Colonial First State

FirstTech

FirstTech 2024–25 SMSF Guide

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Important notes when reading guide

- **Trustee** All references to the trustee(s) of an SMSF also include reference to the directors of a fund's corporate trustee, unless otherwise stated.
- **Trust deed** All references to an SMSF's trust deed include reference to the deed itself and any fund rules attached to the deed.
- **Governing rules** All references to a fund's governing rules include reference to any rules contained in a trust deed, other document or legislation (including any unwritten rules) which govern the establishment or operation of the fund.

Contents

Glossary of terms

The terms and abbreviations have the following meanings:

- **AFCA** Australian Financial Complaints Authority
- **ATO** Australian Taxation Office
- **ATO ID** ATO Interpretative Decision
- **APRA** Australian Prudential Regulation Authority
- **ASIC** Australian Securities and Investments Commission
- **LCR** Law Companion Ruling
- **PCG** Practical Compliance Guideline
- **SIS Act** Superannuation Industry (Supervision) Act 1993
- **SIS Regulations** Superannuation Industry (Supervision) Regulations 1994
- **SMSF** Self-Managed Superannuation Fund
- **SMSFD** Self-Managed Superannuation Fund Determination
- **SMSFR** Self-Managed Superannuation Fund Ruling
- **Tax Act** Income Tax Assessment Act 1997
- **Tax Regulations** Income Tax Assessment (1997 Act) Regulations 2021
- **TBA** Transfer Balance Account
- **TBC** Transfer Balance Cap
- **TBAR** Transfer Balance Account Report
- **TD** Tax Determination
- **TR** Tax Ruling
- **TSB** Total Superannuation Balance

1 Introduction to SMSFs

1.1 What is an SMSF?

A self-managed superannuation fund (SMSF) is a superannuation fund with no more than six members where the members are required to act as the trustees of the fund and take on full legal responsibility for the fund. As trustees, the members will be responsible for operating and administering their fund and for investing the fund's assets to provide retirement benefits.

Although SMSFs have a particular definition, they are otherwise regulated superannuation funds and therefore must comply with the SIS Act at all times.

Where an SMSF complies with the SIS Act it will be eligible to receive concessional tax treatment under the Tax Act as a complying fund.

This guide examines SMSFs and the rules and regulations that apply to these funds. This guide does not discuss funds with more than six members.

1.2 Advantages of SMSFs

SMSFs have a number of perceived advantages. These include:

- control
- flexibility
- cost.

These are summarised as follows:

Control

Because the members of an SMSF also act as the trustees of a fund, they can take more control over how their fund is managed and run. This increased level of control extends to a number of issues. These include:

Control over investments

As the members are the trustees they can take more control over how their superannuation is invested. For example, SMSFs can allow members to:

- develop a tailored investment strategy specific to their needs and circumstances rather than having to invest via a pooled structure
- be directly involved in making the investment decisions for the fund
- target certain industries or asset classes in which the members have a high degree of knowledge, skill or expertise
- invest in alternative asset classes not available in large funds, such as direct property
- acquire business real property which they can then lease back to a related party, such as a member, to use in a business
- borrow via a limited recourse borrowing arrangement to acquire assets such as a property, or

- combine their superannuation balance with other members to increase their purchasing power and reduce costs.

Flexibility

The fact that the members of an SMSF are also required to act as trustees can also make SMSFs more flexible than other fund types as trustees can tailor their fund's rules and make decisions based on the members' needs and circumstances. This increased flexibility can relate to a number of issues as summarised here:

Payment of retirement benefits

Trustees of SMSFs can pay benefits in a manner or form that takes into account the members' needs and circumstances. For example, a trustee could, subject to the rules of the fund:

- pay benefits in the form of an in-specie lump sum benefit where the members wish to maintain control over the asset or to use the asset
- pay a benefit in the form of an income stream that is tailored to a member's personal requirements. For example, a trustee could allow a member to rollover a complying income stream to commence a term allocated pension.

Death benefit payment and planning

Trustees can implement death benefit planning strategies tailored to the members' specific needs and circumstances. For example, the trustees could arrange to:

- allow the members to make very specific binding death benefit nominations, such as a cascading binding nomination, or
- exercise their discretion to pay a death benefit in the most appropriate manner as at the time of death.

This flexibility can also allow trustees to react quickly to any changes in the members' circumstances and take advantage of any changes in the superannuation rules.

Make in-specie contributions

Unlike other superannuation fund types (other than superannuation wraps), SMSFs can accept in-specie contributions – that is, contributions of assets rather than money. This can benefit members as it allows them to increase the value of their retirement savings by transferring certain assets they already own into superannuation without the need to sell the asset first. If that asset is a property, such as commercial property, it can then potentially be leased back to a related party of the fund to use in a business.

However, any in-specie transfer by a member to their SMSF is a capital gains tax (CGT) event for the member and may trigger an assessable capital gain. The SMSF may also incur stamp duty and transaction costs. In addition, in accordance with the SIS investment rules, a trustee can only accept certain types of assets, such as listed securities or business real property, as an in-specie contribution from a member. For more information, please see *Chapter 4: Superannuation investment rules*.

Tax efficiency

While SMSFs are not subject to different tax rules compared to other types of superannuation funds, the level of control and flexibility they allow means trustees can administer the fund to maximise tax efficiency. For example, trustees may decide to employ an investment strategy that seeks to maximise after-tax returns by investing in growth stocks that pay out high levels of franked dividends.

In addition, trustees can exercise their control to convert specific accumulation assets into segregated current pension assets when a member commences a retirement phase income stream. This can then allow the trustee to dispose of the assets capital gains tax-free.

While this tax advantage is also available through superannuation wrap services, these funds may apply restrictions to limit members' ability to invest in certain assets and asset classes up to certain levels. For more information on the taxation of SMSFs, please see *Chapter 5: Taxation of SMSFs*.

Speed of payments

An SMSF can allow the trustees to meet and make administrative decisions much more quickly than trustees of large funds. For example, the trustees of an SMSF could meet and make decisions about the payment of a member's death benefit much more quickly than may otherwise be possible in a large fund.

Cost

SMSFs can also be more cost-effective than large funds. However, this depends on how involved the trustees wish to be in managing their own fund and whether the fund will be large enough to justify the costs of running an SMSF. For more detail on the costs of running an SMSF, see section 1.4 of this chapter.

However, cost should not be the only consideration when deciding to establish an SMSF as there are other factors that may make these funds unsuitable for some people.

Asset protection

Assets held in superannuation funds, including SMSFs, are generally protected from administrators in the event of bankruptcy and cannot be liquidated to meet the settlement of debts to creditors. Therefore, assets held in an SMSF, such as a business real property, will generally be protected. However, this exception does not apply where a member makes contributions to their superannuation fund for the purpose of defeating claims from their creditors.

Note, that the protections in relation to bankruptcy may not extend to garnishee notices issued by the ATO in relation to a tax debt. In this situation, a trustee may be required to pay a member's superannuation benefits to the ATO when the member satisfies a condition of release.[1]

1 For more information on ATO garnishee notices, please see Division 260 of Schedule 1 to the *Taxation Administration Act 1953*.

1.3 Risks and disadvantages

Running an SMSF is not for everyone. Potential and existing trustees need to understand the risks, responsibilities and disadvantages of setting up and maintaining an SMSF.

No statutory compensation for SMSFs

Under Part 23 of the SIS Act, certain trustees can apply to the Federal Government for a grant of financial assistance if the fund has suffered a loss due to theft or fraud. However, this only applies to large Australian Prudential Regulation Authority (APRA) regulated funds and does not apply to SMSFs.

Therefore, the trustee of an SMSF that suffers a loss on an investment due to theft or fraud must take full responsibility for their investment decisions and cannot apply for a grant of financial assistance to offset the impact of the loss on members.

However, SMSF trustees that have suffered a loss due to theft or fraud have an action for compensation for the loss. That means the ability of the other party to pay any compensation awarded is highly relevant.

No access to the Australian Financial Complaints Authority (AFCA)

The Australian Financial Complaints Authority (AFCA), the dispute resolution scheme for financial services, has no jurisdiction to make decisions to resolve disputes involving an SMSF. Therefore, SMSF members or their beneficiaries cannot apply to AFCA to resolve any disputes with the trustee.

Instead, the parties in dispute may need to commence legal proceedings to have the issue resolved by a court – which can be extremely expensive and time consuming.

Trustee duties and responsibilities

As a trustee of an SMSF, a member is legally responsible for ensuring the fund is set up and maintained in accordance with a strict set of legal requirements. Trustees will need to learn and understand those requirements and keep up to date with any changes. This applies equally to all trustees, even trustees less actively involved in running the fund who are still equally liable for ensuring the fund complies with all the relevant super and tax laws.

As part of this requirement, SMSF trustees need to develop, give effect to and regularly review an investment strategy for the fund to ensure it is likely to meet members' retirement needs. This will require trustees to understand investment principles including risk, return, diversification and liquidity as well as comply with the investment rules and restrictions that apply to super funds.

For more information on a trustee's duties and responsibilities, please see *Chapter 3: Trustee responsibilities*. The ATO also provides useful information on its website about the obligations and duties of being a trustee of an SMSF.

Penalties

Where a trustee fails to maintain their fund in accordance with the legal requirements, the ATO can impose a number of penalties. These include:

- ATO administrative penalties
- taking legal action against trustees, in which case a court can impose civil penalties of up to $751,200 per individual trustee or $3.756 million for funds with a corporate trustee and/or five year's imprisonment
- disqualifying one or more trustees
- revoking the fund's complying tax status – which will result in both the fund's income and taxable benefits being taxed at the top marginal tax rate of 45%.

Trustees should also note that where an ATO administrative penalty is applied they will be personally liable and they will not be able to be indemnified out of the assets of the fund.

Finally, trustees can also be subject to civil liabilities where someone suffers a loss or damages due to a trustee act or omission.

For more information on the penalties that can apply for breaches of the SIS Act, please see *Chapter 3: Trustee responsibilities*.

Accessibility to life insurance cover

Unlike large funds that generally offer group life insurance arrangements, an SMSF trustee wishing to provide cover for a member will generally need to acquire an individual policy for that member. As a result, a member of an SMSF wanting insurance through the fund will generally need to be individually assessed for insurance purposes, which may lead to higher premiums, loadings, exclusions or even the refusal of cover.

An alternative could be to maintain a client's insurances in a separate large fund. In this case, a client would need to be warned of any risks or disadvantages of being a member of two separate superannuation funds.

For more information on the insurance issues that must be considered when establishing an SMSF, please see *Chapter 6: SMSFs and insurance*.

Trustees/members become non-resident

To qualify for concessional tax treatment, an SMSF must satisfy the definition of an Australian superannuation fund. If trustees permanently move overseas or if contributions are made for a member while they are living overseas this could result in the fund failing the Australian superannuation fund definition and automatically becoming non-complying.

For more information on the definition of an Australian superannuation fund, please see *Chapter 5: Taxation of SMSFs*.

Cost

While SMSFs can be a cost-effective option for some people they can also be more expensive for others. Whether an SMSF represents a cost-effective option requires consideration of the various costs (including advice costs) applicable to setting up, operating and winding up an SMSF and comparing them with the fees charged by large funds.

Costs must be considered when establishing an SMSF and on an ongoing basis. For example, a change in a fund's membership or circumstances could mean it may cease to be justified from a cost perspective in the future.

For more information on costs and whether an SMSF will be suitable as well as the disclosure requirements regarding costs when providing personal advice about SMSFs to retail clients, please see:

- Section 1.4 of this chapter, and
- ASIC information sheet (INFO274) *Tips for giving self managed superannuation fund advice*.

Trustee disqualification

Where a trustee becomes a disqualified person, such as due to becoming bankrupt, they, or the corporate trustee of which they are a director, will be prohibited from acting as trustee of a superannuation fund, including an SMSF. As a result, the fund may need to be wound up and its assets sold, triggering transaction costs and tax liabilities.

For more information on the disqualification of trustees, please see *Chapter 2: SMSF definition and establishment*.

Relationship breakdown

A breakdown in the personal or business relationship between the trustees could result in a range of negative impacts on the fund. These include:

- members rolling their benefits out of the fund which could reduce the fund's assets to a level where it is no longer justified from a cost perspective
- the fund being forced to dispose of assets to fund rollover requests which could result in the fund crystallising a taxable capital gain or loss and incurring transaction costs
- the dispute expanding to take in fund issues, such as the valuation of fund assets and compliance with the fund's trust deed, which may require legal action to resolve
- trustees attempting to use fund assets as a bargaining chip in their dispute with the other trustees.

Where funds are established with an unusual or atypical membership structure, such as where friends, siblings and/or business partners are members of the same SMSF, there may be an increased risk of relationship breakdown. In this case, the trustees should consider how such risks could be avoided or managed.

Trustees' lack of investment experience

The trustees themselves can pose a significant risk to their SMSF if they lack the financial literacy or the investment experience and skills required to properly manage the fund's assets or to identify potential investment scams. For example, potential members may not have a proper understanding of investment principles such as risk and return and the importance of diversification and may expose their fund to inappropriate levels of risk.

SMSF wind up

Where an SMSF has ceased to be required or is no longer appropriate for the members, it may need to be wound up and the members' benefits transferred to a large fund. Depending on the fund's circumstances, this may require the fund to dispose of assets which may incur capital gains tax and transaction costs as well as require the fund to incur additional wind-up administration costs. As a result all SMSF trustees may need to develop an exit strategy for the fund.

For more information on the issues associated with winding up an SMSF, please see *Chapter 9: Winding up an SMSF*.

FirstTech comment: ASIC tips for giving SMSF advice

ASIC has released Information Sheet 274 (INFO 274) *Tips for giving self managed superannuation fund advice.* The information sheet provides tips to help advice providers comply with their legal obligations when giving advice about SMSFs, including a range of factors to consider when advising a client to withdraw their superannuation from a fund regulated by APRA to set up an SMSF.

It covers the following topics for advisers:

- Understanding your obligations when giving SMSF advice.
- Using your professional judgement to assess whether an SMSF is suitable for your client.
- Considering the risks of an SMSF compared to an APRA-regulated fund.
- Providing appropriate advice to your client that considers the costs of an SMSF and how much they would need to set up an SMSF.
- Considering a suitable trustee structure, investment strategy, the need for ongoing financial advice, and an exit strategy for your client.

INFO 274 replaced Information Sheet 205 *Advice on self managed superannuation funds: Disclosure of risks* (INFO 205) and Information Sheet 206 *Advice on self managed superannuation funds: Disclosure of costs* (INFO 206), which were withdrawn.

1.4 Suitability of SMSF structure

While SMSFs have a number of attributes that may make them suitable for some people, it is very important to understand that they are not appropriate for everyone. Whether an SMSF will be suitable for a client will depend on a range of factors, including the following:

Strategic need

While SMSFs can provide a number of strategic advantages over large funds, it's important to determine whether a client's circumstances justify setting up an SMSF or whether a client's needs could be met by a large APRA fund.

For example, if a client wanted a simple low-touch solution and had no need for any of the potential strategic advantages an SMSF may provide, a large APRA fund would likely be more appropriate.

Cost

Depending on the circumstances, SMSFs can be more cost-effective than large funds. However, this depends on how involved the trustees wish to be in managing their own fund and whether the fund will be large enough to justify the costs associated with running an SMSF.

Some costs applicable to setting up, operating and winding up an SMSF are unavoidable, while other costs will depend on the services engaged, the trustee structure used and the level of administration assistance required. Costs associated with SMSFs include:

Unavoidable costs

- the annual SMSF supervisory levy (collected by the ATO)
- costs to produce annual financial statements and records
- annual independent audit fees
- annual tax return and SMSF return lodgement costs
- costs relating to the establishment of the SMSF, including costs for a trust deed
- the fee for annual actuarial certification (when required)
- time involved in managing an SMSF (which is an 'opportunity cost' for the trustee)
- costs relating to the winding up of an SMSF, including compliance costs and transaction costs related to realising assets.

Discretionary costs

- establishment of a corporate trustee, including ASIC fees to establish a corporate entity and the annual corporate trustee fee
- ongoing SMSF administration costs, including the cost of amending the trust deed of the SMSF
- asset valuation costs

- professional investment advice fees
- legal advice fees
- accounting and book-keeping fees
- investment management fees (these fees may be unavoidable depending on the type of investments made).

To determine whether an SMSF will be a more cost-effective option than a large fund, compare what it costs to run an SMSF with the membership fees charged by large funds.

However, it's important to realise the costs involved in running an SMSF can vary substantially depending on the fund's circumstances, the type, scale and frequency of the fund's investment activities and the cost of engaging certain service providers.

What's more, an SMSF may cease to be cost-effective over time if the balance decreases to a level where it no longer makes sense from a cost perspective (for example, due to negative investment returns or the payment/rollover of member benefits).

FirstTech comment: ASIC comments on SMSF costs

ASIC has released Information Sheet 274 (INFO 274) *Tips for giving self managed superannuation fund advice*. Among other things, INFO 274 includes information about the unavoidable and optional costs that a client may pay when establishing, running and winding up an SMSF.

It also mentions that:

- The starting balance is one of a range of factors that need to be considered when recommending an SMSF as it is relevant to the fund's cost-effectiveness.
- Expenses are proportionally higher, and net returns lower, for lower balance SMSFs.
- There may be circumstances when an SMSF with a lower starting balance is consistent with a client's best interests (e.g. if the trustee is willing and able to undertake much of the administration and management of investments to make it more cost-effective, or a large contribution will be made into the SMSF within a short timeframe (such as within a few months) after the fund is set up).
- There may be circumstances when an SMSF with a higher starting balance is not in a client's best interests because it does not meet their objectives, financial situation or needs.

Note that unlike the guidance it replaced (INFO 206), INFO 274 does not include guidance about a minimum balance for an SMSF to be appropriate, reflecting that balance alone is not the driving indicator of SMSF suitability.[2]

2 ASIC Media release: *ASIC updates guidance on SMSF advice* (8 December 2022).

Trustee responsibilities

Trustees of SMSFs are legally responsible for the fund and must comply with their duties and obligations at all times. If a person is unwilling to accept this responsibility or will not have the time or ability to learn and understand their responsibilities, an SMSF is unlikely to be suitable.

For example, as part of running an SMSF the trustees must:

- formulate, implement and regularly review an investment strategy for the fund
- maintain the fund for the sole purpose of providing retirement and death benefits
- invest the fund's assets in accordance with the superannuation investment rules
- accept contributions and pay benefits in accordance with the superannuation and tax laws
- value assets
- comply with reporting obligations, and
- prepare and lodge annual returns on time.

Even if a trustee outsources some or all of their duties to service providers, or they are less involved in running the fund than other trustees, they remain equally responsible for ensuring the fund complies with the relevant superannuation and tax laws.

For more information on trustee duties and obligations, please see *Chapter 3: Trustee responsibilities*.

Investment knowledge and experience

The trustees of an SMSF will be responsible for investing the fund's assets to provide adequate retirement benefits. Given this, trustees should have a sufficient level of financial literacy as well as the investment experience and skill required to develop an investment strategy and to manage the fund's assets to achieve its investment objectives.

For example, trustees should have a good understanding of investment principles such as risk/return, liquidity and diversification and should understand how investment markets operate and the factors that influence asset valuations.

This applies even if the trustees have engaged a financial adviser to formulate an investment strategy for the fund, as they will still be required to understand the investment strategy and invest the fund's assets accordingly.

Individual circumstances

When determining whether an SMSF is suitable, it's important to consider the client's individual circumstances. Issues that could impact the decision to set up an SMSF include:

- The client's strategic requirements and their ability to make large contributions where the fund would not otherwise be large enough to be justified from a cost perspective.
- Whether the client is a disqualified person and therefore prohibited from acting as the trustee of a complying superannuation fund. For example, a person who at any time has been convicted of an offence involving dishonest conduct would be disqualified from becoming a trustee of an SMSF. For more information on who can act as the trustee of an SMSF and the disqualified person rules, please see *Chapter 2: SMSF definition and establishment*.
- Whether the trustees intend to remain resident in Australia. For example, for an SMSF to qualify as a complying superannuation fund it will need to satisfy the definition of an Australian superannuation fund. To satisfy this definition the trustees/members will generally need to exercise the fund's central management and control while in Australia. For more information on the requirements to meet the definition of an Australian superannuation fund, please see *Chapter 5: Taxation of SMSFs*.
- The client's insurance requirements and whether they would be able to obtain those insurances through an SMSF given their current circumstances or whether they would need to leave their existing insurances in place in their current fund. For more information on the insurance issues that need to be considered when setting up an SMSF, please see *Chapter 6: SMSFs and insurance*.
- The client's proposed membership structure and the risk of a breakdown in the personal relationships between trustees. For example, while all relationships face the risk of breaking down, certain types of relationships can be at higher risk. Therefore, given the impact a relationship breakdown between the trustees could have on a fund, any unusual membership structures, such as those involving friends, business partners or extended family, should be carefully considered. If such a structure is deemed necessary or appropriate, consideration should be given to including dispute resolution mechanisms within the rules of the fund to allow any disputes to be resolved as simply as possible.
- Any relevant vulnerabilities the client may be experiencing (e.g. cognitive impairment, accessibility constraints or coercion/elder abuse).
- The age and capacity of all the members and what the proposed members would want to do in the event of the death or disability of any of the other members. For example, an SMSF may not be suitable for elderly or incapacitated people who may become incapable of continuing to manage the fund over time, or if one member of a couple would either not be capable, or would not want the responsibility of managing an SMSF on their own if their spouse died or became incapacitated.

Even though an SMSF may be suitable today, it may not always be that way. Therefore, it's important for clients to have an exit strategy in place to help them to wind up an SMSF if and when it ceases to be suitable.

Table 1.2 Client circumstances indicating whether SMSF may or may not be suitable

May be suitable	May not be suitable
Clients have sufficient superannuation savings to justify the costs associated with running an SMSF.	Clients have insufficient retirement savings to justify the costs associated with running an SMSF.
Clients wish to implement a tailored investment strategy specific to their circumstances and needs.	Clients do not have a lot of time available to devote to running their SMSF and/or want a simple low-touch solution.
Clients wish to be more involved in the decision-making about how their superannuation savings are actually invested and have the necessary level of financial literacy and investment knowledge and experience.	Clients don't want the additional trustee obligations or to take on the legal responsibility for the fund and would want to delegate all decision-making to someone else.
Clients want the ability to invest in alternative asset classes not available in large funds, such as direct property.	Clients do not have the capacity or level of financial literacy and investment decision-making experience required to manage their own fund.
Clients want the ability to directly gear their superannuation savings via a limited recourse borrowing arrangement.	Clients have simple superannuation needs and objectives that can be met by a large fund and the additional obligations and risks associated with running an SMSF are not justified.
Clients want the ability to pool their retirement savings to increase their purchasing power and to reduce costs.	Clients are older and an SMSF would likely cease to be cost-effective over time and the fund would likely need to be wound up in the event of the death or disability of a more active trustee.
Clients want the ability to implement a tailored superannuation estate planning strategy to suit their own specific requirements.	The clients intend to move overseas permanently or for more than two years.

1.5 Regulation of SMSFs

The ATO took over regulation of SMSFs from APRA on 8 October 1999. The ATO's stated aim as regulator is to ensure that SMSFs:

- comply with the relevant provisions of the SIS Act,
- are administered in a sound manner consistent with the government's retirement incomes policy, and
- are appropriately using superannuation assets for retirement purposes.

However, the ATO does not focus on the prudential regulation of SMSFs as the members, being trustees, are responsible for protecting their own interest in their fund.

Other government bodies with oversight of SMSF related issues

Australian Securities and Investments Commission

ASIC is responsible for regulating the relationship between consumers and providers of financial products and services. In relation to SMSFs, ASIC is responsible for:

- monitoring the appropriateness of any advice provided in relation to an SMSF to ensure it complies with the requirements of the *Corporations Act 2001* (Corporations Act)
- ensuring compliance with the financial product disclosure requirements of the Corporations Act, including those requirements for trustees and financial advisers
- maintaining a register of approved SMSF auditors, and
- monitoring the quality of advice provided to SMSF clients.

ASIC's stated aim is to promote informed participation in the financial system.

Relevant legislation

The trustees of a complying SMSF must administer and maintain their fund in accordance with a number of Commonwealth acts and regulations. These include the:

- *Superannuation Industry (Supervision) Act 1993*
- *Superannuation Industry (Supervision) Regulations 1994*
- *Corporations Act 2001*
- *Income Tax Assessment Acts 1936 and 1997*
- *Taxation Administration Act 1953*
- *Income Tax Assessment (1997 Act) Regulations 2021*

Trustees also have an obligation to maintain their fund in accordance with the clauses of their fund's trust deed. However, where a fund's trust deed conflicts with the SIS Act, the SIS Act will take precedence and override the fund's trust deed.

State trustee acts and general law

SMSFs are established as trusts and therefore trustees must maintain the fund in accordance with the rules and requirements imposed on trustees under both the relevant state trustee act and under general law as defined in the courts. For example, the trustees of an SMSF must exercise any discretionary powers given to them under the fund's trust deed in accordance with their obligations under general law.

2 SMSF definition and establishment

2.1 SMSF definition

To be an SMSF, a superannuation fund must satisfy the SMSF definition outlined in section 17A of the SIS Act.

SMSFs have two different definitions depending on whether the fund is a multi-member fund or a single member fund.

Multi-member fund definition

A superannuation fund (with more than a single member) will be an SMSF if it satisfies the following criteria:

- the fund has no more than six members
- each member of the fund is an individual trustee or a director of the corporate trustee
- if the trustees are individuals – each individual trustee is a member of the fund
- if the trustee is a company – each director of the company is a member of the fund
- no member is an employee of another member, unless the members are related
- no trustee (or director of the corporate trustee) receives any remuneration for duties performed as trustee (or as a director of the corporate trustee) for the fund.

Single member fund definition

A superannuation fund with a single member will be an SMSF if it satisfies the following criteria:

- if the fund has individual trustees:
    - the member is one of only two trustees, one of whom is the member and the other is a relative of a member, or
    - the member is one of two trustees, and the member is not an employee of the other trustee
- if the fund has a corporate trustee:
    - the member is the sole director of the corporate trustee, or
    - the member is one of only two directors of the corporate trustee, and the member and the other director are relatives, or
    - the member is one of only two directors of the corporate trustee, and the member is not an employee of the other director
- no trustee (or director of the corporate trustee) receives any remuneration for duties performed as trustee (or as a director of the corporate trustee) in relation to the fund.

The definition for single member SMSFs differs from multi-member funds in that they are permitted to have non-member trustees and that single member funds are permitted to have the member act as the sole director of the corporate trustee – negating the need for anyone else to be involved with the fund.

Reason for different definition for single member funds

The reason for the different definition between single member funds and multi-member funds relates to trust law requirements. That is, for a trust to exist under general law, there must be a separation between legal and equitable ownership of property. Therefore, the same person cannot be the sole trustee and sole beneficiary of a trust.

To overcome this potential problem for single member funds, the SMSF definition allows for a fund to have a single member where the member is:

- one of two individual trustees, or
- the sole director (or one of two directors) of the corporate trustee.

Therefore, a single member SMSF may have non-member trustees or non-member directors of the corporate trustee.

Requirement for all members to act as a trustee or director of the corporate trustee

The requirement for all members to act as trustee or director ensures that all members are fully responsible for the fund's activities and can act to protect their own interest in the fund.

Ban on trustee remuneration

Under the SMSF definition, no trustee (or director of the corporate trustee) can receive any remuneration for any duties or services performed by the trustee in relation to the fund. This aligns with a general trust law requirement that trustees must not receive any remuneration and also ensures that the fund is maintained purely for retirement purposes and not as a means for members to obtain early access to their superannuation interest.

The restriction, however, does not prevent trustees from being remunerated for non-trustee services they may provide to the fund in a separate professional capacity (for example, for accounting services).

To provide clarity, the government amended the SIS Act to include section 17B to confirm any remuneration paid to the trustee for any services performed in relation to the fund will not cause the fund to fail the SMSF definition if:

- the trustee performs the duties or services other than in the capacity of trustee, and
- the trustee is appropriately qualified, and holds all necessary licences, to perform the duties or services, and

- the trustee performs the duties or services in the ordinary course of a business, carried on by the trustee, of performing similar duties or services for the public, and
- the remuneration is no more favourable to the trustee than that which it is reasonable to expect would apply if the trustee were dealing with the relevant other party at arm's length in the same circumstances.

FirstTech comment

Trustee remuneration

While s17B provides clarity about the specific circumstances in which trustees of an SMSF can be remunerated, the requirements could be restrictive and preclude many trustees from carrying out various activities. For example, the requirement that the service be supplied as part of a business that normally supplies those services means that any trustee who does not conduct such a business cannot be remunerated.

For example, the trustee might be a qualified accountant but only work as an employee and cannot be remunerated for any accounting work they do in relation to the fund.

Furthermore, funds should ensure that proper documentation, that is, a service agreement covering the details of the services provided, is maintained as evidence that the requirements in s17B are satisfied for any remuneration paid.

If a trustee provides services to the fund other than in the capacity of trustee, they should also ensure the fund is only charged a commercial arm's length amount and not more or less.

If a trustee charged more than an arm's length amount, the fund could be deemed to have breached a number of rules including:

- the sole purpose test
- the prohibition on a fund providing financial assistance to a member or relative of a member, and
- the non-arm's length rule.

For more information on these rules, please see section 4.9, 4.10 and 4.12 respectively.

Alternatively, if a fund paid less than an arm's length amount, the fund could be considered to have incurred a non-arm's length expense. This could result in the fund being taken to have derived non-arm's length income which is taxed at the top marginal rate because the fund's net income would be higher than it otherwise should be had the fund paid an arm's length amount. For more information on non-arm's length income and expenses and in what circumstances a person will be acting in their capacity as trustee, please see section 5.7.

No member is an employee of another member

The requirement that no member be an employee of another member unless they are related is designed to eliminate the potential for one member to be pressured or influenced by another member via an employment relationship.

Extended definition of employee

For the purposes of the SMSF definition, a member who is an employee of an employer sponsor of the fund will also be taken to be an employee of another person (another member) if the employer sponsor is:

- a relative of another member
- a company of which another member, or a relative of another member, is a director or a related company
- a trustee of a trust of which another member, or a relative of another member, is a beneficiary
- a partnership of which another member, or a relative of another member, is a:
  - partner in the partnership
  - a director of a company that is a partner in the partnership, or
  - a beneficiary of a trust, if the trustee of that trust is a partner in the partnership.

For example, one member of an SMSF (Jack) would be considered to be an employee of another member (Jill) if Jack was employed by a company of which Jill was a director and the company was an employer sponsor of the fund.

What are employer sponsors?

An employer sponsor of a fund is an employer who contributes to a fund for the benefit of a member who is an employee of the employer, or an employee of an associate of the employer.

Exceptions to extended definition of employee

There are some exceptions to the extended definition of employee to avoid directors and relatives of directors being caught.

For example, in the case of a company with two unrelated directors that was an employer sponsor of a fund, each director would be considered to be an employee of the other director. In this situation, where both directors were members of the same fund, the fund would fail the SMSF definition.

To avoid this situation, SIS Regulation 1.04AA provides an exemption to exclude a director of an employer sponsor company from being an employee of the company or of another director of the company. Therefore, two unrelated directors of a company can be members of the same fund.

In addition, a person who is an employee and a relative of one member of an SMSF will not be taken to be an employee of another member of an SMSF. This allows a relative of a company director, such as a spouse, to be employed by the company without needing to be related to any other director who is also a member of the same SMSF.

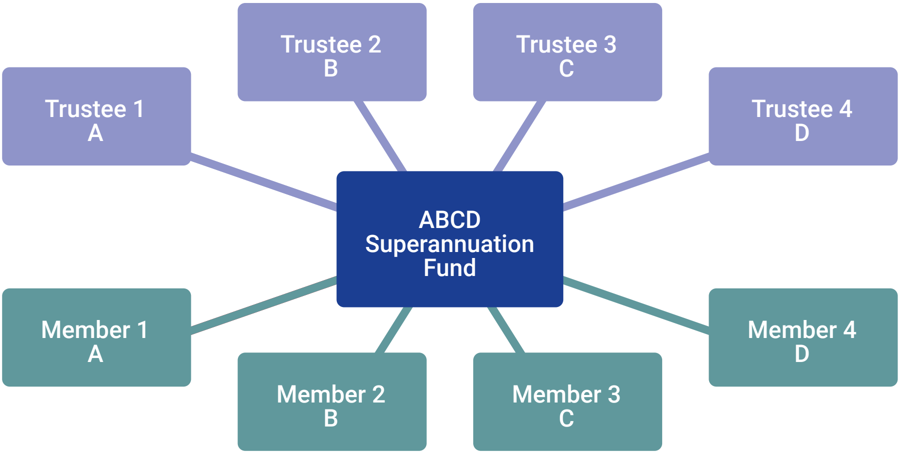
Who is a relative?

