

NEWSFLASH BOOKLET

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SELF MANAGED SUPERANNUATION FUNDS

Important – This booklet is simply a collection of Newsflash articles relevant to SMSF. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

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Super Funds Allowed to “Borrow”

That is the wording being used and some talk suggests super funds can borrow in the same fashion as other entities. This is not correct; there are many restrictions on the circumstances under which a super fund can “borrow”. The two most important being that the loan must be have limited recourse and that assets of the super fund cannot be used as security.

By the way the borrowing does not have to be for property it can be any other assets that a super fund is permitted to purchase.

The way the approved loans work, the super fund borrows money from the “lender”, the lender’s only security is an asset held in trust for the benefit of the super fund. This is where the limited recourse comes in. The Lender can only recover this property if the super fund defaults. The Lender has no further right of action against the super fund’s assets. So the Lender is going to want the super fund to come up with quite a large deposit for the asset held in the trust and probably charge a higher than normal interest rate. The super fund invests this “deposit” in the trust; once the final instalment has been made the asset is transferred to the super fund.

Due to the high costs of these loans a way around this problem maybe to borrow from the bank under normal conditions and then provide the appropriate loan to your super fund yourself. The asset held in the trust could be used as security plus cash from the super fund for the first instalment being the deposit the banks require on a normal loan or you could use other assets held outside the super fund but you cannot use super fund assets. This strategy is accepted by the ATO but we feel it is a vulnerable area as can lead to many abuses so if there is any area of these arrangements where the law is likely to change this is it. You would also need professional advice to make sure the arrangement does not get caught by section 66 of SISA Another option may be to persuade the bank to offer the limited recourse loan but reduce the premium by offering your personal guarantee. Again this maybe caught by section 66. These areas are discussed in detail in the next article.

SMSF borrowings have come about because of changes to section 67(4A) at the end of September, 2007 so there is a lot of dust to settle yet on how the law is going to be interpreted.

ATO Speaks Up About Super Fund Borrowings

On Friday 4th April the ATO released a Tax Payers Alert and a Fact Sheet on the issue of Superannuation Fund borrowings (Instalment Warrants). The law only changed in September 2007 so there has been a great variety of opinion as to how the new laws will be interpreted by the ATO. Professional opinions varied and until now the ATO had remained silent. The following is a summary of the issues covered by the ATO that are relevant to our discussions. The full transcript can be obtained using the ATO web site’s search engine. Search the Aggressive Tax Planning section for TA 2008/5 and the All ATO (except legal data base) section for Instalment warrants and super funds - questions and answers . With the main stream lenders only just starting to come into the non-recourse loan market place, interest rates and charges should become more competitive in the future so it would seem certainty and savings can be gained by waiting a while before entering into these arrangements anyway.

The ATO clearly states that the new law does not prohibit the lender being a related party to the superannuation fund. But it warns in doing so, the superannuation fund must not breach the sole purpose test. The ATO feels this would be breached if the interest charged on the loan was higher than market rates and if it was lower than market rates the interest saving to the superannuation fund could be considered a superannuation contribution by the member which may breach the superannuation contributions cap and lead to excess non-concessional contributions tax being payable.

If a party related to the superannuation fund, provides a personal guarantee to a lending institution in order to secure a “limited recourse loan” for the superannuation fund, the loan may not be considered limited recourse.

If the interest on the loan is capitalised that new borrowing would not be considered to be for the acquisition of the asset so would not be permitted.

A Summary of the Issues with SMSF Borrowings

When the laws were changed to allow superfunds to borrow (if the lenders recourse was limited to the asset the fund borrowed to purchase) there was, surprising, very few changes to the legislation. It left the field wide open, so the object of this article is to list the relevant issues and divide them into must haves and best to avoids. The must haves are specified clearly in the legislation or recent ATO statements and the best to avoids are a grey areas or areas that may change once the dust settles so if you must go there make sure you have an ATO ruling first.

Due to our cheeky name and clever tricks you may consider us to be teetering on the edge of legitimate tax concessions. Its' not the edge we are looking for it is the wall. We take our clients to the absolute limit of where there is clear precedents in case law, legislation or ATO rulings. The BAN TACS advantage is we do the research to find this wall then we find what lays beyond and advice our clients to apply for a ruling to go to the edge. This article shows you the wall and the edge:

The Wall – Must Haves – Clearly required by legislation or ATO warnings

- 1) An “instalment” trust must be set up to hold the new asset until it is no longer required as security
- 2) The asset purchased must be of the type permitted to be purchased by SMSFs ie not domestic rental properties from members or not in breach of the in house asset rules
- 3) The purchase must be within the scope of the investment strategy
- 4) The SMSF trust deed must allow borrowings in this fashion
- 5) The sole motive of entering into the transaction must be to provide for the retirement of the SMSF members.
- 6) The lender of the funds must not have access to any of the superfund's other assets, in the event of default the lender can only take the asset held in the instalment trust.
- 7) If the lender is a member (currently allowed but an area of contention with the ATO) the funds must be lent to the SMSF at market rates, no more or less.

The Edge – Best to Avoid – Quite possibly legal but considering the costs involved in setting up this arrangement, best to get an ATO ruling before going this far.

- 1) Utilising the equity in an asset held in the instalment warrant trust to purchase another property
- 2) The CGT and stamp duty ramifications if the instalment warrant trust is anything other than a bare trust for the SMSF
- 3) A member lending the funds for the investment. This is currently permitted but can lead to so many problems the government may well have to change the law to prohibit such arrangements.
- 4) The members of the SMSF or its trustee or the trustee of the instalment trust giving personal guarantees to the lender.

Lender Update:

The main stream banks are finally entering the market, this is bringing down borrowing costs and interest rates but of course they are conservative. Westpac is the first to release its SMSF loan, price wise it is very competitive, but it requires a guarantee from the SMSF member, so we suggest you get an ATO ruling that this will be acceptable. There is a boutique lender, Calliva Funding, offering a loan that does not venture into the areas we are concerned about but it is a bit more expensive. NAB have just released a product for commercial property only with no personal guarantees if the LVR is 65% and the rent covers the repayments. On the surface it looks like the NAB is a bit cheaper than Westpac.

