Certain issues specific to the SMSF sector constitute the third initiative, while improved governance covers the fourth initiative.

## My Super

### Key issues

Superannuation funds may offer *MySuper* products from 1 July 2013, with pre-retirement products being the initial focus. Further consultation will determine post retirement products. *MySuper* products may be offered from July 2013, however all new contributions made to default funds from 1 October 2013 must be directed to *MySuper* products. Trustees may offer *MySuper* products from 1 July 2013, but will have until 1 July 2017 to transfer existing default balances to *MySuper* products. Consultations with government may lead to an extension of time if existing obligations affect the ability of trustee to transfer balances.

Transitional arrangements will apply to default transfers under enterprise agreements while modern award arrangements may qualify as default products where a fund offers *MySuper* products. Fair Work Australia has the role to ensure *MySuper* rules are met. Consultations will continue.

Existing legacy products and defined benefit funds need not be transferred to *MySuper* products.

*MySuper* insurance products will have the 'own occupation' definition removed from total and permanent disablement (TPD) products and replaced with an 'any occupation' definition to align with the TPD condition of release. This may lead to a significant review of TPD products since many include the 'own occupation' definition. Some flexibility for specific insurance is permitted.

CGT consequences arising from transitioning to *MySuper* products remains unresolved including whether such relief is appropriate. Ongoing government consultations will continue.

The requirement that trustees offering *MySuper* products retain an APRA licence will be dropped in

favour of an industry preferred approach of APRA providing authorisation for each *MySuper* product.

The government will introduce measures for trustee protection where they might otherwise be exposed to legal action in respect of their fiduciary duty to act in the best interest of members when dealing with transitioning arrangements to *My Super*.

### Fees – general

The basic fee structure of *MySuper* is aimed at keeping costs down. Products will have a single investment strategy and a standard set of fees for all prospective members. Fees must be identified under agreed categories for purposes of clarity and comparison.

A single fee structure was dropped to allow flexibility and employers may negotiate reduced administration fees directly with trustees within a standard fee structure. Employers with more than 500 employees may arrange to have *MySuper* products tailored for different services under a given investment strategy with fees different from the main *MySuper* product offered.

***Note: Details of all specially designed MySuper products together with all discounted arrangements for administration fees must be reported to APRA and made public by the trustee.***

### Fees – type

Fees charged for *MySuper* products will be identified under the following headings.

- administration fee
- investment fee (including a performance-based fee, subject to the limitations outlined below)
- buy and sell spreads (limited to cost recovery)
- exit fee (limited to cost recovery), and
- switching fee (limited to cost recovery).

\*Funds selected by employers on behalf of employees for SG contributions when employees do not make a choice.

Trustees may also charge for certain member-specific costs initiated by the member or a court, for example, account splitting following a family law decision. Trustees will not be limited on the types of fees that can be charged for choice products.

### Fees – performance-based

- A reduced base fee to reflect the potential gains from performance-based fees must take into account any fee cap.
- Measurement of performance is on an after-tax (where possible) and after-costs basis.
- Appropriate benchmark for asset class, reflecting risks of actual investments.
- An appropriate testing period will be required.
- Provisions for adjustment of performance-based fee to recoup any prior or subsequent underperformance.

**Note:** Trustees must be able to justify performance-based fee arrangements that differ from the above as being in the best financial interests of the members of the MySuper product.

### Superstream

*SuperStream* is a comprehensive package of reforms to enhance the ‘back office’ of superannuation. It includes measures to implement new data and e-commerce standards for transactions, enables tax file numbers (TFNs) as the primary locator of member accounts, facilitates account consolidation, improves the treatment of contributions made without sufficient member details and establishes a governance body to advise on implementation and maintenance standards.

### Key timelines

#### Data and e-commerce standards

- **Early 2012:** Data standards published and available for use by funds (voluntary uptake).
- **July 2013:** Data standards and use of e-commerce becomes mandatory for APRA-regulated funds and SMSFs for processing rollovers and accepting contributions (provided by employers in the new format).
- **July 2014:** Data standards and use of e-commerce becomes mandatory for large and medium employers making contributions.

- **July 2015:** Proposed application of data standards and use of e-commerce to small employers subject to further consultation on impacts.

Government consultation to continue.

#### Account consolidation

- **July 2011:** Funds can use TFNs as a primary locator to find accounts within a fund.
- **January 2012:** Funds can use TFNs to search the Tax Office’s current service for lost accounts – with member consent.
- **July 2012:** Multiple member accounts within a fund to be consolidated where possible.
- **July 2012:** Tax Office to provide an online facility for members to view active accounts currently reported to the Tax Office, in addition to their lost and other superannuation monies held by the Tax Office (eg. unclaimed money). Funds may search the account information, with member consent.
- **October 2013:** Funds to report inactive, lost and active accounts to the Tax Office.
- **January 2014:** Commencement of auto-consolidation of lost and inactive accounts (two years without contributions or rollover) with a balance of less than \$1,000 and accounts in eligible rollover funds.
- **July–December 2014:** Enrolment process for new employees modified to actively enable account consolidation at this time.

### Self managed superannuation funds

SMSF reforms in the *Information Pack* cover:

- independence of SMSF auditors so they can be relied upon to provide an objective assessment of compliance, and
- conduct of related party transactions through a market, or accompanied by a valuation if no market exists. Increase transparency and ensure such transactions are not used to circumvent legislative requirements.

### SMSF auditors

The development of a framework for SMSF auditor registration is currently ongoing with a principle-based approach as used in the Accounting Professional and Ethical Standards Board’s (APESB) *APES 110 – Code*

of *Ethics for Professional Accountants* for the audit engagement, requiring auditors to be independent both in fact and in appearance. Legislation will require SMSF auditors to comply with *APES 110* as a condition on their registration and will request the APESB to develop guidance for SMSF auditors on how *APES 110* applies in the SMSF context of independence.

***Comment: This is currently a work in progress and we see no reason why use of APES 110 as a template for the SMSF auditor guidance should not provide a firm basis for achieving the objective of auditors independence in both fact and appearance.***

### Related party transactions

The Government will legislate for related party transactions to be conducted through the market should one exist, otherwise it must be supported by a valuation from a suitably qualified independent valuer. The Tax Office's valuation guidelines publication will provide guidance where there is no underlying market.