For the purposes of the SMSF definition, a relative of a person is defined as:

- a parent, child, grandparent, grandchild, sibling, aunt, uncle, great-aunt, great-uncle, niece, nephew, first cousin or second cousin of the individual or of his or her spouse or former spouse, or
- a spouse or former spouse of the individual, or of an individual referred to above.

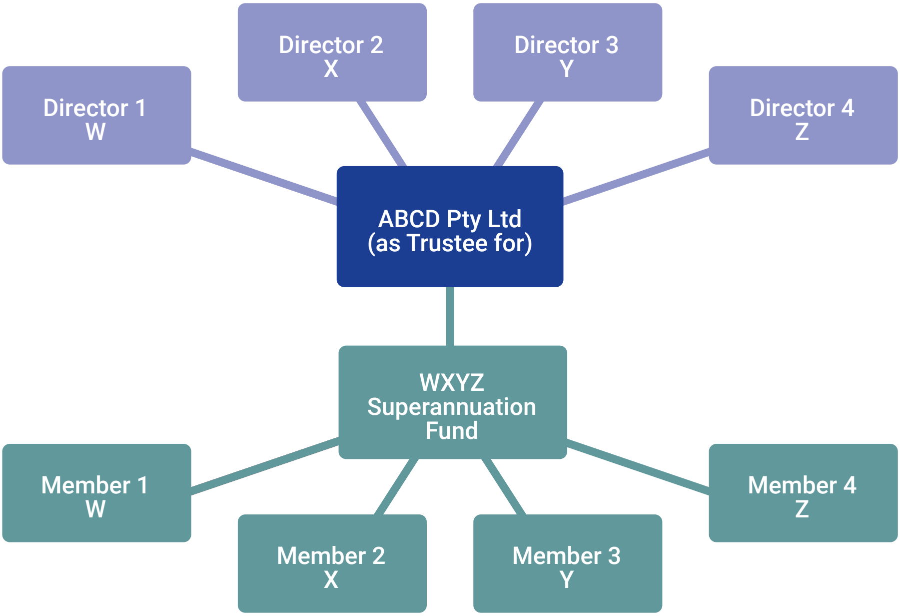
2.2 Examples of complying SMSF structures

Diagram 2.1 Multi-member SMSF with individual trustees



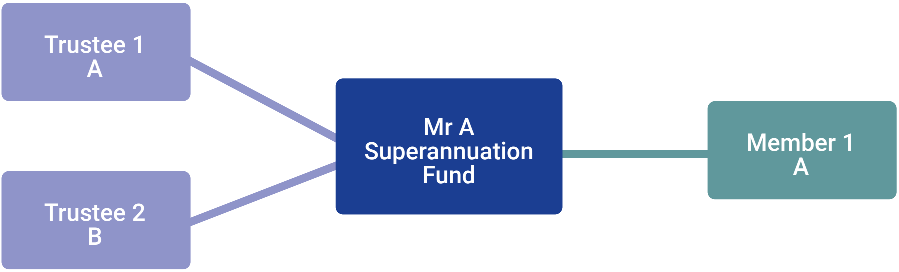
In this case the ABCD Superannuation Fund would qualify as an SMSF as all four members are acting as individual trustees and there are no other trustees.

Diagram 2.2 Multi-member SMSF with corporate trustee



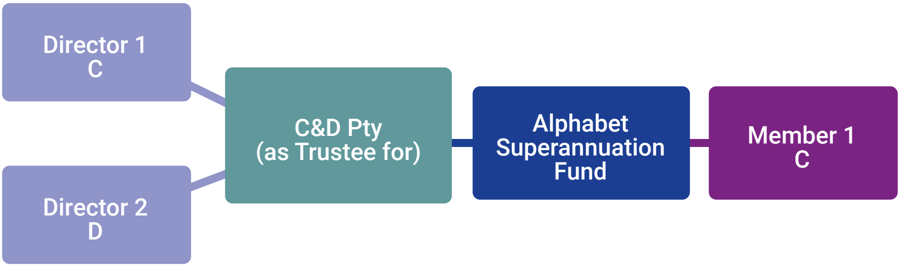
In this case, the WXYZ Superannuation Fund would also qualify as an SMSF as all four members are also acting as directors of the corporate trustee and there are no other directors.

Diagram 2.3 Single member fund with individual trustees



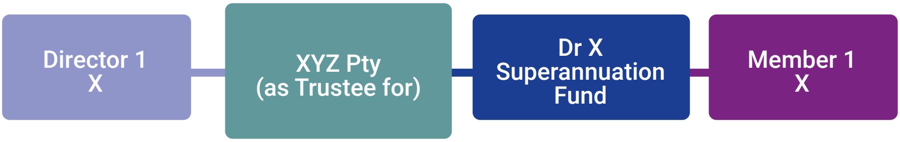
In this situation, the Mr A Superannuation Fund would qualify as an SMSF if A is related to B or if A is not an employee of B.

Diagram 2.4 Single member fund with a corporate trustee and two directors



In this case, the Alphabet Superannuation Fund would also qualify as an SMSF where C is related to D or where C is not an employee of D.

Diagram 2.5 Single member fund with corporate trustee and sole director



In this situation, the Dr X Superannuation Fund would qualify as an SMSF as the sole member of a single member fund is permitted to act as the sole director of the corporate trustee.

2.3 Trustee requirements

Under section 19 of the SIS Act, all superannuation funds are required to have a trustee.

Types of trustee

Section 19 of the SIS Act also requires that the trustee of a superannuation fund must be a constitutional corporation or the fund must be a pension fund. If a fund is a pension fund, the trustees may be individuals.

Therefore, an SMSF can have either individual trustees or a corporate trustee.

What is a constitutional corporation?

A constitutional corporation is a trading or financial corporation formed within the limits of the Commonwealth.

Requiring a constitutional corporation to act as trustee allows the Federal Government to regulate these funds via the corporations powers in the Constitution.

What is a pension fund?

A fund will be a pension fund where the trust deed contains provisions which provide that the sole or primary purpose of the fund is for the provision of old-age pensions.

Requiring a fund to be a pension fund allows the Federal Government to regulate these funds via its pension powers within the Constitution.

However, pension funds can still pay benefits in the form of a lump sum as members will normally be entitled to commute their entitlement to receive a pension to a lump sum, subject to the rules of their fund.

For more information on the relative advantages and disadvantages of corporate and individual trustees, please see section 2.7 of this chapter.

Who can act as trustee?

Under section 120 of the SIS Act, any person or constitutional corporation will be permitted to act as a trustee of an SMSF unless they have been disqualified from acting as the trustee of a superannuation entity.

An individual will be disqualified from acting as a trustee of a superannuation fund in the following circumstances:

- if at any time:
  - the individual has been convicted of any offence either in Australia or overseas involving dishonest conduct, or
  - a civil penalty order regarding a breach of the SIS Act was made in relation to the person
- the person is insolvent under administration, or
- the person has previously been disqualified from acting as a trustee by the regulator because they breached the SIS Act or were deemed not to be a fit and proper person to be a trustee of a superannuation entity.

FirstTech comment

Disqualified trustees register

The ATO has released a disqualified trustees register (available at www.ato.gov.au), which includes details of individuals who it has disqualified from acting as a super fund trustee or director of a corporate super fund trustee. The register is updated quarterly and includes individuals disqualified since 2012.

This register is not a definitive list of all individuals who are disqualified from acting as a super fund trustee or director of a corporate super fund trustee.

FirstTech comment

Meaning of dishonest conduct

The term 'dishonest conduct' is not defined in the SIS Act and therefore takes its ordinary meaning. The Macquarie Dictionary defines dishonesty as to lie, cheat or steal, or to engage in fraudulent conduct. In relation to superannuation, the courts have also confirmed that offences involving theft or deception for personal gain will generally be considered dishonest. Therefore, a person convicted of an offence involving theft, fraud, bribery, embezzlement or tax evasion (among others) would generally be disqualified from acting as the trustee of an SMSF.

This rule applies to disqualify a person who has ever been convicted of an offence involving dishonest conduct. Therefore, a person convicted of shoplifting 20 years ago would still be a disqualified person today.

A body corporate will also be disqualified from acting as the corporate trustee of a superannuation fund where:

- a responsible officer of the body corporate is a disqualified person in their own right, or
- a receiver, or a receiver and a manager, has been appointed in respect of property beneficially owned by the body corporate, or
- an administrator has been appointed in respect of the body corporate, or
- a restructuring practitioner has been appointed in respect of the body corporate, or
- a provisional liquidator has been appointed in respect of the body corporate, or
- the body corporate has begun to be wound up.

Waiver of disqualified person status

If a person has been disqualified due to being found guilty of an offence involving dishonest conduct, they can apply to the ATO to have their disqualified person status waived where the offence did not involve serious dishonest conduct.

Under section 126B of the SIS Act, an offence involves serious dishonest conduct if the penalty actually imposed for the offence is a term of imprisonment of at least two years or a fine of at least 120 penalty units.

Issues the ATO is required to take into account when determining whether to waive a person's disqualified status include:

- the nature of the offence committed by the applicant
- the time elapsed since the applicant committed the offence
- the applicant's age at the time of the offence

- whether the applicant would be likely to contravene the SIS Act or do anything that would result in their SMSF not complying with the SIS Act in the future.

However, for the ATO to consider the application it must be submitted in writing within 14 days of the person's conviction. Therefore, if a person wishing to set up an SMSF was convicted of an offence involving dishonest conduct, such as theft or shoplifting many years ago, they would be prevented from applying to the ATO for a waiver.

Alternatively, under section 126J of the SIS Act, a person in this situation may apply to the Federal Court of Australia for an order that they are not a disqualified person. In this case, no time limit applies.

For example, in Porter [2012] FCA 1431, a person who was convicted of embezzling money from their employer over 25 years ago was able to successfully apply to the court for an order that they are not a disqualified person.

Trustee consent and disqualified person status declaration

To be a trustee (or a director of a corporate trustee) of an SMSF a person must consent to their appointment in writing. A trustee (or a director of a corporate trustee) should also declare that they are not a disqualified person.

Trustee declaration

If a person is appointed as a trustee (or director of a corporate trustee) of an SMSF on or after 1 July 2007, they must sign an ATO declaration stating that they understand the duties and responsibilities of being a trustee. The trustee is required to sign the form in the presence of a witness (who is over age 18) within 21 days of becoming a trustee (or director of a corporate trustee) of the fund.

The declaration does not need to be lodged with the ATO but it must be kept on record for at least 10 years, or as long as the person remains a trustee of the fund.

Penalty for acting as trustee when disqualified

Under section 126K of the SIS Act, any person who knowingly acts as a trustee, or director of a corporate trustee, of a superannuation fund while disqualified will have committed an offence, punishable by:

- two year's imprisonment, or
- a fine of 60 penalty units.

Trustees that have become disqualified must also immediately inform the ATO in writing or they will have committed an offence punishable by a fine of up to 50 penalty units.

For more information on the value of penalty units, please see section 3.8 *Penalty Regime*.

FirstTech comment

What to do if someone becomes a disqualified person

If someone becomes a disqualified person they must immediately notify the ATO of their disqualification (unless they have been disqualified by the ATO) and resign as a trustee. If the person is a director of a corporate trustee, they must also inform ASIC of their disqualification.

Therefore, where a trustee believes there is a risk they could become disqualified, they should seek expert legal advice to understand their options as soon as possible. For example, once they have become disqualified, they will not be able to make any trustee decisions or perform any trustee actions, such as selling fund assets to facilitate a rollover, without breaching the law and risking significant penalties.

Alternatively, where all the trustees have already become disqualified and they still need to do things to facilitate the fund being wound up, such as liquidating assets, they could apply to the Court for special orders to allow them to do so. However, even where the Court consented, any such orders would likely to be very restrictive and only allow the trustees to take such actions that are required to wind up the fund and rollover members' benefits.

Please note – a disqualified person will not be able to appoint their LPR to act as trustee on their behalf, as section 17A(10) prohibits the LPR of a disqualified person from acting as a trustee of the disqualified person's SMSF, or as a director of the SMSF's corporate trustee.

2.4 Other persons who may act as trustee

Subsection 17A(3) outlines circumstances under which other persons will be permitted to act as a trustee (or director of a corporate trustee) on behalf of a member without causing the fund to fail the SMSF definition. This is important as it may allow someone else to act as a trustee on behalf of a member due to a member's death, invalidity or absence.

Death of a member

Where a member of the fund has died, their Legal Personal Representative (LPR) can act as a trustee of the fund (or a director of the corporate trustee) in their place from the time of death until the time a death benefit commences to be paid.

This can allow a deceased member's LPR to step in and to protect the member's interest in the fund and ensure it is paid out as per the member's wishes. However, once the fund has commenced to pay any death benefits, this exemption will cease to apply. In this case, where the fund now fails the SMSF definition, it will still remain an SMSF until the earlier of:

- six months after it would cease to be an SMSF, or
- the appointment of a Registrable Superannuation Entity (RSE) Licensee as trustee.

See section 2.5 below for more information.

What is a Legal Personal Representative?

Section 10 of the SIS Act defines an LPR of a member to mean the executor of the will or administrator of the estate of a deceased member, the trustee of the estate of a member under a legal disability or a person who holds an enduring power of attorney granted by a member.

ATO ID 2010/139 also confirms that where a state or territory administrative tribunal appoints an administrator to manage the estate of a person under a legal disability due to mental incapacity, that administrator will be the LPR of that member under a legal disability.

However, the ability of a deceased member's LPR to step in and act as a trustee on behalf of the member will be subject to the rules in the fund's trust deed. For example, if a fund's trust deed specifies that trustees are appointed by the members of the fund, a deceased member's LPR could only become a trustee of the fund with the consent of the surviving members.

If a deceased member's LPR has been appointed to act as a trustee, the LPR must resign as soon as the member's death benefit has commenced to be paid. For lump sum death benefits this will be from the date of the lump sum death benefit payment (or an interim death benefit payment). For death benefits paid as an income stream this will be from the date of the commencement of the income stream.

For single member SMSFs where the member acted as the sole director of the corporate trustee, practical problems could arise where part of the fund's assets are invested in an illiquid asset that will take some time to sell. In this situation, the deceased member's LPR may need to delay the payment of any lump sum death benefits pending the sale of all the fund's assets, as any interim death benefit payment would require the LPR to resign as a director of the corporate trustee.

Sole director of a corporate trustee of a single member SMSF

If the sole member of a single member SMSF dies and they were also the sole director of the fund's corporate trustee, someone will need to be appointed as a director of the company so that it can continue to operate as the trustee of the fund and to manage the fund's affairs.

Under section 201F of the Corporations Act 2001, the LPR of the deceased director of a sole director company may appoint a new director to the company.

The replacement director can then arrange for the payment of any death benefits and for the fund to be wound up where required.

However, where the sole director of a SMSF's corporate trustee dies without a will, the deceased will not have an LPR until someone is issued with letters of administration and is appointed as the administrator of their estate. Depending on the circumstances, this could significantly delay the payment of any death benefits. In addition, depending on who is issued with letters of administration and the terms of the trust deed, this could also impact how a death benefit is eventually paid.

For example, where a person, such as a deceased member's adult child, was issued with letters of administration, they could elect to appoint themselves as the sole director of the SMSF's corporate trustee. Depending on the terms of the fund's trust deed, they could then exercise their discretion in relation to the payment of the member's death benefit.

For more information about the payment of death benefits from an SMSF, please see *Chapter 8: Death benefit payments and planning*.

FirstTech comment

Need for members of single member SMSF to have a will

To ensure the right person is left in control of their fund, all members of single member SMSFs should have a will that nominates a capable and trustworthy person as their LPR. This will help ensure the death benefit is paid as per their instructions and wishes.

Member under a legal disability

A member's LPR may also act as a trustee (or as a director of the corporate trustee) in place of a member during any period when the member of the fund is under a legal disability (i.e. they lack legal capacity due to age or mental incapacity). This is important as it could assist an existing SMSF to keep functioning where a member has become mentally incapacitated due to an accident or illness.

Member has granted an enduring power of attorney

A member's LPR is also permitted to act as a trustee (or as a director of the corporate trustee) in place of a member regardless of the member's legal capacity where they hold an enduring power of attorney (EPoA) for the member. This is important as it could allow someone else to act as trustee during any period when the member is unable to do so due to circumstance or absence.

In the ATO's Self Managed Superannuation Funds Ruling SMSFR 2010/2[3], the ATO outlines that for a member's LPR who holds an EPoA to act as a trustee on their behalf, the member's LPR must be appointed as a trustee of the SMSF, or a director of the corporate trustee of the SMSF. The member must then cease to be a trustee of the SMSF or a director of the corporate trustee (except where the LPR is appointed as an alternate director). That is, a person who holds an EPoA for a member can't simply act as a trustee on the member's behalf but must be appointed as a trustee in their own right and will be legally responsible for the fund.

LPR of disqualified person cannot act as trustee

The SMSF definition in section 17A of SIS confirms that the LPR of a person who has been disqualified from acting as a trustee of a superannuation fund is not permitted to act as a trustee in the disqualified person's place. For example, a trustee who has become disqualified due to becoming bankrupt could not appoint someone else to act as trustee in their place.

For more information on who is permitted to act as the trustee of an SMSF, please see section 2.3 of this chapter.

Member is a minor

Where a member of an SMSF is under a legal disability due to age and does not otherwise have an LPR, the member's parent or legal guardian can act as trustee (or as a director of the corporate trustee) on their behalf. This allows adult members to include their minor children as members of their fund.

Importantly, this exemption also allows a member's death benefit to be paid to their minor children in the form of an income stream. In this case, the child would generally be required to become a member of the fund but the surviving parent or guardian could then act as trustee.

Trustee suspended or removed by regulator

Under the SIS Act, the ATO as regulator of SMSFs has the power to suspend or remove a trustee of a superannuation entity. Where this occurs, the ATO is required to appoint either a company or an individual to act as trustee on the member's behalf. In this case, the appointment of an acting trustee will not cause the fund to fail the SMSF definition.

3 Self Managed Superannuation Funds Ruling 2010/2: The scope and operation of subparagraph 17A(3)(b)(ii) of the Superannuation Industry (Supervision) Act 1993.

2.5 Fund fails SMSF definition

Trustees need to be aware that any change in a member's personal circumstances could cause a fund to fail the SMSF definition.

For example, if one member of a two-member SMSF that had individual trustees died or otherwise left the fund (for example, due to a relationship breakdown), this would leave the fund with a single member who was also the sole individual trustee – which would not satisfy the single member SMSF definition (see section 2.1 of this chapter). As a result, the fund would need to restructure (for example, by either appointing another person to act as a trustee or for the fund to convert to a corporate trustee structure) in order to remain an SMSF.

Six-month period

Where a fund fails the SMSF definition it will remain an SMSF and continue to be regulated by the ATO until the earlier of:

- the appointment of a Registrable Superannuation Entity (RSE) Licensee, or
- six months after it would cease to be an SMSF.

The six-month period is generally to give an SMSF time to restructure so it can retain its SMSF status. However, this will not apply where the reason the fund fails the SMSF definition is due to the admission of one or more members. For example, where a seventh member was added to an SMSF (leading to the fund exceeding the maximum permitted number of members), the additional member would need to be removed immediately.

What is a Registrable Superannuation Entity (RSE) Licensee?

A RSE Licensee means a constitutional corporation, body corporate, or group of individual trustees that holds an RSE licence that would entitle them to act as the trustee of an APRA-regulated superannuation fund.

Events to be aware of

Trustees and their advisers should be aware of the situations that can lead to a fund failing the SMSF definition and should take action to restructure the fund where required. Circumstances that could result in a fund failing to satisfy the SMSF definition include:

- death of a member
- personal relationship breakdown – resulting in one or more members leaving the fund
- business relationship breakdown – resulting in one or more members leaving the fund
- sale of business interest to partner – resulting in one or more members leaving the fund or ceasing to be a director of the corporate trustee

- an individual trustee (or director of the corporate trustee) being disqualified from acting as a superannuation fund trustee
- a fund's corporate trustee being disqualified from acting as a superannuation fund trustee.

2.6 Small APRA Funds

An alternative to SMSFs are Small APRA Funds (SAFs). Like SMSFs, SAFs are required to have no more than six members. However, they differ from SMSFs in that they are required to have an independent trustee that is an RSE licensee instead of having the members act as the trustees (or directors of the corporate trustee).

Because these funds have an independent trustee, a SAF may be an option for those people who want a small fund but can't act as a trustee of a superannuation fund (such as a disqualified person) or simply do not want to take on the additional responsibility of being a trustee of their own fund.

Some other benefits and features of SAFs include the following:

- they can have arm's length members such as employees of the employer sponsor of the fund (unlike SMSFs)
- members can exercise investment control
- they are permitted to acquire business real property from related parties
- they have access to the Australian Financial Complaints Authority (AFCA) to resolve disputes between the members and the trustee (unlike SMSFs)
- they are subject to the culpability test (unlike SMSFs), which is designed to protect arm's length members who are not involved in trustee decision-making.

Although the members of a SAF can exercise control over the fund's investments, this will usually be subject to limits imposed by the independent trustee.

For example, an independent trustee may limit a fund's exposure to any one security, industry sector or asset class to a certain level to ensure minimum levels of diversification and liquidity are maintained. In addition, SAF trustees may also refuse to hold or invest the fund's assets in private companies or unit trusts.

If an SMSF converts to a SAF, the ATO must be notified of the fund's change in status within 21 days.

2.7 Establishing an SMSF

To establish an SMSF, the members will need to consider these issues and then take these steps:

Pre-establishment issues

Before establishing an SMSF, the members should consider and resolve a number of issues.

Confirm SMSF suitability

Prospective members of an SMSF should consider whether an SMSF will be suitable for their needs and circumstances. Potential members may therefore need to consider:

- if they are willing to accept the duties and responsibilities of being a trustee
- whether the fund will be justified from a cost perspective
- if they have the investment skills and experience required to manage the fund's investments
- if they are disqualified from acting as the trustee of a superannuation fund
- whether they are likely to become non-resident
- if a large fund would better suit their needs and circumstances.

For more information on the suitability of SMSFs, please see *Chapter 1: Introduction to SMSFs*.

People considering setting up an SMSF also need to clearly understand that an SMSF must only be established for the sole purpose of providing retirement benefits and that severe penalties can apply where a fund is established or maintained for any other purpose.

Determine fund membership

A key consideration before establishing an SMSF is to identify who should be included as a member of the fund. This is important as all members, as trustees, will have a say in relation to the control and management of the fund. Issues that should be considered include:

- the ability of each member to act as a trustee and to make decisions for the fund
- the nature of the relationship between the different members and the potential for dispute between members
- whether the members will want or trust anyone else to be involved in the fund.

For example, a person wanting to set up an SMSF may not feel comfortable with other people being involved in the management of their retirement savings. In this situation, they should consider a single member fund where the member acts as the sole director of the corporate trustee.

Parents thinking of establishing an SMSF may also wish to carefully consider if they want their children to be included as members of the fund. While this may not be an issue while the children are minors, it could cause problems once the children turn 18, as they will then be able to act as a trustee in their own right. In this case, children could end up having an equal or dominant say about trustee decisions, such as making investment decisions or the payment of death benefits.

Considering whether to include family members can be even more crucial for blended or complex family arrangements. For example, including a second spouse as a member of an SMSF could increase the potential for dispute between the second spouse and the children from a previous marriage regarding the payment of death benefits. In this case, depending on a person's needs and circumstances it may be prudent to limit fund membership to exclude these types of relationships and to ensure proper arrangements have been put in place for the payment of any death benefits.

FirstTech comment

Unusual membership arrangements

If funds are established with an unusual or atypical membership structure, such as where friends, siblings and/or business partners are members of the same SMSF, there may be an increased risk of relationship breakdown. In this case, the trustees should consider how such risks could be avoided or managed. For example, the members could include dispute resolution mechanisms within the rules of the fund to ensure any disputes can be resolved quickly and simply.

For more information on the risks to an SMSF of a relationship breakdown, please see *Chapter 1: Introduction to SMSFs*.

Determine trustee structure

As previously discussed, an SMSF must either have a corporate trustee or it can be established as a pension fund with individual trustees. Which trustee structure will be most appropriate depends on a range of issues and can vary depending on the membership of the fund and the type of benefits to be paid from the fund.

For example, if a client wishes to establish a single member SMSF and they do not want anyone else to be involved in running the fund, their only option will be a corporate trustee structure. Otherwise they would need to have an additional person act as a trustee to satisfy the SMSF definition.

If a trustee does not need to use one trustee structure over another they should consider the relative advantages and disadvantages of the different trustee types.

Some of these benefits and disadvantages are summarised in Table 2.1.

Table 2.1 Comparison of advantages and disadvantages of individual and corporate trustees

Feature of trustee type	Trustee type Individual	 Corporate
Administrative efficiency where change in fund membership	Member leaving or joining the fund must be removed or appointed as trustee. This requires: • amendment of trust deed • change of legal ownership of fund assets. Member leaving the fund may also require change to corporate trustee where it results in fund becoming single member fund.	**Member leaving or joining the fund must be removed or appointed as director of corporate trustee.** This requires: • resolution to appoint/remove director • ASIC notification of change of director. Legal ownership of assets are not required to change and the departure of a member will not require change in trustee structure where a fund becomes a single member fund.
Easier to identify and keep fund assets separate from personal assets	Trustees recorded as legal owner of assets. Can result in failure to distinguish between fund and personal assets which can lead to: • mixing of fund and personal assets • inadvertent sale of fund assets • fund assets being offered as security for a personal loan. Additional declarations of trust may also be required for certain asset types, such as property, where it is not possible to record ownership as a trustee.	**Company recorded as the legal owner of fund assets.** Allows individuals to clearly distinguish between fund assets and personal assets. Reduces risk of fund assets being mixed with personal assets or of fund assets being inadvertently sold or offered as security for a personal loan. Note – If a corporate trustee is used, similar problems to individual trustees arise where company also undertakes other activities, such as operating a business.
Asset protection	Trustees' personal assets not protected where sued for damages.	**Director's personal assets may be protected where a trustee is sued for damages**
Cost to establish and maintain	No additional costs are incurred to set up an SMSF with individual trustees.	Cost of setting up company to act as trustees fund can increase fund establishment costs by $400 – $1,000. Additional annual ASIC reporting obligations and fees apply.
ATO administration penalties	Maximum ATO administrative penalties of up to $18,780 per trustee.	**Maximum ATO administrative penalty of $18,780.** However, courts can increase maximum penalties for offences by up to five times for a corporate trustee.

ASIC guidance for advisers

In December 2022, ASIC released Information Sheet 274 (INFO 274) *Tips for giving self managed superannuation fund advice.* Among other things, INFO 274 says that advisers should advise a client about whether a corporate or individual trustee structure is appropriate for their circumstances, including providing them with a comparison of the risks and benefits of each structure. The factors ASIC says to consider for a client may include:

- Cost, including the potential cost of changing the trustee structure later on.
- Compliance with the SMSF trust deed, superannuation, corporations and taxation laws, the company's constitution and the Corporations Act.
- Administration and reporting requirements.
- Trustee succession planning for your client (i.e. ensuring arrangements are in place for trustees and directors who are unable to fulfil these roles in the event of illness or death).
- SMSF asset ownership considerations.

FirstTech comment

Avoid using existing trading company as corporate trustee

While a corporate trustee structure generally offers a range of advantages over individual trustees (see Table 2.1), using an existing company that also runs a business to act as a trustee of an SMSF should be avoided as it could have a number of impacts on the fund. These include:

- Any change to the company directors would also impact the SMSF and could require the fund to be restructured.
- Any administrative errors regarding the operation of the business or the superannuation fund could cause the fund to breach the SIS Act. For example, where the fund's cash account was mistakenly used to pay a business expense, this would result in a breach of the sole purpose test.
- If the company became disqualified due to becoming insolvent or having an administrator appointed, the company would need to be removed as trustee and a new trustee appointed.

Establishing a sole purpose company to act as the trustee of the SMSF would avoid these potential issues. A company that acts solely as a superannuation fund trustee will also qualify for reduced ASIC fees for filing annual returns. To qualify for reduced fees, the company's memorandum of association must prohibit the company from distributing any income or capital among its members.

FirstTech comment

Corporate trustee may be required for SMSFs with five or six members

On 1 July 2021, the SMSF definition in the SIS Act was amended to allow up to six members (previously a maximum of four). However, note that some state trustee legislation may only allow a trust (or certain property to be held on trust) with a maximum of four trustees. Some SMSFs with five or six members may therefore need to use a corporate trustee to comply with both SIS and state trustee legislation requirements.

Consider the fund's trust deed

The trust deed is a formal legal document that sets out the rights, duties and obligations of the various parties to a trust arrangement and should only be prepared by a qualified legal practitioner.

The trust deed for a superannuation fund is critical as it sets out all the rules and conditions that apply to that particular fund. For example, a trust deed for an SMSF will usually contain provisions setting out:

- the name of the fund
- the trustee details
- rules about the appointment and removal of trustees
- rules about the amendment of the trust deed
- rules about who can be admitted as a member of the fund
- rules prohibiting trustee remuneration
- rules on the types of benefits that can be paid and when they can be paid
- details of how member benefits will be calculated
- details of who can make contributions to the fund
- details of the types of contributions that can be accepted and whether they can be split with a spouse
- rules specifying what the fund can invest in
- details of the circumstances in which a fund will be permitted to borrow
- details of the ability of trustees to accept a binding death benefit nomination from a member
- rules on the payment of death benefits
- provisions allowing trustees to establish reserves
- rules about trustee voting and the resolution of disputes
- details of the requirements for winding the fund up
- requirement for trustees to comply with the SIS Act and Regulations.

If the members are to act as individual trustees, the deed should also contain a clause specifying that the sole or primary purpose of the fund is the provision of old-age pensions.

SMSF deeds can be obtained directly from legal firms or indirectly via other service providers, such as an SMSF administration service provider. However, before deciding on what trust deed to use, the client should review a draft to ensure it is appropriate for their purposes.

For example, where the members wanted to borrow to acquire property through the fund they should ensure the deed will allow the trustees to set up and maintain a borrowing under a limited recourse borrowing arrangement.

Under general law, the trustees must comply with the rules contained in the deed at all times. Where a trustee breaches a provision of the trust deed they will be in breach of trust and can be held liable for any losses that result from the breach. Trustees should therefore ensure they understand the rules contained in the trust deed and comply with them at all times.

FirstTech comment

The SIS Act and the trust deed

Section 7 of the SIS Act confirms that the Act applies to all superannuation funds despite any provisions contained in a fund's trust deed. Therefore, all trust deeds should be worded to ensure they comply with the SIS Act requirements and should not contain any provisions which would allow, or require, the trustee to breach the Act.

However, this rule does not prevent a fund's trust deed from containing provisions that are more restrictive than the SIS Act. Therefore, trustees and their advisers should always refer to both the SIS Act and the fund's trust deed to confirm whether the trustees/members will be permitted to undertake a particular course of action.

For example, where a trustee wishes to pay a retirement benefit in the form of a pension, the trustees should review the deed to ensure it allows benefits to be paid in the form of an income stream.

Consider insurance

Before deciding to establish an SMSF, the members should consider their current and future insurance needs as well as the cost, availability and options for holding of insurance through an SMSF.

The members should also consider whether it would be better to maintain their existing insurances in a large APRA-regulated fund where they may get the benefit of group insurance arrangements.

However, they should consider any impact that rolling over an amount of the member's benefit in the fund to an SMSF and redirecting their employer contributions to an SMSF would have on the member's insurance cover.

For example, some large funds may require both a minimum balance and the continued receipt of the member's employer contributions for certain cover, such as salary continuance cover, to remain valid.

FirstTech comment

Protecting your super – insurance and inactive accounts

From 1 July 2019, trustees of large APRA-regulated funds are prohibited from providing insurance where the member's account is inactive (in other words, no contributions or rollovers received) for a continuous period of 16 months or more, unless the member has made an election to obtain or maintain insurance in that fund.

If a member has an existing insurance policy, the trustee will therefore be required to cancel the insurance after 16 months of inactivity where no valid election has been made. In this case, members should notify the trustee in writing that they wish to retain their insurance in the account even if it becomes inactive, to ensure that their insurance remains in place.

Obtain a Product Disclosure Statement

Under the Corporations Act 2001, an interest in a superannuation fund, including an SMSF, is defined as a financial product. Therefore, a trustee, or an adviser, must generally give a person a Product Disclosure Statement (PDS) about a superannuation fund when:

- giving personal advice to that person about that fund, or
- offering to issue (or to arrange to issue) an interest in that fund to that person, or
- issuing an interest in that fund to that person.