The Benefits:

So you maybe saying why, when things are so uncertain and costs so high, are people jumping in so enthusiastically? Borrowing through your superannuation fund combines four very sought after benefits:

- 1) Asset protection – providing your contributions to the super fund are not out of character, your creditors cannot access your super fund's assets in bankruptcy.
- 2) Negative gearing – by salary sacrificing or if you have no employer support by making tax deductible contributions to the superfund you are effectively getting a deduction for those payments at your highest marginal rate. If the property is negatively geared in the superfund it will not have to pay the

15% tax on those contributions because they will be offset against the rental property losses. This is as good as if the property was in your own name for tax deduction purposes but it gets even better

- 3) Unlike, if the property was still in your name when you sell or it becomes positively geared the superfund is the one taxed on it at only 15% for the net rent and 10% for the capital gain. Or if the fund has changed to pension stage there is no tax on the net rent or capital gain.
- 4) You get a tax deduction for principle repayments because you get a tax deduction for the super contributions that make the principle repayments but the superfund will have to pay 15% tax on those contributions. So if you are in the 31.5% bracket you are getting a 16.5% tax deduction for making principle repayments, still a lot better than no tax deduction if you make them in your own name. If you are in the 46.5% bracket it means you are effectively getting a 31.5% tax deduction for principle repayments. Further the 15% can be offset by any depreciation that is available to be claimed.

SMSF Auditors will be getting a lot tougher

From the 1st July, 2008 the ATO got a lot tougher on Self Managed Superannuation Funds (SMSFs). The rules are mostly the same but the penalties have increased and a lot of the discretion has been taken away from the SMSF auditor so we will have to report to the ATO what might be considered only a minor infringement. The penalties to a trustee of a SMSF are now up to \$5,500 or 2 years jail for breaches as simple as not appointing an auditor at least 30 days before the SMSF's tax return is due to be lodged. An added worry here is the shortage of accountants, so don't leave it till the last minute. You can expect your auditor to dob you in too, as he or she would be risking a \$5,500 fine or 6 months goal if they don't.

Here is a list of other breaches that auditors are required to report to the ATO:

- Not meeting the definition of a SMSF. The fund cannot have more than four members and they must all be trustees or directors of the trustee if it is a company. The parent of a minor member can be trustee or director for them. Trustees cannot be paid by the fund for their services and no member can employ another member unless they are family. There must be at least two trustees or a company as trustee.
- The trustee or if applicable its directors must not be disqualified from acting. Each year the trustee must make a declaration to this affect. If they do become disqualified and they are also a member of the fund then they may have to move their interest in the fund into a public fund within 6 months of becoming disqualified. A disqualified person is a person convicted of an offence involving dishonesty, a person who has been penalised regarding a SMSF, a bankrupt or under some other form of legal disability
- Documents must be provided to the auditor within 14 days of any request to do so.
- The monies and assets of the fund must be kept separate, for example not accidentally deposited into a non SMSF bank account. A safe guard here would be to arrange for dividends to be automatically debited to the SMSF's bank account. As the cheque will have the name of the trustees on it, it would not be hard to mix SMSF dividend cheques up with private cheques. An unintentional error of depositing dividends in the wrong account is not reportable to the ATO if the Trustee rectifies the situation as soon as he or she becomes aware of it.

If you cannot put the asset in the name of the SMSF (which maybe as simple as the trustees names with ATF after them) and it has to be held in just the personal names of the trustees then make sure you prepare a minute declaring that the asset was purchased on behalf of the SMSF.

- All investments by the fund must have the sole purpose of providing for the members' retirement or family in the event of their death, that is why investments in works or art of jewellery are difficult to justify. Life insurance is acceptable because it provides for the member's family in the event of their death but trauma insurance, that pays a benefit on the diagnosis of a major medical problem would not fit this definition.
- Maintain an investment strategy. This is a minute the covers the fund's investment objectives, the member profile ie years till retirement, risk factors, cash flow and diversification, ideally setting out a percentage of the funds to be held in each asset class.

It is important that each year you review this statement to make sure it does not contradict the activities of the fund.

- The SMSF must not lend to members or their relatives, this includes allowing them to get behind in their rent for business premises used in the member's business. The prohibition of providing financial assistance to a member is quiet wide, the ATO have issued draft ruling SMSFR 2007/D2 with their opinion and examples.
- The SMSF must not purchase assets from members and their relatives with the exception of business real property and widely held shares. There are also concessions in the event of marriage breakdown, inhouse assets up to 5% of the funds assets and units or shares in non geared companies or trusts.
- If a member purchases an asset off the SMSF or sells one to it, the price must be at market value consideration.
- Assets held by the fund must not be mortgaged in anyway.
- Other than business real property, the fund can only invest 5% of the funds assets in items used in a members business
- Minutes must be kept
- Each new trustee must sign a declaration within 21 days of being appointed. If this is not done within at least 14 days of the 21 day deadline we are required to appoint this contravention to the ATO.
- The contributions received by the fund must be within the limits set on contributions ie work requirements, age etc.

This list is an ATO minimum your auditor may consider other breaches significant enough to report to the ATO. The message is if you don't fully understand your role as trustee of your SMSF then don't make a move without consulting your accountant.

If you are thinking that later in life you will sell off some properties to live off the proceeds or simplify your life, don't leave it so late that you can't reduce the affect of the capital gain by contributing to superannuation. The right retirement planning now means paying no tax at all by the time you reach 60 until you die. With the use of a transition to retirement pension you can also arrange your affairs so that you pay no more than 15% tax from the time you reach 55 even though you are still working.

