What is a Self-Managed Super Fund?

A Self-Managed Superannuation Fund (SMSF) is a trust where money or assets are held and managed on behalf of members to provide retirement income in the future. Essentially, SMSFs are for family members and close business associates who wish to take more control of their retirement savings.

Briefly, a SMSF is defined in the following way:

- has 4 members or less;
- all members must be trustees and all trustees must be members (except for single member funds);
- where the trustee is a company, all members must be directors of the trustee company and all directors must be members of the fund (except for single member funds);
- no member of the fund can be an employee of another member unless they are also related; and,
- the trustee cannot receive any remuneration for fulfilling his or her duties as a trustee of the fund.

Where there is only one member of the fund, there are only three trustee structures that are allowed:

- a company with the member as sole director;
- a company with the member as a director in addition to another director where, if the member is an employee of the other director, that director must be a relative; or
- two individuals acting as trustee where one is the member. The member cannot be an employee of the other trustee, unless the other trustee is a relative.

Being a small super fund and controlled by trustees who are also members of the fund, it is imperative that all individuals within a SMSF are prepared to be involved and actively participate in decisions which affect their retirement savings.

Why Establish an SMSF?

For many people the greatest advantage of a SMSF is the greater control, flexibility and investment choice they provide. Through a SMSF you have:

- Greater control over the investment strategy for the fund. This provides you with a greater ability to tailor an investment strategy to suit your circumstances and preferences.

For example, you can change the types of assets you invest your superannuation in and vary the allocation to each. This may mean increasing the allocation to property in your portfolio or varying the allocation to shares at particular points in time.

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Through our discussions you have indicated that this would be of benefit to you and is not currently available through your existing superannuation accounts.

You should note however that this benefit could also be achieved through other strategies such as using a discretionary master trust like Sunsuper and that it is not necessary to establish a SMSF to achieve this objective.

- A wider range of investment options such as direct property, small businesses and art. In some circumstances the SMSF can purchase assets from members of the fund, allowing better consolidation of investment assets.
- A SMSF can be tailored to meet your own personal circumstances in relation to estate planning. You can include family members as long as there are no more than 4 members in the Fund at any given time.
- The confidentiality that these funds provide. Highly paid executives who are able to have employer contributions paid to a SMSF may be able to keep their employment details confidential.
- A SMSF can be used as a vehicle to accumulate superannuation benefit whilst employed and can be maintained well into retirement and beyond, particularly where there are other family members in the Fund.

Additional Compliance Obligations

A major consideration in establishing a SMSF is the additional administration and compliance obligations that go with operating a SMSF.

If you decide to establish a SMSF, you will be a Trustee of the Fund and it will be your responsibility to ensure that the fund complies with the trust deed and the superannuation and taxation laws at all times.

As Trustee, you will need to cover a broad range of responsibilities, which include:

- Lodging appropriate documents with the ATO to establish and register the SMSF;
- documenting an investment strategy for the Fund;
- investing the assets of the Fund;
- maintaining proper records for the Fund;
- ensure annual accounts are prepared;
- having the accounts audited;
- submitting annual returns to the ATO; and
- ensuring that the Fund at all times complies with the relevant legislation.

You should be aware that there are severe penalties for Trustees who fail to ensure that a SMSF is properly administered.

SMSF Investment Restrictions

Although you do have more flexibility in the investments you can make through a SMSF, it is important that you are aware of the regulatory restrictions that do apply. The key areas relate to:

- meeting the sole purpose test;
- in-house asset rules
- conducting all transactions at arm's length
- acquisition of assets from related parties
- prohibition against borrowing (unless via an instalment arrangement under current legislation)
- prohibition on financial assistance to members and their relatives.

Underpinning the SMSF regulatory regime is the sole purpose test – the sole purpose of your fund must be to provide retirement benefits to fund members. In line with this, trustees are required, first and foremost, to have an investment strategy which they invest in accordance with.

A fund must also maintain its assets separately from those of a business in which one or more of the trustees is involved. For example, if assets are held in the name of one of the trustees rather than being clearly held as part of the fund, the fund risks the loss of the asset if the trustee is declared bankrupt or if their business is placed in receivership.

A failure to separate assets is a clear contravention of SIS. To help ensure that the assets of an SMSF will be available to provide retirement income, SMSFs are restricted in the investments they can make. However, one of the concessions that SMSFs enjoy is their ability to invest up to 100% of the fund's assets in business real property – though an issue for trustees to consider is whether this lack of investment diversification is a prudent investment strategy. You should also understand that residential property rarely fits the conditions necessary for it to be considered 'business real property'.

While there are no restrictions on SMSFs investing in collectibles such as art, the ATO has highlighted that the sole purpose test means that members cannot enjoy a benefit from the investment prior to preservation age. This means that it is unlikely that the art can be displayed in the trustee's home or office.

The meeting of fiduciary responsibilities by SMSFs is also important, particularly in relation to the fund holding its own bank account (rather than banking being done through personal accounts of one or more of the trustees) and not overdrawing that account.