***Comment: We do not believe this is warranted for the transfer of listed securities. It will add unnecessary costs and be reflected in lower retirement savings. Given the focus on auditor independence and the existing compliance regime this is an overreaction. With the cost containment measures the government is pursuing for APRA-regulated funds, a similar approach in the SMSF sector is desirable.***

### Other SMSF issues

The Government considers that SMSFs should have the flexibility to tailor their trust deeds and that SMSF trustees should be aware of the obligations imposed by their trust deed. It will therefore not amend the superannuation legislation to automatically deem anything permitted by the superannuation or taxation legislation to be permitted by SMSF trust deeds.

### Governance

The government seeks a heightened obligation on trustees to manage their funds' assets prudently and in the best interests of the members of the fund through a greater awareness of the expected costs of strategies and their taxation consequences and by providing appropriate valuation information. Better protection is also intended for superannuation members from losses due to failures in the operations of their fund. Briefly these include:

- introducing a duty for trustees and directors to give priority to the interests of fund members when that duty conflicts with other duties
- strengthening the requirements for individual directors in relation to managing conflicts of interest
- increasing the standard of care, skill and diligence required of trustees and directors of corporate trustees to that of a prudent person of business
- clarifying the duties applying to individual directors of corporate trustees to act honestly and to exercise independent judgment,
- introducing a requirement for trustees to devise and implement an insurance strategy and impose a statutory duty on trustees to manage insurance with the sole aim of benefiting members.
- have APRA and ASIC address the issue of disclosure of proxy voting policies and procedures so voting rights attached to the assets of a fund are managed in the interests of members
- The Government will introduce an operational risk financial requirement which will replace the existing trustee capital requirements after a suitable transitional period. APRA will develop a prudential standard which will set out the approach for determining the financial requirement for individual funds.
- the Government will also make certain changes to complaints handling, support a voluntary code of governance developed by industry in consultation with APRA, ensure choice trustee offer adequate choice, require trustees to exercise due diligence in the selection and monitoring of investment options.

### Conclusion

The majority of these decisions relate to APRA funds with the government seeking to improve the member position in respect of fees and access to relevant information plus greater responsibilities and improved governance from trustees for members. We await the ongoing consultation in relation to aspect of these important *MySuper* and *Superstream* initiatives. ■

# Actuarial certificates

By Graeme Evans

A self managed superannuation fund (SMSF) is an appropriate vehicle in which an individual can build up significant superannuation assets over their working life. In addition, an SMSF in the benefit distribution phase (ie. pension mode), is able to deliver retirement incomes to its members in the form of tax-effective superannuation income streams (SISs) while continuing to generate wealth. Most importantly, earnings on an SMSF's assets supporting an SIS are exempt from income tax and capital gains tax (CGT).

By comparison, where superannuation benefits are simply being withdrawn in the form of superannuation lump sums (**SLSs**), any investment earnings in the fund in respect to those interests, are taxed at 15% (10% effective tax rate on capital gains in relation to CGT assets held for at least 12 months).

Actuarial Certificates (**ACs**) can play a significant role in the tax-effectiveness of an SMSF in full or part pension mode. This article casts some light on ACs in order to help SMSF trustees gain an understanding of their purpose and application.

[Unless otherwise stated, all section and division references are to the *Income Tax Assessment Act 1997 (ITAA97)*].

## Overview

Understanding precisely what is required for an SMSF to qualify for this important pension mode tax exemption is critical in terms of maximising retirement benefits. In particular, SMSF trustees looking to implement a retirement income stream strategy need to understand that they may need to obtain an AC in the following circumstances:

- to qualify for an exemption from tax on the fund's income attributable to paying its current pension liabilities, or
- to certify the solvency (ie. provide an 'insolvency certificate') of SMSFs who are able to pay defined benefit pensions (**DBPs**) (eg. lifetime and life expectancy pensions).  
*(Please note that due to regulatory changes, new SMSFs established after 11 May 2004 are unable to offer DBPs. Also note that a discussion of 'insolvency certificates' is beyond the scope of this article.)*

## Who needs an AC?

An AC is most commonly required by fund trustees because the SMSF is paying SISs and the trustee wishes to claim a tax exemption on part or all of the fund's income. However, funds providing DBPs (ie. where the trustee promised to pay a particular benefit - say a lifetime pension) are subject to additional requirements. The *Superannuation Industry (Supervision) Act 1993 (SISA93)* and the *Superannuation Industry (Supervision) Regulations 1994 (SISR94)* require these SMSFs to obtain actuarial certification of their solvency (ie. their ability to finance the defined benefits over the longer term).

An AC will be required **every year** if:

1. The SMSF's assets are not segregated and the fund paid any type of pension at any time of the year.
2. The fund is paying a DBP (such as a lifetime pension or fixed term pension). This applies whether the SMSF's assets are segregated or unsegregated.
3. The SMSF terminated a DBP at some stage during the year and its assets were segregated, but the reserves required for the DBP were not kept separate from the actuary's best estimate of the amount required to finance the pension.

For the purpose of determining whether or not a SMSF needs an AC, the rules for Account Based Pensions (**ABPs**) are exactly the same as for the older Allocated Pensions (**APs**) and Market Linked Pensions (**MLPs**). In other words, an AC is required each year if the SMSF's assets are unsegregated.

## When are assets unsegregated?

The assets of an SMSF are considered to be segregated if specific assets are identified which support member

pension account(s) and the SMSF keeps these assets separate from the remaining SMSF assets.

Any other arrangement is an unsegregated SMSF. Some examples of segregation are:

1. An SMSF where all the members have converted all of their balances to pension mode, no further contributions are made, there are no reserves and only ABPs, APs or MLPs are being provided. These SMSFs are automatically segregated because they have no accumulation balances or reserves.
2. An SMSF where there are still some accumulation balances (ie. members have not fully converted to pension mode or have reserves), but the pension assets are invested separately. It is important to note that if there are several pensions, the fund will be segregated even if the assets for all the pensions are pooled together.

### What does the AC actually do?

The AC calculates the percentage (not the dollar amount) of the fund's investment income that is exempt from tax. Section 295-390(3) sets out the way in which the percentage is calculated. For a SMSF that has no DBPs and no segregated assets, the calculation is as follows:

$$\text{Exempt income percentage} = \frac{\text{Average value of the pension balance}}{\text{Average value of the fund as a whole}} \text{ (ie. Actuarial Percentage (AP))}$$

The following example explains the mechanics of ACs.

#### EXAMPLE

It is 9 September 2011 and the AC Super Fund (ACSF) is preparing its SMSF *Annual Return 2011*. As at the 30 June 2011, it has unsegregated assets of \$2,000,000.

Member A (who is in pension mode and receiving a SIS benefit in the form of an ABP) has an account balance of \$1,200,000, and Member B (who is still in accumulation mode) has an account balance of \$800,000.