However, ASIC have outlined in Regulatory Guide RG 168 that an exception applies to exclude a trustee or an adviser from having to issue a PDS for an SMSF where the issuer or adviser believes on reasonable grounds that the member joining the fund has received, or has (and knows they have) access to all the information that is required to be included in a PDS.

In RG 168 ASIC have outlined that an adviser cannot rely on the fact that a member, as trustee, is obliged to know about the fund to fulfil their duties as a trustee (or director of the corporate trustee) to avoid having to provide a PDS.

Therefore, unless a trustee or adviser has some other reasonable basis for not providing a PDS, they will generally be required to issue a PDS to each new member joining an SMSF. To avoid this situation, advisers and trustees should ensure the fund uses a trust deed that comes with a PDS.

For funds that will have a corporate trustee – obtain a director identification number for each director

A director identification number (director ID) is a unique identifier that all company directors are required to have since 2022. Director IDs were introduced to:

- prevent the use of false or fraudulent director identities
- make it easier for external administrators and regulators to trace directors' relationships with companies over time, and
- identify and eliminate director involvement in unlawful activity.

Where a new fund will have a corporate trustee, all persons that will be appointed as a director of the fund's corporate trustee must apply for and obtain a director ID before their appointment.

For further information about director IDs, including the application process, refer to www.abrs.gov.au/director-identification-number

Establishing the fund

Once the pre-establishment issues have been resolved here is what members need to do to establish a fund.

Step 1 – Obtain and sign fund application forms

The members of the fund should obtain and complete application forms to become members of their fund and to establish a corporate trustee (where relevant). Application forms are generally available from SMSF documentation/administration services as part of a fund establishment kit and generally include the option to set up and register a company with ASIC. These forms capture data that can be used to create fund documents and member accounts and appoint members as directors of a corporate trustee.

Information generally captured on a fund application form includes member:

- name
- date of birth
- address
- Tax File Number
- retirement status
- trustee details (individual or corporate).

Information from the application form can also then be used to prepare the fund's trust deed.

Step 2 – Execute deed, appoint trustees, admit members and adopt investment strategy

The members will need to meet to execute the trust deed and appoint themselves as a trustee, or directors of the corporate trustee. Trustees will also need to sign the various consents and declarations as well as adopt an investment strategy for the fund. These are summarised as follows:

- Execute the deed – the trust deed must be signed and dated in accordance with the relevant state or territory law. In some states the deed must also be stamped by the relevant office of state revenue.
- Sign trustee consents – under the SIS Act, trustees must consent in writing to their appointment as a trustee. Trustees may also be required to sign a declaration confirming that they are not disqualified from acting as a trustee of a superannuation fund.
- Sign trustee declaration – all new trustees (or directors of a corporate trustee) must sign a declaration within 21 days of becoming a trustee, confirming they understand the duties and obligations of being a trustee. The declaration does not need to be lodged with the ATO but it must be kept on record and provided to the ATO on request.
- Formulate and adopt an investment strategy for the fund (See *Chapter 3: Trustee responsibilities* for more detail).

Step 3 – Set up a bank account

Trustees will need to establish a bank account to facilitate a range of fund transactions, which include:

- accepting future contributions and receiving rollovers
- funding the acquisition of fund assets
- receiving investment income and the proceeds from the sale of fund assets, and
- paying benefits and funding operating expenses and liabilities.

However, some financial institutions may refuse to open a bank account for an SMSF unless the fund has already been registered with the ATO and included on the register of complying funds (see Step 4). Unfortunately, this creates a chicken-and-egg situation as the ATO will generally refuse to register a fund unless it has assets.

To resolve this issue the ATO has advised[4] that:

- If the fund expects to receive a rollover or contribution in the near future, an SMSF can be established with a nominal amount (for example a member could give the trustee $10 to be held with the trust deed). Once the fund has been registered a bank account can then be opened and the $10 deposited and accounted for as a member contribution.

4 https://www.ato.gov.au/super/self-managed-super-funds/setting-up/create-the-trust-and-trust-deed/

- If a member is not eligible to contribute due to age, the ATO has confirmed it can apply administrative discretion to allow a nominal contribution. In all cases the nominal contribution must be allocated to the member solely for the purpose of registering the fund. The member must then receive further money into the SMSF (such as via rollover) before the end of the year the fund was established.

Alternatively, some financial institutions may agree to establish a bank account without requiring the fund to be registered first. However, in these situations an institution may restrict account transactions until the fund is registered.

Once the trustee has established the fund's bank account they will also need to advise the ATO of the account details. This ensures the fund will be able to receive rollovers from large funds, as large funds are required to confirm a range of details with the ATO (via the SMSF verification service – see below) prior to rolling over any amounts to an SMSF. This includes an SMSF's bank account details.

Step 4 – Register the fund with the ATO

Once the fund has been established and holds assets the trustees are then required to register the fund with the ATO. As part of the registration process the trustees will be required to:

- confirm the fund has assets
- make an election for the fund to be regulated – to qualify for concessional tax treatment all new superannuation funds must make an irrevocable election to the ATO to be regulated under the SIS Act within 60 days of the fund being established
- apply for a Tax File Number and Australian Business Number
- register for Goods and Services Tax (GST) where required.

Trustees can do all these things by completing the Application for ABN Registration for Superannuation Entities form.

> **Note**
> The ATO will generally refuse to register a fund unless it has assets.
> See Step 3 for more information.

FirstTech comment: **Reporting requirement in first year**

If an SMSF has assets and has been established and registered it will be required to lodge an annual return for that year. This applies regardless of when the fund was established in that year. Therefore, trustees considering setting up an SMSF close to the end of the financial year may wish to consider delaying until after 30 June to save on costs.

Alternatively, where a fund has been registered but does not have assets set aside for the benefit of members in the first year it was registered, the ATO has confirmed[5] the trustee can request to either:

- cancel the fund's registration, or
- flag the SMSF's record as Return Not Necessary (RNN) if the SMSF confirms in writing that:
  - although registered, it had no assets and did not receive contributions or rollovers in the first financial year
  - it has documentary evidence of the date the SMSF first held assets and commenced operating (for example the SMSF's first bank statement) and
  - it will be lodging future returns.

When making the request the trustees must confirm:

- the SMSF's name, TFN or ABN
- that it meets all eligibility conditions
- documentary evidence of the date assets were first placed into the fund.

Trustees should contact the ATO directly. Alternatively, where the fund has a tax agent, the tax agents can use the ATO Tax Agent Portal.

GST and superannuation funds

A superannuation fund must register for GST if its annual turnover is greater than $75,000. For superannuation funds, turnover includes income from the leasing of equipment or commercial property owned by the fund.

Amounts that are not included in the turnover of an SMSF include:

- member contributions
- investment income (other than income from the leasing of commercial property)
- administration fees
- fees charged for life and total and permanent disability insurance
- rents from the leasing of residential property
- receipts from the transfer of capital assets.

5 ATO website: https://www.ato.gov.au/super/self-managed-super-funds/administering-and-reporting/lodge-smsf-annual-returns/#Newlyregisteredwithoutassets

Where it is optional for a fund to register for GST, the trustees should compare the benefits of registering and being able to claim a proportion of any GST paid (through a reduced input tax credit) with the additional record keeping and reporting costs involved.

Step 5 – Accept contributions and receive rollovers

Once a fund starts accepting contributions and receiving rollovers, trustees should ensure that those amounts are properly documented, including recording of the amount and type of any contributions as well as the tax component breakdown and preservation status of any rollovers (as advised in the rollover benefits statement from the previous fund).

Prior to rolling over benefits to an SMSF, a superannuation fund is required to use the SMSF verification service (SVS).

The SVS is a web service administered by the ATO that allows authorised entities (such as large APRA funds and SMSFs) to verify an SMSF's details before rolling over any benefits to an SMSF via SuperStream.

The SVS will verify the following:

- SMSF status (complying or regulated)
- that the TFN of the individual is associated with the SMSF
- no verified date of death exists for the individual/SMSF member associated with the SMSF
- SMSF bank details held by the ATO
- Electronic Service Address (ESA) held by the ATO.

Where the ATO verifies all these details, the fund can proceed with the rollover request.

However, where the ATO is unable to verify all these details as being correct, the ATO will not confirm the rollover request as verified and the large fund will not proceed with the rollover until any inconsistencies or errors are resolved. This may require the trustee to check what details, such as bank account details etc, they reported to both the ATO and the large fund. Once any inconsistencies or errors have been resolved, the trustee will then need to re-initiate the rollover request with the large fund.

It is therefore important to ensure both the rollover fund and the ATO hold current up-to-date information for both the member and the SMSF before requesting a rollover to avoid any delays.

SuperStream, employer contributions and rollovers

Superannuation funds, including SMSFs, must receive employer contributions electronically (including both the amount of the contribution and the contribution information). For SMSFs, these rules only apply to contributions from unrelated employers.

Trustees setting up a new fund that will accept contribution from unrelated employers should refer to their accountant or administration service provider to determine whether they can register and obtain an electronic service address for the fund. If not, the trustees will need to register the fund with an electronic messaging provider themselves. For a list of messaging providers see the register of SMSF messaging providers on the ATO website.

For more information on SuperStream please see section *7.1 Accept and Allocate Contributions*.

SMSFs are also required to pay and receive all rollovers to and from other complying funds electronically and in accordance with the SuperStream data and payment standard.[6] For further information about SMSF rollovers and SuperStream, please see section 3.4.

Step 6 – Invest fund assets

Trustees must invest fund assets in accordance with the fund's trust deed and investment strategy. The trustees must also comply with the SIS investment rules. When acquiring and holding assets, the trustees must ensure the ownership of the assets is recorded as being in the name of all the individual trustees, as trustees for the fund, or in the name of the corporate trustee, as trustee for the fund. This helps ensure the fund's assets aren't confused with an individual's personal assets.

Where it is not possible to identify or record that the asset is being held in trust, such as in the case of real property in most states, trustees should ensure they maintain sufficient records to demonstrate the fund's ownership of the asset. For example, this could include trustee minutes documenting the trustee's decision to acquire the asset and financial statements and records demonstrating that the fund's resources were used to acquire the asset and that all income generated from the asset has been paid back to the fund.

Alternatively, or in addition, the trustees could also register a caveat over the asset or put in place a declaration of trust over the asset. However, before putting in place a declaration of trust over dutiable property, the trustee may wish to seek specialist stamp duty advice as a declaration of trust can trigger an ad valorem stamp duty liability.

Step 7 – Appoint external service providers

Trustees need to appoint service providers to undertake certain tasks in relation to their fund. These could include:

- an approved auditor to audit the fund
- a lawyer to draft or amend a trust deed
- an actuary to provide an actuarial certificate to confirm the tax-free status of a fund's pension assets
- a qualified independent valuer to assess the market value of a collectable to be disposed of to a related party.

6 To the extent that a rollover is done via an in-specie transfer of assets, it is not required to be processed via SuperStream.

Other service providers a trustee may choose to appoint (but which are not mandatory) include:

- a financial adviser to draft the fund's investment strategy
- an accountant to administer the fund and to prepare the fund's tax return, accounts and operating statements
- an SMSF administration service to administer the fund and to prepare the fund's tax return, accounts and operating statements.

However, while a trustee can engage service providers to undertake certain tasks or duties for the fund, they cannot delegate their responsibility for the fund. For example, where a trustee breached a provision of the SIS Act, the trustee would be held accountable even though the breach was caused by relying on incorrect advice provided by a third party service provider.

3 Trustee responsibilities

3.1 Trustee legal responsibilities

As a trustee of a superannuation fund, the trustee of an SMSF must maintain the fund in accordance with the SIS Act. However, as a trustee of a trust, SMSF trustees also have a range of duties and obligations under general law.

General law duties

A trustee's general law duties have been set down by the courts over many hundreds of years and include the requirement to:

- acquaint themselves with the terms of the trust
- adhere to and carry out the terms of the trust
- secure the legal title to, or control over, the trust property
- properly invest the trust's funds in accordance with the trust deed and the law
- act impartially and in the best interest of all beneficiaries
- keep proper accounts
- report to beneficiaries and to authorities where required
- exercise reasonable care
- complete and lodge any required returns for the trust
- pay benefits to the right beneficiary.

Where a trustee has failed to comply with the terms of the trust a court can act to compel the trustee to comply. If a beneficiary has suffered a loss or damages due to the failure of the trustee to comply with their duties, they can also be held liable for those losses.

Trustees and their advisers should therefore ensure they have a good understanding of what their general law duties and obligations are and should endeavour to comply with them at all times.

The SIS covenants

To provide certainty, a number of general trust law requirements were codified in the SIS Act as covenants. For SMSFs these statutory covenants are outlined in sections 52B and 52C of the SIS Act. They are deemed to be included in each SMSF's trust deed and apply to trustees in addition to their general trust law duties. Specifically, the covenants require trustees to:

- act honestly in all matters concerning the fund
- ensure the trustee's duties and powers are performed and exercised in the best financial interests of the beneficiaries

- keep money and other assets of the fund separate from the money and personal assets of the trustee and any related parties
- exercise the same degree of care, skill and diligence as an ordinary prudent person in managing the fund
- retain control of the fund and not enter into any contracts that would prevent the trustees from exercising their proper duties and powers
- formulate and give effect to an investment strategy for the fund that has regard to the whole of the circumstances of the fund, including but not limited to, risk and return, diversification, liquidity and the ability of the fund to discharge its liabilities
- where there are any reserves – formulate and give effect to a strategy for their prudential management consistent with the fund's investment strategy and its capacity to discharge its liabilities when they fall due
- allow a beneficiary to access prescribed information or documents, such as the financial situation of the fund, the investments of the fund, and the member's benefit entitlements.

In addition, SIS Regulations 4.09 and 4.09A restate and expand upon some of the requirements outlined in the SIS covenants. These include the requirement for SMSF trustees to:

- formulate, regularly review and give effect to an investment strategy for the fund
- keep money and other assets of the fund separate from the money and personal assets of the trustee and any related parties
- consider whether the fund should hold a contract of insurance that provides insurance cover for one or more of the members of the fund.

Under section 55 of the SIS Act, if a trustee has breached a covenant contained, or taken to be contained, in the trust deed of the fund and a person has suffered a loss or damage due to that breach, anyone involved in the breach, including a trustee or their financial adviser or accountant, can be held liable for those losses or damages. Regulations 4.09 and 4.09A are also included as SIS operating standards (see section 3.4) and additional penalties may apply for any intentional or reckless breach of these requirements.

Therefore, the trustee of an SMSF and their professional advisers must understand the rules contained in a fund's trust deed and the duties and obligations imposed upon them under both general law and statute. This is vital, as a court will always refer to the terms of a fund's trust deed and will take into account a trustee's statutory and general law obligations when determining an issue or dispute.

Example of breach of trust deed and SIS covenants

The case of Dunstone v Irving (Supreme Court of Victoria, 2000) provides a good example of how a trustee can be held liable for losses suffered due to breaching their trustee duties and obligations.

The case involved a dispute between two business partners, who were both members of an SMSF. The dispute related to the calculation of one of the partner's entitlement in the fund where they had decided to leave the fund. As a result, the continuing trustee refused to sign a cheque to allow the departing trustee to rollover their interest in the SMSF to another superannuation fund.

The court resolved the dispute by finding in the departing trustee's favour and ordered the remaining trustee to do all necessary things to transfer the departing trustee's entitlement. Importantly, the court also found that the remaining trustee had breached both the fund's trust deed and their trustee obligations under the superannuation covenants by blocking the transfer of the departing trustee's entitlement.

The court ordered the remaining trustee to pay damages of $250,000 under section 55 of the SIS Act to compensate the departing trustee for lost investment returns they would have earned had the remaining trustee not breached their duties and obligations under both general law and the SIS Act.

Situations that may lead to disputes

Situations where disputes can, and do, arise regarding SMSFs include where:

- a couple have separated due to relationship breakdown and they are going through a contested property settlement
- a fund has suffered significant investment losses due to an unauthorised unilateral investment decision by a single trustee
- a member has died without leaving a binding death benefit nomination and there is a number of beneficiaries with competing claims
- there has been a breakdown in a business relationship resulting in a member leaving an SMSF.

3.2 Comply with sole purpose test

Under the sole purpose test in section 62 of the SIS Act, a trustee must ensure the fund is maintained solely for one or more core purposes. These include the provision of benefits:

- for each member on or after their retirement
- for each member on or after their reaching age 65
- in respect of each member on or after their death if they died before turning age 65.

If a trustee maintains a fund for at least one core purpose they can also maintain the fund for a number of ancillary purposes. These include the provision of benefits:

- for each member on or after the termination of the member's employment with an employer who had contributed to the fund in relation to the member
- for each member where they have ceased work due to ill-health
- in respect of each member on or after their death if they died after turning age 65
- for or in respect of each member which the cashing restrictions in the SIS Regulations permit or require to be paid. These include the payment of benefits on the grounds of terminal illness, severe financial hardship or compassionate grounds.

A trustee must maintain the fund in accordance with the sole purpose test requirements at all times. This extends to all activities undertaken by the trustee, and includes:

- acquiring and investing fund assets
- employing and using fund assets
- accepting contributions
- administering the fund
- paying benefits from the fund
- the payment of fees and charges from the fund (including to related party service providers).

The ATO has confirmed in SMSFR 2008/2[7] that the sole purpose test is a strict test which requires exclusivity of purpose. That is, to comply, the fund must be maintained solely to provide allowable benefits to members and not just for a dominant or principal purpose.

For example, where a trustee is investing the fund's assets, any investment decision should be based solely on the provision of benefits consistent with the sole purpose test and not for any other current day collateral or parallel purpose.

For more information on the sole purpose test and how it interacts with the SIS investment rules, please see *Chapter 4: Superannuation investment rules*.

7 SMSFR 2008/2 Self Managed Superannuation Funds: The application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits.

Sole purpose test and advice fees

Where a financial adviser provides advice to a member of a superannuation fund regarding their interest in that fund, the trustee may be able to pay for that advice without breaching the sole purpose test, as it relates to the payment of retirement and/or death benefits to the member.

However, where the member also received advice about their superannuation interests in another fund or on non-superannuation related issues, the trustee would be prohibited from paying for that other advice as it would not comply with the sole purpose test. In this situation, the adviser would be required to segment their fees and only charge the fund for the advice that related to the member's interest in the fund.

3.3 Formulate and implement an investment strategy

Under the superannuation covenants and operating standards, the trustee of a superannuation fund is required to formulate, regularly review and give effect to an investment strategy that has regard to the whole of the circumstances of a fund, including:

- the risks and likely return from investments having regard to the fund's investment objectives and cash flow requirements
- the composition of the fund's investments and the risks associated with inadequate diversification
- the liquidity of the fund's assets having regard to its expected cash flow requirements
- the fund's ability to pay benefits (such as when members retire and require a lump sum payment or regular pension payments) and other costs it incurs
- whether to hold insurance cover (such as life, permanent or temporary incapacity insurance) for each member.

The requirement for an investment strategy is designed to help trustees to make appropriate investment decisions that are consistent with the member's retirement needs and objectives and to reduce the risks associated with ad-hoc investment decisions that don't consider the circumstances of the fund. The requirement to consider the need to hold insurance for members is designed to ensure each member's insurance needs are taken into consideration.

However, this requirement does not prescribe or impose any requirement to hold insurance for any member or to limit the type of investments a fund can and cannot invest in. It simply requires the trustee to consider a number of issues regarding the fund and its members and to develop an appropriate plan for how the fund's assets should be applied.

FirstTech comment

Need for written investment strategy

The ATO has confirmed[8] that an SMSF investment strategy should be in writing and that it should be tailored and specific to the relevant circumstances of a fund rather than be a document which just repeats the words in the legislation. Having a written investment strategy also:

- demonstrates that a fund has complied with the requirements
- provides guidance to the trustees when making investment decisions, and
- allows the fund's auditor to confirm that the fund's assets are in accordance with the fund's investment strategy and that the trustees have considered the need to hold insurance.

8 https://www.ato.gov.au/super/self-managed-super-funds/investing/your-investment-strategy/

FirstTech comment: **ASIC comments on investment strategy advice**

ASIC has released Information Sheet 274 (INFO 274) *Tips for giving self managed superannuation fund advice*. Among other things, INFO 274 says advisers must advise potential SMSF clients about the requirement and purpose of the SMSF's investment strategy. They should also ensure their clients understand:

- before they start making investments, they must have an investment strategy
- the investment strategy must be reviewed regularly
- they should consider whether to hold insurance cover (see What about your client's insurance arrangements?), and
- the investment strategy should be in writing and any changes should be documented.

ASIC also says that advisers can assist their clients to develop their investment objectives and an investment strategy for the SMSF. However, they must ensure that their clients understand that they are responsible for managing the investments in the best financial interests of its members and in accordance with the law.

Things that should be considered and discussed with clients include:

- the fund's investment objectives and types of investments the fund can make.
- diversification (different assets and asset classes).
- the risk and likely return from investments.
- liquidity of fund assets and ability to meet fund expenses as they arise (including retirement benefits).
- whether their investment strategy is consistent with the trust deed.
- members' tolerance for risk (capital loss, longevity risk, market risk and inflation risk).
- the benefits associated with diversification (different assets and asset classes).
- the restrictions that apply to SMSF investments.
- whether to hold insurance cover.
- the transactions that are prohibited, such as lending the fund's money, or providing financial assistance, to a member of the fund or their relatives.

For further information, see INFO 274 at www.asic.gov.au

Investment strategy structure

An investment strategy is best described as a plan for making, holding and realising fund assets consistent with a fund's circumstances and the objectives of its members. A comprehensive investment strategy would generally set out:

Circumstances of the fund

To help outline the fund's investment needs, the investment strategy should provide an overview of the fund's relevant circumstances. These include (but are not limited to) the personal circumstances of the members such as:

- member ages
- employment status
- risk profile, and
- retirement objectives.

Understanding the circumstances of the fund allows trustees to gauge the investment time frame for the fund and its ability to accept certain levels of investment risk and volatility as well as to determine the types of returns that may be required.

The investment objective

The investment objective is a simple statement that outlines a fund's desired investment outcome. To determine a fund's investment objective, the trustees will need to take into account the circumstances of the fund, including:

- the position of the fund members relative to their retirement expectations
- whether the fund has any current pension liabilities
- the fund's tax position, and
- the size of the fund.

For example, a fund with members who were still in the accumulation phase and 20 years from retirement would generally have a very different investment objective to a fund that had members who were all retired and drawing an income stream. This is because each fund would have different investment time frames and liquidity requirements and the members would likely have different risk profiles.

The investment objective should clearly state the expected range of investment return and how it is to be measured. For example, an investment objective for a fund could be expressed this way:

- To obtain a rate of return matching or exceeding the Consumer Price Index (CPI) by 3% over the medium to long-term.
- To invest in assets that will generate an after-tax return that exceeds the S&P/ASX 200 index over a rolling five-year period.
- To provide real long-term (at least 10 years) capital growth of at least 5% compounded and a level of income of no less than 2% from a balanced portfolio.

As the investments of a superannuation fund are usually long-term, the trustees could also consider outlining the fund’s tolerance to negative returns when formulating the fund’s investment objective. For example, the investment objective could specify that the fund will invest in a way to reduce the risk of negative returns occurring in any more than a certain number of years within a prescribed period.

Investment strategy

The investment strategy is simply a plan for how the trustees will then invest the fund’s assets to achieve the fund’s investment objective. The investment strategy will therefore usually specify how the trustees will address the issues of investment risk, diversification and liquidity and outline the strategic asset allocation that will be adopted to achieve the fund’s investment objective.

Where the trustee wishes to express the fund’s investment strategy in terms of an asset allocation, the ranges adopted for each asset class should be set wide enough to allow for normal market fluctuation but not so wide as to render it meaningless as a strategy or as a monitoring tool.

For example, when formulating an investment strategy, it is not a valid approach to merely specify investment ranges of 0 to 100% for each asset class. In this case, there is a risk that the trustees could be held to have failed in their duty to formulate and implement an investment strategy in accordance with the requirements in the superannuation covenants and operating standards.

However, it may be appropriate to set the fund’s cash holding at 0 to 100% to cater for situations where the members make large cash contributions or if the trustees wish to liquidate assets, perhaps to facilitate benefit payments or as part of the trustee re-balancing the fund's asset weightings. In this case, the investment strategy should specify why the asset range for cash has been set so wide.

Investment considerations

The investment strategy could also specify what the trustees should consider when implementing the investment strategy. This could include consideration of the following issues:

- How the fund will invest into certain asset classes, that is, whether directly or via managed investment vehicles such as managed investment trusts, listed investment companies or exchange traded funds.
- What considerations the trustees should take into account when investing in certain assets. For example, for an investment in direct shares or property, the trustees may need to consider the issues of expected dividend/rental yield and capital growth.
- Whether the investment is authorised under the fund’s trust deed and the need for all investments to be made for the sole purpose of providing retirement benefits to members or death benefits to a member’s dependants.
- Whether the investment is allowable under the superannuation investment rules.

Consider the need to hold insurance

The investment strategy should confirm that the trustees will consider the need to hold a contract of insurance that provides cover for one or more members. To comply with this requirement the trustee will need to consider the personal circumstances of fund members and any other legislative requirements, such as the sole purpose test. For example, a trustee may wish to consider issues, such as:

- each member's existing insurance arrangements both inside and outside the SMSF
- the member's income, assets and liabilities at the time of review
- whether the member and/or their dependants would be able to maintain their current quality of life if the member dies or if the member was unable to work due to their temporary or total and permanent disability.

Once the trustee has considered these issues they should then document their decision in the fund's investment strategy or the minutes of a trustee meeting along with any other decisions made about the fund's investments during that year.

For more information on the need to consider insurance and the advice issues around this requirement, please see *Chapter 6: SMSFs and insurance*.

FirstTech comment

Need to consider insurances

This rule only requires trustees to consider the need to hold insurances for members. It does not require a trustee of an SMSF to provide a minimum or default level of insurance for each member. For example, a trustee may decide not to hold any insurance policies because:

- members have adequate insurances in place elsewhere, that is, outside of superannuation or held via another superannuation fund
- members have significant assets that are well in excess of liabilities (if any) and do not require insurance
- members are happy to accept the risk of being uninsured and don't want the insurance premiums impacting their retirement savings
- the trustee would be unable to obtain affordable life insurances due to the members' health or age.

Investment strategy review

Under the SIS regulations, trustees are required to regularly review the fund's investment strategy. Therefore, the investment strategy should also contain details on how often and in what circumstances the trustees should review the investment strategy. For example, the investment strategy should specify that it must be reviewed at least annually or whenever there is a material change in the circumstances of the fund or the members. Events that may require a trustee to review the fund's investment strategy include:

- the death or departure of an existing member
- a member joining the fund
- an existing member commencing an income stream
- changing legislative environment
- changing economic conditions
- changing insurance needs of the members.

The investment strategy could also specify what the trustees must consider when reviewing the investment strategy. For example, as part of reviewing the strategy, the trustees could be required to consider:

- whether the fund's investment objective is still appropriate taking into account any changed circumstances
- whether the existing asset allocation is still appropriate and if it is achieving the fund's desired investment objective
- whether the fund's current investments are appropriate or if they need to be changed
- whether the fund's assets correspond with the existing strategy
- the need to hold a contract of insurance that provides cover for one or more members and/or whether the fund's existing insurance levels are still appropriate given the members' current circumstances.

The investment strategy should also outline what options the trustees have where the fund assets no longer correspond with the existing strategy due to fluctuations in market value.

Single asset strategies

While a trustee can choose to invest all their fund's assets in one asset or asset class, trustees need to be aware that certain risks such as return, volatility and liquidity risks can be minimised by implementing a diversified investment strategy to spread investment risk.

Investing a large proportion of the fund's assets in one asset or asset class can lead to concentration risk. In this situation, the trustees should be able to demonstrate they considered the risks associated with a lack of diversification and be able to justify why it is appropriate.

For example, a single asset investment strategy could be justified on the basis that:

- the investment objectives of the fund are most likely to be achieved by investing in the single asset or asset class
- the expected return from the single asset or asset class justifies the potential risks or disadvantages associated with a lack of diversification
- the fund maintains sufficient cash to meet ongoing costs but has no other liabilities and is unlikely to have to pay a benefit in the short-term due to the age of the members.

Trustees wishing to implement a single asset strategy should also outline how the lack of diversification would be addressed over time. For example, they could specify that future investment income and/or contributions will be invested into other asset classes when received.

Trustees should also be aware that asset concentration risk may be increased where a fund borrows via a limited recourse borrowing arrangement to acquire an asset, such as a single property. Investment strategies such as this can expose members' retirement savings to significant losses if the asset suffers a decline in value due to a change in market conditions or some other issue impacting the asset's valuation.

Multiple investment strategies

Depending on a fund's circumstances, a trustee can elect to separate assets into a number of different pools and run a different strategy for each pool of assets. This can help a trustee deal with situations where it would not be appropriate to adopt a single investment strategy due to the fund having a number of members with different needs and objectives and different risk profiles.

However, a fund adopting multiple segregated investment strategies will be more complicated to administer and therefore would likely cost more to operate.

Reserve investment strategies

Where a trustee intends to operate reserves, they will also be required to formulate and implement an investment strategy for those reserves that relate to their intended purpose or use. For example, where the trustees wish to maintain a reserve to pay for any fund expenses, they would need to develop an investment strategy that ensured the fund had sufficient cash flow and liquidity to be able to service its debts as they fall due.

Important ATO guidance on use of reserves by SMSF trustees

In SMSFRB 2018/1[9], the ATO indicates that it expects that SMSF trustees should only be using reserves in very limited circumstances and only for specific and legitimate purposes. See section 3.4 for further information.

9 SMSF Regulator's Bulletin SMSFRB 2018/1: the use of reserves by self managed superannuation funds

3.4 Trustee administrative duties and responsibilities

The trustees must administer the fund in accordance with the SIS Act and Regulations as well as the fund's trust deed. The trustee's administrative duties and responsibilities are outlined as follows:

Declare they understand their duties as a trustee of an SMSF

If a person becomes a trustee (or a director of the corporate trustee) after 1 July 2007, they must sign a declaration on an ATO approved form[10] that they understand their responsibilities as a trustee of an SMSF.

The member must sign the form within 21 days of becoming a trustee. The form must be kept with the fund's records for a minimum of 10 years or for as long as the person is a trustee of the fund, whichever is longer.

The form is not required to be lodged with the ATO but it must be made available on request. A trustee administrative penalty may apply for failure to comply with this requirement.

Meet to carry on the business of the fund

Trustees will generally be required to meet to resolve any matters affecting the fund or to make key strategic decisions about the fund. These could include the decision to adopt or amend an investment strategy for the fund, to acquire or dispose of fund assets or to agree to pay a benefit in the form of an income stream to a member of the fund.

Trustee meetings should be run in accordance with the rules contained in the fund's trust deed. A trust deed will usually contain a number of rules about the conduct of trustee meetings and the making of resolutions. These may include:

- who can call a trustee meeting and how often they can be called
- rules for attendance at trustee meetings, for example, a deed may require a trustee to be physically present to be able to participate in a trustee meeting
- the requirement for a quorum to be present at a trustee meeting
- the circumstances under which any trustee resolution will be passed.

For example, a trust deed may allow any trustee to call a trustee meeting at their discretion but may require at least 75% of the trustees to be present at the meeting for a quorum to be reached. It may also require that any resolution be carried by a simple majority to be effective. Alternatively, a trust deed could require resolutions relating to a particular issue, such as the payment of a member's death benefit, to be carried by a unanimous vote of trustees.

10 ATO publication: *Trustee declaration – to be completed by new trustees and directors of corporate trustees of self-managed super funds*. Available at: https://www.ato.gov.au/Forms/Trustee-declaration/

Trustee voting rules

Depending on the trust deed, each individual trustee or director of the corporate trustee will generally have one vote on any resolution. Alternatively, some trust deeds may also allow proportional voting to resolve trustee dead locks. Proportional voting is generally based on withdrawal benefits in the fund. For example, a trustee that had $50,000 of benefits in a fund that had total benefits of $500,000 would only be able to exercise 10% of the votes on any issue.

The trustees are also required to keep proper minutes of any trustee meetings. The minutes should specify the date of the meeting, which trustees were present, what documents (if any) were presented and should contain enough information to allow the trustees to explain the fund's actions to a third party, such as the fund's auditor or the ATO.

FirstTech comment: **Proportional voting**

While proportional voting may appear to help resolve deadlocks, trustees must still comply with their legal requirement to make decisions in the best interests of all beneficiaries – rather than just in their own interests. Therefore, a trustee with a majority vote must act in the best interests of all members and not put their own interests ahead of any other members. In addition, from a practical perspective, the existence of proportional voting may not assist where a second trustee signature is required to implement a decision, for example to dispose of an asset or to write a cheque.