If you are looking to pay no tax at all once you reach 60 then you need to plan to only have \$21,680 in taxable income each as a member of a couple, outside of superannuation. This is the figure for 2008, it is index each year, just as your rents will increase so will that threshold. But what happens when you run out of depreciation to claim? The next trap could be that you may not be able to spend all your income. You will be forced every year to draw a minimum amount out of your pension fund. This is a percentage of the total amount in there. The percentage increases as you get older. If you don't spend all this it could earn you income and push you over the tax free threshold mentioned above. Terrible problem to have but a good reason to start out with earnings considerably under the threshold while you still have the opportunity to move funds into superannuation.

Ultimately, you will need to find some clever ways to cash in your properties without losing too much to CGT. You need to look at each of your properties and see if any of them would fit into the following tricks: Taxable Gain of less than \$200,000 after the discount and owned in joint names. This is a great one to sell just after you retire if you are over 50, though if you are over 65 you will need to carefully combine the work test and having so little in wages that you qualify to claim a tax deduction for your superannuation contribution.

The Beach shack with a huge capital gain. Hopefully you have had the foresight to hold, in your rental property portfolio a little beach shack that will suit you very well for your retirement. Being by the beach will probably also mean it has heaps of capital gains tax attached to it. Never mind if it is still considered you home when you die your heirs inherit the property at the market value at your date of death. Yes, all the lurking CGT liability disappears. This means you have effectively covered both your old home and this beach house as your main residences during the time you owned your old home. Don't worry if you are living somewhere else in your later years you can rent the place out for 6 years and still have it considered your main residence when you die but if you go over the 6 years it maybe more profitable to not rent it out. You see the 6 year rule extends to an indefinite period if the property is not income producing. Now what about getting the beach house into a state suitable for your retirement? Make sure you do all the repairs to get it into just as good condition as it was in when you purchased it, while it is still a rental or at least in the same financial year that it was a rental so the cost will be fully deductible.

The house you used to live in before you updated to your current one. As discussed on page 64 of March API the last place you want your main residence to be is the property you live in because any expenses (including interest, rates, insurance, repairs and even light globes and cleaning materials) that are not claimed as a tax deduction can increase the cost base if it was purchased after 20th August, 1991. If it is a rental then those expenses would have been claimed as a tax deduction. So if you have a previous home that is now a rental see how little CGT you would have to pay if you sold it but left your main residence exemption there for 6 years after you moved out.

The family home, being classic baby boomers you probably have a house that is far too big for your needs now. If you can't use the trick above, this can usually be sold free of CGT and without reducing deductible debt ie deductions against income outside of superannuation. If you can utilize the trick above still do the sums on this option after claiming all the holding costs while you lived there the CGT maybe minimal. It's not just the costs while it wasn't covered by your main residence exemption that increase your cost base it is the costs for the whole time you lived there.

Pre CGT property Note if your home is pre CGT make sure you leave your main residence elsewhere if you have ever lived in any of your other properties. A Pre CGT property is the best one to sell later in life (maybe the nursing home nest egg) as your death will mean it loses its pre 1985 status anyway so you have made the most you can of it and as the proceeds will be tax free you don't have to worry that you are too old to put them into super.

Consider changing the property to commercial. This is something to do while you are still able to contribute to superannuation. You see a property that is used solely in a business can be transferred into your superannuation fund. Superannuation law does not specify that it be a commercial building though you would probably be in a bit of bother if the business isn't legally allowed to operate there. A change of use to home occupation won't cut it because you would have to live there as well which would mean it wasn't solely used for business. The business does not have to be your own business and it can be any type. For example professional rooms which domestic properties easily adapt to. Just remember that transferring the property into your SMSF will still create a CGT liability for you and if you put some of the proceed of the sale into the superannuation fund to help it pay for the purchase the fund will pay 15% tax on them if you claim the contribution as a tax deduction.

Hopefully that is enough to get all your retirement savings exactly where you need them at minimal tax. Don't feel mean leaving the CGT to your children. They are only going to pay it if they sell the property and then there are some strategies they can also implement. For example to get the small business CGT concessions which can reduce the CGT to zero an asset has to be used in a business for 7.5 years or half the time it is owned. Leave the high CGT property to a child in business. They can use it in their business and as long as they qualify as a small business and have used the property in the business for half the time they (not you) own it they could eliminate the CGT completely.

You have to get financial planning advice to get these ideas to work at their best for your circumstances. This is just intended to get you thinking and maybe dreaming.

SMSF Purchasing Your Rental Property

BAN TACS is getting quiet a reputation for coming up with tax solutions that are thinking outside of the box. But we have to give some credit to our imaginative clients. This one was all her idea we just had to check up on the legislation.

The client has a home that is also her place of business but it looks like a normal home on the outside. She would like to get this property across into her SMSF because she wants to live elsewhere but is happy for the business to continue operating from the house. Her question was if the business is operating from there is it business real property which qualifies for the exception under section 66(2) which will allow the SMSF to purchase it from its members. The answer is yes! She was talking about changing the zoning etc but the legislation makes not mention of commercial zoning being necessary, though on the other hand it may interfere with the argument that a business is being carried on in the premises if it is not permitted by council

to do so. The property must be exclusively used in a business (not necessarily the business of the owner) so this means she would have to move out and use the whole property in the business. This also means that a simple home occupation right with council will not suffice because it would be conditional upon the owner living there.

The relevant of the Superannuation Industry Supervision Act 1993 are:

Section 66(2) (b) if the fund is a superannuation fund with fewer than 5 members – the asset is business real property of the related party acquired at market value.

Section 66(5) Business Real Property (a) any freehold or lease hold interest of the entity in real property or (b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer... Where the real property is used wholly and exclusively in one or more businesses.

Business includes any profession, trade, employment vocation or calling carried on for the purpose of profit including:

- (a) The carrying on of primary production; and
- (b) The provision of professional services

But does not include occupation as an employee

Of course such an investment needs to be within the fund's investment strategy.

SMSF Audit Hot Spots

There have been changes in the laws regarding Self Managed Superannuation Funds. Particularly alarming are the new penalty provisions for example we could be fined \$5,500 or face 6 months imprisonment if we don't lodge the audit report on time, so please get your work in early this year.