As ACSF's assets are unsegregated, the trustees must obtain an AC in order to claim an amount for Exempt Current Pension Income (ECPI). The actuary

will need to calculate the average pension liabilities and average value of the fund as a whole. The first thing the actuary will ask for is confirmation that the account balances provided are based on the market value of the fund's assets. This is because the calculation must be done using market values of both the pension accounts and the fund as a whole. The AC shows that 60% of the SMSF's liabilities (ie. \$1,200,000 / \$2,000,000) relate to the paying of Member A's SIS benefit. The amount of ECPI shown on the fund's tax return is simply:

$$\text{Actuarial percentage} \times \text{Normal assessable income}$$

Normal assessable income (NAI) is assessable (not taxable) income but it excludes contributions and 'non-arm's length income' (say dividends from related companies or distributions from related discretionary trusts). In most cases NAI would merely be the fund's assessable investment income. Hence, if ACSF had received \$160,000 in interest, rent, dividends etc. during 2010-11 and the AC certifies that 60% (ie. the actuarial percentage) of ACSF's liabilities relate to the paying of the SIS benefit, then \$96,000 (ie. \$160,000 x 60%) of the fund's NAI is exempt income.

ACSF will record the following amounts in its SMSF annual return 2011:

Total assessable income	\$160,000 (included at item 10 label V)
less ECPI	\$96,000 (the fund claims this exemption by including this amount at item 11 label K)
Equals taxable income	\$64,000 (included at item 11 label O)

(For a detailed discussion about ECPI, please refer to an article entitled *Exempt current pension income*, which appeared in *Superannuation Quarterly*, Issue 51, December 2010 p 6.)

### What about deductions?

If a SMSF has some income which is exempt from tax, it is reasonable to expect that there will be limits on the tax deduction it can claim for expenses. A common misconception is that the actuarial percentage is always used to limit the deductibility of expenses.

Returning to the above example, assume ACSF incurred expenses of \$10,000 that would normally be fully deductible (such as investment costs, accounting, administration and audit fees etc.) If the AC certified that 60% of the fund's investment income was exempt from tax, would 60% of these expenses be non-deductible (leaving the fund only \$4,000 in deductions)? In short – not necessarily.

Generally, expenses are deductible to the extent that they are incurred in gaining or producing assessable income. Some expenses in ACSF would therefore be entirely non-deductible. For example, the actuary's fee to prepare the AC relates exclusively to the exempt income and is therefore not deductible. Other expenses might need to be apportioned between assessable and exempt income.

Taxation Ruling TR 93/17 provides some useful guidance on how this should be done. It indicates that each expense should be considered on a case-by-case basis and it may be entirely appropriate to apportion different costs in different ways.

For example, some expenses such as brokerage costs relate directly to investment income. They would therefore generally be divided into the same ratio as the actuarial percentage. In the case of ACSF, 60% of the fund's investment expenses would not be deductible but the remaining 40% would be deductible. However, other expenses (such as fund accounting and administration costs) all relate

to assessable income – not just the investment income of the fund. Hence it would be reasonable for a fund with other taxable income (say employer contributions) to claim a higher proportion of these costs as a tax deduction.

(For a detailed discussion about fund deductions and TR 93/17, please refer to an article entitled *Tax deductions for SMSFs*, which appeared in *Superannuation Quarterly*, Issue 52, March 2011 p 1.)

## When must the AC be obtained?

The AC must be obtained before the fund lodges its tax return for the year if the trustee will be claiming any ECPI in that year. For example, ACSF would need to obtain its AC sometime after 30 June 2011 but before the *SMSF Annual Return 2011* is lodged.

Most importantly, the fund cannot claim any ECPI without first obtaining an AC, even if the calculation required to determine the percentage appears quite straightforward and is worked out by the fund accountant, trustee or the administration software. These calculations can be useful estimates but they cannot be used as a basis for lodging the annual return.

Where a SMSF commences a pension very late in the financial year and has earned very little investment income after that time, the trustee may decide that the cost of obtaining the AC outweighs the value of the tax exemption. There is no requirement to obtain an AC under these circumstances.

Examples of unsegregated SMSFs	AC required?
Bob is drawing an ABP and Jan is still in accumulation mode	Yes
Greg (single member fund) has a transition to retirement income stream and is also making contributions	Yes
Jack and Pam are drawing down on ABPs	No <sup>1</sup>
On 1 October 2010, Justin and Janet commence drawing ABPs putting their SMSF into full pension mode.	No <sup>2</sup>
Paul has an ABP. He then makes a \$450,000 contribution into his SMSF. <ul style="list-style-type: none"> <li>• He leaves the money in accumulation.</li> <li>• He commences a pension immediately.</li> </ul>	Yes No
<ol style="list-style-type: none"> <li>1. Where all fund assets convert to pension, it is considered that the SMSF is segregated and therefore all assets are exempt from tax.</li> <li>2. As per 1 above. Income generated between 1 July 2010 and 30 September 2010 will be assessable and from 1 October 2010 all income is exempt. Furthermore, there is no need for an AC.</li> </ol>	

(Please note that different deadlines apply for the SIS certificates required for defined benefit funds)

### What doesn't the AC do?

Given the very specific purpose of ACs (ie. supporting a tax exemption within the fund) there are many things they don't do. For example, ACs obtained for the purposes of s295-390 **do not**:

- provide any form of compliance certification for the fund or the pension(s) – this is not required
- confirm the minimum/maximum pension amounts for the previous year or the following year. This calculation does not have to be performed by an actuary, and
- legitimise or confirm the commencement of a new pension. An AC is not required for this purpose. In fact, the first AC cannot be obtained

until after the end of the financial year in which the pension started. This is because the actuary needs to know the market value of the fund's assets and the pension accounts at the end of the financial year to do the calculations.

### Conclusion

Any AC is required annually for unsegregated funds paying any kind of pension and for any fund paying a DBP. Failing to satisfy the AC requirements may result in an SMSF losing its valuable tax exemption on the fund's income attributable to its current pension liabilities.