Comply with operating standards

Trustees must operate the fund in accordance with the operating standards for regulated superannuation funds as outlined in section 31 of the SIS Act. The operating standards work by referencing rules outlined in the SIS Regulations, which prescribe how a fund must be maintained and operated. The operating standards that impact SMSF trustees include rules about:

- persons who may contribute to the fund
- the amount of contributions that a fund may accept and the circumstances in which they may be accepted
- the preservation and payment of benefits
- the form in which benefits may be provided
- the investment of fund assets
- fund record-keeping requirements
- fund reporting and disclosure requirements
- the winding up of funds.

Trustees that intentionally or recklessly contravene a SIS operating standard can be subject to fines and other penalties.

Accept contributions

Trustees must accept contributions in accordance with the minimum standards specified in the SIS Regulations. These standards are designed to ensure that contributions are made for retirement purposes only. Trustees are also required to report contributions received in the SMSF annual return.

FirstTech comment: Refer to trust deed

In addition to the SIS contribution rules, trustees should check the fund's trust deed before accepting any contributions to ensure the trustee is able to accept the relevant contribution type. For example, while the SIS Regulations specify which types of contributions a trustee is able to accept and in what circumstances, a fund's trust deed may include additional rules which could prevent a trustee from accepting certain types or contributions, such as a downsizer contribution.

In these situations, the deed would need to be amended before the trustee could accept the contribution.

For more information on accepting and reporting contributions, please see *Chapter 7: Contributions and benefit payments*.

Acknowledge deduction notices

If a member provides a valid 'notice of intent to claim or vary a deduction for personal super contributions' form, the trustee must, without delay, give the member a written acknowledgement of the valid notice.

For more information on the requirements and process to claim a tax deduction for personal contributions, please see the FirstTech Super and Retirement Income Streams guide.

Accept rollovers

The trustees of the fund may accept rollovers from other complying superannuation funds once the fund has been established and has become a regulated complying superannuation fund. Any rollovers to or from an SMSF must be processed via SuperStream.[11]

SuperStream is a data and payment standard that allows for the digital transfer of money and information to facilitate employer contributions and rollovers between funds. From an SMSF perspective, the rules previously only applied to require trustees to accept employer contributions from unrelated employers via SuperStream. However, since 1 October 2021, the rules apply to all rollovers (excluding those done via in-specie transfer) into and out of SMSFs.

11 To the extent that a rollover is done via an in-specie transfer of assets, it is not required to be processed via SuperStream.

To process a rollover via SuperStream an SMSF will need:

- an electronic service address (ESA)
- an Australian business number (ABN)
- a bank account.

If an SMSF has been established via an intermediary such as an SMSF administrator, tax agent or accountant, they may be able to register and obtain an ESA on the fund's behalf. However, if this is not the case, the trustees may be required to register directly with an SMSF messaging provider. The ATO maintains a list of messaging providers on its website.[12]

Invest and manage fund assets

Trustees must invest the fund's assets in accordance with the fund's trust deed and investment strategy (see above) and the SIS investment rules.

For more information on the SIS investment rules, please see *Chapter 4: Superannuation investment rules*.

Maintain reserves where required

Where an SMSF trustee maintains reserves, it should ensure that it formulates and implements an investment strategy for those reserves that relate to their intended purpose or use. See section 3.3 for further information.

Important ATO guidance on use of reserves by SMSF trustees

In SMSFRB 2018/1[13], the ATO indicates that it expects that SMSF trustees should only be using reserves in very limited circumstances. Its general concerns about the use of reserves by SMSF trustees include:

- whether a general reserve without a clearly articulated purpose is a permitted reserve under Section 115 of the SIS Act
- whether the use of a particular reserve is in line with the sole purpose test
- whether trustees have formulated and regularly reviewed an appropriate reserve management strategy.

The ATO is also concerned about SMSF trustees using reserves to circumvent superannuation reforms introduced largely on 1 July 2017, including:

- the intentional use of reserves to reduce a member's total superannuation balance for a range of reasons, including:
  - to allow the member to access a higher non-concessional contributions cap
  - to allow the member to use carried forward unused concessional cap amounts
  - to allow an SMSF to use the segregated pension assets method when determining the fund's exempt income for tax purposes

12 www.ato.gov.au/super/superstream/self-managed-super-funds/electronic-service-address/register-of-smsf-messaging-providers/
13 SMSF Regulator's Bulletin SMSFRB 2018/1: the use of reserves by self-managed superannuation funds

- the intentional use of reserves to reduce the value of a member's transfer balance account below their transfer balance cap while allowing a greater amount to be in retirement phase.

The guidance indicates that the Commissioner will scrutinise these arrangements closely with a view to applying tax avoidance provisions where the taxpayer has entered into a scheme to obtain a tax benefit.

The ATO had indicated it will not apply compliance resources to review arrangements entered into before 1 July 2017, provided the reserve complies with the requirements of Section 115 of the SIS Act and the governing rules of the fund, and the circumstances do not indicate the use of reserves was intended to circumvent the 1 July 2017 super reforms.

However, any unexplained increase in reserves through the creation of new reserves or increase in the balance of existing reserves, and any allocation of amounts from a reserve directly to retirement phase, are likely to attract close scrutiny.

Comply with minimum benefit standards

The trustees must comply with the minimum benefit standards for each member's benefits in a fund. A member's minimum benefits are defined (for an accumulation fund) in SIS Regulation 5.04 as all of the member's benefits in the fund.

Under SIS Regulation 5.08 trustees must ensure that each member's minimum benefits are maintained in the fund until the benefits are:

- cashed as benefits of the member (other than to pay a temporary incapacity benefit), or
- rolled over or transferred as benefits of the member to another complying fund; or
- transferred, rolled over or allotted under to a member's spouse in accordance with a spouse contribution-splitting arrangement.

The minimum benefit standards apply to ensure that a member's benefit in a fund cannot be reduced other than in very specific circumstances for benefit payments and rollovers. In addition, the minimum benefit rules generally restrict a trustee from being able to pay a temporary incapacity benefit to a member from their benefit in the fund. Instead, these types of benefits are usually funded from the proceeds of an income protection insurance held by the trustee in respect of the member.

Pay benefits to members

Trustees must only pay benefits to members in accordance with the cashing restrictions outlined in the SIS Regulations and the terms of their trust deed.

For more information on the cashing and preservation rules, please see the FirstTech Super and Retirement Income Streams guide.

FirstTech comment

Refer to trust deed

In addition to the SIS preservation rules, trustees should check the fund's trust deed before paying any benefits, as the trust deed may limit the type of benefits able to be paid or impose more restrictive cashing restrictions than allowed under the SIS Regulations.

For example, where a trust deed prevented a member taking any type of benefit before age 65, the trustees would be prevented from paying a benefit to the member before that age even where the SIS Regulations would permit it. In this situation, the trustees would need to arrange for their deed to be amended before they could pay a benefit to a member under the age of 65.

For more information on paying benefits from an SMSF, please see *Chapter 7: Contributions and benefit payments*.

Keep assets separate

Under both the SIS Covenants and the SIS Regulations, trustees are required to keep the money and other assets of the fund separate from the money and personal assets of the trustee and any related parties.

Trustees should therefore ensure fund monies are kept in a separate bank account and that when acquiring an asset the trustees should ensure the asset is properly identified as being held in trust for the SMSF.

Where it is not possible to identify or record that the asset is being held in trust, such as in the case of real property in most states, trustees should ensure they maintain sufficient records to demonstrate the fund's ownership of the asset. For example, this could include trustee minutes documenting the trustee's decision to acquire the asset and financial statements and records demonstrating that the fund's resources were used to acquire the asset and that all income generated from the asset has been paid back to the fund.

Alternatively, or in addition, the ATO has outlined that trustees could also consider registering a caveat over the asset or putting in place a declaration of trust over it. However, before putting in place any such arrangements over dutiable property, such as real property, trustees may wish to seek specialist legal advice to ensure it would not trigger any stamp duty or other liabilities.

Value fund assets

To prepare the fund's accounts and statements the trustees are required to value the fund's assets at market value.

Trustees must also value certain assets at market value to confirm the fund has complied with relevant superannuation law for:

- reporting the value of the member's interests for the purposes of calculating total superannuation balance
- the acquisition of assets from related parties
- the requirement for investments to be made and maintained on an arm's length basis
- determining the value of a fund's in-house assets as a proportion of the fund's total asset holding
- determining the value of any pensions a member commenced during the year
- disposing of certain collectable and personal use assets to a related party
- determining the value of any amounts that may count towards a member's contribution caps
- determining the level of the fund's non-arm's length income.

What is market value?

Market value is defined in section 10 of the SIS Act as the amount that a willing buyer of the asset could reasonably be expected to pay to acquire the asset from a willing seller, assuming:

- the buyer and the seller dealt with each other at arm's length in relation to the sale
- the sale occurred after proper marketing of the asset
- the buyer and the seller acted knowledgeably and prudentially in relation to the sale.

Who can value a fund's assets?

The ATO has confirmed[14] that, other than in specific circumstances where a qualified independent valuer must be used, it is the validity of the valuation process undertaken rather than who conducted it that governs its acceptability.

Therefore, other than in those specific circumstances where a qualified independent valuer must be used, anyone, including the fund's trustees, can value the fund's assets.

However, the ATO also confirms that, other than where required, a trustee should consider the use of a qualified independent valuer where:

- the asset represents a significant portion of the fund's assets
- the nature of the asset indicates that the valuation is likely to be difficult or complex.

14 ATO publication: *Valuation guidelines for self-managed superannuation funds* available at: https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/SMSF-resources/Valuation-guidelines-for-self-managed-super-funds/

FirstTech comment

Consider use of valuer

Even though trustees can value certain assets themselves, sometimes it may be prudent to obtain an independent valuation to remove any uncertainty. For example, where a trustee wishes to acquire a business real property from a member, the transaction must occur at market value to:

- be permitted, and
- to avoid the application of the non-arm's length income rules due to the fund incurring a non-arm's length expense in relation to the acquisition of the asset.

Therefore, to avoid any uncertainty about whether the transaction was permitted, it may be worthwhile to obtain an independent valuation as evidence.

Use of qualified independent valuers

A qualified independent valuer is only required to value an asset that is a collectable or personal use asset in the following circumstances:

- the asset was acquired on or after 1 July 2011 and disposed of to a related party
- the asset was acquired before 1 July 2011 and disposed of on or after 1 July 2016 to a related party.

Who is a qualified independent valuer?

A valuer will be qualified either through holding formal valuation qualifications or by being considered to have specific knowledge, experience and judgement by their particular professional community. This may be demonstrated by being a current member of a relevant professional body or trade association, such as an antique or art dealers association or property valuation association.

The valuer must also be independent. This means that the valuer should not be a member of the fund or a related party of the fund (for example, they should not be a relative). They should be impartial and unbiased and not be influenced or appear to be influenced by others.

Valuation principles

Regardless of who conducts the valuation, the trustees must be able to demonstrate that the valuation has been arrived at using a 'fair and reasonable' process and is based on objective and supportable data.

Generally, a valuation is considered to be 'fair and reasonable' if all of the following are satisfied:

- it takes into account all relevant factors and considerations likely to affect the value of the asset
- it uses a rational and reasoned process
- it has been undertaken in good faith
- it is capable of explanation to a third party.

Whenever trustees of an SMSF value an asset themselves they must keep written records of the process undertaken so that it can be explained to a third party where required.

How frequently do assets need to be valued?

To prepare the fund's financial statements and accounts, the ATO has confirmed that where the value of an asset is easy to determine, such as cash, listed securities and widely held unit trusts, they should be revalued each 30 June. However, other assets, such as real property, may not need to be revalued each year unless a significant event has occurred that impacts its value.

Significant events

To prepare SMSF financial accounts and statements, assessing compliance with the in-house asset test or determining the value of assets that support a pension, a recent valuation should be undertaken where there has been a significant event that affects the value of an asset. These events may include:

- a natural disaster
- macro-economic events
- market volatility
- changes to the character of the asset.

FirstTech comment

Increased ATO focus on asset valuations

Since the introduction of the total superannuation balance and transfer balance cap rules on 1 July 2017, the value of an SMSF's assets has become more important as they help to determine:

- the level of non-concessional contributions that can be made by a member
- whether the fund has incurred a non-arm's length expense in relation to the acquisition of an asset, which could result in all future income and capital gains derived from the asset being assessed as non-arm's length income
- the level of assets that could be used by the fund to support existing retirement phase income streams at 30 June 2017 and can be used to commence new retirement phase income streams on or after 1 July 2017.

The ATO may therefore be more active in scrutinising the values of assets reported by trustees.[15]

To minimise the risk of incorrectly valuing fund assets, trustees should consider obtaining asset valuations from a qualified independent valuer, particularly where:

- the asset represents a large portion of the fund's total assets or the asset is complicated and hard to value
- a member's total superannuation balance at 30 June in a year will be close to an important threshold (for example, $1.9 million).
- the asset will be used to commence a retirement phase income stream, or was supporting an existing retirement phase income stream at 30 June 2017.

For more information on how to value assets held by an SMSF, please refer to the 'Valuation guidelines for SMSFs' document, available on the ATO website.

15 ATO scrutiny on valuations could also increase from 2025–26, when 15% Division 296 tax (proposed only at the time of writing) would apply to earnings corresponding to the portion of a member's total superannuation balance over $3 million. For further information about this proposal, see section 5.1.

Use of reasonable estimates when commencing income streams

The market value of assets supporting an income stream needs to be determined on the commencement day of the income stream.

The ATO valuation guidelines for SMSFs confirm that trustees may use a reasonable estimate of the value of assets supporting a member's income stream when:

- an income stream is commenced part way through a financial year, or
- an income stream is commenced on 1 July of a financial year, the trustee is required to report the event for transfer balance cap purposes by 28 October of that year and a full valuation of assets supporting the income stream is not possible by that date.

However, trustees cannot rely on this reasonable estimate when preparing the SMSF's financial accounts and calculating the SMSF's entitlement to exempt current pension income (ECPI).

Keep proper records

Trustees must ensure proper records are kept to verify and explain trustee decisions and to allow the fund's accounts and financial statements to be prepared and audited. Trustees must keep certain records for specified periods of time and must make them available to the fund's auditor or the ATO on request.

Table 3.1 Summary of record keeping requirements

Records to be kept for five years	Records to be kept for 10 years
• Accurate and accessible accounting records that explain the transactions and financial position of the fund, including contribution and rollover benefit information • The fund's annual operating statement and statement of financial position • The SMSF annual return lodged with the ATO • Copies of any rollover benefits statements provided to other funds	• Trustee declarations and written consents • Minutes of trustee meetings, including details of investment decisions and the decision to pay benefits • Records of all changes of trustees • Copies of any reports provided to members

Failure to maintain proper records will not only cause problems and delays creating the fund's accounts and getting the fund audited, but is also considered a breach and may incur penalties.

Prepare year end accounts

Trustees must ensure that for each year of income the following accounts and statements are prepared at market value for their fund:

- an annual operating statement, and
- an annual statement of financial position.

The completed accounts and statements must then be signed by a minimum number of individual trustees or directors of the corporate trustee as follows:

Where the fund has a corporate trustee:

- if there are only one or two directors: each director
- otherwise at least half the directors.

If the fund has individual trustees:

- if there are only two trustees: each trustee
- otherwise at least half the trustees.

Appoint approved SMSF auditor

Trustees must appoint an approved SMSF auditor to audit the fund. To be an approved SMSF auditor, the auditor must be registered by ASIC. To qualify as an approved SMSF auditor, a person must demonstrate:

- they hold the necessary qualifications, such as a degree (minimum three years) in accounting which included a course in auditing
- they have at least 300 hour's experience auditing SMSFs in the previous three years under the direction of an approved SMSF auditor or they are a registered company auditor
- they have passed a competency exam, and
- ASIC is satisfied that they:
  - are unlikely to contravene the ongoing obligations of an approved SMSF auditor
  - are capable of performing the duties of an approved SMSF auditor
  - are a fit and proper person to be an approved SMSF auditor
  - hold adequate and appropriate professional indemnity insurance
  - are an Australian resident
  - are not subject to an enforceable disqualification or suspension order.

To maintain their approved SMSF auditor status, auditors will need to satisfy continuing professional development requirements, maintain adequate and appropriate levels of professional indemnity insurance and report to ASIC annually.

Auditors who fail to comply with their ongoing registration requirements or who have been reported for failing to properly carry out an independent audit can be suspended or deregistered.

Auditor independence

Under the SIS Act, an approved auditor must carry out and perform their duties adequately and properly. To satisfy this requirement, an auditor must generally:

- carry out the audit both independently and competently
- conduct the audit in accordance with the Australian Auditing Standards
- adhere to their profession's ethical standards or code of conduct
- report as required under superannuation law.

To satisfy audit independence requirements, SMSF auditors must comply with prescribed independence requirements as set out in the Accounting Professional and Ethical Standards Board's pronouncement, APES 110 Code of Ethics for Professional Accountants.

In general, audit independence requires both:

- independence of mind – being free to form an opinion without being affected by influence or compromise, and
- independence in appearance – avoiding all circumstances and situations that could result in a reasonable person knowing all the facts forming the opinion that the auditor's integrity, objectivity or professional scepticism have been compromised.

Threats to an auditor's independence can come about in a number of ways and can result from self-interest, self-review or intimidation. Some auditor independence threats are summarised in Table 3.2.

Table 3.2 Auditor independence threats

Independence threat	Description*	Example
Self-interest threat	The threat that a financial or other interest will inappropriately influence an auditor's judgment or behaviour.	The auditor or one of their relatives is a trustee of the fund being audited.
Self-review threat	The threat that an auditor will not appropriately evaluate the results of a previous judgment made, or an activity performed by the auditor or another member of their firm (or employing organisation), on which the auditor will rely when forming a judgment as part of performing an audit.	The auditor prepares the fund's accounts and operating statements and then audits their own work.
Advocacy threat	The threat that an auditor will promote a client's or employing organisation's position to the point that the auditor's objectivity is compromised.	The auditor acts as an advocate for the SMSF in litigation or dispute.

Familiarity threat	The threat that due to a long or close relationship with a client, or employing organisation, an auditor will be too sympathetic to their interests or too accepting of their work.	Due to a close personal relationship an auditor becomes too sympathetic to the client's interests.
Intimidation threat	The threat that an auditor will be deterred from acting objectively because of actual or perceived pressures (including attempts to exercise undue influence over the auditor).	The trustee threatens to withdraw business if a breach is reported.

* ATO Auditor independence conceptual framework. See https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Auditor-Independence/?page=2#Scenarios_giving_rise_to_independence_threats

The ATO has confirmed that some threats to independence can only be eliminated or reduced to an acceptable level by an auditor declining or removing themselves from the audit engagement – this includes an engagement to audit the fund where the auditor:

- is a trustee or director of a corporate trustee or a member of the fund
- is a relative or close associate of a trustee or director of a corporate trustee or a member of the fund
- has prepared the accounts and the statements for the fund being audited (if the auditor is a sole practitioner, this includes instances where one of their employees has prepared the accounts and statements)
- provides advice (such as financial or investment) to the fund being audited.

FirstTech comment

Updated APESB Independence Guide released

In May 2020, the Accounting Professional & Ethical Standards Board (APESB) released an updated auditor independence guide.

The guide includes a number of scenarios involving SMSFs that would always result in a breach of auditor independence requirements. For example, the guide indicates that an auditor:

- Cannot audit an SMSF where the auditor, their staff or their firm has prepared the financial statements for the SMSF unless it is a routine or mechanical service.
- Cannot audit their own or an immediate family member's SMSF.
- Cannot audit an SMSF where a partner within their firm is a member/trustee of the SMSF.
- Cannot audit an SMSF where they have a business relationship with a member/trustee of the SMSF.
- Should not audit the SMSF where a relative or a related party of the auditor is a member/trustee of the SMSF or where the auditor has a close personal relationship with a member/trustee of the SMSF.

For further information, refer to the APESB Independence Guide at www.apesb.org.au

Further ATO auditor independence guidance

The ATO has subsequently released further guidance[16] on SMSF auditor independence, which indicates:

- Some independence requirements apply specifically to firms and network firms[17] that provide non-assurance services to SMSF audit clients. Independence threats may arise where an auditor conducts an audit for an SMSF client who is receiving other services for the fund from another firm within the network.
- Where a firm or network firm only prepares a self managed super fund's annual return for an SMSF audit client, this will not generally give rise to an independence threat. This is because such a service ordinarily involves the auditor collecting, analysing and presenting data from the fund's accounts and financial statements in accordance with established tax law and practice, and calculating the amount of tax payable based on that information.

16 The ATO's guidance can be found at the following page of the ATO website: www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Auditor-Independence/

17 A network firm is a firm that belongs to a network that is aimed at cooperation and clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

- Firms and network firms are prohibited from providing the following tax services to the trustees of an SMSF that the firm audits:
  - tax planning and other tax advisory services – when the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements, and there are reasonable doubts as to the treatment or presentation, and the outcome or consequences of the advice will have a material effect on the financial statements
  - tax services that involve assisting in the resolution of tax disputes – where the services involve acting as an advocate before a public tribunal or court in resolution of a tax matter, and the amounts involved are material to the financial statements on which the firm will express an opinion.
- The provision of other tax services by a firm or network firm to an SMSF audit client may lead to independence threats, including:
  - tax planning and other tax advisory services not covered by the above prohibition (self-review or advocacy threats)
  - tax calculations of current and deferred tax liabilities (or assets) for the purposes of preparing the accounting entries for the fund's financial statements (self-review threats)
  - tax services involving valuations (self-review or advocacy threats)
  - assistance in the resolution of tax disputes referred to a court or tribunal not covered by the above prohibition (self-review or advocacy threats).
- If a firm or network firm has provided financial planning advice to an SMSF trustee, it is likely that auditing the fund will create self-interest and self-review independence threats.
- In-house audits[18] are only permitted in limited circumstances and must comply with the following requirements:
  - A firm or network firm must not have a management responsibility[19] for an audit client
  - If a firm or network firm that has not assumed management responsibility provides accounting or bookkeeping services to a client (including preparing the fund's financial statements on which the firm will express an opinion) the firm cannot audit the fund unless the services are routine or mechanical and the firm addresses any independence threats created by either eliminating the circumstances creating the threats, or by applying appropriate safeguards to reduce the threats to an acceptable level.

While the ATO initially adopted a transitional educative approach to compliance for firms engaged in in-house audits, for audits completed on or after 1 July 2021 it is enforcing compliance with independence requirements.

18 The term 'in-house audit' commonly refers to a situation where the audit of an SMSF is conducted by an auditor who works for a firm or network firm that provides non-assurance services to the SMSF trustee.

19 In general terms, management responsibilities involve controlling, leading and directing an entity, including making decisions on its behalf, such as setting strategic direction.

3.5 Annual reporting obligations

Trustees must report certain information to the ATO within specified time frames. This section outlines these duties and obligations.

Complete and lodge SMSF annual return

Trustees must arrange for an SMSF annual return to be completed and lodged with the ATO each year by the due date. The annual return includes:

- the fund's tax return for the year
- member contribution information
- member retirement phase and accumulation phase benefit values
- verification that the fund's financial and compliance audit has been completed.

The lodgement date varies for different funds depending on when they were established and if the trustees prepare their own return. Failure to lodge by the due date will incur penalties.

FirstTech comment

Reporting requirement in first year

An SMSF with assets that has been established and registered must lodge an annual return for that year. This applies regardless of when the fund was established in that year. Therefore, trustees considering setting up an SMSF close to the end of the financial year may wish to consider delaying until after 30 June to save on costs.

Alternatively, where a fund has been registered but has no assets set aside for the benefit of members in the first year it was registered, the ATO has confirmed[20] the trustee can request to either:

- cancel the fund's registration, or
- flag the SMSF's record as return not necessary (RNN) if the SMSF confirms in writing that:
  - although registered, it had no assets and did not receive contributions or rollovers in the first financial year
  - it has documentary evidence of the date the SMSF first held assets and commenced operating (for example the SMSF's first bank statement)
  - it will be lodging future returns.

When making the request the trustees must confirm:

- the SMSF's name, TFN or ABN
- confirmation that it meets all eligibility conditions
- documentary evidence of the date assets were first placed into the fund.

Trustees should contact the ATO directly. Alternatively, where the fund has a tax agent, the tax agents can use the ATO Tax Agent Portal.

Tax return

The trustees must calculate the fund's taxable income on a self-assessment basis and remit any tax due. Trustees should therefore maintain sufficient records to substantiate the level of the fund's assessable income and any deductions or offsets claimed.

For more information on the taxation of SMSFs, please see *Chapter 5: Taxation of SMSFs*.

20 ATO website: https://www.ato.gov.au/super/self-managed-super-funds/administering-and-reporting/lodge-smsf-annual-returns/#Newlyregisteredwithoutassets

Member contribution information

Trustees must report all contributions (and any amounts allocated from a reserve) received by the fund in the annual return. This return is then used by the ATO to determine:

- eligibility to claim a tax deduction for a personal contribution for a year
- whether the member has exceeded their concessional or non-concessional contribution caps
- entitlement to a superannuation co-contribution or any other income-tested tax concession that takes into account reportable superannuation contributions or reportable employer superannuation contributions
- whether an employer has complied with their superannuation guarantee obligations
- the level of a member's low tax contributions for Division 293 tax purposes.

ATO Tax Ruling TR 2010/1[21] outlines the ATO's views on what amounts should be reported as a contribution and when they are deemed to have been made for tax purposes.

For more information on what amounts must be reported as a contribution, please see *Chapter 7: Contributions and benefit payments*.

Member retirement phase and accumulation phase benefit values

The trustee must calculate and report each member's accumulation and retirement phase account balances. Depending on the circumstances, the ATO may then use these figures to calculate the member's total superannuation balance each 30 June.

Alternatively, the trustee may report separate accumulation and retirement phase values (as opposed to account balances) for each member that take into account any realisation, tax, administration or exit costs that would apply to reduce the amount of benefits a member would receive if they voluntarily withdrew their benefits on 30 June. If the trustee reports a different accumulation and/or retirement phase value for a member, the ATO will then use those values to calculate the member's total superannuation balance for that 30 June.[22]

A member's total superannuation balance at 30 June in a year is then used to determine their non-concessional cap for the following year, and their eligibility for certain superannuation concessions, such as:

- the ability to carry forward eligible unused concessional cap amounts from previous years
- the ability for a member between age 67 and 75 to be eligible to claim a tax deduction for a personal contribution under the work test exemption
- the super co-contribution.

21 Taxation Ruling TR 2010/1: Income Tax: Superannuation Contributions.

22 SMSF annual return instructions 2023. See instructions for completing Accumulation and Retirement phase values (Boxes X1 and X2) in 'Other transactions' in Section F.

Financial and compliance audit

The trustees must arrange for the fund's approved auditor (see above) to conduct a financial and compliance audit on the fund each year and to provide an audit report to the trustees in the approved form. Information from the audit report is then required to be included in the SMSF's annual return.

The financial audit

The financial audit involves the approved auditor auditing the fund's accounts and financial statements (including the statement of financial position and operating statement) to confirm that they accurately reflect the fund's financial position.

As part of conducting the financial audit, the approved auditor will need to confirm or verify a range of matters in relation to a fund, including:

- existence of assets, liabilities and entitlements
- occurrence of transactions
- completeness of all transactions, events and assets being recorded
- ownership, rights and obligations the SMSF has in relation to assets, entitlements and liabilities
- accuracy of amounts recorded.

To achieve this, the approved auditor may need to sight documents such as title deeds, valuation reports, share certificates, dividend statements, distribution statements and bank records. Where a fund holds collectables, such as a piece of artwork, an auditor may also need to physically sight the artwork (or art collection) and to confirm the conditions under which it is stored.

The compliance audit

The compliance audit involves the auditor verifying the fund has complied with specific provisions of the SIS Act and Regulations at all times during the year. The specific provisions are outlined in the approved audit report form, and include:

SIS Act provision	Name	SIS Reg Provision	Name
17A	The fund must meet the definition of an SMSF	1.06(9A)	Pension payments must be made at least annually, and must be at least the amount required
35AE	The trustees must keep and maintain accounting records for a minimum of five years	4.09	Trustees must formulate, regularly review and give effect to an investment strategy for the fund
35B	The trustees must prepare, sign and retain accounts and statements	4.09A	Duty to hold and keep SMSF assets separate from trustees' personal assets

SIS Act provision	Name	SIS Reg Provision	Name
35C(2)	The trustees must provide the auditor with the necessary documents to complete the audit in a timely and professional manner; and within 14 days of a written request from the auditor	5.03	Investment returns must be allocated to members in a manner that is fair and reasonable
62	Sole purpose test	5.08	How minimum benefits are to be treated
65	Lending to members of regulated super fund prohibited	6.17	Payments of member benefits must be made in accordance with preservation rules and be permitted by the trust deed
66	Acquisitions of certain assets from members of regulated super funds prohibited	7.04	Contributions accepted in accordance with eligibility requirements
67	Prohibition on funds borrowing	8.02B	Asset must be valued at market value
67A	Limited recourse borrowing arrangements	13.12	Trustees must not recognise an assignment of a super interest of a member or beneficiary
67B	Limited recourse borrowing arrangements – replacement assets	13.13	Trustees must not recognise a charge over or in relation to a member’s benefits
82–85	In-house asset rules	13.14	Trustees must not give a charge over, or in relation to, an asset of the fund
103	Duty to keep minutes and records	13.18AA	SMSF-investment in collectables and personal use assets
104	Duty to keep records of changes of trustees		
104A	Trustees etc. of SMSF – recognition of obligations and responsibilities		
105	Duty to keep reports		
109	Investments of super entity to be made and maintained on arm's length basis		
126K	Disqualified persons not to be trustees, investment managers or custodians of super entities		

FirstTech comment: Auditor verification of downsizer contributions

The ATO has confirmed that when conducting an SMSF's annual audit, auditors need to obtain sufficient and appropriate audit evidence to verify the fund has complied with the downsizer contribution requirements.

This includes:

- That the member had reached the required eligibility age at the time of the contribution.
- The member's TFN has been provided.
- The trust deed allows for the contribution.
- A valid 'downsizer contribution into superannuation' form was provided to the fund no later than when the contribution was made.
- The contribution does not exceed the $300,000 downsizer contribution cap.
- The member has not made downsizer contributions to the fund from a previous sale of property.
- The contribution has been correctly allocated to the member's account.

Auditors are not required to check if a member has met any other downsizer eligibility requirements (for example whether the member held the property for at least 10 years and qualified for a partial main residence exemption on the sale) – they can rely on the member's declaration in the form for this purpose.

The auditor must report to the trustee where, in the course of conducting the audit, they have formed the opinion that:

- a breach may have occurred, may be occurring or may be about to occur regarding the SMSF, or
- the financial position of the fund may be, or may be about to become, unsatisfactory.

The trustees must then take steps to rectify the issue to the auditor's satisfaction as soon as possible.

Audit contravention report

However, where the financial position of the fund has become unsatisfactory, or where a breach has occurred that meets certain prescribed criteria, the auditor must also report the issue to the ATO in an audit contravention report. Compliance matters that must be reported to the ATO include:

- any situation where the fund has failed the SMSF definition
- any breach where the fund was established less than 15 months before the end of the financial year
- a breach of any provision that the trustees had previously breached in an earlier year (a repeated breach)
- any breach from a previous year that is yet to be rectified
- any breach where the trustee failed to meet a statutory time period by more than 14 days (that is, a trustee failed to dispose of in-house assets that were in excess of the 5% in-house asset limit by the end of the following financial year)
- all breaches in a financial year where the total value of all contraventions was greater than $30,000
- all breaches in a financial year where the total value of all contraventions was greater than 5% of the total value of the fund's assets.

What happens when a fund is reported?

Where the ATO receives an audit contravention report regarding a fund, it has a number of options available to it. These include:

- take no further action – this may occur where the audit contravention report indicates that the breach has already been rectified or the trustee has put in place an action plan to do so
- conduct a full audit of the fund – this is more likely in the event of a serious breach or where the nature or pattern of breaches indicates the trustee acted deliberately or recklessly or has made no effort to learn and understand their duties as a trustee.

Depending on the outcome of the ATO's investigations, it may take compliance action against the fund and the trustees. This can involve applying administrative penalties, issuing a rectification or education direction, disqualifying the trustees, applying the SIS penalty regime and removal of the fund's complying status.

See section 3.8 for more information.

Pay supervisory levy

As part of lodging the SMSF annual return, the trustee must also pay the annual supervisory levy to the ATO at the time of lodging the fund's return and paying the fund's tax liability.

Reporting associated with members' total superannuation balances

A member's total superannuation balance, whose value needs to be determined at 30 June each financial year, is the sum of:

- retirement phase values, and
- accumulation phase values, and
- a proportion of the outstanding balance of certain LRBAs established after 30 June 2018 (see below), and
- in transit rollovers not reflected in the above values.