As trustee of your SMSF you also risk a \$5,500 fine or 2 years jail if you do not appoint an auditor at least 30 days before the report is due, the due date is the date the SMSF's tax return is due to be lodged. Worse still we are compelled to report you to the ATO for this contravention. In fact the list of reportable contraventions has increase considerably; it now includes a duty of the trustees to keep minutes. Each new trustee must sign a declaration within 21 days of being appointed. If this is not done within at least 14 days of the 21 day deadline we are required to report this contravention to the ATO.

Further if we request information from you and do not receive it within 14 days this is also a reportable contravention. To help keep this area tidy here is a list of the sort of material we need to perform an audit:

- The minutes, original banks statements, dividend notices, share transaction documents and rates notices
- The trust deed and investment strategy
- A declaration from the trustees that they are not disqualified from holding office, that there are no related party transactions and no charges have been made over the fund's assets
- If the portfolio includes properties, each year you need to inform us of the market value of each property and the market rent.

Super Funds Allowed to “Borrow” to Buy Property

That is the wording being used and some talk suggests super funds can borrow in the same fashion as other entities. This is not correct, there are many restrictions on the circumstances under which a super fund can “borrow”. The two most important being that the loan must be have limited recourse and that assets of the super fund cannot be used as security.

By the way the borrowing does not have to be for property it can be any other assets that a super fund is permitted to purchase.

The way the approved loans work, the super fund borrows money from the ” lender”, the lender's only security is an asset held in trust for the benefit of the super fund. This is where the limited recourse comes in. The Lender can only recover this property if the super fund defaults. The Lender has no further right of action against the super fund's assets. So the Lender is going to want the super fund to come up with quite a large deposit for the asset held in the trust and probably charge a higher than normal interest rate. The super fund invests this “deposit” in the trust, once the final instalment has been made the asset is transferred to the super fund.

To date it does not seem that any lenders are offering this facility and it is expected that if they did, in order to compensate for the limited recourse, the interest rate would be higher and probably only a 50% lend.

A way around this problem maybe to borrow from the bank under normal conditions and then provide the appropriate loan to your super fund yourself. The asset held in the trust could be used as security plus cash from the super fund for the first instalment being the deposit the banks require on a normal loan or you could use other assets held outside the super fund but you cannot use super fund assets. The ATO has not yet commented on whether it would be acceptable for a member of a super fund to provide the borrowings and it certainly seems that of section 66 of SISA could prevent a member or his or her associate from being the lender or the trustee for the asset subject to the loan. Another option may be to persuade the bank to offer the limited recourse loan but reduce the premium by offering your personal guarantee. Again this maybe caught by section 66.

The changes to section 67(4A) that opened up this possibility, only became law at the end of September, 2007 so there are no cases or ATO rulings to use as a guideline yet. I have read commentary on both sides of the fence regarding section 66 so I would prefer to wait and see at this stage.

Current costs for setting up such an arrangement range from \$5,000 to \$23,000 so it is not worth it for the average investor. If the cost doesn't put you off and you are not prepared to wait and see, make sure you have a ruling from the ATO that you are permitted to act as a go between on the loan.

SMSF Borrowing – ATO Concerned

In the December 2007 minutes of the Superannuation Consultative Committee concerns were raised about the instalment warrant products being marketed to SMSFs with a resolution to provide the public with better information on these products and watch for any associated risks. Unfortunately full details of the discussion were not available so we do not know what area of the use of instalment warrants the ATO is concerned about.

ATO Finally Speaks Up About Super Fund Borrowings

On Friday 4th April released a Tax Payers Alert and a Fact Sheet on the issue of Superannuation Fund borrowings (Instalment Warrants). We have covered this issue in as much detail as possible as it has become available. The law only changed in September 2007 so there has been a great variety of opinion as to how the new laws will be interpreted by the ATO. Professional opinions varied and until now the ATO had remained silent. The following is a summary of the issues covered by the ATO that are relevant to our discussions. The full transcript can be obtained using the ATO web site's search engine. Search the Aggressive Tax Planning section for TA 2008/5 and the All ATO (except legal data base) section for Instalment warrants and super funds - questions and answers . With the main stream lenders only just starting to come into the non-recourse loan market place, interest rates and charges should become more competitive in the future so it would seem certainty and savings can be gained by waiting a while before entering into these arrangements anyway.

The ATO clearly states that the new law does not prohibit the lender being a related party to the superannuation fund. But it warns in doing so, the superannuation fund must not breach the sole purpose test. The ATO feels this would be breached if the interest charged on the loan was higher than market rates and if it was lower than market rates the interest saving to the superannuation fund could be considered a superannuation contribution by the member which may breach the superannuation contributions cap and lead to excess non-concessional contributions tax being payable.

If a party related to the superannuation fund, provides a personal guarantee to a lending institution in order to secure a "limited recourse loan" for the superannuation fund, the loan may not be considered limited recourse.

If the interest on the loan is capitalised that new borrowing would not be considered to be for the acquisition of the asset so would not be permitted.

CGT Cap Amount

Readers are probably aware that they can only contribute \$150,000 per year into super as an undeducted contribution (ie a contribution they or their employer have not claimed a tax deduction for), though there is a concession that \$450,000 can be contributed in 1 year providing nothing is contributed for the next 2 years. This \$150,000 limit does not apply to CGT concessional amounts. That is the 15 year CGT exemption and the retirement exemption amounts. These amounts are tax free to the business owner and are not taxed in the

hands of the super fund. The retirement exemption is limited to \$500,000 in a life time. The total amount of CGT concessional amounts that can be exempted in a life time has just been increased, for 2008/09 to \$1,045,000. This means with careful planning you could transfer another \$545,000 into super via the 15 year concession on top of the \$500,000 allowed under the retirement exemption. The 15 year exemption applies to assets that have been active in a business and owned for 15 years or more.