### Further examples

The table on page 13 outlines a series of circumstances where an AC would or would not be required by an unsegregated SMSF. ■

Seminar Series  
2012

Taxpayers AUSTRALIA INC

# 2012 SEMINAR SERIES

Presented by Roger Timms  
Head of Tax & Superannuation

### Fringe Benefits Tax

Melbourne: Tuesday 14 February  
Sydney: Thursday 16 February  
Brisbane: Tuesday 21 February

### Superannuation

Melbourne: Thursday 31 May  
Sydney: Thursday 7 June  
Brisbane: Tuesday 29 May

### Small Business & CGT Concessions

Melbourne: Tuesday 28 August  
Sydney: Thursday 30 August  
Brisbane: Thursday 23 August

### Estate Planning

Melbourne: Thursday 15 November  
Sydney: Thursday 22 November  
Brisbane: Tuesday 20 November

### VENUES

**Melbourne:**  
Leonda by the Yarra, 2 Wallen Road, Hawthorn  
**Sydney:**  
The Grace Hotel, 77 York Street, Sydney  
**Brisbane:**  
Royal on the Park, Corner Alice & Albert Street

### IMPORTANT INFORMATION

**Members:** \$209 (includes GST)  
**Non-members:** \$242 (includes GST)  
**Time:** 9am-12:30pm  
**CPE/CPD Hours:** 3.5 hours  
Attendees receive detailed notes & morning tea.

For more info & to register, visit [www.taxpayer.com.au/seminars](http://www.taxpayer.com.au/seminars)

# The Preservation Regime

By Graeme Evans

**In accordance with the relevant legislation, a member's superannuation interest must not only be broken down into its tax components (ie. tax free and taxable), but it must also be broken down into preservation categories. An understanding of these preservation categories is critical for Self Managed Superannuation Fund (SMSF) trustees. This article outlines the preservation regime to assist trustees to gain a necessary understanding of the relevant rules. [Unless otherwise stated, all regulation and division references are to the *Superannuation Industry (Supervision) Regulations 1994 (SISR94)*]**

---

## Overview

There are specific SISR94 rules on when a member's benefits must or may be paid from a superannuation fund (r6.21). They ensure that the voluntary cashing of a member's benefits are paid only in accordance with the payment and preservation operating standards which restrict access to benefits until a condition of release occurs. An example of a 'condition of release' is a fund member retiring from gainful employment after reaching his or her preservation age.

The concept of preservation of superannuation benefits is governed by the payment standards in Division 6.1 and Schedule 1 of the SISR94. Specifically, benefits may only be paid by being cashed out, rolled over or transferred in accordance with these standards.

## Preservation categories

Under the SISR94, a member's benefits in a regulated superannuation fund may comprise one or more of the following categories of benefits:

1. Unrestricted non-preserved benefits (ie. unpreserved benefits) (**UNPBs**).
2. Restricted non-preserved benefits (**RNPBs**).
3. Preserved benefits (**PBs**).

### Unrestricted non-preserved benefits (ie. unpreserved) (r6.10)

#### Definition

A member's unrestricted non-preserved benefits (**UNPBs**) can be withdrawn from a superannuation fund whenever the member requests, provided that the fund's trust deed allows for this to happen. A member's UNPBs are the sum of:

1. Member benefits in their current employer-sponsored fund that will become unpreserved

when the member leaves. The most common example is where the employee has made undeducted contributions (**UDCs**) (ie. called non-concessional contributions from 1 July 2007) to the fund before 1 July 1999. Those contributions can be cashed when the member leaves their employment with that employer, provided the employer has been making contributions to the fund as an employer-sponsor.

2. Certain Eligible Termination Payments (**ETPs**) from a source other than a superannuation fund, received by the superannuation fund before 1 July 2004 (ie. ETPs from an employer following termination of employment).
3. Any UNPBs rolled-over from another fund. Provided the recipient fund's governing rules allow, these benefits can be withdrawn at any time the member requests.
4. Any RNPBs (that is UDCs made between 1 July 1983 and 30 June 1999) that become unpreserved when the member is terminated with and employer who has contributed to that fund.
5. Member benefits of less than \$200 held in a standard employer-sponsor fund at the time the employee leaves that employer.
6. Member benefits held in a fund where the member:
  - reaches 65 years of age
  - retires between 55 and 60 and will not work again part-time or full time
  - turns 60 and ceases employment with an employer
  - suffers from a terminal medical condition
  - dies

- becomes permanently incapacitated and is unlikely to ever work again in a capacity for which he or she is reasonably qualified because of education, experience or training, or
- is temporarily incapacitated and the benefit is paid as a non-commutable income stream for a period of up to two years (or longer if approved by the Commissioner) whilst the member is temporarily unable to work.

Benefits may also be accessed on financial hardship or compassionate grounds. Benefits released under 'severe financial hardship' grounds are subject to limitations.

- in each 12 month period, where the amount withdrawn is a single lump sum which is a minimum of \$1,000 and a maximum of \$10,000, or
- where the member is at least 55 years and 39 weeks old and has received eligible Government support payments for a cumulative period of 39 weeks since turning age 55, and is not employed at least on a part-time basis, there is no limit on the amount withdrawn under this test. (Amounts withdrawn under this condition of release will be treated as a superannuation lump sums (**SLSs**)).

Benefits released under 'compassionate' grounds either:

- Limited to a single SLS determined by the regulator in the case where they are to:
  - pay for the treatment of a life-threatening illness
  - pay to modify a home and or a vehicle to suit the needs of a severely disabled person, or
  - pay for medical transport, palliative care, funeral or burial expenses.
- As an amount released in each 12 month period to:
  - prevent the forced sale of the member's family home however the amount released cannot exceed the sum of three months repayments and 12 months interest on the outstanding balance of the loan.

Where a UNPB has been cashed in the form of a pension, annuity, or the benefit is a non-commutable life pension or non-commutable life annuity, the investment earnings are UNPBs (r6.15A).

Once benefits become UNPBs, they will retain that status, until they are actually cashed by the member.

### Restricted non-preserved benefits (r6.07, r6.08 & r6.09)

#### Definition

A member's restricted non-preserved benefits (**RNPBs**) are UDCs made on or after 1 July 1983 and on or before 30 June 1999 that do not have to be preserved in a superannuation fund but cannot be cashed until:

- one of the 'conditions of release' occurs (see listing under 'Unrestricted non-preserved benefits' heading), or
- the individual leaves their current employer who had contributed to the fund on behalf of the member.

The calculation of a member's RNPBs as at 1 July 1999 depends upon the member's classification under r6.07 and whether the fund is a defined benefit fund or an accumulation fund.

Over time, RNPBs should become obsolete as they:

- cannot increase through contributions or investment earnings accruing on or after 1 July 1999
- can only increase through roll-overs or transfers of RNPBs to the fund, and
- can decrease by cashing, roll-overs or transfers from the fund, reclassification of preservation category, administration costs and negative investment earnings.