A proportion of the outstanding balance of certain Limited Recourse Borrowing Arrangements (LRBAs) established after 30 June 2018 are included in the calculation of a member's total superannuation balance where:

- the member's interests in the fund are supported by assets subject to an LRBA and the member has satisfied a condition of release with nil cashing restrictions (retirement, reaching age 65, terminal medical condition, permanent incapacity), or
- the member's interests in the fund are supported by assets subject to an LRBA between the SMSF and its associates.

See section 4.11 for further information about the inclusion of the outstanding balance of certain LRBAs in a member's total superannuation balance.

For further details about the calculation of a member's total superannuation balance, please see the FirstTech Super and Retirement Income Streams guide.

FirstTech comment

Total superannuation balance

To calculate an SMSF member's total superannuation balance, the ATO will generally use the accumulation and retirement phase account balance details reported for them in the SMSF's annual return (at Boxes S1-S3).

Alternatively, the trustee may report different accumulation and retirement phase values (as opposed to account balances) for each member that take into account any realisation, tax, administration or exit costs that would reduce the amount of benefits a member would receive if they voluntarily withdrew their benefits on 30 June. Where the trustee reports a different accumulation and/or retirement phase value for a member (at Boxes X1-X2), the ATO will then use those values to calculate the member's total superannuation balance for that 30 June.[23]

Note: Reporting a lower accumulation and/or retirement phase value for a member compared to their accumulation and/or retirement phase account balance may be worthwhile where it would result in the member qualifying for any concessions where the eligibility criteria include the level of their total superannuation balance, such as the catch up concessional contribution rules. However, it would be unnecessary if it would make no difference as the member's total superannuation balance is not near any of the relevant threshold values.

3.6 Transfer balance cap event based reporting

With the introduction of the transfer balance cap (TBC) from 1 July 2017, SMSF trustees that pay retirement phase income streams must report TBC events to the ATO.

Reporting is completed via a Transfer Balance Account Report (TBAR), which can be provided to the ATO as a paper or online form, or through the ATO Business and Tax Agent Portal. A separate TBAR is required for each member but up to four events can be reported per TBAR.

For further information about the transfer balance cap and transfer balance account, including a list of and the timing of TBC events, refer to the FirstTech Super and Retirement Income Streams guide.

23 SMSF annual return instructions 2023. See instructions for completing Accumulation and Retirement phase values (Boxes X1 and X2) in 'Other transactions' in Section F.

Reporting TBC events

Prior to 1 July 2023, depending on its situation an SMSF reported TBC events either on a quarterly or annual basis.

Since 1 July 2023, all SMSFs must report TBC events on a quarterly basis, within 28 days after the end of the quarter in which the event occurs.[24]

For further information about TBC event reporting for SMSFs, see 'Event-based reporting for SMSFs' at www.ato.gov.au

SMSFs may avoid issues by reporting TBC events as early as possible

APRA-regulated funds must report TBC events within 10 business days of the event occurring.

This difference in reporting can lead to a double counting of a retirement phase income stream for periods of time if a member commutes and rolls their retirement phase income stream from an SMSF to an APRA-regulated fund.

For example, Michael has an account based pension in an SMSF. On 5 April in a financial year, he commutes his pension and rolls over his benefit to the ABC super fund (an APRA-regulated fund) and immediately commences a new account based pension.

For TBC event reporting purposes, the APRA-regulated fund is required to report the commencement of his account based pension within 10 business days. However, Michael's SMSF is not required to report the commutation of his account based pension until 28 July in the next financial year.

Due to the timing difference, the ATO may therefore have an extra (double counted) credit recorded against Michael's transfer balance account for a number of months. As a result, this could impact his entitlement to any TBC indexation under the proportional indexation rules, as his highest balance would be overstated, and could lead to Michael being issued with an incorrect excess transfer balance determination.

To avoid any TBC event timing issues, particularly where a member is rolling their retirement phase income stream from an SMSF to an APRA-regulated fund, SMSF trustees should consider reporting TBC events as soon as possible after they occur.

24 Any unreported TBC events that occurred prior to 30 September 2023 needed to be reported by 28 October 2023. This meant that an SMSF who was previously required to report on an annual basis had to report any TBC events from 2022–23 by this date.

Exception: specific timeframes for certain TBC events

Specific reporting timeframes apply to some TBC events as shown in Table 3.4.

Table 3.4 Specific reporting timeframes applying to some TBC events

Event	Reporting deadline
The commutation of an income stream in response to an excess transfer balance determination issued to a member.	Within 10 business days after the end of the month in which the TBC event occurred.
SMSF's response (e.g., commuting an income stream) to a commutation authority.	Within 60 days after the date on which the commutation authority was issued.

Some TBC events not reported by SMSF trustees

The following TBC events are not reported by SMSF (or other fund) trustees:

- family law payment splits
- transfer balance account debits associated with fraud, dishonesty or bankruptcy
- structured settlement contributions made before 1 July 2007.

These TBC events are instead reported to the ATO by the member using a Transfer Balance Event Notification (TBEN) form.

3.7 Other trustee reporting requirements

Trustees must also report to the ATO when these following events occur:

Trustee becomes a disqualified person

The trustee of a fund who becomes disqualified must notify the ATO in writing immediately upon becoming disqualified.

An existing trustee can become disqualified when:

- a trustee (or director of the corporate trustee) is found guilty of an offence involving dishonest conduct
- a trustee (or director of the corporate trustee) becomes bankrupt
- a provisional liquidator is appointed to the company acting as the corporate trustee.

For more information on who is a disqualified person, please see *Chapter 2: SMSF definition and establishment*.

Change of fund details

A trustee must notify the ATO within 28 days whenever there is a change in:

- trustees
- directors of the corporate trustee
- members
- contact details
- name of fund.

Trustees can notify the ATO of a change in details by filling out a 'Change of details for superannuation entities' form available on the ATO website and forwarding it to the ATO.

Fund ceases to be an SMSF

A trustee of a superannuation fund that has ceased to be an SMSF must notify the ATO in writing within 21 days of the fund's change in status.

For example, where an SMSF converted to a SAF, the trustees would be required to notify the ATO in writing within 21 days of the fund's change in status.

Fund becomes an SMSF

A trustee of a previously existing superannuation entity that becomes an SMSF must notify the ATO in writing within 21 days of the fund's change in status to an SMSF.

For example, where a SAF converted to an SMSF structure, the trustees would have 21 days to notify the ATO of the fund's change in status.

Significant adverse events

The trustees must notify the ATO immediately where they become aware of any events that are likely to have a significant adverse effect on the financial position of the fund.

A significant adverse event would include any event which would render the fund unable to make payments to beneficiaries when obliged to do so.

Table 3.5 summarises a trustee's other reporting obligations and the reporting time frame.

Table 3.5 Trustee reporting requirements

Reportable event	Reporting time frame
Trustee becomes disqualified	Immediately
Change of fund details	28 days
Fund ceases to be an SMSF and becomes a SAF	21 days
Fund becomes an SMSF after being a SAF	21 days
The fund suffers a significant adverse event	Immediately

3.8 Penalty regime

If a trustee fails to comply with their requirements under the relevant legislation or there is a breach of trust under general law, a number of penalties can be applied.

ATO administrative penalties

The ATO can issue administrative penalties for certain breaches of the SIS Act that occur on or after 1 July 2014.

The penalties apply to each individual trustee or to the corporate trustee. Where a penalty is imposed on a corporate trustee, the directors will be jointly and severally liable for the penalty (that is, one penalty amount will apply regardless of the number of directors). However, if an individual director breaches an administrative penalty provision, the penalty may be imposed on that individual director.

Where a trustee disagrees with the application of an administrative penalty they will be able to appeal the decision in the Administrative Appeals Tribunal.

Furthermore, any penalty imposed will need to be paid by the individual trustees or by the directors of the corporate trustee in their personal capacity and cannot be paid from the assets of the fund.

A summary of some of the administrative penalties is outlined in Table 3.6

Table 3.6 SMSF administrative penalties

SIS Act provision	Penalty units	Dollar value
Operating standards (contribution and preservation standards etc)	20	$6,260
Requirement to comply with an education direction by due date	5	$1,565
Requirement to prepare financial statements	10	$3,130
Prohibition on lending money or providing financial assistance to members or relatives	60	$18,780
Prohibition on trustees borrowing money	60	$18,780
Requirement to comply with in-house asset rules	60	$18,780
Duty for trustees and directors to keep minutes and records	10	$3,130
Duty to keep record of any changes of trustees or directors	10	$3,130
Duty to keep copies of member reports	10	$3,130
Duty to notify the regulator of significant adverse events	60	$18,780
Duty to notify the ATO of change in status of entity	20	$6,260
Requirement that investment managers must be appointed in writing	5	$1,565
Comply with data gathering requirements	5	$1,565
Requirements on how information must be provided to the ATO	5	$1,565

Penalty unit

Under Commonwealth law, a penalty unit is defined in the Crimes Act 1914 and is valued at $313 as at 1 July 2023. Where a corporate trustee is convicted, the Crimes Act allows the court to impose penalties of up to five times the maximum fine that could apply to an individual.

Note: The value of a penalty unit is indexed every three years in line with CPI, with the next indexation date being 1 July 2026.

Government proposal: Increasing the value of Commonwealth penalty unit

The Government has introduced a Bill into parliament which would increase the value of the Commonwealth penalty unit from $313 to $330, commencing on 1 July 2024. Under the proposal, the next indexation to the value of a penalty unit would still occur on 1 July 2026.

At the time of writing, this Bill had not passed parliament or become law.

ATO approach to administrative penalties

The ATO has released Practice Statement Law Administration PS LA 2020/3 which provides guidelines to ATO staff regarding the issuing of administrative penalties.

The ATO indicates that the following steps should be taken when determining how to apply administrative penalties:

1 Determine if an administrative penalty has been imposed by the law

An administrative penalty will arise under law where a contravention of a provision in Section 166 of the SIS Act occurs. Section 166 also sets out the amount of the penalty.

2 Determine who is liable to pay the penalty

Where a fund has a corporate trustee, the penalty is generally imposed on the corporate trustee and all directors are jointly and severally liable to pay the penalty. For some contraventions however (for example, not complying with an education direction), the penalty is imposed on an individual director who is then personally liable to pay the penalty.

Where the fund has individual trustees, separate penalties are imposed on each individual trustee.

3 Determine if remission of part or all of the penalty is appropriate

ATO staff have discretion to remit all, part, or none of an administrative penalty, with the remission decision applying separately to each trustee on whom the penalty applies (for example, two individual trustees could receive different penalty amounts for the same contravention due to the remission decision).

The ATO has indicated that the following factors (although not an exhaustive list) should be considered when making a remission decision:

- The purpose of the penalty provision, which includes to:
  - encourage greater levels of voluntary compliance by ensuring that there are consequences for non-compliance appropriate to the conduct
  - promote consistent treatment by specifying the amount of penalty for each relevant contravention, and
  - shift the behaviour of trustees so they do not contravene again.
- Trustee behaviour and circumstances, which includes:
  - considering if the trustee has acted in a way that would reasonably be expected of another trustee in the same circumstances
  - taking into account the individual circumstances of each case, giving appropriate consideration to the background and experience of the trustees, as well as their intentions surrounding the circumstances of the contravention
  - the compliance history of the trustee or director of a corporate trustee of an SMSF
  - whether rectification has occurred or the trustee is in the process of rectifying before any ATO contact
  - whether the trustees made a voluntary disclosure before any ATO contact
  - whether there were circumstances beyond the trustee's control that:
    - caused the contravention
    - affected their ability to comply with their regulatory obligations, or
    - impacted on their capacity to rectify any contraventions.
- Seriousness of the contravention, which could include considering to what extent the fund's assets were impacted by the contravention, and over what time period the contraventions occurred.
- Unintended or unjust results: ensuring that the cumulative penalty imposed on a trustee or director is appropriate and is not so large as to be excessive in the circumstances.
- Situations where multiple penalties apply. Where a trustee's behaviour resulted in more than one administrative penalty applying, it is important to consider whether the cumulative penalty is defensible, proper and just. Considerations for this include:
  - whether multiple penalties arose from a single course of conduct or a particular event

- whether a single course of conduct or behaviour resulted in multiple penalties being imposed from multiple contraventions of the same provision
- where a particular event results in multiple penalties under more than one provision, the ATO will generally remit to a level reflecting the primary contravention (the primary contravention is determined by considering the behaviour and intention of the trustees).

4 Notify each trustee and/or director of the liability to pay the penalty

The ATO staff member must give a written notice to the trustee or director informing them of their liability to pay the penalty, and of the reason they are liable. If the penalty has not been remitted in full, they must also provide an explanation of why this has not occurred either before, or at the same time.

Enforceable undertakings

Where part of the SIS legislation has been contravened by an SMSF trustee, section 262A of the SIS Act allows the ATO to accept an enforceable undertaking offered by a trustee as an alternative to being penalised.

Where the ATO accepts an enforceable undertaking, it cannot be varied or withdrawn without the ATO's consent.

If the trustee breaches the conditions of an enforceable undertaking, the ATO can apply to a court for further penalties.

Rectification directions

The ATO is able to issue a rectification direction to a trustee of an SMSF that has breached the SIS Act or Regulations on or after 1 July 2014.

A rectification direction will require the trustee to undertake specified actions to rectify a breach within a specified period of time. The trustee must then provide evidence to the ATO that it has complied with the direction within the required time.

This differs from an enforceable undertaking in that it allows the ATO to specify what actions are required to rectify a breach rather than the ATO having to accept an offer by the trustee to enter into an enforceable undertaking to rectify the breach.

Failure to comply with the requirements specified in a rectification direction within the specified time period is an offence and may incur a penalty of up to 10 penalty units.

Education directions

The ATO can issue an education direction to a trustee of an SMSF that has breached the SIS Act or Regulations on or after 1 July 2014. This will apply where the person's lack of knowledge and/or understanding of their obligations contributed to committing the breach.

An education direction will require the trustee to undertake an approved course of education within a specified time period. Trustees must also provide evidence to the ATO that they completed the course within the required time period.

Approved education courses must be free of charge; however, trustees must pay their own out-of-pocket expenses to attend the course and will not be permitted to be indemnified from the assets of the fund.

Where a trustee fails to comply with an education direction within the required time period they may incur a penalty of up to 10 penalty units.

Trustee disqualification

The SIS Act allows the ATO to disqualify a person from acting as a trustee of an SMSF (or from being a director of a corporate trustee) if:

- the person has contravened the SIS Act or the Financial Sector (Collection of Data) Act 2001 on one or more occasions and the nature, number or seriousness of the contraventions provide grounds to disqualify, or
- the ATO is satisfied that they are not a fit and proper person to be a trustee (or a director of a corporate trustee) of a superannuation fund.

Once an existing trustee has been disqualified from being a trustee, they must cease to be a trustee or a director of a corporate trustee immediately.

Where a trustee knowingly acts as a trustee of a superannuation fund while disqualified they can be subject to fines or up to two year's imprisonment.

Fines may also apply where a trustee becomes a disqualified person and does not inform the ATO in writing immediately.

Implications for SMSFs where a trustee becomes disqualified

Where a trustee becomes disqualified they will need to resign as a trustee or as a director of the corporate trustee. They must also cease to be members of their fund due to the SMSF definition, i.e. all members must be trustees or a director of the corporate trustee.

Therefore, the disqualification of one or more trustees will generally result in the fund needing to be restructured, converted to a SAF or wound up.

SIS penalty provisions

In addition to the administrative penalties, the SIS Act provides for a range of different penalties to be applied to trustees where a breach of a penalty provision occurs. The penalties vary depending on the type of penalty that applies.

Civil penalty

Sections of the SIS Act that are subject to civil penalties include:

- Sole purpose test
- In-house asset rules

- Lending and financial assistance to members
- Prohibition of borrowing in superannuation funds
- Requirements for investments to occur on an arm's length basis.

Where a breach of a SIS civil penalty provision occurs, the ATO can apply to the court for a civil penalty order of up to 2,400 penalty units.

Alternatively, a breach of a civil penalty provision can be upgraded to an offence with maximum penalty of five year's imprisonment applying.

Offences under criminal code

Strict and fault liability penalties apply for breaches of provisions deemed to be an offence under the Criminal Code Act 1995.

Strict liability

Sections of the SIS Act that are subject to strict liability penalties include:

- requirement to keep minutes of meetings for 10 years
- requirement for a trustee to notify the ATO immediately on becoming a disqualified person.

Fault liability

Sections of the SIS Act that are subject to fault liability penalties include:

- requirement to comply with the prescribed operating standards for superannuation funds
- a disqualified person knowingly acting as a trustee
- requirement to keep correct records of accounts.

Two-tier liability

Where a section is both a strict and fault liability provision, the penalties attached to the fault liability option are higher (generally double) than those for the same breach under the strict liability option.

Sections of the SIS Act that are subject to two-tier liability include:

- requirement to lodge annual return with the ATO
- requirement to keep accounting records for five years
- requirement to arrange for audit of accounts.

Civil liability

The SIS Act preserves the rights of members and their beneficiaries to take legal action against trustees under general or other statutory law. This will commonly be for losses suffered by members or beneficiaries as a result of a breach of the trust deed or a trustee duty.

In addition, the SIS Act specifically gives members the right to take legal action against the trustee or any other person involved in a contravention.

This might be rare for SMSFs (as members and trustees are one and the same). However, it could allow a member to take action against a professional service provider, such as a financial adviser who provided advice that resulted in the fund breaching its governing rules (such as an existing investment strategy) and suffering a loss as a result.

Where a contravention that is subject to the civil penalty provisions occurs, members or beneficiaries can sue the trustee for compensation for either the profit that they made or the loss that the fund incurred.

Trustee right of reimbursement and indemnity

Under general law, trustees can usually be reimbursed from the fund's assets for liabilities incurred while acting as trustee. Section 56 of the SIS Act provides that any provisions in the trust deed seeking to limit this right are invalid.

However, section 56 of the SIS Act also specifies that the trustee cannot be indemnified out of the assets of the fund where:

- a breach of trust has occurred and the trustee has not acted honestly
- a breach of trust has occurred and the trustee has intentionally or recklessly failed to exercise the degree of care and diligence that was required
- the trustee has incurred an administrative penalty
- the trustee has incurred a liability for the cost of undertaking an approved course of education in compliance with an education direction, or
- the trustee has received a fine under a civil penalty order.

What is a breach of trust?

A breach of trust occurs where the trustee acts outside the fund's governing rules. Examples could include:

- a trustee not carrying out a required trustee duty, or
- a trustee exercising a power or discretion in a way that would breach the provisions of the fund's trust deed.

Loss of complying fund status

In the case of extreme or repeated contraventions, the ATO can revoke the complying status of an SMSF. To do this it must issue a notice to the trustee under section 40 of the SIS Act that the fund is a non-complying superannuation fund.

However, where a contravention has occurred, the ATO must not determine that an SMSF is non-complying without first considering:

- the seriousness of the contraventions that have occurred
- the tax consequences that would arise if the fund was made non-complying
- any other relevant factors.

Case study – SMSF made non-complying

An Administrative Appeals Tribunal (AAT) decision to uphold the ATO's issuing of a notice of non-compliance to an SMSF highlights some important considerations for trustees.

This case (JNVQ and Commissioner of Taxation [2009] AATA 522 (14 July 2009)) involved an SMSF that had loaned a significant portion of its capital (more than 90% at one point) to a related company so that it could continue to trade during a period of financial difficulty. This led to a contravention of the sole purpose test and a breach of the 5% in-house assets limit. The loan took some four years for the company to repay despite repeated requests from the ATO.

In upholding the ATO's decision to make the fund non-complying, the AAT mentioned that the scale of the breach and the lack of action by the trustee to rectify the situation quickly were major factors in its decision.

The important lessons that trustees can take from this decision are that:

- serious and knowing contraventions of SIS legislation will be dealt with much more harshly than minor or inadvertent contraventions
- the ATO is more likely to look favourably upon a trustee who, on becoming aware of a contravention, takes action to rectify it as quickly as possible.

Consequences of losing complying fund status

If an SMSF becomes a non-complying fund, it is no longer subject to a concessional tax rate of 15% and instead has its assessable income taxed at 45%.

During the first financial year that an SMSF becomes non-complying, it is penalised further by being subject to 45% tax on any assessable income in previous financial years. Commonly, this previous assessable income will equal the sum of all members' taxable components at the start of the financial year.

For further detail about the taxation of SMSFs that become non-complying, please see *Chapter 5: Taxation of SMSFs*.

How does the ATO ensure compliance with SIS legislation?

The primary way in which the ATO ensures that SMSFs are complying with SIS legislation is through the annual external audit process. The auditor's report and contravention report provide the auditor's opinion as to whether the trustee has complied with the SIS legislation and, if not, what contraventions have occurred.

For more information on the audit requirements for an SMSF, please see section 3.5 of this chapter.

4 Superannuation investment rules

4.1 Introduction

SMSFs allow members to exercise a high level of control over how the fund is managed and operated. This includes allowing members to control how the fund's assets are invested and used. However, the SIS Act imposes a strict set of investment rules to ensure superannuation assets are invested to provide retirement benefits and to ensure member benefits are protected.

It is extremely important that trustees and their advisers are aware of and understand these rules and comply with them at all times. Failure to do so can result in significant penalties being applied and loss of the fund's complying status.

4.2 Related parties

In general, the SIS Act does not prescribe what type of assets a superannuation fund is permitted to acquire. As a result, trustees are generally free to make properly considered investment decisions in accordance with the fund's investment strategy and the fund's trust deed.

However, the SIS Act does impose a range of restrictions on trustees making investments or entering into certain transactions or arrangements that involve a related party of the fund. These rules include:

- the prohibition of acquiring certain assets from a related party
- the in-house asset rules
- the arm's length investment rules
- the sole purpose test
- restrictions on lending or providing financial assistance to members and relatives.

It is therefore vital to have a good understanding of the definition of a related party of a superannuation fund.

Definition of related party

A related party of a superannuation fund is defined in section 10 of the SIS Act and encompasses a wide range of individuals and entities. A related party is specifically defined as:

- a member of a fund
- a standard employer sponsor of a fund
- an associate of a member or standard employer sponsor of a fund (as defined in Part 8 of the SIS Act).

Member

A member of a fund generally includes a person who has applied to be a member of the fund or who is a beneficiary of the fund.

Standard employer sponsor

A standard employer sponsor of a fund is an employer who contributes (or who would contribute) to the fund under an arrangement between the employer and the trustee of the fund. For example, corporate and industry superannuation funds are generally standard employer sponsored funds.

Where an employer contributes to a fund under an arrangement between the employer and the members of the fund, instead of under an arrangement between the employer and the trustee of the fund, the employer would be an employer sponsor of the fund but not a standard employer sponsor of the fund.

Therefore, unless there is an arrangement between the employer sponsor of an SMSF and the trustees of the fund about membership and the making of contributions, an SMSF will generally not have a standard employer sponsor.

However, under section 70A of the SIS Act, the ATO can determine a person who is not a standard employer sponsor of a fund to be one. In this situation, the ATO must notify the trustee of the fund in writing of that determination.

Associates of a member

An associate of a member of an SMSF is defined in Part 8 of the SIS Act and includes:

- a relative of the member
- the other members of the SMSF
- the non-member trustee (or non-member director of a corporate trustee) of a single member SMSF
- a partner (and their spouse and child) of a member or a partnership in which the member is a partner
- a trustee of a trust where a member controls that trust
- a company that is sufficiently influenced by, or in which a majority voting interest is held by, the member or an associate of the member.

The definition of associate also captures situations where a member is acting in the capacity of trustee of another trust. For example, where a member held a majority voting interest in a company via their role as a trustee of a family discretionary trust, the company would be an associate of the member.

Who is a relative of a member?

A relative of a member is defined in section 10 of the SIS Act and includes a member's:

- parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the member or of his or her spouse
- the spouse of the member or any of the above individuals.

Meaning of partnership

Partnership is defined in section 70E of the SIS Act to have the same meaning as in the Tax Act. A partnership is defined in section 995.1 of the Tax Act as:

- an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly, or
- a limited partnership.

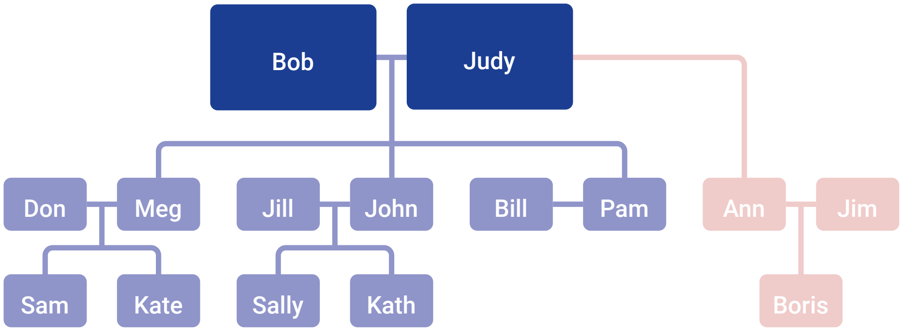
Therefore, under the definition, it is not necessary that persons only carry on a business together for their association to be treated as a partnership. If they derive income jointly there is a partnership. In addition, in TR 93/32 the ATO confirms that people will earn income jointly where they co-own assets as either joint tenants or tenants in common.

For example, where two otherwise unrelated people owned an investment property together as tenants in common which they leased out, they would come under the definition of partners and therefore they would be considered to be associates of each other.

An associate of a standard employer sponsor (where an SMSF has a standard employer sponsor) is also defined in Part 8 of the SIS Act and varies depending on whether the standard employer sponsor is an individual, a company or a partnership.

Related party case study – relatives (part 1)

Bob and Judy are married and have three children, Meg, John and Pam. Judy also has a daughter, Ann, from a previous relationship. All of Bob and Judy's children, including Ann, are in relationships and Meg, John and Ann also have children of their own. Bob and Judy's family tree is outlined as follows:



If Bob had his own single member SMSF (without Judy), the following people would be defined as a relative of Bob and therefore a related party of his fund:

- Judy – as she is Bob's spouse
- Meg, John, Pam, Sam, Kate, Sally and Kath – as they are lineal descendants of Bob
- Don, Jill and Bill – as they are the spouses of Bob's lineal descendants
- Ann and Boris – as they are lineal descendants of Bob's spouse
- Jim – because he is the spouse of the lineal descendant of Bob's spouse.

Related trusts

A trustee of a trust (in the capacity of trustee of that trust) will be a related party where the member controls that trust.

Under section 70E of the SIS Act, a member will control a trust where:

- the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts), or
- a group in relation to the member has a fixed entitlement to more than 50% of the capital or income of the trust, or
- a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust. Note – for discretionary trusts, the person (or persons) nominated in the deed as the 'appointor' of the trust generally have the power to remove or appoint the trustee of the trust.

Meaning of a group

A group in relation to a member means:

- the member acting alone, or
- an associate of the member acting alone, or
- the member and one or more associates of the member acting together, or
- two or more associates of the member acting together.

Meaning of the term 'accustomed' or 'might reasonably be expected'

The terms 'accustomed' and 'might reasonably be expected' are not defined in the SIS Act and therefore take their ordinary meaning. However, some useful guidance on the meaning of the word 'accustomed' and how it relates to the control of an entity can be obtained from a recent Administrative Appeals Tribunal (AAT) case (Gutteridge and Commissioner of Taxation [2013] AATA 947) involving the small business CGT concessions.

The AAT was reviewing the ATO's decision about the control of an entity where the wording under the applicable control test is almost exactly the same as that used in section 70E. In its decision the AAT outlined that a person would be considered to be accustomed to act in accordance with another person's instructions or wishes where they "treated that other person's instructions or wishes as a sufficient reason so to act, rather than making personal decisions where those instructions or wishes were merely a factor considered".

Importantly, the AAT went on to outline that decisions made in pursuit of one's own business goals, even if consistent with the wishes of another party, do not necessarily render the decision maker accustomed to acting in accordance with the other party's wishes.

Whether a particular arrangement would be caught under this control test can be complex depending on the circumstances. If in doubt specialist legal advice should be sought.

Therefore, based on the AAT view, the trustee of a trust will be a related party of an SMSF where a member and/or an associate of the member either alone or together:

- have a fixed entitlement to more than 50% of the capital or income of the trust, or
- are accustomed to being able to direct the trustee of the trust and the trustee would treat those instructions as sufficient reason to act rather than considering those instructions when making their own decision, or
- are able to remove and appoint the trustee of the trust.

Related party case study – related trusts (part 2)

Following on from part 1 – Bob's son and daughter-in-law, John and Jill, hold 100% of the units (50% each) in a unit trust – the J&J Unit Trust. John and Jill are also the sole directors of Company X, which acts as the trustee of the unit trust.

In this case, as both John and Jill are associates of Bob they form a group together. This group will then be considered to control the trust on the basis that the members of the group together:

- hold more than 50% of the units in the trust, and
- are the sole directors of the unit trust's corporate trustee (Company X), which would then be expected to act in accordance with their directions, instructions or wishes.

As a result, Company X, as the trustee of the J&J Unit Trust, would also be included as a related party of Bob's SMSF.

Related companies

A company will be a related party of an SMSF where:

- the company is sufficiently influenced by a member or an associate of a member, or
- a member or their associate holds a majority voting interest in the company.

Meaning of 'sufficiently influenced' and 'majority voting interest'

The terms 'sufficiently influenced' and 'majority voting interest' are defined in section 70E of the SIS Act as follows:

- sufficient influence – a company is sufficiently influenced by an entity or entities if the company, or a majority of its directors, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts)
- majority voting interest – an entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

Therefore, a company will be a related party of an SMSF where:

- a majority of the directors of a company might reasonably be expected to act in accordance with the directions, instructions or wishes of a member or an associate of a member of the fund, or
- a member and their associates combined hold more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

For more information on the terms ‘accustomed’ or ‘might reasonably be expected to act,’ please see previous discussion on related trusts in this chapter.

Related party case study – related companies (part 3)

Following on from part 1 and part 2 – Assume Bob has part ownership of a private company through which a business is operated. The distribution of the voting shares of the company is as follows:

- Bob – 1 share
- Don (Bob’s son-in-law) – 1 share
- Company X (as trustees of the J&J Unit Trust) – 3 shares.

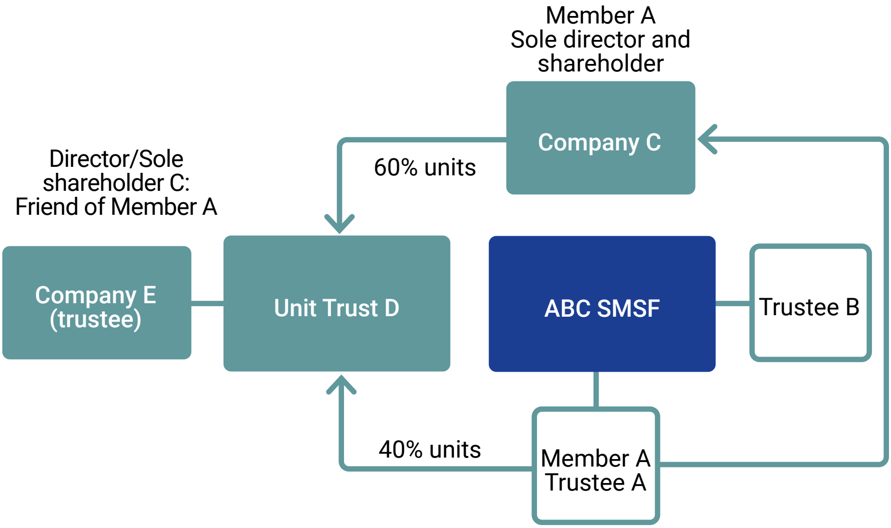
In this situation, the private company would be a related party of Bob’s SMSF, as Bob and his associates (Don as well as Company X) between them hold 100% of the voting shares – which exceeds the 50% control test.

Related party look-through

Note that when assessing whether a trustee or a company is a related party you must determine whether any other related parties, including other related companies or trustees, also have an interest in (or are able to effectively control) the entity that is being tested. Therefore, you may need to ‘look-through’ a number of related companies and trusts to determine whether an entity is a related party of a member.

The following structures are examples of entities that would be a related party of an SMSF due to the involvement of other related party entities.