To maximize this strategy it is important that the 15 year exemption is used whenever possible. Certainly the law requires the 15 year exemption to be used rather than any other exemption whenever it is applicable. What we are suggesting is if the 15 years is getting close don't think it doesn't matter I will use the retirement exemption instead. It may be worth waiting to utilize the 15 years as you may need to use the \$500,000 exemption later. Note the \$500,000 life time retirement exemption limit is not indexed each year but the \$1,045,000 total life time CGT concession for deposits to super is so the amount you can transfer into super from the 15 year exemption will continue to grow.

Another tactic, if you are not required to put the CGT concessional amount into super, is take \$150,000 of it as a tax free payment and then contribute it to super fund as a normal undeducted contribution, using up that years threshold without affecting your life time limits. You can even take this one step further and call forward your undeducted contribution limit the following two years as discussed above.

Note if an active asset in a business is pre CGT it also qualifies to be put into a super fund without affecting the \$150,000 annual cap but will count towards the \$1,045,000 life time cap.

This is a complex issue that needs professional advice, the main point for readers to consider is that electing to put a capital gain that was exempted under the 15 year or retirement exemption into a super fund classed as that is a last resort if you have already used up your annual \$150,000 undeducted limit because it will affect your life time limit. Though in most cases you will be forced to deposit as a CGT concessional contribution to qualify for the CGT concession in the first place, for example if you want to use the retirement exemption and you are under 55 years of age. And consider before you sell whether it may be worth holding out for the 15 years.

SMSF Auditors will be getting a lot tougher

From the 1st July, 2008 the ATO got a lot tougher on Self Managed Superannuation Funds (SMSFs). The rules are mostly the same but the penalties have increased and a lot of the discretion has been taken away from the SMSF auditor so we will have to report to the ATO what might be considered only a minor infringement. The penalties to a trustee of a SMSF are now up to \$5,500 or 2 years jail for breaches as simple as not appointing an auditor at least 30 days before the SMSF's tax return is due to be lodged. An added worry here is the shortage of accountants, so don't leave it till the last minute. You can expect your auditor to dob you in too, as he or she would be risking a \$5,500 fine or 6 months gaol if they don't.

Here is a list of other breaches that auditors are required to report to the ATO:

- Not meeting the definition of a SMSF. The fund cannot have more than four members and they must all be trustees or directors of the trustee if it is a company. The parent of a minor member can be trustee or director for them. Trustees cannot be paid by the fund for their services and no member can employ other members unless family. There must be at least two trustees or a company as trustee.
- The trustee or if applicable its directors must not be disqualified from acting. Each year the trustee must make a declaration to this effect. If they do become disqualified and they are also a member of the fund then they may have to move their interest in the fund into a public fund within 6 months of becoming disqualified. A disqualified person is a person convicted of an offence involving dishonesty, a person who has been penalised regarding a SMSF, a bankrupt or under some form of legal disability
- Documents must be provided to the auditor within 14 days of any request to do so.
- The monies and assets of the fund must be kept separate, for example not accidentally deposited into a non SMSF bank account. A safeguard here would be to arrange for dividends to be automatically debited to the SMSF's bank account. As the cheque will have the name of the trustees on it, it would not be hard to mix SMSF dividend cheques up with private cheques. An unintentional error of depositing dividends in the wrong account is not reportable to the ATO if the Trustee rectifies the situation as soon as he or she becomes aware of it.

If you cannot put the asset in the name of the SMSF (which maybe as simple as the trustees names with ATF after them) and it has to be held in just the personal names of the trustees then make sure you prepare a minute declaring that the asset was purchased on behalf of the SMSF.

- All investments by the fund must have the sole purpose of providing for the members' retirement or family in the event of their death, that is why investments in works or art of jewellery are difficult to justify. Life insurance is acceptable because it provides for the member's family in the event of their death but trauma insurance, that pays a benefit on the diagnosis of a major medical problem would not fit this definition.
- Maintain an investment strategy. This is a minute that covers the fund's investment objectives, the member profile ie years till retirement, risk factors, cash flow and diversification, ideally setting out a percentage of the funds to be held in each asset class.

It is important that each year you review this statement to make sure it does not contradict the activities of the fund.

- The SMSF must not lend to members or their relatives, this includes allowing them to get behind in their rent for business premises used in the member's business. The prohibition of providing financial assistance to a member is quite wide, the ATO have issued draft ruling SMSFR 2007/D2 with their opinion and examples.
 - The SMSF must not purchase assets from members and their relatives with the exception of business real property and widely held shares. There are also concessions in the event of marriage breakdown, inhouse assets up to 5% of the funds assets and units or shares in non geared companies or trusts.
 - If a member purchases an asset off the SMSF or sells one to it, the price must be at market value consideration.
 - Assets held by the fund must not be mortgaged in anyway.
 - Other than business real property, the fund can only invest 5% of the funds assets in items used in a members business
 - Minutes must be kept
 - Each new trustee must sign a declaration within 21 days of being appointed. If this is not done within at least 14 days of the 21 day deadline we are required to report this contravention to the ATO.
 - Contributions received by the fund must be within the limits set on contributions ie work requirements, age etc.
- This list is an ATO minimum, your auditor may consider other breaches significant enough to report to the ATO. The message is if you don't fully understand your role as trustee of your SMSF then don't make a move without consulting your accountant.

The Numbers for a SMSF with an Investment Property

Borrowing in your Self Managed Superannuation Fund allows you to combine three very important goals, tax effectiveness, asset protection and leverage. The tax effectiveness allows you all the normal advantages of negative gearing but when the property becomes positively geared it will be taxed at a maximum of 15% or zero if you have reached pension stage. Capital gains will be taxed at a maximum of 10% (providing the asset has been held for more than 12 months) or zero if you have reached pension stage. If that wasn't enough in itself the asset protection provided by a superannuation fund is arguably better eventhan even that provided by a discretionary trust (which is now under a cloud since Richstar's case). Providing you have not made an unusually large superannuation contribution to avoid creditors your creditors are not entitled to touch your superannuation savings. The only area that SMSFs lack is leverage. Now that they are able to borrow there is some leverage available, the only trouble is that the asset can only be borrowed against once. You can refinance but not to draw more equity out of that asset and once the original borrowings are repaid the asset belongs to the superannuation fund which still cannot borrow against any asset it owns.