### Preserved benefits (r6.03)

#### Definition

A member's preserved benefit (**PB**) at any time on or after 1 July 1999, is the member's total benefit in the superannuation fund less the member's restricted non-preserved benefits (RNPBs) and unrestricted non-preserved benefits (UNPBs) (r6.03). As a member's PBs are, by this method of calculation, a residual amount, contributions and earnings of the superannuation fund automatically become preserved.

## EXAMPLE

Jake was 20 years old when he joined ABC Super Fund on 1 August 1999. This has been his only fund membership and he has not met a 'condition of release'. Therefore, the whole of Jake's superannuation benefit in ABC Super Fund is preserved, as no part of his benefit can comprise either of RNPBs or UNPBs.

If Jake, had joined ABC Super Fund prior to 1 July 1999, it would be necessary to first calculate the amount, if any, of RNPBs and UNPBs before the amount of PBs can be identified.

Preserved benefits remain preserved until a 'condition of release' occurs with no cashing restriction (see listing under 'Unrestricted non-preserved benefits' heading). Usually this is when a member retires after reaching their preservation age (ie. currently age 55, but gradually being increased to age 60). The benefits in the fund at the time the 'condition of release' is satisfied will then become UNPBs (ie. unpreserved benefits). Where a condition of release is subject to a cashing restriction (eg. terminating gainful employment with an employer sponsor, attaining preservation age etc.) preserved benefits may be cashed only in accordance with those restrictions.

### Rollovers

Where there is a rollover of superannuation benefits, that part of the rollover consisting of benefits that were PBs in the transferor fund continue to be PBs in the transferee fund (r6.06).

### Investment earnings on non-commutable income streams

Investment earnings on benefits in non-commutable income streams commenced under the transition to retirement income stream (TRIS) condition of release (Item 110 of Schedule 1 of SISR94) are classified as PBs until a 'Nil' cashing condition is satisfied (r6.15A). This effectively avoids the need to apportion investment earnings on a TRIS containing a mixture of preserved and non-preserved benefits.

### Allocation of negative investment returns

In the event that a negative investment return (ie. a loss) on or after 1 July 1999 is more than the amount of a member's PBs, the negative amount must be offset against the member's preservation categories in the following order (r6.16A):

- a. PBs
- b. RNPBs, and
- c. UNPBs

Alternatively, these negative investment returns can be absorbed against the superannuation fund's reserves, if any.

Fund trustees are responsible for determining the 'period' when investment returns are ascertained and allocated to member's benefits. Depending on the circumstances of the superannuation fund, this may be on a daily, weekly, monthly or annual basis. However, this period should be no longer than 12 months, consistent with the disclosure requirements for reporting periods under s1017D of the *Corporations Act 2001* (also see *APRA Superannuation Circular I.C.2* at paragraph 118).

As investment returns from 1 July 1999 are preserved in accordance with r6.03, a member's RNPBs or UNPBs which have been reduced because of earlier negative returns cannot be restored to their pre-reduction levels by subsequent positive investment returns.

### Family law issues

All SLs, rollovers or transfers of benefits in respect of a non-member spouse pursuant to a splitting agreement or court order under the *Family Law Act 1975 (FLA75)* are required to be taken proportionately from the UNPBs, RNPBs and PBs of the member spouse (r7A.12 and r7A.13).

### Termination payments

All employer eligible termination payments (ETPs) rolled over to a superannuation fund between 1 July 2004 and 30 June 2007 must be preserved. (Please note that since 1 July 2007, ETPs cannot be rolled over to a superannuation fund).

All directed termination payments (DTPs) rolled over to a superannuation fund from 1 July 2007 must be preserved.

### Other contributions

Contributions made under the superannuation CGT cap, government co-contributions and eligible spouse contributions must also be preserved.

### Contributions-splitting

A spouse contributions-splitting amount rolled over or transferred for the benefit of the member's spouse is deemed to be a PB (r6.15(2)) unless and until the fund trustee is satisfied that they are not PBs (r6.15(1)).

### Calculation of the pre-1 July 1999 amount

The rules for calculating a member's PBs before 1 July 1999 are contained in r6.02 and Schedule 2 of the SISR94.

### Other

The PBs of a member can also include:

1. benefits transferred from another superannuation fund, that are PBs in the transferor fund (r6.06 & r6.12)
2. contributions made, or benefits rolled over or transferred, to the fund which are taken by the trustee to be PBs (r6.15), and
3. benefits in the fund re-categorised by the trustee as PBs in accordance with the fund's governing rules (r6.16) (see below).

### Other matters

#### Redistribution of preservation categories

Regulation 6.16 of the SISR94 allows the governing rules of a superannuation fund, or the trustee of the superannuation fund, to move a member's benefits from one preservation category to another, so long as it does not decrease the member's PBs, or increase the member's UNPBs. The application of this regulation allows the fund's governing rules or the fund trustee to:

- change UNPBs into RNPBs, or
- change RNPBs into PBs.

### Conclusion

The preservation regime forms part of the payment standards applying to a superannuation fund, which must be complied with at all times. Fund trustees must be able to demonstrate compliance with these standards to their funds' auditor and to the regulator as required. Significant penalties may apply to fund trustees for failing to comply with these standards. ■

## Estate Planning 2011: Seminar Notes & DVD



Roger addresses Business Interests in an estate plan.

Avail yourself of the detailed notes, PLUS a 30-minute video presentation by Roger Timms, TAI's Head of Tax & Superannuation, summarising key issues relevant when establishing an estate plan. The DVD will assist in honing your skills by referring to the detailed notes.

**Estate Planning Notes & 30-minute DVD:** Members: \$110 / Non-members: \$143

**Estate Planning Notes only:** Members: \$77 / Non-members: \$88

View a preview of the DVD & order online, visit: [www.taxpayer.com.au/notes](http://www.taxpayer.com.au/notes)

Or, contact: 1300 657 572 / [info@taxpayer.com.au](mailto:info@taxpayer.com.au)

*NOTE: The DVD is a companion to the seminar notes and is not sold separately. Prices incl. GST and p&h.*

# Managing residency risk

By Graeme Evans

The continued growth in the number of complying Self Managed Superannuation Funds (SMSFs) together with an increasingly globalised workforce will undoubtedly lead to increased numbers of SMSF members working overseas. This possibility would not of itself cause a potential issue for SMSFs, but for the need to continually meet the definition of 'Australian superannuation fund' (ASF) as defined in s295-95(2) of the *Income Tax Assessment Act 1997* (ITAA97). Although this definition is relevant to all super funds, the residency based requirements are more likely to have an impact on SMSFs. The implication of not meeting this definition is the imposition of significant tax penalties by becoming a non-complying fund. This article examines the key requirements of the ASF definition which may be relevant where SMSF members are overseas for an extended period. Taxation Ruling TR 2008/9 (the Ruling), sets out the Commissioner's interpretation of the definition of ASF. The Ruling will be referred to in this article.