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ATO Resources

You must also read the following attached documents from the ATO to help you understand your roles and responsibilities as a trustee of a SMSF:

- ‘Setting up a self-managed super fund’ (NAT71923)
- ‘Running a self-managed super fund’ (NAT11032)

Limited Recourse Borrowing Arrangement

Gearing or ‘borrowing to invest’ is a common strategy that uses borrowed funds to buy additional investments.

One benefit of gearing is that the pool of funds you have available to invest is bigger which allows you to spread your super balance across a wider range of investments, giving you greater diversification, helping reduce your overall investment risk and increasing your potential to earn more. In addition, some or all of the interest on the investment loan may be tax deductible.

Although the benefits of gearing are attractive, you should also be aware that the risks are generally much higher than for non-geared investments. If the investments perform badly, your losses will be magnified compared to the losses for a non-geared investment.

Understanding Gearing in Super

A super fund is now allowed to borrow money to invest provided all the following terms are met:

The borrowing, in conjunction with your cash contribution, is used to acquire an asset, including (but not limited to) equities, property and managed investments.
Assets are held on trust (via an ‘instalment trust’) so that the super fund receives a beneficial interest and a right to acquire the legal ownership of the asset (or any replacement) through the payment of instalments.

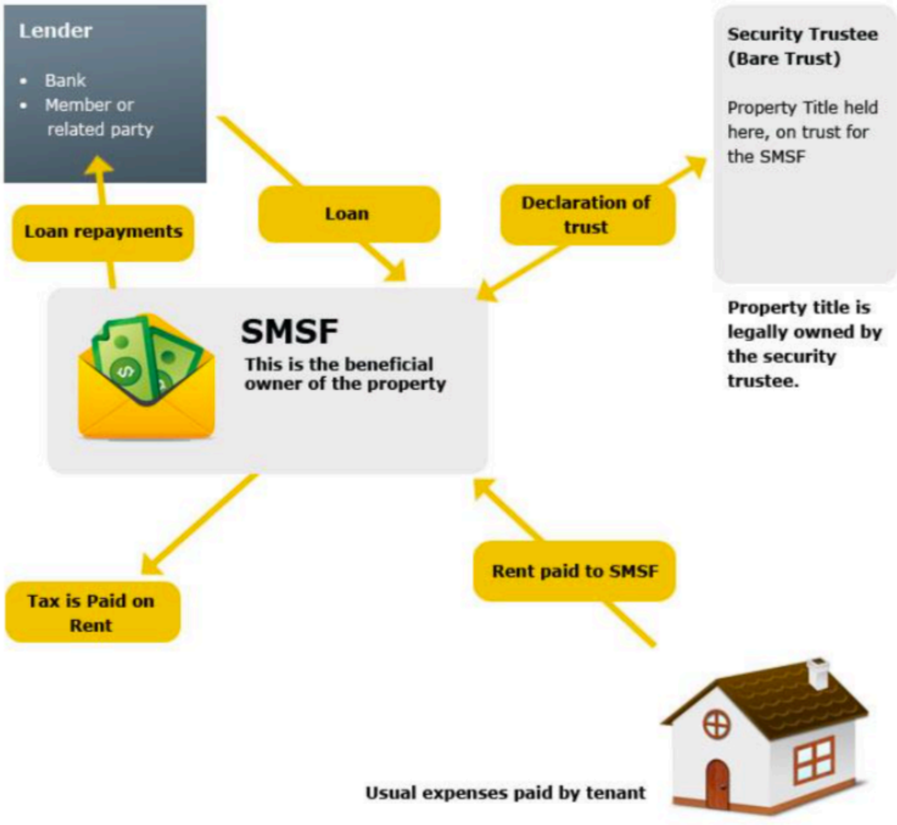
The lender’s recourse against the fund’s trustees in the event of default on the borrowing and related fees, or the exercise of rights by the fund’s trustees is limited to rights relating to the asset. The lender cannot recover money through the fund’s other assets.

The asset (or any replacement) must be one which the super fund trustees would be permitted to acquire and hold directly (i.e. the existing investment restrictions continue to apply).

To invest via an ‘instalment trust’, a super fund requires an Appropriate Investment, a Trust Structure and a source of Limited – Recourse Finance.

There are steps you can take to minimise the risks associated with gearing in super and these are outlined in my recommendations.

This diagram of an instalment arrangement structure may help you understand how it works:



Just as with gearing in a non-super investment, the benefits of gearing within a super fund will depend on a number of factors, including (but not limited to) investment returns, interest rates, taxation, the amount borrowed and your ability to cover the interest costs of the loan.

It is important you seek appropriate legal and taxation advice prior to implementing a gearing in super strategy.

Setup of a Limited Recourse Borrowing Arrangement

When you have decided upon the Investment Property you would like to purchase, we recommend you establish a limited recourse borrowing arrangement to allow the fund to borrow money to meet the shortfall.

This will allow the fund to purchase a beneficial interest in the asset and take advantage of receiving all of the income, without having to fund the total cost upfront. The fund will not have legal ownership of the asset until the loan is repaid.