To explain how the tax effectiveness works here is an example of a superannuation tax return profit and loss:

Rental Income	\$20,000	\$20,000
Salary Sacrificed super contributions	\$20,000	\$15,000
Less Expenses:		
Rates, Insurance, Repairs, Management Fees etc	\$ 8,000	\$ 8,000
Interest	\$27,000	\$27,000
Depreciation	<u>\$ 5,000</u>	<u>\$ 5,000</u>
Taxable income to super fund	0	\$ 5,000 loss

If the above property was held by the individual it would show a \$20,000 loss in their tax return. Because \$5,000 of that loss is depreciation the taxpayer would have only outlaid \$15,000 to achieve this loss. To have the same effect on the individual's taxable income through a SMSF arrangement they would have to salary sacrifice \$20,000 into their SMSF. Their taxable income would be the same but they have contributed an extra \$5,000 in before tax dollars. If they are in the 31.5% tax bracket this will reduce their take home pay by \$3,425. If they are in the 41.5% tax bracket their tax home pay would be reduced by \$2,925 and at 46.5% by \$2,675. But they don't lose that money it is just in the SMSF instead so their overall wealth increases because instead of just having the tax refund that \$5,000 would have generated wrong!!! they still have the full \$5,000 but just can't touch it until they are at least 55 years old. And yes it is the full \$5,000 no tax is payable on this money or the other \$15,000 going into the SMSF fund because the SMSF can deduct the rental property losses against the contributions received to pay zero tax. If the individual chooses not to make the extra \$5,000 contribution then the loss is carried forward by the fund. Now remember this \$5,000 extra you put in was not needed to meet the costs associated with the rental property so it is available to make more investments or pay principle off the loan.

It gets even better than this because you can effectively get a tax deduction for principle repayments on the loan. If you salary sacrifice more funds into the SMSF to pay the principle off the loan the full amount of the pre tax dollars go into the fund, providing you have not reached the age limits discussed below. So the worse tax rate they will face is 15% in the hands of the SMSF if it does not have any other deductions to offset against the contribution. If you are looking to maximise your leverage it maybe better not to pay any principle off the loan but instead use the extra contribution as a deposit for the next property purchase.

Don't go overboard on this strategy, remember if you are under 50 years of age you can only make \$50,000 worth of deductible superannuation contributions a year. Even if you are 50 or over, so qualify for the \$100,000 per year, this is only available until 2012 and your investments could stay negative for longer than that.

SMSF Investment Strategy Document

Auditors of Self Managed Superannuation Funds (SMSFs) will, from the 1st July, 2008, be required to report the SMSF to the ATO if they have not maintained an investment strategy. This is a minute that must cover all of the following:

The fund's investment objectives – ie the return required to achieve long term goals, income versus capital growth etc

Each member's profile – ie years till retirement, expected future contributions, size of fund etc

Risk factors – What is an acceptable risk for a higher return?

Cash flow – Restricting the money available to invest considering the need to pay benefits in near future and bills as they become due.

Diversification – Ideally setting out a percentage of the funds to be held in each asset class. Though there is no actual prohibition to investing in just one class.

It is important that each year you review this statement to make sure it does not contradict the activities of the fund.

Superannuation of Temporary Residents

By the end of this year the changes to this law will be finalised by receiving Royal Assent. Superannuation funds holding superannuation for temporary residents will still be required to transfer the funds across to the Government but not until 6 months after the temporary resident's visa has expired. In the meantime the temporary resident can withdraw their superannuation after leaving the country. Further they will continue to be covered by any life insurance in the policy until it is transferred to the Government.

Temporary residents who do not claim back their superannuation before it is transferred to the Government can later claim it back from the government.

Superannuation funds will no longer be required to transfer the funds across every 12 months while the temporary resident is still in Australia so this will also help maintain any life insurance premiums.

SMSF Using “Instalment Warrants” to Buy Shares or Units

The new rules allowing superannuation funds to borrow actually describe the sort of loan that is caught by Division 247. Fortunately, division 247 does not apply to rental properties but it does apply to non recourse loans to purchase shares or unit in a trust. The basic concept is if the interest rate charged is higher than “normal” because the lender takes the risk of the asset decreasing in value. In a limited or non recourse loan the borrower can default and the lender can only take the asset given as security. If this cannot be sold for enough to cover the original loan that is the lender’s problem, not the borrowers.

The ATO is of the opinion that the premium interest charged is a fee for guaranteeing the capital return on the investment, therefore it is capital in nature and not tax deductible. This hasn’t caused many problems to date because the ATO has only considered a premium to be charged when the interest rate exceeds that for personal unsecured loans. This is about to change to the interest rate for standard housing loans. So any borrowings at a rate higher than the standard housing rate, where shares or units are purchased and the lender has no recourse beyond the value of the assets given as security, will be caught and the interest not fully tax deductible. This applies retrospectively to arrangements entered into after budget night, 13th May, 2008.

When You Can Claim Super, Has Changed

A little realised trap created by the changes to superannuation means that people who have only a small wages income say less than \$450 or because you are under 18 and work less than 30 hours a week or you are over 70. Note from 1st July, 2007 you may (subject to all the normal limitations) qualify for a tax deduction for superannuation contributions you make if they are made before 28 days after your 75th birthday.

Can still not claim their superannuation contributions unless they satisfy the 10% rule. This is due to a change in the wording of the legislation so just because you could claim last year doesn’t mean you will be able to this year.

For example if you are on a low wages income of less than \$450 per month but have, say, a \$35,000 capital gain you cannot get a tax deduction for any money you put into superannuation even though your employer is not required to contribute for you, because more than 10% of your income is from wages, even though those wages do not attract employer superannuation contributions. The best you can do in this situation is to ask your employer to salary sacrifice your earnings into superannuation.