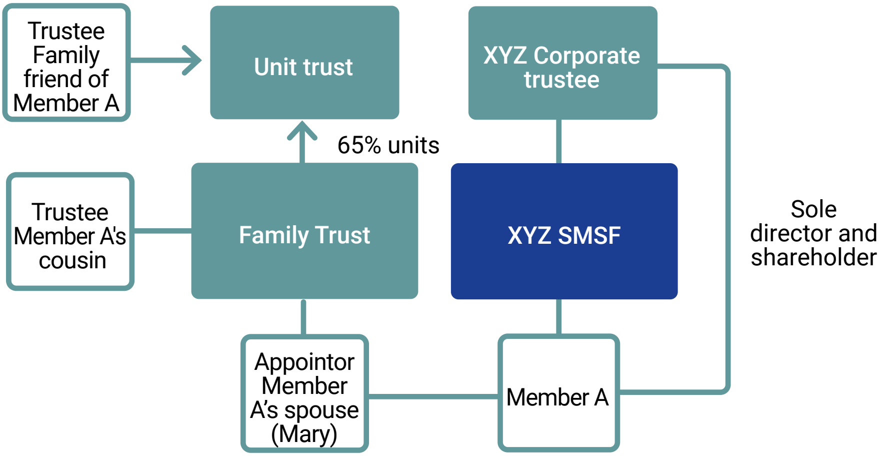
Example 1



In this example the following entities would be related parties of the ABC SMSF:

- Member A – being a member of the ABC SMSF
- Trustee B – being a non-member trustee of ABC SMSF – which is a single member super fund
- Company C – as Member A owns more than 50% of shares in Company C
- Company E (as trustee of Unit Trust D) – as member A and their associate (Company C) together own more than 50% of the units in Unit Trust D

Example 2



In this example the following entities would be related parties of the XYZ SMSF:

- Member A – as a member of the XYZ SMSF
- XYZ Corporate trustee – as Member A owns more than 50% of shares in XYZ
- Mary – as a spouse and therefore relative of Member A
- Member A's cousin (as a trustee of the family trust) – as Member A is taken to control the family trust via one of their associates (Mary) being the appointor of the trust
- Family friend (as trustee of the unit trust) – as an associate of Member A (Member A's cousin as the trustee of the family trust) owns more than 50% of units in the unit trust

4.3 Acquisition of assets from related party

Section 66 of the SIS Act prohibits a trustee or investment manager of an SMSF from intentionally acquiring an asset from a related party of the fund.

In SMSF Ruling SMSFR 2010/1,[25] the ATO has confirmed the term 'acquiring an asset from a related party' has a broad application and encompasses not only the purchase of an asset by a trustee or investment manager, but also any means by which the trustee becomes the legal or equitable owner of an asset.

The ruling also confirms that an asset is widely defined as any form of property and includes every type of right, interest or thing of value that is legally capable of ownership, including real property and personal property. Real property consists of land, interests in land and any buildings or structures permanently fixed to the land. Personal property includes all forms of property other than real property and includes tangible and intangible personal property.

25 SMSFR 2010/1: The application of subsection 66(1) of the *Superannuation Industry (Supervision) Act 1993* to the acquisition of an asset by a self managed superannuation fund from a related party.

Therefore, an asset for the purposes of Section 66 of the SIS Act would include:

- a freehold interest in land
- rights arising under a contract
- an option to acquire something
- a boat, motor vehicle or machinery
- collectables
- shares in a company
- units in a unit trust
- an intangible asset, such as goodwill
- money including other negotiable instruments such as cheques
- a promissory note
- a license, permit, quota or right to undertake certain restricted activities
- a patent, trademark or copyright.

Therefore, if the trustee of an SMSF acquired a residential property from a related party via either a purchase arrangement or a transfer for no consideration (in other words, an in specie contribution), the trustees will have acquired an asset from a related party and the general prohibition would apply.

Exceptions to the acquisition of assets from related party rules

Section 66 of the SIS Act provides a number of exceptions to the general prohibition from the acquisition of assets from related party rule. These include:

- money
- listed securities acquired at market value
- Business Real Property (BRP) acquired at market value
- a life insurance policy[26] issued by a life insurance company (other than a policy acquired from a member of the fund or from a relative of a member)
- a deposit with an authorised deposit-taking institution (ADI)
- a deposit with an approved non-ADI financial institution
- an investment in a pooled superannuation trust (where the trustee of the fund and the trustee of the pooled superannuation trust acted at arm's length in relation to the making of that investment)
- an investment in a widely held unit trust acquired at market value
- an in-house asset of the fund acquired at market value where the acquisition of the asset would not result in the level of in-house assets of the superannuation fund exceeding 5% of the value of the fund's assets

26 Note – life insurance policies are defined in the Life Insurance Act and include disability policies such as income protection policies.

- an asset included in a class of assets specified in the regulations not to be an in-house asset, acquired at market value
- where the asset is acquired under a merger between regulated superannuation funds by the trustee of a regulated superannuation fund
- an asset of a kind which the regulator, by written determination, determines may be acquired by any fund, or a class of funds in which the fund is included
- an asset acquired from another regulated fund as a result of a relationship breakdown.

Some of these exemptions are now discussed in more detail.

Money

The meaning of money is not defined in the SIS Act; however, the ATO has defined it in a number of different rulings relating to SMSFs as:

- legal tender, whether Australian currency or foreign currency,[27] and
- any generally accepted medium of exchange for goods, services or the payment of debts that confers complete liquidity on its holder.[28]

In SMSFR 2010/1, the ATO also confirms that a fund will have accepted money if there has been an actual increase in the funds held by the SMSF and that it is the substance of the transaction that is relevant rather than the means of the transaction. Therefore, there will be no contravention of section 66 where funds are transferred from a related party to an SMSF in one of the following ways:

- as a cash payment (either in Australian currency or foreign currency)
- via the electronic transfer of funds from the related party's account to an SMSF's account
- via the provision of a money order or bank cheque on which payment is made
- via the provision of a personal cheque that is presented and honoured with cash (or its electronic equivalent)
- where a related party (as maker) issues a promissory note payable at face value to the trustee or investment manager and it is honoured with cash (or its electronic equivalent).[29]

27 SMSFR 2010/1: *The application of subsection 66(1) of the Superannuation Industry (Supervision) Act 1993 to the acquisition of an asset by a self managed superannuation fund from a related party*

28 SMSFR 2009/2 Self managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the Superannuation Industry (Supervision) Act 1993.

29 Please note – in SMSFR 2010/1 the ATO warns that a promissory note that is issued by an unrelated third party at a discount from face value to raise finance is in the nature of a debt instrument. Typically, such notes are traded on secondary markets. If a trustee or investment manager acquires such a promissory note from a related party, the acquisition results in a contravention of subsection 66(1) because it is an asset but not the acceptance of money and there is no other relevant exception.

Collectable bank notes and coins

In SMSFR 2010/1 the ATO confirms that in its view collectable coins and bank notes are assets in their own right and are therefore not money for the purposes of section 66. The ATO has also confirmed that coins or bank notes will be collectables where their value exceeds their face value.

In the ruling the ATO also confirms that trade dollars and barter credits are also not money.

FirstTech comment

Are bullion coins money?

While the ATO has not specifically dealt with the question of whether bullion coins are money, similar concepts would apply. Therefore, where a bullion coin had a value that was different from its face value, that is, if its value was derived from its collectable status or its metal content, it would not be treated as money for the purposes of section 66 regardless of its status as legal tender.

For example, it is possible to purchase gold bullion coins that have the status of legal tender from the Perth Mint. However, where the value of those coins exceeds their face value due to their gold content, they would not be treated as money and could not be acquired from a related party under section 66.

FirstTech comment

Is cryptocurrency money?

Cryptocurrency is a term to describe digital assets in which encryption is used to regulate the generation of additional units and verify transactions. Cryptocurrencies, such as Bitcoin, operate independently of central banks or government.

In 2014, the ATO issued two taxation determinations (TD 2014/25 and TD 2014/26) that confirm that bitcoin and cryptocurrencies like bitcoin are not money but are capital gains tax (CGT) assets.

As a result, the ATO has also confirmed on its website (see SMSF investing in crypto assets[30]) that the acquisition of assets from a related party rules will apply to restrict the transfer of cryptocurrency from a related party to a fund, such as via an in-specie contribution.

30 www.ato.gov.au/super/self-managed-super-funds/in-detail/smsf-investing/smsf-investing-in-crypto-assets/

Listed securities acquired at market value

A listed security means a security listed for quotation in the official list of any of the following:

- an approved stock exchange as outlined in schedule 5 of the Tax Regulations, and includes the Australian Securities Exchange as well as most international stock exchanges, such as the New York, NASDAQ, London, Tokyo, Hong Kong, Singapore and Ljubljana stock exchanges
- a licensed market within the meaning of section 761A of the Corporations Act 2001
- a market exempted under section 791C of the Corporations Act 2001.

A security generally includes a share, bond, debenture, unit, option or any other security.

For example, an SMSF trustee would be permitted to acquire a share in a company that is listed on the Australian Securities Exchange via either a purchase arrangement or a contribution.

The exemption for listed securities only applies where the securities have been transferred at market value. The ATO has confirmed that for the transfer to be done at market value it should be done at the closing price on the relevant stock exchange as at the date of transfer. It may also be possible to use some other value where it can be justified, such as the average value of trades for that security on the day of transfer. However, trustees may wish to verify what evidence an auditor may require to confirm the transaction occurred at market value.

A business real property of a related party acquired at market value

A trustee is permitted to acquire an asset that is business real property, such as a commercial property, from a related party at market value.

For a full description of the meaning of a business real property, please see section 4.5 of this chapter.

An investment in a widely held unit trust acquired at market value

A trust will meet the definition of a widely held trust where it is a unit trust in which entities have fixed entitlement to all of the income and capital of the trust and any 20 entities do not have:

- fixed entitlements to 75% or more of the income of the trust
- fixed entitlements to 75% or more of the capital of the trust.

For example, a managed fund would be a widely held trust where the top 20 unit holders held less than 75% of the units in the trust between them.

In most cases, units in a large managed fund would qualify as a widely held trust due to the large number of unit holders involved. However, SMSF trustees should always double-check with the fund administrator before transferring any units to ensure the fund satisfies the definition of a widely held trust.

The market value for the widely held trust should be the published unit price for the trust on the date of transfer.

Asset acquired due to relationship breakdown

A trustee of an SMSF is permitted to acquire an asset from another SMSF that would be a related party of the first SMSF if:

- the asset is acquired for the benefit of a particular member of the fund
- the other fund is a regulated fund
- the acquisition is related to reasons directly associated with the total and permanent breakdown of a relationship between spouses (or former spouses)
- the asset represented all or part of the member's own interest in the SMSF or all or part of a member's entitlement as determined under a superannuation splitting arrangement.

For example, this exemption could allow a member of an SMSF to transfer an asset, such as a residential investment property, from their existing SMSF to a new SMSF where the transfer was directly related to the permanent breakdown of their relationship with their spouse, who is also a member of the existing fund.

In-house assets

Trustees are permitted to acquire certain in-house assets from a related party of the fund as long as the asset was acquired at market value, and:

- the acquisition would not cause the fund to breach the 5% in-house asset limit, or
- the asset has been included in a class of assets specified in the SIS Regulations not to be an in-house asset, such as investments in certain non-geared companies and trusts.

For more information on the definition of an in-house asset and what assets are excluded from being an in-house asset, see the section 4.4 in this chapter.

Life insurance policies

Under the exemptions, a trustee will be permitted to acquire a life insurance policy issued by a life insurance company that is acquired at market value from a related party other than a member, or a relative of a member, of the SMSF.

Therefore, a trustee would not be permitted to acquire a life insurance policy from a member or a relative of a member. However, a trustee could acquire a life insurance policy held over a member that was owned by a related entity, such as a related company or trust.

Alternatively, where a member wanted to transfer an existing life insurance policy into their SMSF, they could consider approaching their existing insurer to inquire whether it would be willing to cancel the member's existing policy and to issue an identical policy to the trustee. Depending on the circumstances, an insurer may agree to this without additional underwriting on the basis it is already on risk for the life insured.

Note

Life insurance policies are defined in the Life Insurance Act 1995 and include disability policies such as income protection policies.

FirstTech comment

Acquisition of term life policies from members

Members considering arranging for an existing policy to be cancelled and reissued in the name of the trustee may wish to confirm a range of details before doing so. These include:

- that the policy is of a type that a trustee of a superannuation fund is permitted to acquire – for more information on allowable insurances, please see *Chapter 6: SMSFs and insurance*
- whether the policy has level premiums and whether cancelling and reissuing the policy will result in an increase in the level of the premiums, and
- whether the trustee will be permitted to acquire and hold insurances under the terms of the trust deed.

Anti-avoidance provisions

The acquisition from related party prohibition also includes anti-avoidance provisions that prohibit trustees from entering into a scheme that would result in the trustee acquiring a prohibited asset from a person who has a connection with a related party of the fund.

For example, this would prohibit a member of an SMSF from transferring an asset to another person or entity with whom the member has a connection, but who is not a related party of the SMSF, with the intention that the trustee of the SMSF would then acquire the asset from that person.

4.4 In-house asset rules

The in-house asset provisions are a complex set of rules designed to limit the risks associated with superannuation funds entering into certain transactions with related parties by limiting the fund's total exposure to certain specified 'in-house' assets.

Section 71 of the SIS Act defines an in-house asset of a superannuation fund to be an asset of the fund that is:

- a loan to or an investment in a related party,
- an investment in a related trust of the fund, or
- an asset of the fund that is subject to a lease, or lease arrangements, between the trustee and the related party of the fund.

For a full discussion of the meaning of related parties, please see section 4.2.

Related trusts

A related trust of a superannuation fund means a trust that a member or a standard employer sponsor of the fund controls (see section 4.2 for more information on controlled trusts). However, a related trust excludes any trust arrangement that arises due to an asset being held on trust for a fund as part of an instalment warrant arrangement.

Meaning of terms 'loan', 'invest in', 'lease' and 'lease arrangement'

SMSFR 2009/4[31] clarifies the meaning of certain terms regarding the in-house asset definition. These terms are now discussed in more detail.

Meaning of 'loan'

A loan is defined in section 10 of the SIS Act as including the provision of any credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings. This is a very broad definition and could capture a broad range of situations, including:

- the lending of money
- the sale of goods or land on credit
- instalment payment arrangements
- an unpaid present entitlement to the distribution of trust income
- arrangements for the deferral of payments of debts or entitlements.

For example, where the trustee of an SMSF entered into a contract to sell an asset of the fund to a member, but the trustee and the member entered into an arrangement to defer the payment of all or part of the purchase price for a specified period, the arrangement would constitute a loan to the member and would be an in-house asset of the fund.

31 SMSFR 2009/4: The meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the Superannuation Industry (Supervision) Act 1993.

Meaning of 'invest in'

The ruling confirms the ATO's view that where money or assets are provided for the benefit of a related party or related trust for the purpose of receiving income, interest, profit or gain, a sufficiently close connection will be established between the investment and that entity for it to be described as an investment in that entity.

For example, if an SMSF purchased units in a trust and those units entitled the fund to receive a proportion of any interest, income, profit or gain derived by the trust, the SMSF will be considered to have invested in the trust.

Meaning of 'lease'

The ruling confirms that the meaning of the term lease differs depending on whether the lease is in respect of real property (in other words, land and attached buildings) or non-real property, such as personal property.

A lease in respect of real property involves an agreement where the lessee is granted exclusive possession of the property, generally in exchange for rent. That is, the tenant not only has the right to occupy the premises, but to exclude access to all others, including the legal owner of the land.

A lease over non-real property involves a legally enforceable hiring agreement involving the payment of consideration by the hirer in exchange for enforceable temporary possession of the asset.

Meaning of 'lease arrangement'

The ruling clarifies that a lease arrangement includes informal arrangements under which a person uses or controls the use of fund property. This includes arrangements where a related party gains possession of an asset of the SMSF, even where no rent is payable in exchange for that possession.

For example, if an SMSF trustee allowed another entity to take possession and use an asset of the fund, such as real property, without entering into a formal lease and without requiring rent to be paid, that arrangement would be a lease arrangement.

In-house asset limit

The market value of a fund's in-house assets is limited to 5% of the market value of the fund's assets.

The level of a fund's in-house assets is calculated using the formula set out in section 75 of the SIS Act as follows:

$$\frac{\text{Number of whole dollars in value of the in-house assets of the fund}}{\text{Number of whole dollars in value of all the assets of the fund}} \times 100$$

Trustees must measure the level of a fund's in-house assets:

- on the acquisition of the asset
- at the end of each financial year.

Acquisition of an asset that would be an in-house asset

Under the exceptions to the rules prohibiting trustees intentionally acquiring assets from related parties, a trustee is permitted to acquire an asset that would be an in-house asset of the fund from a related party, where the acquisition would not cause the level of the fund's in-house assets to exceed the 5% in-house asset limit.

For example, the trustee of an SMSF with $1 million in assets would be permitted to acquire up to $50,000 of shares or units in a related company or trust (assuming the fund had no other in-house assets). However, if the trustees invested more than $50,000 in a related company or trust, the exemption would not apply and the fund would have breached the prohibition on a fund acquiring assets from a related party.

To avoid doubt, the in-house asset rules also specify that acquiring an asset also includes making an investment or a loan, or entering into a lease or a lease arrangement, if the resulting investment, loan or asset subject to a lease or lease arrangement would be an in-house asset.

For example, a trustee would be prohibited from leasing an existing residential property that made up 50% of the assets of the fund to a related party, as they would be deemed to have acquired an in-house asset in excess of the 5% in-house asset limit.

Existing in-house assets at the end of each financial year

Under section 82 of the SIS Act, trustees are required to measure the level of the fund's existing in-house assets (based on the market value of those assets) as at 30 June of each financial year. Where the level of the fund's in-house assets exceeds the 5% limit, the trustee must prepare a written plan identifying the amount of in-house assets that exceed the 5% limit and the steps the trustees will take to ensure that:

- one or more of the fund's in-house assets are disposed of by the end of the following financial year, and
- the value of the assets disposed of will result in the level of the fund's in-house assets being reduced to an allowable level.

Trustees therefore need to be aware of the fund's in-house assets and to monitor their value in relation to the total value of the fund's assets. For example, a fund could breach the in-house asset limit due to:

- the value of the fund's in-house assets appreciating in value at a faster rate compared to the rest of the assets of the fund
- the value of the fund's in-house assets not depreciating in value, or depreciating in value at a lower rate compared to the rest of the fund's assets.

For example, where an SMSF held an in-house asset, such as a loan to a related company or trust that was valued at 4% of the fund's assets, and the rest of the fund's assets suddenly depreciated in value, such as due to a corporate collapse or severe market down turn, the relative value of the loan against the rest of the fund's assets would increase and could cause the fund to breach the 5% in-house asset limit.

Once a fund has been found to have breached the in-house asset limit as at the end of the financial year, the trustees must dispose of the amount of the excess by the end of the following year. That is, they will not be permitted to make additional contributions to water down the in-house asset level or wait until markets recover. However, making contributions could be effective if made before the end of the financial year, to ensure a fund's in-house assets are within the allowable limit as at 30 June.

Exceptions to the in-house asset definition

The in-house asset rules contain exemptions which specifically exclude certain assets of a fund from being an in-house asset. These include:

- a business real property subject to a legally enforceable lease with a related party
- units in widely held unit trusts
- property held by the fund and a related party of the fund as tenants-in-common (provided the property is not subject to a lease between the trustee and a related party – other than if the lease is in relation to a business real property)
- an asset the ATO has determined not to be an in-house asset
- investments in certain non-geared trusts and companies
- deposits with Authorised Deposit-taking Institutions (banks)
- a life insurance policy
- arm's length investments in pooled superannuation trusts
- certain public sector fund assets
- trust arrangements set up as part of a complying limited recourse borrowing arrangement
- investments in certain related trusts and companies under the specific transitional arrangements.

Some of these exemptions are now discussed in more detail.

Business real property

The definition of a business real property for the purposes of in-house asset rules is the same as the definition for the rules prohibiting the acquisition of assets from related parties. For more information on the definition of a business real property, please see section 4.5 in this chapter.

Widely held trusts

If a trust is a related party of an SMSF, any investment by the fund in that trust will not be an in-house asset where the trust is also a widely held trust.

The definition of a widely held trust for the purposes of in-house asset rules is the same as the definition for the rules prohibiting the acquisition of assets from related parties. For more information on the definition of widely held trusts, please see section 4.3 in this chapter.

Limited recourse borrowing arrangements

Where an SMSF has borrowed to acquire an asset under a limited recourse borrowing arrangement (see section 4.11 in this chapter), the trust required to hold the asset on behalf of the fund will not be an in-house asset of the fund where:

- the only property of the trust is the single acquirable asset acquired with the borrowing (or an allowable replacement asset), and
- the asset held on trust for the SMSF would not be an in-house asset of the SMSF if it were held directly by the SMSF.

For example, if a trustee acquired a residential investment property under a Limited Recourse Borrowing Arrangement (LRBA), and the property was then leased to an unrelated party, the holding trust would be exempt from the in-house asset rules. However, if the property was instead leased back to a related party, such as a member of the fund, the exemption would not apply as the property would be an in-house asset if it were held directly by the fund.

Under the in-house asset exemption, the trust is strictly only exempt from being an in-house asset during the period that the loan is in place. Therefore, where the trust was established before the loan was established, for example if a deposit has been paid to acquire an asset, the trust would strictly be an in-house asset of the fund. The same situation would also occur where the asset was maintained in the trust arrangement once the loan had been repaid.

To address this situation, the ATO registered a legislative instrument[32] on 4 April 2014 confirming that the holding trust established under an LRBA will not be an in-house asset of a fund where:

- the loan under an LRBA has not yet begun, and
- the related trust does not yet hold the asset to be acquired under the LRBA and that it is reasonable to conclude that the:
  - borrowing will occur
  - related trust will hold the asset to be acquired under the LRBA
  - asset acquired under the LRBA would not cause the holding trust to be an in-house asset of the fund when the holding trust begins to hold the asset.

In addition, the instrument also confirms that the holding trust will not be treated as an in-house asset once the loan is repaid where the in-house asset exemption for LRBA arrangements:

- resulted in the holding trust not being an in-house asset of the fund from the time the related trust began to hold the asset acquired under the LRBA, until when the borrowing was repaid; and
- would result in the holding trust not being an in-house asset of the fund but for the fact that borrowing had been repaid.

32 Self-Managed Superannuation Funds (Limited Recourse Borrowing Arrangements – In-house Asset Exclusion) Determination 2014, available at: https://www.legislation.gov.au/Details/F2014L00396

For example, where an SMSF acquired a residential investment property under an LRBA, there would be no requirement to transfer the legal title of the property back to the SMSF after the loan has been repaid as the in-house asset exemption will continue to apply (as long as the property wouldn't itself have been an in-house asset if it was held directly by the fund).

This is important as it could allow a trustee to maintain the asset in the trust so as to avoid any risk of stamp duty applying to the transfer of the property from the trust to the SMSF once the loan has been repaid.

Tenants-in-common arrangements

Property held by the fund and a related party of the fund as tenants-in-common will not be an in-house asset provided the property is not subject to a lease between the trustee and a related party.

This exemption therefore allows the trustees of an SMSF to jointly acquire real property with one or more related parties of the fund via a tenants-in-common arrangement as long as the property is not leased back to a related party. However, the restriction on leasing the property back to a related party will not apply where the property is a business real property as a business real property leased to a related party is otherwise exempt from the in-house asset rules (see above).

Case study

Kim and Harry are the trustees and members of their SMSF. The SMSF has total assets of $800,000 but Kim and Harry have identified a property that they would like to acquire for $1 million. Kim and Harry have the cash available and could afford to contribute the additional $200,000 to allow the fund to acquire the asset; however, they don't want the $200,000 to be preserved until retirement and they don't want the fund to borrow.

In this situation, Kim and Harry could arrange to acquire the property as tenants-in-common with their SMSF. This structure is demonstrated in this diagram.

The benefits of this strategy are:

- it has allowed Kim and Harry as trustees of the SMSF to acquire an interest in an asset they could not otherwise afford to acquire outright without having to borrow or needing to contribute to the fund and have their contributions preserved until retirement
- if the property was a business real property, Kim and Harry could arrange to lease it from the fund. In addition, as trustees of their SMSF, they could arrange for the fund to purchase their interest in the property from them when their SMSF could afford to do so or they could arrange to transfer the share of the property to their SMSF as in-specie contributions
- the strategy would generally be much easier and less costly to implement than establishing an LRBA.

However, acquiring assets as tenants-in-common with a related party has several issues to consider, which include:

- where the property did not qualify as business real property, that is, it is vacant property or a residential property, the trustee of the SMSF would be prohibited from leasing the property back to a related party or from subsequently acquiring the member's interest in the property, as it would not qualify under any of the exemptions
- where the property was a business real property and the trustees wished to acquire a related party's ownership interest over time, for example as separate in-specie contributions, the trustees would need to arrange for a property conveyance for each transfer.

Furthermore, if a related party, such as a member, would need to borrow to acquire their interest in the property, they would generally need to have some other asset that they could offer as security for the loan. This is because:

- a third party lender will generally require the whole of the asset to be offered as security as a condition of the loan, but
- the trustee would be prohibited from allowing a charge to be given over its interest in the property.

However, even in a situation where a lender was willing to take security over only the related party's interest in the asset, the trustee of the SMSF would still need to consider whether entering into such an arrangement would be prudent. This is because there is a risk that the trustees may have to dispose of the fund's interest in the asset if the related party has to liquidate its assets.

ATO determination that asset is not an in-house asset

Where an SMSF trustee has breached the in-house asset limit it can appeal to the ATO for a written determination specifying that the asset is not, or will not be, an in-house asset of the fund.

However, in Practice Statement Law Administration PS LA 2009/8,[33] the ATO has confirmed that it will only issue such a determination where the facts of the case indicate circumstances that are unusual or out of the ordinary. Circumstances will only be considered unusual or out of the ordinary where:

- a trustee has complied with the SIS Act requirements when investing the fund's assets
- certain events occur, which are unforeseeable and beyond the trustee's control, and
- these events result in the fund exceeding the 5% in-house asset limit.

To clarify, the practice statement confirms that circumstances would not be considered unusual or out of the ordinary where they related to:

- fluctuations in economic conditions
- ignorance of the rules
- the trustee relying on incorrect professional advice
- a significant benefit to the fund from the investment
- the trustee not wanting to incur additional costs to keep the in-house assets below the 5% limit.

If a trustee believes that unusual or out of the ordinary circumstances apply, it should apply to the ATO in writing.

Investments in certain non-geared companies and trusts

Under section 71(1)(h) of the in-house asset rules, an investment in a related company or unit trust will be exempt from the 5% in-house asset limit where the company or trust satisfies the requirements specified in:

- SIS Regulation 13.22B and 13.22D where the shares or units were acquired before 28 June 2000, or
- SIS Regulation 13.22C and 13.22D where the shares or units were acquired on or after 28 June 2000.

For more information on the requirements of Regulation 13.22C and 13.22D, please see section 4.7 of this chapter.

33 Practice Statement Law Administration PS LA 2009/8: *The Commissioner's determination under paragraph 71(1)(e) of the Superannuation Industry (Supervision) Act 1993 that an asset is not an in-house asset of a self-managed superannuation fund.*

In-house asset transitional arrangements

Under the in-house asset rules certain investments in related companies and trusts and loans and assets subject to a lease arrangement with a related party will be exempt from the in-house asset rules where the arrangement was first entered into before 12 August 1999.

For more information on these pre 12 August 1999 arrangements, please see section 4.6 of this chapter.

In-house asset anti-avoidance provisions

The in-house asset rules contain a number of anti-avoidance provisions which are designed to capture any schemes or arrangements designed to circumvent the in-house asset rules. These include provisions to look-through any agreements established between different parties to avoid the application of the in-house asset rules or to artificially reduce the value of a fund's in-house assets.

The SIS Act also allows the ATO to make a written determination declaring any loan, investment or asset subject to a lease or lease arrangement that is not an in-house asset to be an in-house asset.

4.5 Definition of business real property

Business Real Property (BRP) is a key concept for both the prohibition of the acquisition of assets from related party rules and the in-house asset rules and is defined, in relation to an entity, to mean:

- any freehold or leasehold interest of the entity in real property, or
- any interest of the entity in crown land, other than a leasehold interest that is capable of assignment or transfer, or
- another class of interest in relation to real property as prescribed by the regulations,

where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not) but does not include any interest held in the capacity of beneficiary of a trust estate.

To help explain the meaning and application of the term 'business real property', the ATO released SMSFR 2009/1.[34] That ruling confirms that for a property to satisfy the definition of BRP two basic conditions must be satisfied:

- the relevant entity must hold an interest in real property, and
- the underlying land must satisfy the business use test, which requires the real property to be 'used wholly and exclusively in one or more businesses'.

When applying the BRP definition for the acquisition of assets from related party rules, or the in-house asset rules, the definition must be applied to a particular entity.

34 SMSFR 2009/1: *Business real property for the purposes of the Superannuation Industry (Supervision) Act 1993.*

The relevant entity will vary depending on the circumstances and the particular rule that is being applied. For example, the BRP definition would apply to:

- the related party from which a property is being acquired (under the acquisition of assets from related party rules), or
- the entity that is leasing the property from the trustee of the SMSF (under the in-house asset rules).

Once the relevant entity has been identified it can then be determined whether the basic conditions have been satisfied.

Asset must be an interest in real property

The ruling confirms that to satisfy the definition of a business real property, the asset must be an eligible interest in real property and not personal property. The ruling then confirms that real property refers to land and all structures permanently fixed to the land, such that they form part of the land.

Other assets, such as a vehicle, plant and equipment, taxi plates or a fishing licence are personal property, and therefore would not qualify as BRP regardless of whether it is used as part of running a business.

When buildings and other objects form part of the land

The ruling outlines that a building or other object will form part of the land where it:

- is permanently fixed to the land, and
- was fixed to the land for the purpose of the better enjoyment of the land and not for the benefit of the building itself.

The ruling then goes on to confirm that to determine whether a building or object forms part of the land requires an objective assessment of a range of factors, including:

- whether removal would destroy the attached property
- whether the cost of removal would exceed the value of the attached property
- whether removal would occasion significant damage to the land or buildings to which the property is attached
- the nature of the property itself
- the contemplated use of the property
- the period of time for which the property was to be in position.

For example, the ruling confirms a demountable structure that was only affixed to a piece of land by its own weight would not form part of the land and would be a separate asset. Conversely, the ruling also confirms that a structure that was originally demountable could now form part of the land where it was no longer practically demountable, i.e. it has been attached to permanent foundations and has been wired for electricity and plumbed into water and sewerage services.

FirstTech comment

Take care to ensure all assets to be acquired form part of the property

When assessing whether a property can be acquired from a related party under the BRP exemption identify exactly what is proposed to be acquired under the transaction, and confirm whether there are any assets that would not form part of the property and therefore would need to be treated as a separate asset.

For example, where the trustee of an SMSF wished to acquire a warehouse premises from a related party and the purchase contract included office equipment, storage racking and a forklift, these inclusions would not form part of the property. Therefore, they would need to be treated as separate assets, which the trustee would be prohibited from acquiring from a related party.

Property is used in a business

The business use test requires that the property must be used wholly and exclusively in the course of carrying on one or more businesses. To satisfy this requirement, the ruling confirms that there must be some business-related activities, operations or actions occurring on the land in question.

The SIS Act defines a business as any profession, trade, employment, vocation or calling carried on for the purpose of profit, including the carrying on of primary production and the provision of professional services, but does not include occupation as an employee.

Therefore, a real property used in carrying on a business, such as a manufacturing, primary production or the provision of professional services would generally satisfy the business use requirement.

However, to pass the business use test, the ruling then confirms that any and all uses of a property must then be taken into account to determine whether the property is being used ‘wholly and exclusively’ in one or more businesses. That is, there must be an assessment of whether the property in its entirety (that is, 100% of the property 100% of the time) is used in one or more businesses to the exclusion of all other uses.

For example, where a property was used partly to operate a business and partly as a private residence, the private use of the property would generally cause the property to fail the ‘wholly and exclusively’ test.

However, the ruling confirms that a common sense approach will allow some departure from the literal application of the ‘wholly and exclusively’ requirement. That is, where part of a property is not used in a business, the ‘wholly and exclusively’ requirement may still be satisfied as long as the property is used to an appreciable degree or extent in one or more businesses and there is no other non-business use of the property.

For example, an industrial warehouse would still qualify as BRP where only 80% of the floor space was used in the operation of the business, as long as the remaining 20% was not used for any private or domestic purposes.

Private use that is incidental and relevant to the business being carried on or occasioned by the business being carried on

The ruling also confirms that any use of a property of a private or non-business nature will not cause the property to fail the business use test where that use is incidental and relevant to the business being carried on, or occasioned by the business being carried on.

For example, if a property, such as a hotel, was used by a paying guest for their private purposes, using the property in that way would be incidental and relevant to, and occasioned by, the hotel business being carried on.