These are the steps that you need to complete:

1. Establish a Holding Trust (Bare Trust)
   To establish the Trust, the fund will require the services of a qualified legal professional to draw up the legal documentation. We recommend the custodian is an entity other than the Trustee of your Super Fund.
2. Identify the Asset to be purchased
3. Apply for a Loan to fund the purchase of the asset
4. Income and Tax Deductions
   When the Holding Trust is established, your fund will receive all of the income from the asset, such as rent, and will be entitled to claim any associated tax deductions such as maintenance and interest costs. If the fund is in pension phase, the income will be tax free and therefore expenses will be non-deductible. We strongly recommend tax advice is sought in relation to these matters.
5. Make your Loan Repayments
6. Acquiring the Asset
   If the loan is full repaid, the Super fund has the right (but not the obligation) to acquire the asset. An assessment of whether or not your fund acquires the asset at the end of the term of the loan will be determined closer to that time.
7. Stamp Duty and Capital Gains Tax Issues
   Stamp Duty and Capital Gains Tax may apply on the transfer of the asset to the fund from the Limited Recourse Borrowing Arrangement. Professional legal advice must be obtained to avoid double Stamp Duty and Capital Gains Tax issues.

Things you should consider

- Gearing increases the risk and volatility of your total portfolio. If the value of your portfolio decreases, gearing will magnify the loss that results from the decrease in the value of your portfolio.
- The interest rate on the investment loan may be subject to change at any time. This will affect the affordability of your loan repayments and may have a negative effect on the net returns of your portfolio.
- You must ensure your Fund has adequate cash flow. Failure to meet loan repayments will result in default, giving the loan provider the right to take action to enforce its security. This may result in the redemption of the fund’s investments at an unfavourable time and at an unfavourable price.

- The loan must be limited in recourse and be used to purchase an asset which is held on trust. The superannuation fund will have a beneficial interest in the asset. The asset purchased must be an asset which:
  - the fund would not be prohibited from acquiring
  - would not be considered an in-house asset if it were purchased directly by the fund
  - The fund maintains the right to acquire the legal ownership of the asset after all the instalments have been paid.
- When considering how you will repay the loan it is critical that you consider the superannuation contribution limits. These limits allow you to make a non-concessional contribution of $180,000 per financial year or if eligible at a maximum of $540,000 over a period of 3 financial years provided you are under age 65 at the start of the first financial year in which the contributions are made in excess of the $180,000 limit. Amounts contributed in excess of the limit are subject to tax at the top marginal rate (plus Medicare levy). The tax will be levied against the individual who must withdraw the amount from the superannuation fund or instruct the superannuation fund to pay the tax directly to the Australian Taxation Office (ATO).
- Other potential consequences of contributing more than the non-concessional contribution limit could include a loss on the additional contribution where the value of your portfolio has decreased. The withdrawal of the tax liability may also affect the structure of your overall investments within your superannuation fund and this may change how your superannuation is invested. If you decide to contribute more than the above limits you should seek independent taxation and or legal advice in relation to your decision.
- Any Fund assets cannot be used as security for the borrowings. Where the lender requires a party (such as a member of the SMSF) to act as guarantor for the limited recourse loan, that party will be liable for any loan repayments should the superannuation fund fail to make an instalment and hence default under the loan arrangement. In order to meet the requirements of the Superannuation Legislation you will also need to waive any right you have as guarantor to indemnity from the borrower (i.e. the superannuation fund). This means you will not be able to recover any amount from the superannuation fund that you become liable for in your capacity as guarantor. The Australian Taxation Office has advised that in certain circumstances a guarantee payment under an instalment warrant arrangement could be considered a contribution to the superannuation fund. In this case the contribution could be taxable if made as concessional contribution. You would also need to consider any relevant contribution caps.
- The trust deed of the Fund must allow the trustee of the superannuation fund to borrow and the Fund's investment strategy must justify the appropriateness of the investment and specifically addresses any risk that may arise as a result of limited recourse loan.
- The new provisions in the legislation are quite broad and remain open to interpretation. To date the regulators have only provided limited clarification on their approach to governing the new provisions. Given the broadness in the drafting of the provisions and the lack of clarification by the regulators, there remains a degree of legislative risk involved with implementing strategies concerning borrowing within superannuation.

- Moving an asset owned by you into your superannuation fund may trigger capital gains tax and stamp duty implications. There could also be additional tax implications when paying a death benefit from your super fund to a non-tax dependent. It is important that you discuss these implications with your tax adviser before implementing my advice.
- To ensure the arrangement complies with the appropriate requirements you should seek professional advice from your legal adviser and accountant. Your legal adviser should also assist you in the review and development of any legal documentation required.

- A gearing strategy requires surplus cash flow. You need to consider how the fund will meet the instalments when they fall due. If the contributions, expenses or any other aspects of the fund change, and result in a decrease in surplus cash flow, please contact me to review the strategy.
- Gearing increases the funds under management and therefore my advice and service fees.
- Legislative risk should also be considered. Current rules and regulations may change in the future – especially in regards to Capital Gains Tax and interest deductibility.
- Changing the underlying investments, or redeeming from the recommended investments prior to the minimum timeframe of five years, may mean exposing the fund to volatility risks and may be redeeming the investments at a loss or unfavourable price.