SMSFs and Property

With the major banks now lending to superannuation funds and the growing frustration with the performance of public funds that cannot invest directly in houses, now is the time to find out a bit more about self managed superannuation.

Self Managed Superannuation Funds (SMSFs) have always been able to purchase property, if it is in accordance with their investment strategy, but not many of them could afford to because until September 2007 they could not borrow. They can now borrow through non recourse loans. These arrangements are explained in detail in our Self Managed Superannuation Funds Booklet which is available under free publications on our web site.

The exciting thing is that they can provide much better asset protection and tax benefits than holding a negative geared property in your own name. Here is how it works.

Providing you do not make an unusually large contribution to defeat creditors the bankruptcy trustee cannot touch your superannuation. In my opinion it does not get better than that. Generally, asset protection means not holding a property in your own name, which usually means that the negative gearing benefits cannot be offset against your income. Certainly a loss in a SMSF cannot be deducted in your personal tax return but a contribution to a SMSF can usually be deducted in your return or if you are a wage earner you can utilise salary sacrificing to reduce your taxable income before it even reaches your tax return. For example, the super fund may have a rental property that is generating a \$10,000 loss, this means if you contribute \$10,000 in deductible super contributions to the fund it will not even have to pay the 15% contributions tax on that money and you or your employer will get a full tax deduction for the amount so it is as good as claiming the rental loss in your own return with the added advantage of asset protection. If you make enough superannuation contributions for the fund to be able to pay principle off the loan then the principle repayments are effectively taxed at 15% rather than your marginal rate if the property was held in your name. If you have

some non cash flow deductions such as depreciation the 15% contributions tax won't even apply to your principle repayments.

It gets even better than this. The ultimate for a property investor is to get the deductions while their other income is high but reduce the tax on the capital gain. If the property is owned in a SMSF then any capital gain is taxed at a maximum of 10%. If you wait until you are 60 and it is in pension stage the tax rate is zero to the super fund and zero to you when you withdraw it from your fund.

And there is even more! A SMSF is not subject to land tax until the unimproved value of its freehold land holdings exceeds \$350,000, as at 30th June, 2008.

SMSFs And 5% In-house Asset Limit

Other than commercial real estate used in the members' business, SMSF cannot hold more than 5% of its assets in in-house assets. For example equipment it might lease to the business. This calculation is done each accounting period based on the market value of all the fund's assets. This can be a bit of a problem if the fund's assets have decreased dramatically due to the global financial crisis.

Exceeding the in-house asset limit is a serious offence and can lead to a SMSF being declared non complying. Fortunately you have 12 months to fix the problem. All you will have to do to keep your auditor happy is have a strategy in place that will correct the problem within 12 months. It is best to document this with a minute. Strategies can include reducing the amount of funds the SMSF has tied up in in-house assets and making contributions to the SMSF that are sufficient to bring the ratio back to 5%

Superannuation Contributions for 08/09 Financial Year

There is a rumour circulating that the budget will reveal an increase in the tax imposed on superannuation. Would be quiet a surprise if it did actually happen but the concern is that the new tax will apply to contributions made after budget night ie 12th May, 2009. So if you have money sitting around that you intend putting into superannuation before 30th June it maybe prudent to put it in now.

This year the various rules and thresholds for superannuation are:

Co Contribution – If you contribute \$1,000 to your superannuation fund that you or your employer have not claimed a tax deduction for, the government will add \$1,500 to it if you pass certain requirements. The co contribution is reduced on a pro rata basis if you contribute less than \$1,000. The government's \$1,500 and your \$1,000 will not be taxed in the hands of the superannuation fund. Your assessable income (not taxable income) needs to be under \$30,342 if it exceeds this but is less than \$60,342 you will still get some co contribution, the \$1,500 shades out at the rate of five cents for every dollar over the \$30,342. .

You need to have 10% or more of your income from employment where your employer is required to make superannuation contributions for you. This 10% rule can also apply to income from running a business. Or wages and business income can be combined to reach the 10% threshold. You also need to be under 71 years of age and you will need to lodge a tax return.

Age Restriction to Claiming a Tax Deduction For Your Superannuation Contribution - If you do not have employer support, and you are under 65 years of age you can make a tax deductible superannuation contribution for yourself up to the age base limit of \$50,000 if you are under 50 and \$100,000 for 50 and over. From the day you reach 65 years of age you must have worked more than 40 hours in a period of 30 days or less, in the financial year the contribution is made. Careful here, if you retire at the 30th June and decide to make a superannuation contribution for yourself the very next day you will not meet the work test because the contribution was made in a different financial year.

If you are 65 years of age or over your employer is entitled to make a superannuation contribution for you and claim it as a tax deduction providing it is only the amount your employer is required to contribute under the superannuation guarantee or your award. There is one exception to this rule, if you are less than 69 years of age and satisfy the work test above your employer's contribution is not limited to the guarantee or the award, so you can utilize salary sacrifice.

If you are between 65 and 75 years of age but satisfy the work test you are entitled to make a superannuation contribution for yourself. If you do not have employer support you will be entitled to claim the contribution as a tax deduction providing it is less than \$100,000. You have up to 28 days after your 75th birthday to make the contribution.

Rebate for Low Income Spouse Contributions - The tax offset for making non deductible super contributions for your spouse is \$540 if you contribute \$3,000, providing your spouse's assessable (**not** taxable) income is under \$10,800. Shading provisions reduce the amount of Co Contribution you receive by one dollar for every dollar over \$10,800 disappearing completely when your spouse's income exceeds \$13,800.

Column by Noel Whittaker

The Federal budget is now a distant memory but it included substantial changes to the superannuation system and the aged pension system. In a column prior to the budget I mentioned that changes to the transition to retirement pensions TTRs were a possibility and advised anyone eligible to start one and who could benefit from doing so to seek advice.

They were not mentioned in the budget so on the surface they appear to be left alone. But, as usual, the devil is in the detail. You see, TTRs can only give you large tax savings if you can salary sacrifice a hefty amount to super. Also, they work best for high income earners because they take advantage of the difference between the 15% tax on contributions to super and income tax of at least 41.5% on money taken in your pay packet.