Other examples of an incidental and relevant use of a property outlined in the ruling include:

- leasing a residential property to a tenant where the property is used as part of carrying on a property investment business
- allowing or requiring employees and managers to reside at the business premises where 24-hour on-call services are provided, such as in the case of a hotel or motel
- permitting employees to park their cars on business premises, and
- allowing or requiring a security guard to sleep on the business premises.

FirstTech comment

Leasing out residential investment property generally not running a business

Where a taxpayer acquires and leases real property, the taxpayer will be considered to have engaged in a property investment activity. However, whether that activity constitutes the operation of a business requires an objective assessment of those activities. Factors that may indicate that a business is being carried on include (but are not limited to):

- the keeping of business records separate to personal records
- the size of the operation and the extent of capital investment involved
- whether activities are conducted continuously and systematically rather than on an ad-hoc basis
- a level of repetition and regularity of activities constituting the business
- whether activities are carried on in a similar manner to other like businesses
- whether activities are planned, organised and carried on in businesslike manner
- the scale and permanency of operations, and
- the existence of a business plan.

The ATO confirms in the ruling that it considers that it would be rare for an SMSF to meet the conditions necessary to establish a property investment business. Therefore, before the trustee of an SMSF acquires a residential property from a related party on the basis that the related party is using the property in a property investment business, it may be prudent to seek administrative guidance from the ATO before doing so. This would particularly be the case where the property is used to provide short-term holiday accommodation via peer-to-peer accommodation websites such as Airbnb. In this case, it may be possible for a residential property to qualify as a BRP, but this will depend on the circumstances and legal/ATO guidance should be sought.

Exemption for real property used in primary production business

Consistent with allowing any incidental and relevant non-business use of a property, subsection 66(6) of the SIS Act provides a specific safe harbour to allow a residential dwelling to be located on a property used in a primary production business without causing the property to fail the 'wholly and exclusively' requirement. However, this will only apply where:

- the area containing a dwelling used primarily for domestic or private purposes does not exceed two hectares, and
- the domestic or private use is not the predominant use of the property.

For example, where real property used in a large-scale primary production business involving the grazing of cattle contained a residential dwelling, the private or domestic use of the dwelling would not cause the property to fail the 'wholly and exclusively' test as long as the area containing the dwelling did not exceed two hectares and the private or domestic use was not the predominant use of the property.

In this case, it's also important to note that the 2-hectare exemption relates to the total area set aside for private or domestic purposes. Therefore, a farm that had multiple dwellings located on it could still qualify as BRP where the total area set aside for private and domestic purposes does not exceed 2 hectares.

Relevance of the entity carrying on the business

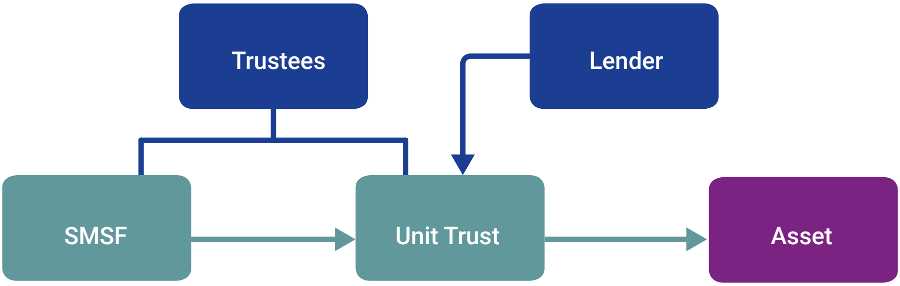
The BRP definition specifically provides that the entity that owns the property does not need to be the entity using the property to conduct a business. For example, as long as the property is being used by someone, such as a tenant, to operate a business, the property can qualify as BRP.

4.6 Pre 12 August 1999 investments

Before August 1999, the definition of an in-house asset was limited to a loan to, or an investment in, a standard employer sponsor of the fund. As a result, there was a perception that many SMSFs were dealing with non-arm's length parties, such as members, and that many trustees were investing in related unit trusts to facilitate geared investments.

For example, before August 1999, a common strategy employed by SMSF trustees/members wanting to gear the fund's investments was to set up a separate unit trust which they controlled and then to arrange for their SMSF to acquire 100% of the units in that trust. The unit trust would then borrow for investment purposes, effectively allowing the fund to circumvent the SIS borrowing restrictions. A diagram of this arrangement is shown as follows:

Diagram 4.1 Pre-12 August 1999 related party lending arrangements



To limit the risks associated with these types of investment activities and to ensure the integrity of the retirement savings system as a whole, the government introduced legislation on 11 August 1999 to extend the definition of an in-house asset to cover a range of transactions with a related party, including investments in controlled companies and trusts. This effectively made investing in a related company or unit trust impracticable in most circumstances.

Pre 12 August 1999 investments, loans and lease arrangements

However, to avoid the new in-house asset rules applying to pre-existing arrangements, the government included the following exemptions:

Investments in related companies and trusts

Investments by an SMSF trustee in a related company or trust that were made before 12 August 1999 are excluded from the definition of an in-house asset where they would not have otherwise been an in-house asset at that time. Therefore, the value of any units or shares in a company or trust acquired before 12 August 1999 (where the company or trust was not a standard employer sponsor of the fund at that time) will not be included in the 5% in-house asset limit.

In addition, under this exemption, if an SMSF held partly paid shares in a company or units in a unit trust before 12 August 1999, the trustee could also pay up any unpaid capital on those shares or units until 30 June 2009 under transitional provisions.

Reinvestments

Where an SMSF invested in a company or trust before 12 August 1999 (and that investment was not an in-house asset of the fund under the previous rules), any additional investments in the company or trust up until 30 June 2009 that represented a reinvestment of earnings from that investment (and any reinvestments) are exempted from being an in-house asset.

Additional investments into geared companies and trusts

Where an SMSF had invested in a company or trust before 12 August 1999 (and that investment was not an in-house asset of the fund under the previous rules), the trustee could make additional investments in the company or trust up until 30 June 2009 – but only where the total value of the additional investment did not exceed the level of any outstanding loans held by that company or trust as at 11 August 1999.

To qualify for this exemption, the trustee must have made a written election to use it by no later than 23 December 2000. Where a trustee made that election, the exemption for reinvestments (see Reinvestments, above) would cease to apply.

For example, if the trustee of an SMSF held units in a related unit trust at 11 August 1999, and the trustee of that unit trust had outstanding bank loans of $100,000 as at that date, the trustee could elect to make additional investments in that unit trust up to the value of $100,000 until 30 June 2009. However, where the trustee elected to do this it would not be permitted to reinvest any earnings after 11 August 1999.

Loans to related parties

Loans made by the trustee of an SMSF to a related party before 12 August 1999 are excluded from the definition of an in-house asset where the loan would not otherwise have been an in-house asset at that time. Therefore, the value of any such loans currently still outstanding will not be included in the 5% in-house asset limit.

This exemption also applies to loans made after 11 August 1999 under a legally binding contract that was entered into before 12 August 1999. For example, where a trustee had lent money to a related company under a legally binding loan contract that was dated 11 August 1999 or earlier, the loan would be excluded from the definition of an in-house asset and its value would not be included in the 5% in-house asset limit.

> FirstTech comment
>
> **Loans to members and relatives prohibited**
>
> Section 65 of the SIS Act applies to prohibit the trustee of an SMSF from lending money to members and relatives of members and that those rules apply regardless of the in-house asset rules. As a result, this exemption is only really relevant for loans made to other entities, such as related companies and trusts.

Assets leased to related parties

An asset subject to a lease or lease arrangement (or an uninterrupted sequence of lease arrangements) between the trustee of the fund and a related party that was entered into before 12 August 1999 is excluded from being an in-house asset.

Therefore the value of the asset being leased will not be included in the 5% in-house asset limit. This exemption also applies to assets subject to a lease or legally binding lease arrangement entered into before 12 August 1999, but which came into effect after that date.

For example, if a trustee of an SMSF entered into a legally binding lease arrangement to lease a residential property owned by the fund to a related party on or before 12 August 1999, that property would be excluded from being an in-house asset of the fund so long as the original lease arrangement was still in place (or it had been subject to an uninterrupted sequence of lease arrangements).

FirstTech comment

In-house asset lease exemption and collectables

If a trustee of an SMSF was leasing a collectable asset to a related party under this exemption, the trustee's ability to do so ceased after 30 June 2016 when the transitional period for collectable assets ceased for assets acquired before 1 July 2011.

For example, where a trustee acquired and then leased an antique clock to a member before 12 August 1999, the clock would be excluded from being an in-house asset of the fund and its value would not count towards the 5% in-house asset limit. In addition, as it was acquired before 1 July 2011, it was covered under the transitional provisions that applied for collectable assets up until 30 June 2016. However, from that date, the prohibition on collectable assets being leased to, or used by, a related party apply.

Maintenance of Pre 12 August 1999 trust arrangements[35]

Where the trustee of an SMSF acquired units in a related trust before 12 August 1999 that are excluded from the in-house assets rules, the trustee can continue to hold those units indefinitely. In addition, where the trust has borrowings it can continue to maintain those borrowings and take out additional borrowings where it has sufficient cash flow to do so.

However, the in-house asset rules will apply to any units acquired after 30 June 2009. Therefore, the 5% in-house asset limit will apply to any additional units acquired via the reinvestment of distributions after 30 June 2009.

Use of Pre 12 August 1999 trust assets by related parties

The SIS Act does not directly apply to the investment activities carried on by the trustee of a related unit trust. Therefore, the trustee may be able to enter into transactions with a related party of the fund which would be prohibited if they involved the SMSF directly.

For example, the ATO has confirmed[36] that the members of an SMSF can lease a residential property from a related Pre 12 August 1999 trust without causing the fund to contravene the in-house asset rules. In outlining its reasons, the ATO cited the fact that the lease between the members of the SMSF and the trustee of the unit trust did not come under the definition of an in-house asset as the property was not an asset of the SMSF.

35 Note – the grandfathering rules also apply to pre 12 August 1999 investments in companies, however the majority of pre 12 August 1999 arrangements involve trusts, therefore the following discussion is limited to trusts for simplicity and relevance.

36 ATO Interpretative Decision 2002/388: In-House Assets and leasing property from a Unit Trust.

Despite this, the other SIS investment rules still apply to the SMSF's investment in the trust. Therefore, where the trustee of a Pre 12 August 1999 unit trust entered into a non-arm's length transaction with a related party, the SMSF's trustee's continuing investment in the trust could breach a range of regulatory provisions, including the:

- sole purpose test
- non-arm's length rules
- prohibition of providing financial assistance to a member or a relative of a member, and
- investment strategy covenants.

For example, in the case of ZDDD v the Federal Commissioner of Taxation[37], the ATO issued a notice of non-compliance to the trustee of an SMSF that held units in a Pre 12 August 1999 unit trust where an interest-free loan was made from the Pre 12 August 1999 unit trust to a member of the fund. In this case, the ATO took the view that the trustee's continued investment in the unit trust constituted a breach of the:

- sole purpose test
- non-arm's length rules and
- prohibition of providing financial assistance to a member or a relative of a member of the fund.

Therefore, it is imperative that any transactions between the related parties of an SMSF and the trustee of a related Pre 12 August 1999 trust are always conducted on an arm's length basis.

4.7 Investments in non-geared companies and trusts

Under the acquisition of assets from a related party rules, a trustee of an SMSF will be permitted to invest in a related company or trust without restriction where the company or trust is included in a class of assets defined not to be an in-house asset. To be included in this class of assets, the company or trust must satisfy the requirements specified in:

- SIS Regulation 13.22B – where the shares or units were acquired before 28 June 2000, or
- SIS Regulation 13.22C – where the shares or units were acquired on or after 28 June 2000.

In addition, SIS Regulation 13.22D also applies to specify a range of circumstances in which 13.22B and 13.22C will cease to apply.

The following text deals with the requirements of Regulations 13.22C and 13.22D.

37 ZDDD v FCT [2011] AATA 3.

Investments in Regulation 13.22C companies and trusts (or non-geared companies and trusts)

An investment in a related company or trust will satisfy the requirements of SIS Regulation 13.22C where, at the time the investment is made:

- the company or the trustee of the unit trust is not party to a lease (or legally binding lease arrangement) with a related party of the fund, unless the lease relates to BRP[38]
- the company or the trustee of the unit trust does not have any outstanding borrowings
- the assets of the company or unit trust do not include:
  - an interest in another entity – including a share in a company or a unit in another trust
  - a loan to another entity, unless the loan is a deposit with an authorised deposit taking institution within the meaning of the Banking Act 1959
  - an asset over, or in relation to, which there is a charge
  - an asset (other than money) that was acquired from a related party of the fund after 11 August 1999, unless the asset was BRP acquired at market value
  - an asset (other than money) that had (at any time) been owned by a related party of the superannuation in the previous three years, unless the asset was BRP acquired at market value.

In addition, SIS Regulation 13.22D confirms that Regulation 13.22C will cease to apply to an investment in a related company or trust where any of the following events happen:

- the company or the trustee of the unit trust fails any of the requirements in SIS Regulation 13.22C
- the number of members of the superannuation fund increases to more than six
- the company or the trustee of the unit trust conducts a business
- the company or the trustee of the unit trust conducts a transaction otherwise than on an arm's length basis.

In addition, the ATO has confirmed in SMSFD 2008/1[39] that once Regulation 13.22C ceases to apply, the shares in the company or the units in the trust will never again be able to be exempt from the in-house asset rules.

As a result, where the trustee of the unit trust entered into a transaction that caused the trust to fail the requirements, such as acquiring a share in a company, the trustee would not be able to rectify the breach by selling the share. In this case, the SMSF trustee would then be required to treat the units in the trust as an in-house asset and may be forced to dispose of them should the fund's level of in-house assets exceed the 5% limit at the end of the financial year.

38 Including both directly and indirectly via a series of interposed entities.
39 Self Managed Superannuation Funds Determination 2008/1: *How does the happening of an event in subregulation 13.22D(1) of the Superannuation Industry (Supervision) Regulations 1994 affect whether a self managed superannuation fund's investments in related companies or unit trusts are in-house assets of the fund?*

Therefore, trustees considering investing in a non-geared company or trust need to be aware of the specific requirements involved to establish and maintain a complying non-geared trust arrangement. Otherwise a simple error could result in an SMSF breaching the in-house asset rules and being required to sell down the shares or units held in the fund.

FirstTech comment: **Beware Regulation 13.22C and 13.22D traps**

Where a trustee of an SMSF wishes to invest in a Regulation 13.22C trust or company, they must understand the rules and be aware of any potential traps. For example, clients should be warned against:

- acquiring an interest in another entity, including shares in a listed company or units in a managed fund, as the ATO has confirmed this would cause the company or trust to fail the Regulation 13.22C requirements,[40] or
- depositing money into a foreign bank account, as this would technically constitute a loan to another entity but it would not qualify for the exemption for deposits with an authorised deposit-taking institution within the meaning of the Banking Act 1959 as the deposit would not be to an Australian bank account.

You should also warn clients about the requirement that the company or the trustee of the unit trust must:

- conduct all transactions on a commercial arm's length basis
- not carry on any activities that could be considered to involve the carrying on of a business – including any property development activities
- not allow a charge of any kind to be given over an asset of the trust, and
- not inadvertently allow the membership of the SMSF to increase to more than six members.

The trustee of a Regulation 13.22C unit trust should also ensure that it distributes all amounts of income back to the SMSF within a reasonable period of time after the trust's accounts are completed each year. For example, where a trustee neglected to distribute its net income in a year, the resulting unpaid present entitlement could result in a loan being deemed to be made from the SMSF to the trust, which would result in the trust failing the Regulation 13.22C requirements.

For more information on Regulation 13.22C trusts and unpaid present entitlements, please see section 4.8 of this chapter.

40 ATO ID 2008/51 – Self managed superannuation fund: *Division 13.3A of SIS Regulations – interest in another entity – units in a unit trust* and *ATO ID 2008/52 – Self managed superannuation fund: Division 13.3A of SIS Regulations – interest in another entity – listed company shares.*

Uses of non-geared (Regulation 13.22C) trusts and companies

Investments in Regulation 13.22C trusts and companies can be used to achieve a number of strategic outcomes in the context of an SMSF, as summarised below.

As an alternative to purchasing assets with a related party as tenants-in-common

Under the SIS investment rules a trustee of an SMSF is permitted to acquire an asset as tenants-in-common with a related party, as long as the asset is not then leased back to a related party (other than if a business real property).

However, acquiring assets as tenants-in-common with a related party has several disadvantages including:

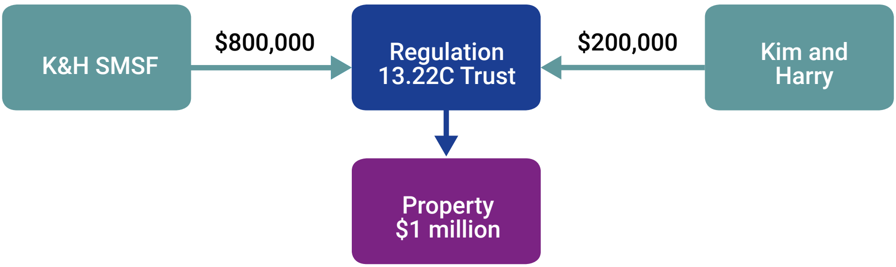
- where the SMSF and the related party held property as tenants-in-common, the trustee of the SMSF would be prohibited from subsequently acquiring the member's interest in the property, unless it was business real property
- where the SMSF wished to acquire a related party's ownership interest in a business real property, it would need to arrange for a property conveyance for each transfer.

Alternatively, the SMSF trustee and the related party could arrange to acquire units in an interposed Regulation 13.22C trust established for the purpose of acquiring the property. In this case, the trustee of the SMSF could then simply acquire the units in the trust.

Case study

Kim and Harry are the trustees and members of their SMSF. The SMSF has total assets of $800,000 but Kim and Harry have identified a property that they would like to acquire for $1 million. Kim and Harry have the cash available and could afford to contribute the additional $200,000 to allow the fund to acquire the asset; however they don't want the $200,000 to be preserved until retirement and they don't want the fund to borrow.

In this situation, instead of Kim and Harry acquiring the property as tenants-in-common with their SMSF they could establish a Regulation 13.22C trust and then arrange for their fund and themselves to each invest the required amount to allow the trust to acquire the property. This structure is demonstrated in the following diagram.



The benefits of this strategy are that:

- it has allowed Kim and Harry to acquire the property without having to borrow and without needing to contribute to the fund and have their contributions preserved until retirement
- as trustees of their fund Kim and Harry could arrange for the fund to acquire their units from them when their SMSF could afford to do so regardless of the nature of the property and without needing to change its legal ownership. Alternatively, Kim and Harry could arrange to transfer their units to their SMSF as in-specie contributions over time if they wanted to.
- the strategy would generally be much simpler and cheaper to implement than establishing an LRBA.

The disadvantages of this strategy are that the rules are complex and easily breached. Furthermore, the whole of the property will not effectively be held within the concessionally taxed superannuation environment, which they could have achieved had their fund acquired the asset using an LRBA.

Trustees and members wishing to transfer their units in the trust to their SMSF over time also need to consider any potential capital gains tax implications as well as any indirect taxes, such as state government stamp duty. For example, land holder duty could apply to the transfer of units in a trust where the trust's assets include property and the acquisition exceeds certain thresholds.

4.8 Units trusts, unpaid present entitlements and SMSFs

An Unpaid Present Entitlement (UPE) of a unit trust is generally an amount payable by a trustee of the trust from a distribution of trust income.

Where an SMSF holds an investment in a trust and there are UPEs owing for a significant amount, or where payment has not been sought within a reasonable period, the ATO has confirmed in SMSFR 2009/3[41] that such arrangements could result in a breach of a range of regulatory provisions, including:

- the in-house asset rules
- the non-arm's length rules
- the sole purpose test.

41 SMSFR 2009/3 Self Managed Superannuation Funds: application of the Superannuation Industry (Supervision) Act 1993 to unpaid trust distributions payable to a Self Managed Superannuation Fund.

UPEs and the in-house asset rules

In relation to the in-house asset rules, the ATO ruling confirms that where a UPE is owing to an SMSF, the amount of the UPE could be considered to be a loan from the SMSF to the related trust and therefore an in-house asset of the fund where:

- the trustee of the unit trust and the SMSF agree to bring in place a loan arrangement for the amount of the UPE by executing a loan agreement. Where this occurs the distribution will be considered to have been constructively received by the SMSF and the amount loaned back to the trust
- the non-payment of the trust distribution results in the provision of credit or financial accommodation to the trust by the SMSF.

Alternatively, the trustee of the SMSF may enter into an agreement whereby a UPE is converted into additional units or is added to the capital of the trust to increase the value of the SMSF's units. In these situations, the ATO ruling confirms that such arrangements would also be an additional investment, which would therefore be subject to the in-house asset rules.

UPEs and Regulation 13.22C trusts

Where the related trust satisfies the requirements of SIS Regulation 13.22C, any additional investment in the trust will be excluded from the in-house asset rules under that exemption.

However, where the UPE constitutes a loan to the unit trust, the trust will then fail the Regulation 13.22C requirement that the trust does not have any outstanding borrowings. In this case, the exemption to the in-house asset rules would cease to apply and all of the SMSF's units in the trust would become in-house assets.

UPEs and the non-arm's length rule and sole purpose test

Where an SMSF holds an investment in a related trust, the trustee must be holding that investment on an arm's length basis and in accordance with the requirements of the sole purpose test.

Where a trustee of an SMSF has failed to seek the payment of a substantial amount of unpaid distributions from a related trust without proper compensation being paid, i.e. a market rate of interest or the issue of additional units in the trust, the ATO ruling confirms that the trustee of the SMSF would not be considered to be maintaining the investment on an arm's length basis.

In addition, where the failure to pay any compensation for the non-payment of distributions effectively resulted in a low-cost source of capital for the related trust, the ATO ruling also confirms the fund could be considered to have breached the sole purpose test – especially where the SMSF was not the sole beneficiary of the trust.

For example, in Montgomery Wools v Federal Commissioner of Taxation,[42] the Administrative Appeals Tribunal affirmed the ATO's decision to issue a notice of non-

42 Montgomery Wools Pty Ltd Superannuation Fund and FCT [2012] AATA 61; 2012 ATC 10–233.

compliance to an SMSF on the basis that an unpaid distribution from a related unit trust resulted in:

- a loan from the SMSF to a related trust which breached the in-house asset rules, and
- support being provided to a family business which breached the sole purpose test.

FirstTech comment

Ensure timely payment of trust distributions

To avoid any potential compliance issues associated with unpaid distributions, trustees should seek payment of any distributions owing as soon as is reasonable. This should generally be as soon as possible after the trust's accounts have been finalised for the year and the SMSF's entitlement to its share of the trust's income has been determined.

4.9 The sole purpose test

The SIS Act requires trustees to ensure their fund is maintained in strict accordance with the sole purpose test. The sole purpose test is in section 62 of the SIS Act and requires that all superannuation funds must be maintained for the sole purpose of providing retirement benefits to members or death benefits to their beneficiaries in the event of their death. See *Chapter 3: Trustee responsibilities* for more information on the sole purpose test.

The sole purpose test and trustee investment activities

In relation to a fund's investments, the sole purpose test requires that all fund investments must be made and maintained for the sole purpose of providing retirement benefits (or death benefits) and that the fund's assets must not be used or applied in a way that provides a current day benefit to a member or other related party. A current day benefit would include allowing a fund member or other related party to use or otherwise benefit from the assets of the fund in a way that would not be consistent with providing a retirement or death benefit.

Examples of situations which would constitute a breach of the sole purpose test include:

- allowing a member or other related party to stay at a beach house owned by the fund rent-free
- a trustee allowing the assets of the fund to be used as a security for a loan made to a member or related party of the fund
- a trustee paying 100% of the fees charged by a financial adviser where part of the advice provided related to subject matter other than the SMSF or the member's interest in the SMSF (for example, non-super investments, investments in other superannuation funds, or general financial, retirement or estate planning strategies).

Sole purpose case study: Aussiegolfa Pty Ltd (Trustee) vs Commissioner of Taxation

In August 2018, the full Federal Court handed down an appeal decision on the application of the sole purpose test that provides important guidance on how the sole purpose test applies to a trustee's investment activities and decisions. The ATO also subsequently released a decision impact statement that outlines its view about that judgement.

Background

The case [Aussiegolfa Pty Ltd (Trustee) v Commissioner of Taxation [2018] FCAFC 122 (10 August 2018)] involved the corporate trustee (Aussiegolfa Pty Ltd) of a single member SMSF (the Benson Family Super Fund (the SMSF)) investing in a residential investment property via a Managed Investment Scheme (MIS).

After being acquired the property was then leased to a number of different unrelated individuals over a two year period before being leased to a related party of the fund (the member's daughter) for the same rent paid by the previous unrelated tenants.

In the initial Federal Court case [Aussiegolfa Pty Ltd (Trustee) v Commissioner of Taxation [2017] FCA 1525 (14 December 2017)] the judge ruled the trustee of the SMSF had breached both:

- the in-house asset test – as the investment in the MIS constituted an investment in a related trust which exceeded the 5% in-house asset limit, and
- the sole purpose test – as the fund was being maintained in part for the non-incidental purpose of providing accommodation to a relative of a member.

In response, the trustee appealed, arguing there was no breach of either provision as:

- the investment in the MIS constituted an investment in a widely held trust which is exempt from the 5% in-house asset limit, and
- the fund's decision to acquire the property was to gain exposure to a real property investment and that there was no evidence the decision related to the desire to provide accommodation to a relative.

Finding of appeal court

The full Federal Court confirmed the original judge's finding the SMSF had breached the 5% in-house asset limit.

However, the Court ruled the fund had not breached the sole purpose test on the basis the lease to the daughter was on arm's length terms. Specifically, the Court was not satisfied that the member or their daughter had obtained any financial or other non-incidental benefit from the property being leased to the daughter as opposed to some other unrelated tenant. In addition, the Court found that any comfort or convenience derived by either the daughter or the member from the leasing arrangement was only an incidental benefit.

In contrast, the judge noted that in other cases where it had been found that the sole purpose test had been breached, these cases all exhibited two features:

- either payments were made to members otherwise than upon retirement, or
- benefits were provided on non-arm's length terms.

Circumstances which may have changed the outcome

As part of the ruling, the Court specified that this outcome would have been different if:

- the lease was not for market rent, or
- if the investment strategy for the fund had been affected by the leasing of the property to the daughter.

In this case, the second point indicates that if the trustees had amended the fund's investment strategy to facilitate the property acquisition and the property was then immediately leased to the daughter for a market rent, the trustees may have been found to have breached the sole purpose test. This is because it would have indicated the trustees purpose in acquiring the property was not to provide retirement benefits for members but to provide accommodation to the daughter.

ATO decision impact statement

In December 2018 the ATO released a decision impact statement [ATO Decision Impact Statement: Aussiegolfa Pty Ltd (Trustee) v. Federal Commissioner of Taxation] in which it outlined its view that the decision of the court was referrable to several important facts of the case, which included that:

- the property had been leased to two tenants unrelated to the SMSF for two years before the premises being leased to the daughter of the member
- the daughter paid equivalent market rent to that paid by the two previous tenants, and
- there was no suggestion that the leasing of the property to the daughter influenced the fund's investment policy.

As a result, the ATO confirmed it does not consider the case is authority for the proposition that a super fund trustee will not contravene the sole purpose test where it leases an asset to a related party for market value rent.

Instead, the ATO confirmed that it is the purpose of making and maintaining a fund's investments that is central to determining whether a contravention of the sole purpose test has occurred. The ATO then noted the court's observation that a collateral purpose, and a contravention of the sole purpose test, could have resulted if leasing to a related party had influenced the fund's investment policy.

This means the ATO is likely to take the view that a trustee will contravene the sole purpose test if the facts of a case indicate a fund acquired an asset for a collateral purpose of providing benefits to a related party of the fund – even where those benefits are provided on commercial arm's length terms.

Implications

This case is useful as it provides judicial guidance on the application of the sole purpose test and confirms that arm's length arrangements entered into for the legitimate, objective reason of providing retirement benefits may not contravene the sole purpose test just because they involve related parties. However, like any arrangement, this will depend on the specific facts and circumstances and any SMSF clients wishing to enter into any such arrangements with a related party should seek expert legal opinion.

Finally, it is critical to recognise that the superannuation rules contain a number of other provisions that may also apply to prohibit or restrict any such arrangements, such as the in-house asset rules and the prohibition on trustees acquiring assets from related parties.

Collectable and personal use assets

Investments by SMSF trustees in collectable and personal use assets have traditionally posed particular problems for SMSFs as their personal use nature can result in a current-day benefit being provided if they are used or otherwise enjoyed by a member without compensation. To address this issue the sole purpose test was amended effective 1 July 2011 to apply additional restrictions on trustees investing in certain collectable and personal use assets after that date.

Restricted assets

Under SIS Regulation 13.18AA collectible assets subject to additional restrictions include:

- artwork within the meaning of the Tax Act[43]
- jewellery
- antiques
- artefacts
- coins, medallions or bank notes[44]
- postage stamps or first-day covers
- rare folios, manuscripts or books
- memorabilia
- wine or spirits
- motor vehicles
- recreational boats

43 This is defined to include a painting, sculpture, drawing, engraving or photograph; a reproduction of such a thing; or property of a similar description or use.

44 Note – coins and bank notes are defined to be collectable where their value exceeds their face value. In addition, the ATO has confirmed that bullion coins will be a collectable if they have a value that exceeds their face value and they are traded above the spot price of their metal content.

- memberships of sporting or social clubs.[45]

Where the trustee of an SMSF holds one of the above assets, SIS Regulation 13.18AA applies the following additional restrictions:

The asset must not be subject to a lease or lease arrangement with a related party

Where the fund holds a collectable or personal use asset it must not be leased to a related party of the fund. This applies regardless of the in-house asset rules. For example, under these rules a trustee would be prohibited from leasing an artwork to a related party of the fund regardless of the fact that the lease would otherwise be permitted under the 5% in-house asset threshold.

The asset must not be used by a related party

While the word 'use' is not defined in the SIS Act, the rules would generally apply to prohibit the display, wearing, reading, operation or the exercising of a right regarding one of the specified asset types.

For example, the ATO has confirmed[46] that these rules would prohibit a trustee from driving a vintage car owned by the fund in order to maintain its condition and value, as any use by a related party is prohibited regardless of the purpose of that use.

The asset cannot be stored in the private residence of a related party

The ATO has confirmed[46] a private residence includes all parts of a private dwelling (above or below ground), the land on which the private residence is situated and all other buildings on that land, such as garages or sheds.

> **Note**
>
> While this would technically allow a collectable to be stored in the business premises of a related party, remember that the prohibition on leasing or using the asset would still apply. For example, the rules would prohibit an artwork owned by the fund from being displayed in a related party's business premises.

The trustee must keep a written record of the decisions (and reasons for the decisions) relating to the storage of the asset

This record must then be kept for a period of 10 years after the decision is made.

45 Section 62A of the SIS Act also includes an additional definition of collectibles which includes 'assets of a particular kind, if assets of that kind are ordinarily used or kept mainly for personal use or enjoyment (not including land)'. However, SIS Reg 13.18AA does not apply the additional restrictions to these types of collectible assets.

46 https://www.ato.gov.au/super/self-managed-super-funds/investing/restrictions-on-investments/collectables-and-personal-use-assets/

The asset must be insured in the fund's name within seven days of acquisition

This requirement applies even where the asset is to be covered by a separate insurance policy owned by a third party. For example, where an artwork that was stored in a professional art gallery was covered under the gallery's insurance policy, the trustees would still need to insure the artwork under a policy owned by the fund.

Where the asset is to be sold or transferred to a related party it must be valued at market value by a qualified independent valuer

The ATO has confirmed[46] a valuer will be qualified either through holding formal valuation qualifications or by being considered to have specific knowledge, experience and judgment by their particular professional community.

This is generally best demonstrated by being a current member of a relevant professional body or trade association such as:

- Australian Antique and Art Dealers Association
- Auctioneers and Valuers Association of Australia
- National Council of Jewellery Valuers.

A valuer will be independent if they are independent of the interests of the fund. This means that the valuer should not be a member of the fund or a related party of the fund (for example, an investment partner).

For more information on the valuation of assets and the requirement for an asset to be valued by a qualified independent valuer, please see *Chapter 3: Trustee responsibilities*.

FirstTech comment

Trustees need to consider additional costs of holding collectables

Trustees intending to acquire collectable assets will need to carefully consider all the additional costs that may be incurred to comply with these requirements. For example, a trustee acquiring an artwork would need to take into account the cost of storage and insurance as well as any additional operating costs, such as the cost of an auditor physically inspecting the artwork to confirm its existence and storage arrangements.