## Residency requirements

An SMSF must satisfy the relevant residency rules at all times in order to be eligible for the tax concessions available to complying superannuation funds (CSFs). A key requirement within the residency rules is the fund must be an ASF. For a SMSF to meet this requirement, it must satisfy three residency tests, all of which must be satisfied concurrently at some time during the year of income.

### Test 1 – Australian establishment or situated asset

The SMSF must either be established in Australia, or any asset of the SMSF must be situated in Australia. For SMSFs, this first test is readily met. The Ruling states that a super fund is established in Australia, if the initial contribution establishing the fund is paid to and accepted by the trustee(s) in Australia. The Commissioner says the 'establishment of the fund' requirement is a once and for all requirement. That is, once it is determined that a fund was established in Australia, it will satisfy this first test at all relevant times, even if at a later time, no fund asset is situated in Australia. It should also be noted that the place where the fund's trust deed is signed and executed is not relevant to this test.

### Test 2 – Central management and control (CMAC)

#### Overview

The CMAC test requires that, at a particular time, the CMAC of a fund is 'ordinarily' in Australia (s295-95(2)(b)).

In the Ruling, the Commissioner says that the CMAC test focuses on the 'who, when and where' of the strategic and high level decision making processes and activities of the fund. The test focuses on the performance of the following duties and activities:

- formulating the investment strategy for the fund
- reviewing, updating or varying the fund's investment strategy as well as monitoring and reviewing the performance of the fund's investments
- if the fund has reserves - the formulation of a strategy for their prudential management, and
- determining how the assets of the fund are to be used to fund member benefits.

Further, the Commissioner is of the view that the day-to-day operations of the fund's activities will not necessarily constitute CMAC, as they are not of a strategic or high level nature. For example, the acceptance of contributions, the actual investment of the fund's assets, the fulfilment of administrative duties and the preservation and portability of benefits **do not** in his view constitute CMAC.

#### Where is the CMAC exercised?

As CMAC is not defined in the ITAA97, its definition has evolved from case law, which defines CMAC as being where the real business is carried on (*De Beers Consolidated Mines Ltd v Howe* (1906) AC 455, 458), and the location where the business's operations are controlled and directed (*Koitaki Para Rubber Estates Limited v FCT* (1941) 64 CLR 241, 248).

The Ruling adopts this case law, stating that the location of the CMAC of the fund is determined by where the high level strategic decisions of the fund are made and high level duties and activities of the fund (as described above) are performed.

### Who exercises CMAC?

Establishing who is exercising the CMAC of a SMSF is a question of fact to be determined with reference to the circumstances of each case.

For a SMSF with individual trustees, it is the trustees of the fund that have the legal responsibility or duty to exercise CMAC of the fund. If the SMSF has a corporate trustee, it is the directors of the corporate trustee that have the legal responsibility or duty.

However, according to the Commissioner, the mere duty to exercise CMAC does not, of itself, constitute CMAC. It is the view of the Commissioner, that a trustee will only be exercising the CMAC of a fund if the trustee in fact performs the high level duties and activities of the fund.

If the SMSF utilises an investment manager to conduct day to day operations, this does not mean that the CMAC is exercised by the Manager.

### The 'ordinarily' in Australia requirement

Whether the CMAC of a SMSF is 'ordinarily' in Australia at a particular time involves determining whether, in the ordinary course of events, the CMAC of the SMSF is regularly, usually or customarily exercised in Australia. The Tax Office says that this requires some element of continuity or permanence.

#### TIP!

If the CMAC of a SMSF is being temporarily exercised outside of Australia, this will not prevent its CMAC being 'ordinarily' in Australia at a particular time (see TR 2008/9 at para 28).

### The 'temporary absence' rule

Over the course of its life, an SMSF's CMAC may be outside of Australia from time to time.

The temporary absence rule provides that the CMAC of a fund is deemed to be ordinarily in Australia at a time even if that CMAC is temporarily outside of Australia for a period of 'not more than two years' (s295-95(4)).

In the Ruling, the Commissioner says that the temporary absence rule does not otherwise restrict the meaning of 'ordinarily' so that the CMAC of the fund can only be outside of Australia for a period of two years or less. That is, if the CMAC of the fund is outside Australia for greater than two years, the fund can still satisfy the CMAC test if it satisfies the 'ordinarily' requirement (TR 2008/9 paragraph 31).

#### EXAMPLE

Assume husband and wife members of an SMSF were located outside Australia for a period of three years on a work assignment. As trustees they monitor fund investment activities and performance during the three year period and therefore exercise CMAC. The fund accountants attend to statutory obligations in Australia. Provided the husband and wife trustees are outside Australia on a temporary basis, the CMAC of the fund will 'ordinarily' be in Australia.

In the Ruling, the Commissioner indicates that factors which may be relevant in determining whether the absence is temporary may include:

- the intended and actual length of stay in the overseas country of the person or persons which exercise the CMAC of the fund
- any intention of the person or persons exercising the CMAC of the fund to return to Australia at some definite point in time or to travel to another country
- whether the person or persons exercising the CMAC of the fund have established a home (in the sense of a dwelling place; a house or other shelter that is fixed residence) outside Australia
- whether any residence or place of abode exists in Australia or has been abandoned because of the overseas absence, and
- the durability of association that the person or persons exercising CMAC have with a particular place in Australia, for example maintaining bank accounts in Australia, place of education of children and so on.

While the CMAC of a fund can be outside Australia for a period greater than two years, the Commissioner says the period of absence must still be temporary. Furthermore, if the CMAC of a fund is not temporarily outside of Australia, it will not ordinarily be in

Australia at a time even of the period of absence is less than two years.

**TIP!**

Where there are equal numbers of SMSF trustees both in Australia and overseas who equally participate in the CMAC of the fund, the requirement that the CMAC of the SMSF be ordinarily in Australia, would be met (TR 2008/9 para 175).

### Test 3 – Active member(s)

The ‘active member test’ requires that a fund has either no active members or, if there are active members, that at least 50% of all active members’ assets (either based on market value or the value payable to the member) are attributable to active members who are Australian residents (s295-95(2)(c)).