Think about a person aged 55 earning \$180,000 a year. Under the present system they could salary sacrifice \$100,000 to super and lose just \$15,000 in tax. However, the maximum that can be contributed by people aged 50 or over from 1 July 2009 is \$50,000 and from 1 July 2012 just \$25,000. A person on \$180,000 a year would already be receiving \$16,200 from the compulsory employer 9% contribution and so would have just \$8,800 left that was able to be salary sacrificed at the 15% rate.

Despite the changes TTRs are still a useful strategy and anyone aged 55 or over should seek advice to see whether starting one is appropriate for their own situation. However, it is important to understand their benefits will be somewhat reduced from 1 July 2009 and substantially reduced from 1 July 2012.

Noel Whittaker is a director of Whittaker Macnaught, a division of St Andrew's Australia. This advice is general in nature and readers should seek their own expert advice before making financial decisions. Noel's e-mail address is noelwhit@gmail.com

David Thompson & Julie Lockeridge from Whittaker Macnaught are regularly available to see clients in our office

SMSFs Investment Strategy Update

Self Managed Superannuation Funds (SMSFs) are required to keep an up to date investment strategy and follow it. If the investment strategy does not comply the ATO, in extreme cases, could claim the fund is not complying and tax it at 46.5%.

Many investment strategies state the expected return on an investment. If this applies to your investment strategy, this may not be possible in the current financial climate. Nevertheless, you may want to continue to hold your current investments in anticipation of a recovery. It is important that you create a minute evaluating your position and documenting the change in strategy.

SMSF Rulings

SMSFR 2009/3 states the ATO considers that a SMSF may have contravened the inhouse asset rules, arm's length rules and sole purpose test if it is entitled to a distributions from a related trust but the distribution is not promptly paid across to the SMSF.

The distribution maybe considered not paid across to the SMSF if it is not paid within a month of the lodgement of the relevant trust tax return.

Reportable Superannuation Contributions

Reportable super contributions are going to be included as part of your income for the following:

- the Medicare levy surcharge threshold calculation
- the Medicare levy surcharge (lump sum payment in arrears) tax offset

- all dependent tax offsets
- the senior Australian tax offset
- the pensioner tax offset
- the Higher Education Loan Programme and Student Financial Supplement Scheme repayments.

Before a superannuation contribution can even be considered reportable it must have been claimed as a tax deduction either by you or your employer.

Any superannuation contributions you make for yourself that you qualify for a tax deduction for, will be added back to your income when the definition of income for that particular threshold includes reportable benefits.

If you are an employee your reportable superannuation contributions will be any your employer makes for you over and above the following:

- The 9% required under the guarantee
- An amount required to be paid by an industrial agreement
- Required by the trust deed or governing rules of a super fund
- Required by a federal, state or territory law

In other words if you salary sacrifice into super it will now be a reportable superannuation contribution.

Note this only applies from 1st July, 2009 so will not flow through for a while yet but employers may need to adjust their record keeping to have the necessary information available when they prepare next year's PAYG summary.

Taxpayers that qualify to claim a tax deduction in their personal tax return (generally self employed or retirees under 75 years of age) will also have that deduction added back to their income in a similar way to the reportable super amount for an employee. There is no concession for the 9% guarantee etc but on the other hand their personal contributions will not be added back when testing the thresholds for:

- the mature age worker tax offset
- the spouse super contributions tax offset
- super co-contributions
- deductions for personal super contributions.

If you are a Centrelink customer, your reportable super contributions will be included in your income to work out if you are eligible to receive certain Centrelink benefits.

SMSFs - What They Can Own

You may think you are missing out on something because you have a friend who is using his or her SMSF to buy something they are also getting a benefit from. There is a lot of it going around. The money held in superannuation must be solely used to provide for the members retirement or their dependants in the event of their death. This is called the sole purpose test. Paragraph 15 of SMSFR 2008/2 states:

“Investments consisting of collectables and other boutique items such as works of art, antiques, jewellery, classic cars and wine, pose particular issues in relation to the application of the sole purpose test. These kinds of assets lend themselves to personal enjoyment and therefore can involve significant current day benefits being derived by those using or accessing the asset. Trustees should be in a position to show (for example, by reference to independent expert opinion) how acquiring assets of this kind involves a reasonable investment for the SMSF.”

A member cannot enjoy the benefit of an asset held in a superannuation fund. This means he or she cannot use the assets held for investment. In the case of paintings and antiques they cannot be stored in their home. In the case of holiday houses they should not even stay there for one night. SMSFR 2008/2 in example 4, paragraphs 37 to 40 make it clear that it is ok for the sole purpose test if the property is vacant and market rent is paid. The problem is once there is some private use of the asset the full value of the asset is considered to be an inhouse asset. So it is not the sole purpose test that is the problem. SMSFs are only permitted to hold 5% of their assets as inhouse assets. It is not the market value of a night's accommodation that is considered an inhouse asset it is the full value of the property so you would need to have a lot of assets in your superannuation fund before the value of the holiday home would be less than 5% of the funds assets.

Saving Tax on Your Investment Property – The Book

“Every investment property tax-related question you’ve ever wondered about is answered here and – perhaps more importantly – the ones you didn’t think to ask but should have! For property investors who want to refine their strategy for maximum gain, this resourceful handbook will make a great constant companion.” Eynas Brodie, Editor, Australian Property Investor magazine.

Combining Noel Whittaker’s easy reading style with Julia Hartman’s mind numbing attention to detail was a major challenge which ran way over schedule but it is finished, printed, and in the book stores. You can also purchase it online by going to: www.bantacs.com.au/property.php. The cost is \$29.95 plus \$5.95 postage – tax deductible of course!

Ask BAN TACS

For \$39.95 you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. For your Accountant, we will include ATO references to support our conclusion. Just go to www.bantacs.com.au and look for the Ask Bantacs link under ‘Most Popular’ on the home page.

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Disclaimer: Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.