**TIP!**

Members of SMSFs should carefully consider the implications of making contributions whilst non-residents.

A member of a fund is an ‘active member’ at a particular time if he or she is a contributor to the fund or contributions have been made on his or her behalf. However, this does not include an individual who is a foreign resident and is not a contributor in his or her own right and after becoming a foreign resident has had contributions made on his or her behalf in respect of a period when he or she was an Australian resident.

**EXAMPLE**

Harry is an Australian resident and a member of an industry fund.

In August 2011, Harry’s employer makes a contribution into the industry fund. In September 2011, Harry ceases to be an Australian resident and from that time does not have any contributions made to his industry fund on his behalf. Harry is not an ‘active member’ from that time (ie. September 2011).

In October 2011, Harry’s employer makes a contribution for him in relation to work done in August 2011. Although both the August and October contributions relate to a period when Harry was an Australian tax resident, as he is now a non-resident for tax purposes, he does not become an active member because of the operation of s295-95(3)(b) (iii) in respect to the October 2011 contribution.

## Planning opportunities

A number of planning opportunities are available to SMSFs in order for them to satisfy tests 2 and 3.

### Appoint Australian residents as additional trustees or directors

Depending upon the type of trustee structure, appointing additional resident individuals as trustees or trustee company directors in order to achieve a resident majority may be an option, assuming suitable and willing individuals can be identified. Care will also need to be taken to ensure that any change in the residency of directors does not trigger a breach of the *Corporations Act 2001*, which requires that there be at least one Australian resident director.

However, fund members should consider whether it is desirable to introduce new parties to their SMSF and obtain legal advice where necessary.

**WARNING!**

Introducing additional members may give rise to issues of control. In addition, problems may also arise in the event of a divorce or a bankruptcy occurs.

### Changing to a corporate trustee

Greater certainty for satisfying the CMAC test and more flexibility can be provided by appointing a corporate trustee rather than maintaining individual trustees. The CMAC compliance may be more readily demonstrated where Australian residents hold a majority of the shares in the company and have voting rights. An Australian resident director may also be appointed chair and given a casting vote. In this regard, it is important to review the constitution of the company as some constitutions give equal voting rights to shareholders while others weight voting rights according to the number of shares held.

While strategic trustee decisions should be made in Australia, the day-to-day operational decisions may be made by circulating resolution (providing this is permitted by the company’s constitution). In the case of a corporate trustee, it is important to note that the *Corporations Act 2001* (**CA01**) requires the corporate trustee to have at least one director who must ordinarily reside in Australia (s201A CA01).

### Appoint alternative trustees by way of an enduring power of attorney

An alternative to appointing resident trustees or directors (and therefore, admitting additional members to the SMSF) is for the non-resident directors or trustees to execute an Enduring Power of Attorney (**EPA**) in favour of an Australian resident. This gives an Australian resident the power to act on their behalf as a director or trustee (that is, the attorney steps in as trustee or director and the non-resident ceases to be a trustee or director).

It is important to note, however, that an EPA is merely a means of enabling a resident to act in the role of director or trustee. Once the resident is a director of the corporate trustee, for example, they act in their own right and not, for instance, as an alternate director. It is important to note that the resident individual trustee or trustee company director acting under an EPA, performs the dual roles of LPR and trustee or directors of the trustee company.

#### **WARNING!**

SMSF trust deeds should allow for the appointment of an EPA holder!

#### **TIP!**

EPA holders are usually adult children or other relatives, close friends or a trusted family lawyer or accountant.

### Appoint an APRA approved trustee

Another option is to appoint an Australian Prudential Regulation Authority (**APRA**) approved trustee who can satisfy the residency requirements. This results in the SMSF becoming a Small APRA Fund (**SAF**) and switching regulators from the Tax Office to APRA.

#### **TIP!**

When a SMSF elects to appoint an approved APRA trustee, it must notify the Tax Office within 21 days of the change using the *Change of details for superannuation entities approved form* (NAT 3036).

It is important to note that SAF approved trustees also complete the fund's income tax and regulatory returns. There may be additional fees charged. They may also impose certain investment restrictions.

### Rollover benefits to a public offer fund and windup the SMSF

This is usually an option of last resort for SMSF members facing the possibility of non-residency. Whether this option is practical is likely to be dependent on the SMSF's asset classes, which will also determine their liquidity and volatility. It also raises potential CGT and legal consequences as well as the probable entry fees charged by the target rollover fund.

### Exercise caution with contributions

Provided the required level of planning is undertaken during periods where one or more SMSF members are non-resident, it is still possible for contributions to be made to an SMSF without it becoming non-complying due to a breach of the 'active member test'. As mentioned above, an active member is one for whom the fund receives contributions and rollovers. Caution should be exercised and professional advice obtained before any contributions are made to an SMSF that may have residency risk.

Contribution planning activities may include:

- avoidance of any form of contribution by or on behalf of members which are subject to residency risk
- considered use of 'spouse contributions' when only the recipient spouse is a resident, or
- make contributions to only public offer superannuation funds during non-residency periods and possibly rollover these amounts to the SMSF in a later period when residency had been resumed.

While each of the above alternatives may enable an SMSF to satisfy the CMAC test, the non-resident members may lose substantial control of their fund.

### Effects of non-compliance

This article has focused on strategies to stop an SMSF from becoming non-complying. Should these strategies fail to be implemented where necessary and an SMSF were to become non-complying, it would result in significant adverse tax consequences.

Broadly, these consequences are:

- the market value of the SMSF assets as at the end of the financial year before it became non-complying less the value of any undeducted contributions is included in the assessable income of the SMSF for the year it became non-complying
- the concessional tax rate of 15% is lost and the SMSF's taxable income will be taxed at the highest marginal tax rate (currently 45%), and
- the Commissioner may impose the general interest charge and penalties, where applicable.

## No discretion for non-compliance

Ordinarily, where an SMSF is to be made non-complying, the taxpayer can request the Commissioner to exercise discretion as to whether the SMSF is non-complying; by considering a range of factors (see the Tax Office's *Practice Statement Law Administration PS LA 2006/19* at paragraph 34).

However, where a notice of non-compliance is issued by the Commissioner because the SMSF fails to meet the definition of an ASF, the Commissioner (or any Tribunal) does not have the power to exercise a discretion to not apply the notice.

In *CBNP Superannuation Fund v Commissioner of Taxation* (2009) AATA 709, an audit contravention

report for an in-house asset breach was reported to the Commissioner. Upon further investigation, the Commissioner found that the fund was not a resident fund and issued a notice of non-compliance for this reason. The taxpayer requested a review by the Administrative Appeals Tribunal (**AAT**) and ultimately argued that the AAT should be able to exercise a discretion in relation to the fund being non-complying. Although the AAT sympathised with the trustee of the fund, it found that no discretion was available and held that the fund did not satisfy the definition of resident superannuation fund.

## Conclusion

Advisers with clients who are SMSF members and who leave Australia for extended periods of time should review the SMSF residency rules and implement appropriate strategies before their clients leave for overseas in order to prevent SMSF's from becoming non-complying and thereby avoid a significant tax impost.

Where an adviser becomes aware of an SMSF which has a non-resident member, the arrangements for this SMSF should be reviewed to ensure compliance with the residency requirements. If there appears to be a contravention, appropriate professional advice should immediately be sought to identify remedies. ■

## Dates for your diary

<b>28 November 2011</b>	<i>Super guarantee charge statement – quarterly</i> for quarter 1 (1 July - 30 September) 2011-12.
<b>1 December 2011</b>	Payment of income tax for taxable large/medium business super funds Lodgment of the return is due 15 January 2012 (except where there is a prior year income tax return outstanding as at 30 June 2011).
<b>15 December 2011</b>	Due date for the payment of assessments of superannuation contributions surcharge and termination payments surcharge issued on 15 November 2011.
<b>22 December 2011</b>	Due date for the lodgment of superannuation assessment variation advice, where applicable, for the variation of an assessment issued on 15 November 2011.

# Taxpayers Australia membership application/product order form

## Taxpayers Australia subscription<sup>1,2,3</sup> ..... \$396 pa

*The Taxpayer*  Print only  Electronic only  Both  
*Tax Summary*  Print OR  Electronic  
*Tax Summary*  Print AND Electronic<sup>4</sup> ..... add \$22 pa   
 6 Helpline calls pa

## Superannuation Australia Subscription<sup>5</sup> Print \$326 pa Electronic \$293 pa

Includes *DIY Manual* and *Updates* (quarterly),  
*Superannuation Quarterly*, *Superannuation Strategies*  
 and *Individuals Tax & Superannuation Online*  
 5 Helpline calls ..... add \$220

## Combined Taxpayers Australia and Superannuation Australia package<sup>6</sup> ..... Print \$627 pa Electronic \$605 pa

As per above entitlements  
*Tax Summary*  Print AND Electronic<sup>4</sup> ..... add \$22

Prices valid as at 01/07/2011 and subject to change. Includes GST and p&h.  
 1. Membership includes 24 issues of *The Taxpayer* (paper and electronic), *Tax Summary* (paper or electronic) and helpline.  
 2. Up to 6 helpline calls pa (limit of 10 mins per enquiry, incl research).  
 3. The electronic version of the *The Taxpayer* and/or *Tax Summary* can be downloaded from the members area of [www.taxpayer.com.au](http://www.taxpayer.com.au)  
 4. The additional cost of \$22 to receive the *Tax Summary* in both print and electronic delivery format, applies to ONE copy only as part of the membership.  
 5. Includes *DIY Superannuation Manual* on joining, *Updates* to the *Manual* and *Superannuation Quarterly*, *Superannuation Strategies* (quarterly) and *Individuals Tax & Superannuation Online*  
 6. Please indicate above configuration of delivery options for all publications. Introductory rate for first 12 months only.

## In-house publications Non-member Member

*Tax Summary 2011 & 2012* ..... \$121  \$99   
*The Taxpayer* (paper) ..... \$198 pa  \$143   
*DIY Superannuation Manual* ..... \$176  \$165   
 Updates for *Manual* (quarterly) ..... \$182 pa  \$171 pa   
*Superannuation Quarterly* ..... \$60.50 pa  \$55 pa   
*Superannuation Quarterly* and  
*Superannuation Strategies* ..... \$121 pa  \$110 pa   
 Monthly Tax Update Library:  
 11 issues per year (PDF download) ..... \$330  \$220

## Taxpayers Australia & Superannuation Australia Products

TA trial subscription (3 months) ..... \$156   
 (*Tax Summary*, 6 issues of *The Taxpayer*,  
 1 helpline call & members' website access)  
 SA trial subscription (3 months) ..... \$198   
 (*DIY Superannuation Manual*, 1 copy of *Superannuation Quarterly*, *Superannuation Strategies*, *Individuals Tax & Superannuation Online* and members' website access)  
 Binder: *The Taxpayer* ..... \$23  \$23   
 Binder: *Superannuation Quarterly* ..... \$23  \$23   
 Helpline plus (buys 5 calls) ..... \$220 pa

## Superannuation Trust Deeds

Economy Deed ..... \$286  \$253   
 Economy Deed (with PDS) ..... \$330  \$286   
 Deluxe Deed ..... \$440  \$407   
 Deluxe Deed (with PDS) ..... \$484  \$440

**Please call 1300 657 572 for more information or go to [www.taxpayer.com.au](http://www.taxpayer.com.au)**

Mr/Miss/Ms/Mrs First name \_\_\_\_\_ Surname \_\_\_\_\_

Company name (if applicable) \_\_\_\_\_ Address \_\_\_\_\_

City/town/suburb \_\_\_\_\_ State \_\_\_\_\_ Postcode \_\_\_\_\_ Member no (if applicable) \_\_\_\_\_

Daytime tel no \_\_\_\_\_ Fax \_\_\_\_\_

Email (please print) (required for electronic publications) \_\_\_\_\_

Please send me your: Free monthly super e-news  Free fortnightly tax e-news  Notify me when next year's Tax Summary available   
 I enclose my cheque made payable to Taxpayers Australia OR Visa  Mastercard

Card no. \_\_\_\_\_ Expiry date \_\_\_\_\_ / \_\_\_\_\_

Authorised payment amount (\$) \_\_\_\_\_ Cardholder's name \_\_\_\_\_ Signature \_\_\_\_\_

**Taxpayers Australia, PO Box 292, Kew East, Victoria 3102 Phone: 1300 657 572 Fax: 03 8851 4588**

Taxpayers Australia shall not be under any legal liability for any loss or damage whatsoever or whosoever caused to any person or entity using any product including but not limited to any written article, legal text or document, computer program or other product supplied by any third party on behalf of Taxpayers Australia to any party in respect of any loss or damage arising from or caused by either directly or indirectly the application and or use of the product supplied by the third party.

**This form becomes a Tax Invoice upon payment Taxpayers Australia Inc. ABN: 96 075 950 284 Reg.No A0033789T December 2011**