Running a business and the sole purpose test

Traditionally, it was considered that trustees could not run a business within an SMSF as it would not be consistent with the sole purpose test. However, the ATO has confirmed that the rules that govern the operation of SMSFs do not directly prohibit a trustee from carrying on a business.[47] However, the ATO warns that:

- the trustee must be allowed to operate a business under the trust deed
- the activities of the trustees in running a business must not breach the sole purpose test.

Where a trustee does attempt to operate a business through the SMSF, the ATO have identified a number of arrangements that would attract its attention. These include where:

- the trustee employs a family member (the ATO would look at, among other things, the stated rationale for employing the family member and the level of salary or wages paid)
- the trustee carries on a business that relates to an activity that is commonly carried out as a hobby or pastime
- the business carried on by the fund has links to associated trading entities
- there are indications that superannuation fund assets are available for the private use and benefit of the trustee or related parties.

Even where a trustee is satisfied that the carrying on of business activities within an SMSF would be consistent with the sole purpose test (and would be allowable under the fund's investment strategy and trust deed), it would still need to consider whether an SMSF would be the best structure in which to operate a business given that SMSFs:

- are generally restricted from borrowing, i.e. the trustees would need to ensure they had sufficient cash reserves to operate the business as the fund would be prohibited from going into overdraft or taking out any loans for cash flow purposes
- are prohibited from, or restricted in, dealing with related parties
- must conduct all transactions on an arm's length basis
- are required to formulate and give effect to an investment strategy, i.e. the nature of the business activities and the manner in which they are conducted would need to be in accordance with the fund's investment strategy
- must preserve profits until they become accessible where one or more members satisfy a condition of release.

Trustees carrying on a business would also need to take into account the different taxation rules that apply to business activities.

47 https://www.ato.gov.au/super/self-managed-super-funds/investing/carrying-on-a-business-in-an-smsf/

FirstTech comment

Running a business within an SMSF

While the ATO fact sheet could be interpreted to mean that SMSF trustees are free to run a business within their fund, trustees should exercise a high degree of caution before deciding to do so. The carrying on of business activities within a fund will still be subject to all of the SIS investment rules, such as the sole purpose test, the ban on borrowing, the non-arm's length rules, the ban on fund assets being used as security for a loan and the in-house asset rules, just to name a few.

Trustees should also carefully consider whether it would make good sense to attempt to run a business in a structure that has so many restrictions and is so heavily regulated.

Incidental, remote or insignificant benefits

In SMSF Ruling 2008/2,[48] the ATO has confirmed that in certain circumstances the trustee of an SMSF may provide benefits that would fall outside the scope of the sole purpose test where they are incidental, remote or insignificant and they are an inherent or unavoidable part of the other activities carried on by the trustee that are consistent with the requirements of the sole purpose test. However, the ATO confirms in the ruling that a number of factors would need to be considered to determine whether such 'incidental, remote or insignificant' benefits could be provided without causing a breach of the sole purpose test. These factors include (but are not limited to) whether:

- the trustees sought out or negotiated the benefit
- the benefit influenced the decision-making of the trustee
- the benefit is provided to the financial detriment of the fund
- there is a pattern of events that when viewed in their entirety amount to a material benefit.

Case study – Incidental, remote or insignificant benefits

The ABC SMSF holds ordinary shares in a financial institution which are listed on the Australian Securities Exchange. The trustees of the ABC SMSF also hold personal bank accounts with the same financial institution.

The trustees of the ABC SMSF decided to purchase further shares in the financial institution in accordance with the fund's investment strategy as the expected long-term return is consistent with the fund's investment objective. However, the increase in the SMSF's shareholding entitles the SMSF to receive a discount card,

48 SMSFR 2008/2: *The application of the sole purpose test in section 62 of the Superannuation Industry (Supervision) Act 1993 to the provision of benefits other than retirement, employment termination or death benefits*

the terms of which allow the SMSF to nominate an individual to receive. The discount card entitles the holder to receive lower transaction fees, extra interest on term deposits and a waiver of any application fees on home loans.

As long as the trustees did not seek out or negotiate for the provision of the discount card, or its availability did not influence the decision-making of the trustees and was not provided to the financial detriment of the fund, the use of the discount card by a member for their own benefit may be considered to be an incidental benefit. However, if the trustees increased the ABC SMSF's shareholding in the financial institution specifically to qualify for the discount card so that a member could qualify for a waiver of an application fee on a home loan, the member's use of the discount card would unlikely be considered an incidental benefit as its availability influenced the decision-making of the trustee.

4.10 Lending to members and relatives prohibited

Section 65 of the SIS Act prohibits the trustee (or an investment manager) of a regulated superannuation fund from lending money or providing any form of financial assistance to a member, or a relative of a member, of the fund.

A relative of a member is defined in section 10 of the SIS Act:

- a parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the member or of his or her spouse, and
- a spouse of the member or any other individual referred to above.

Therefore, a trustee of an SMSF would be prohibited from lending any amount to a member or to any of their relatives, such as their brother, sister, parent or child.

Unfortunately, ATO statistics indicate that breaches of this provision are the most common breach reported for SMSFs. This is likely due to:

- administration errors that resulted in money being accidentally withdrawn from an SMSF's bank account rather than a member's bank account being treated as a loan
- members seeing the superannuation fund's cash account as a convenient source of liquidity at a time when they have insufficient cash flow or liquid assets to pay their outstanding liabilities.

In these situations the ATO would have the power to issue an administrative penalty to trustees, or in more serious cases involving deliberate or reckless actions by the trustee, the ATO could seek to make the fund non-complying and/or to have a maximum penalty of up to 2,400 penalty units applied by the courts for a breach of a SIS civil penalty provision.

Loans to members and relatives and the in-house asset rules

Under the in-house asset rules, a trustee or investment manager can generally lend up to 5% of the value of the fund to a related party. As previously discussed, a related party of an SMSF includes a member of the fund and their relatives.

Therefore, there is a clash between the lending rules and the in-house asset rules as a trustee is prohibited from lending any amount to a member or a relative under section 65 of the SIS Act, but is permitted to lend up to 5% of the fund's value to a related party under the in-house asset rules.

To resolve this apparent contradiction, section 65 specifies that nothing in the in-house asset rules limits the operation of the ban on lending or providing financial assistance to members or relatives. Therefore, despite the in-house asset rules, trustees must not lend any amount or provide any form of financial assistance to a member or a relative of a member of a fund.

For example, while a trustee could lend up to 5% of the fund's assets to a related party that was a company or trust, a trustee would be prohibited from lending anything to a member or a relative of a member.

For more information on the in-house asset rules, see section 4.4 in this chapter.

Providing financial assistance

Section 65 also prohibits a trustee from providing any form of financial assistance to a member or a relative of a member and that financial assistance is much broader than just the provision of a loan or the giving of money or assets to members or relatives of members.

In SMSF Ruling 2008/1,[49] the ATO confirms that financial assistance can extend to the giving of a guarantee, indemnity, security or charge, or the taking on of an obligation, or any arrangement that, on objective assessment, provides financial assistance to a member or relative using the resources of the fund.

Assistance will have been provided if some help or assistance is given to a person and a fund's resources will have been used if an arrangement or transaction relies on the assets of the fund, regardless of the impact the arrangement has on the assets of the fund.

For example, the ruling confirms that the following arrangements will constitute the provision of financial assistance:

- gifting an SMSF's asset to a member or relative of a member
- selling an asset for less than market value to a member or relative of a member
- purchasing an asset for greater than its market value from a member or relative of a member
- acquiring services in excess of what the SMSF requires from a member or relative of a member

49 SMSFR 2008/1: Giving financial assistance using the resources of a self managed superannuation fund to a member or relative of a member that is prohibited for the purposes of paragraph 65(1)(b) of the *Superannuation Industry (Supervision) Act 1993*.

- paying an inflated price for services acquired from a member or relative of a member
- forgiving a debt owed to the SMSF by a member or relative of a member
- releasing a member or relative of a member from a financial obligation owed to the SMSF, including where the amount is not yet due and payable
- delaying recovery action for a debt owed to the SMSF by a member or relative of a member
- satisfying, or taking on, a financial obligation of a member or relative of a member
- giving a guarantee or an indemnity for the benefit of a member or relative of a member
- giving a security or charge over SMSF assets for the benefit of a member or relative of a member.

Case study

Helen is a member and trustee of the High Tide SMSF. Her son Paul wishes to purchase his first property. However the bank will only lend Paul the necessary funds if he can provide a guarantor for the loan. Helen as trustee of the High Tide SMSF provides the bank with a written guarantee for the amount of the loan. The bank then lends the money to Paul.

As Helen has given a guarantee to the bank to secure the loan using the resources of the SMSF, this has placed the SMSF assets at risk of being diminished as Paul may be unable to repay the loan. Helen as trustee has therefore provided financial assistance to Paul (a relative of a member) using the resources of the SMSF.

Financing arrangements

The ruling also confirms that financing arrangements will also be considered to be financial assistance and will be a breach of section 65.

A financing arrangement is an arrangement that, based on an objective analysis of the facts, is principally to provide a member or a relative of a member with finance other than by lending money.

For example, an arrangement which involved all of the following characteristics would likely be classified as a financing arrangement, and therefore would be financial assistance:

- a member sells an asset, such as a business real property, to their fund for market value
- the investment by the fund in the business real property does not match the fund's investment strategy
- the member invests the proceeds in a business venture
- the member arranges for the fund to sell the property back to the member in a manner that equates to the repayment of a loan, whether with or without an interest component.

Indirect financial assistance

The ruling also confirms that section 65 will be breached where an SMSF provides indirect financial assistance to a member or a relative of a member through another entity. That is, financial assistance provided by another entity to a member or their relative would be deemed to have been provided by an SMSF where:

- the financial assistance would not have been given by the entity had the SMSF not entered into an arrangement with the entity that relies on SMSF resources
- the entity is in effect passing on financial assistance given to it by the SMSF. This also includes money or assets flowing from the SMSF through a chain of related entities to the member or a relative of a member of the SMSF, or
- there is something else to indicate that financial assistance given by the entity relied upon, or was in some way conditional or dependent upon, the SMSF's resources.

For example, the ruling outlines that financial assistance will be indirectly given to a member or relative of a member of an SMSF if the SMSF agrees to sell an asset (at market value) to another entity and as part of that arrangement, the other entity agrees to release a member or relative from a financial obligation owed to it by the member or relative.

4.11 Borrowing restrictions

Section 67 of SIS prohibits a trustee of a superannuation fund from borrowing money or maintaining a borrowing of money.

SMSF Ruling 2009/2[50] defines a borrowing as an arrangement that exhibits the following characteristics:

- a temporary transfer of an amount of money from one entity (the lender) to another entity (the borrower), and
- an obligation or an intention on the part of the borrower to repay that amount to the lender (which may be satisfied by the provision of an asset).

Examples of transactions or circumstances that would be prohibited under the borrowing rules include:

- taking out a loan of money, whether secured or unsecured or whether full recourse or limited recourse
- drawing down on a margin lending account
- drawing down on a bank overdraft facility.

For example, if an SMSF made a payment by cheque to a third party for services rendered but the fund's bank account went into overdraft to fund the payment, the fund will have borrowed and will have contravened section 67.

50 SMSFR 2009/2: The meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the *Superannuation Industry (Supervision) Act 1993*.

Transactions not a borrowing

However, the ruling confirms that certain circumstances and transactions will not be considered a borrowing and would not be prohibited. These include:

- the liability of a fund to pay benefits to members or their beneficiaries
- normal commercial delays in the payment of expenses incurred by an SMSF trustee
- arrangements where an expense of a fund is paid by a third party, but where a reimbursement is immediately sought and paid by the fund.

For example, if a member paid an invoice for accounting services provided to their fund, the payment would not be treated as a borrowing in the following circumstances:

- the amount of the payment was recorded as a contribution made on behalf of the member, or
- the member immediately sought to have the amount reimbursed by the fund.

However, if the member paid an expense of the fund on the understanding that the amount would be repaid at some later date, or over a certain period of time, the amount would be a borrowing and the fund will have contravened section 67.

Case study

Anna and Ben are the trustees and members of the AB SMSF. They wish to purchase a property in their SMSF, but the SMSF has insufficient money available to pay the deposit. Anna decides to pay the deposit on behalf of the SMSF enabling the purchase and transfer of title to the property from the vendor to the SMSF. The SMSF agrees to repay the amount to Anna in 12 months.

This would be a borrowing arrangement as there is an obligation that the amount be repaid by the SMSF at a fixed or determinable time in the future. If there was no obligation for the SMSF to repay Anna, the payment of the deposit made by Anna would generally be treated as a contribution to the SMSF made by Anna. For more information on when amounts will count as a contribution please see *Chapter 7: Contributions and benefit payments*.

Borrowing exemptions

The SIS Act provides a number of exceptions to the general borrowing prohibition. These are summarised as follows.

Borrowing to fund a payment to a beneficiary

A trustee will be able to borrow money to make a payment to a member or their beneficiary where all of the following circumstances are satisfied:

- the payment is required by law or by the trust deed of the fund
- the trustee would not be able to make the payment if the borrowing was not permitted
- the period of the borrowing does not exceed 90 days
- the total amount of the borrowing does not exceed 10% of the assets of the fund.

For example, a trustee would generally be permitted to borrow up to 10% of the fund's assets to fund the payment of a death benefit to a member's beneficiaries where the trustee did not otherwise have any available cash to fund the payment and was waiting to receive the proceeds from the sale of an asset, such as a real property.

Borrowing to cover settlement of certain security transactions

A trustee is permitted to borrow money to cover the settlement of a range of securities where all of the following circumstances are satisfied:

- at the time the investment decision was made it was unlikely the borrowing would be required
- the period of the borrowing does not exceed seven days
- the total amount borrowed does not exceed 10% of the value of the fund's assets
- no written determination was made by the ATO exempting the borrowing from this exemption.

For example, this exemption could allow an SMSF to borrow to fund the settlement of transactions involving certain securities such as shares, futures contracts, interest rate swap contracts and foreign currency. For a full list of the specified securities and contracts, see sub-section 67(3) of the SIS Act.

Limited recourse borrowing arrangements

A trustee is permitted to borrow to acquire assets under a limited recourse borrowing arrangement. These rules are discussed in more detail in the following section.

Limited recourse borrowing arrangements

A limited recourse borrowing arrangement is a specific type of borrowing arrangement that allows an SMSF trustee to borrow for investment purposes. The requirements for limited recourse borrowing arrangements are outlined in sections 67A and 67B of the SIS Act.

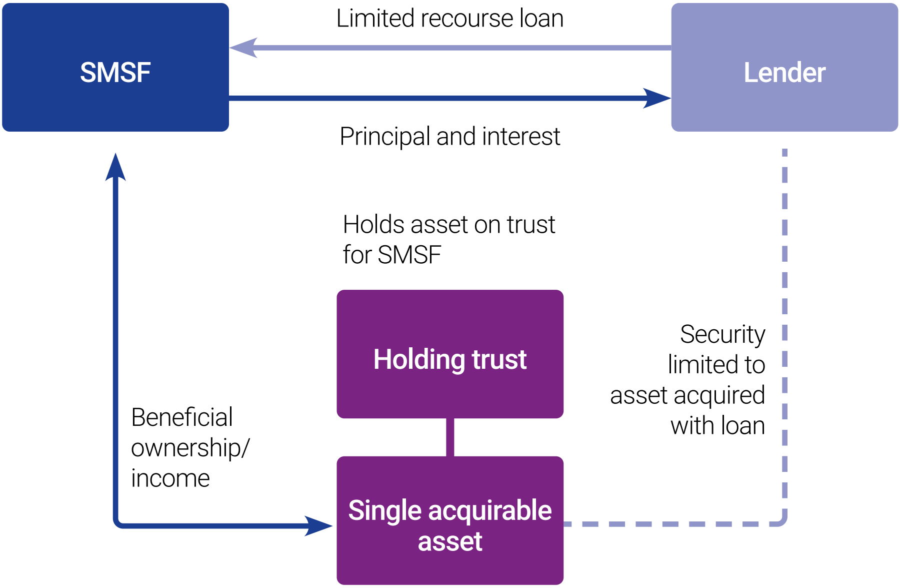
Under these rules a trustee of a superannuation fund is permitted to borrow money, or to maintain a borrowing of money, under an arrangement which satisfies the following criteria:

- the money is or has been used to fund the acquisition of a single acquirable asset, including:
  - expenses incurred with the borrowing or acquisition, or in maintaining or repairing the acquirable asset but not to improve the asset
  - money used to refinance an allowable borrowing
- the acquirable asset is held on a separate trust arrangement so that the trustee acquires the beneficial interest in the acquirable asset
- the trustee has the right to acquire the legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest
- the rights of the lender or any other person against the trustee in relation to the sum of the borrowing, and any related charges, are limited to the rights relating to the acquirable asset
- if, under the arrangement, the trustee has a right relating to the acquirable asset (other than a right to acquire the legal ownership) – the rights of the lender or any other person against the trustee for, in connection with, or as a result of, whether directly or indirectly, the trustee's exercise of its right are limited to rights relating to the acquirable asset, and
- the acquirable asset is not subject to any charge (including a mortgage, lien or encumbrance) other than that provided in relation to the borrowing.

Limited recourse borrowing structure

The following diagram illustrates the structure of a typical limited recourse borrowing arrangement.

Diagram 4.2 Typical limited recourse borrowing arrangement



Once the loan has been repaid, the arrangement can then be unwound and legal title to the asset transferred to the SMSF or the holding trust can continue to hold the asset.

Intermediary LRBAs

In May 2020 the ATO released Superannuation Industry (Supervision) In-house Asset Determination – Intermediary Limited Recourse Borrowing Arrangement Determination 2020. This determination is important as it confirms SMSFs can enter into LRBAs where the trustee of the holding trust, instead of the SMSF, is the borrower under an LRBA. In this case, the trustee of the SMSF will then be responsible for maintaining the borrowing.

The Intermediary LRBA is an arrangement entered into by the parties which meets the following requirements:

1 a holding trust is established with members of a fund being the only trustees (or shareholders and directors of the corporate trustee) of the holding trust

2 the trustee of the SMSF is a beneficiary of the holding trust

3 the trustee of the holding trust holds the acquirable asset (asset) on trust for the trustee of the SMSF, who is beneficially entitled to the asset

4 the asset is a single acquirable asset (as referred to in subsection 67A(1)) that the trustee of the fund is allowed to acquire under the SIS Act

5 the trustee of the holding trust enters into a borrowing as principal with a lender with the borrowing secured by a mortgage over the asset

6 the contract or deed of borrowing, referred to in (5), between the trustee of the holding trust and the lender may not limit the lender's right of recourse, under the contract or deed, to only the asset in the event of default

7 the lender may require that personal guarantees are given as part of the Intermediary LRBA

8 the arrangement is established by a legally binding deed(s) under which the trustee of the fund and the holding trustee agree, for:

   i the trustee of the SMSF to maintain all borrowing obligations entered into by the trustee of the holding trust in respect of the borrowing referred to in (5)

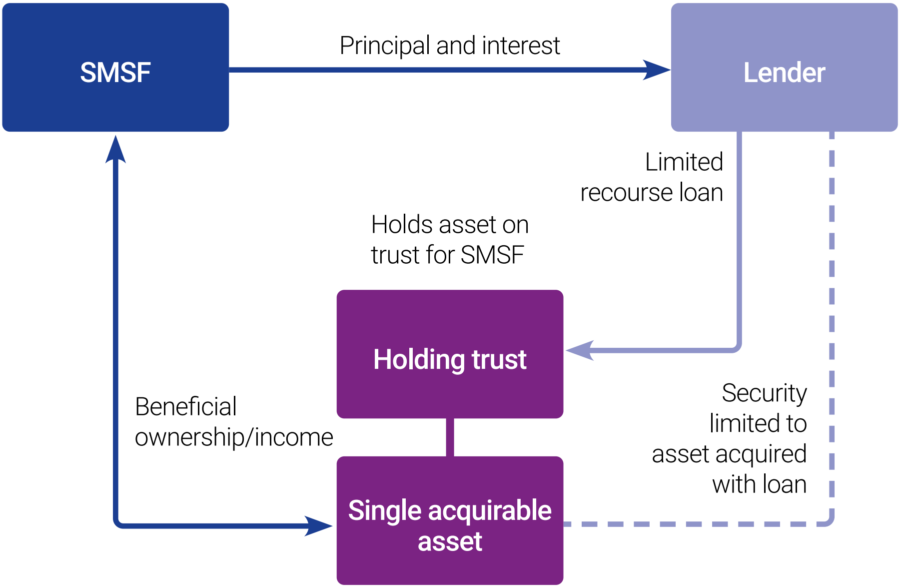
   ii the trustee of the SMSF is absolutely entitled to any income derived from the asset, less fees, costs, charges and expenses incidental to the acquisition, holding or management of the asset

   iii the trustee of the SMSF has the right to acquire the legal title of the asset on completion of the borrowing referred to in (5)

   iv the rights of the trustee of the holding trust or any guarantors against the trustee of the SMSF in connection with default on the borrowing referred to in (5) is limited to the asset.

9 the documentation referred to in (8) in connection to the borrowing referred to in (5), is disclosed to the lender at the time of the borrowing.

Diagram 4.3 Typical intermediary limited recourse borrowing arrangement



Meaning of single acquirable asset

In SMSF ruling SMSFR 2012/1[51] a single acquirable asset is defined as any single asset, other than money, that neither the SIS Act nor any other law prohibits the trustee from acquiring. A single acquirable asset may also include a collection of identical assets that have the same market value that are bought and sold as a whole.

Examples of a single acquirable asset include:

- a single title of land including any structures, such as a house, permanently fixed to the land
- a collection of shares of the same class in a single company that is bought and sold as a whole
- a collection of units that have the same fixed rights in a trust that are bought and sold as a whole
- a collection of economically identical commodities, such as gold bars, that are bought and sold as a whole.

Assets that are made up of a number of different assets, such as a strata title apartment with a car space on a separate title, or farmland on several parcels of land on different titles, will generally not qualify as a single acquirable asset unless they are distinctly identifiable as a single asset.

Relevant factors in determining whether multiple assets can be treated as a single asset include:

- the existence of a unifying physical object, such as a building across two titles of land that is permanently fixed to the land and is significant in value relative to the value of the land
- whether there is a state or territory law that requires the assets to be dealt with together.

In contrast, a physical object situated across two or more titles would not cause the separate titles to be treated as a single asset where the physical object is:

- not significant in value relative to the value of the land, or
- temporary in nature or otherwise able to be easily relocated or removed, allowing the titles to be dealt with separately.

Furthermore, a borrowing will only be permitted where it is used to acquire an asset the fund would not otherwise be prohibited from acquiring.

51 SMSFR 2012/1: Self Managed Superannuation Funds: Limited recourse borrowing arrangements – application of key concepts.

Therefore, a trustee would not be permitted to borrow to acquire an asset if the acquisition would otherwise cause a breach of the:

- sole purpose test
- non-arm's length transaction rules
- acquisition of assets from related party rules
- in-house asset rules
- fund's governing rules (including the provisions of the fund's trust deed and investment strategy).

Case study example

The trustees of Rainy Days SMSF would like to enter into an LRBA to acquire a factory from a related party, which has been built across two separate titles of land. On investigation it is confirmed the property is used wholly and exclusively to operate a manufacturing business and that the building makes up a significant portion of the value of the property as a whole.

In this case, the trustees of the SMSF would be permitted to acquire the asset from the related party under a single LRBA on the basis that the:

- property qualifies as BRP and would be a permitted acquisition from a related party, and
- existence of a single unifying physical object (of significant value) over both titles of land means the property can be treated as a single acquirable asset.

However, had the factory building been a temporary or derelict structure of negligible value, the two properties would not qualify as a single acquirable asset and each would need to be acquired under a separate LRBA, assuming they each still qualified as BRP.

Separate trust arrangement

Under the limited recourse borrowing rules, the asset acquired with the borrowing must be held on trust so that the trustee of the SMSF acquires a beneficial interest in the asset. This means that the SMSF trustee will not be permitted to hold the legal title of the asset and that a separate custodian or holding trustee must hold the legal title of the asset under a separate trust arrangement for the benefit of the SMSF.

Depending on whether an SMSF has a corporate trustee, the members of an SMSF may act as the holding trustee and hold the asset for the benefit of their fund.

However, in many situations a lender will require a separate company be established for the specific purpose of acting as the holding trustee with the members being appointed as directors. This ensures compliance with the requirement of a clear separation of ownership between the trustee of the SMSF and the custodian holding the asset.

In-house asset rule exemption – for traditional LRBAs

Under a traditional LRBA the acquirable asset is required to be held via a separate holding trust arrangement so that the SMSF trustee acquires the beneficial interest in the asset. However, in accordance with SMSFR 2009/4[52], the acquisition of the asset by the trustee of the holding trust using money provided by the SMSF would technically result in the SMSF 'investing in' the holding trust.[53] This in turn would then constitute an in-house asset of the fund as it would be an investment in a related trust and would be subject to the 5% in-house asset limit.

To avoid this situation subsection 71(8) of the SIS Act exempts an SMSF's investment in a related trust from being an in-house asset where:

- the related trust is a holding trust set up to hold the acquirable asset for the trustee of the SMSF in connection with a borrowing, by the trustee of the fund, that is covered by the LRBA rules in subsection 67A(1), and
- the only property held within the related trust is the acquirable asset acquired under the LRBA (or an allowable replacement asset), and
- the acquirable asset held via the holding trust would not otherwise be an in-house asset of the fund if it were held directly by the fund.

For example, if a trustee acquired a residential investment property under an LRBA, and the property was then leased to an unrelated party, the holding trust would be exempt from the in-house asset rules. However, if the property was instead leased back to a related party, such as a member of the fund, the exemption would not apply as the property would be an in-house asset if it were held directly by the fund.

Under the in-house asset exemption, the trust is strictly only exempt from being an in-house asset during the period that the loan is in place. Therefore, where the trust was established before the loan for example where a deposit has been paid to acquire an asset, the trust would strictly be an in-house asset of the fund. The same situation would also occur where the asset was maintained in the trust arrangement once the loan had been repaid.

To address this situation the ATO registered a legislative instrument[54] on 4 April 2014, confirming that the holding trust established under an LRBA will not be an in-house asset of a fund where:

- the loan under an LRBA has not yet begun, and
- the related trust does not yet hold the asset to be acquired under the LRBA and that it is reasonable to conclude that the:
  - borrowing will occur

52 SMSFR 2009/4: The meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the Superannuation Industry (Supervision) Act 1993.

53 SMSFR 2009/4 confirms the ATO's view that where money or assets are provided by an SMSF for the benefit of a related entity, such as a holding trust, for the purpose of receiving income, interest, profit or gain, a sufficiently close connection will be established between the investment and that entity for it to be described as an investment in that entity.

54 Self-Managed Superannuation Funds (Limited Recourse Borrowing Arrangements – In-house Asset Exclusion) Determination 2014.

- related trust will hold the asset to be acquired under the LRBA
- asset acquired under the LRBA would not cause the holding trust to be an in-house asset of the fund when the holding trust begins to hold the asset.

In addition, the instrument confirms that the holding trust will not be treated as an in-house asset once the loan is repaid where:

- the in-house asset exemption for LRBA arrangements resulted in the holding trust not being an in-house asset of the fund from the time the related trust began to hold the asset acquired under the LRBA until the borrowing was repaid, and
- the in-house asset exemption for LRBA arrangements would result in the holding trust not being an in-house asset of the fund but for the fact that that borrowing had been repaid.

For example, where an SMSF acquired a residential investment property under an LRBA, there would be no requirement to transfer the legal title of property back to the SMSF after the loan has been repaid as the in-house asset exemption would continue to apply (so long as the property wouldn't itself have been an in-house asset if it was held directly by the fund).

This is important as it could allow a trustee to maintain the asset in the trust to avoid any risk of stamp duty applying to the transfer of the property from the trust to the SMSF once the loan has been repaid.

In-house asset rule exemption – for intermediary LRBAs

Like traditional LRBAs the acquirable asset will be required to be held via a separate holding trust so that the SMSF trustee acquires the beneficial interest in the asset. However, the same as traditional LRBAs, this will cause an in-house asset issue as the trustee of the SMSF, as a beneficiary of the trust, will be deemed to have invested in the holding trust. However, as an intermediary LRBA does not involve the trustee of the SMSF undertaking the borrowing, the in house asset exemption in section 71(8) of the SIS Act that applies to traditional LRBAs will not apply.

To resolve this issue, the Superannuation Industry (Supervision) In-house Asset Determination – Intermediary Limited Recourse Borrowing Arrangement Determination 2020 confirms that an SMSF's investment in a holding trust that forms part of an intermediary LRBA will not be an in-house asset of the fund where:

- an asset of a fund is an investment in a related trust of the fund, and
- the related trust is a holding trust (as described in paragraph 67A(1)(b)) established to hold an asset for the trustee of the SMSF in connection with an intermediary LRBA, under which the trustee of the fund is maintaining a borrowing that is covered by the LRBA rules in subsection 67A(1), and
- the only property of the related trust is the acquirable asset mentioned in paragraph 67A(1)(b), and
- the acquirable asset held via the holding trust (as described in paragraph 67A(1)(b)) would not otherwise be an in-house asset of the fund if it were held directly by the fund.

For example, if a trustee acquired a residential investment property via a complying intermediary LRBA, and the property was then leased to an unrelated party, the holding trust would be exempt from the in-house asset rules. However, if the property was instead leased back to a related party, such as a member of the fund, the exemption would not apply as the property would be an in-house asset if it were held directly by the fund.

However, for this in-house asset exemption to apply the borrowing arrangement must satisfy the requirements of an intermediary LRBA (see above). In this case, it will be crucial to disclose all the required documentation about the LRBA to the lender (see point 9), otherwise the arrangement will not qualify as an intermediary LRBA and the in-house asset exemption will not apply.

Limited recourse loan requirement

One of the main requirements of the limited recourse borrowing arrangement rules is that the rights of the lender, or any other person, against the SMSF trustee in relation to a default on the borrowing are limited to the asset acquired with the borrowing.

That is, the lender must not have any recourse to any of the fund's other assets if the SMSF trustee defaults on the loan and the asset's sale proceeds are insufficient to repay the outstanding loan.

Due to the limited recourse requirement of these loans, many lenders will limit the amount they will agree to lend without a third party agreeing to guarantee the loan or to indemnify the lender for any losses suffered in the case of a default. For example, a lender may only lend up to 50% of the value of a residential property under a standard limited recourse loan arrangement, but may agree to increase this to a higher LVR where a third party guarantee or indemnity is provided.

Related party lenders

The LRBA rules in section 67A do not prohibit an SMSF from entering into a borrowing arrangement with a related party of the fund, such as a member of the fund. The ATO also confirmed in ID 2010/162[55] that the superannuation law arm's length provisions (see section 4.12) will not be breached where the arrangement is on arm's length terms or the terms are more favourable to the SMSF than arm's length terms.

However, in 2014 the ATO released interpretative decisions, which were replaced by TD 2016/16,[56] confirming that, for tax purposes, the income derived by an SMSF from an asset acquired under an LRBA where some or all of the terms of the arrangement were not established on purely commercial terms, and the terms are more favourable to the SMSF than commercial terms, will be non-arm's length income (taxed at 45%).

55 ATO ID 2010/162: *Superannuation: Self managed Superannuation Fund: limited recourse borrowing arrangement – borrowing from a related party on terms favourable to the self managed superannuation fund.*

56 Tax Determination TD 2016/16: *Income tax: will the ordinary or statutory income of a self managed superannuation fund be non-arm's length income under subsection 295-550(1) of the Income Tax Assessment Act 1997 (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?*

Therefore, despite ATO ID 2010/162, trustees considering borrowing from a related party under a LRBA should ensure that all aspects of the arrangement are established on commercial arm's length terms and not on terms that are either more or less favourable to the SMSF.

In April 2016, the ATO released practical compliance guideline PCG 2016/5 to assist trustees with this. The PCG sets out the 'Safe Harbour' terms on which SMSF trustees may structure their LRBAs so they are consistent with an arm's length dealing. The PCG outlines safe harbour terms for both loans over real property and stock exchange listed shares and units.

The safe harbour terms for loans over real property are summarised in table 4.1. For the safe harbour terms for loans over stock exchange listed shares and units, please see ATO PCG 2016/5.

Table 4.1 Safe harbour terms for loans over real property

Loan terms & conditions	Safe harbour requirements
Interest rate	Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors. Applicable rates for the: • 2015–16 year, 5.75% • 2016–17 and later years, the rate published for May (the rate for the month of May immediately before the start of the relevant financial year). For current rates, refer to the FirstTech Pocket Guide.
Interest rate – fixed or variable	Interest rate may be variable or fixed • Variable – uses the applicable rate (as set out above) for each year of the LRBA • Fixed – trustees may choose to fix the rate at the commencement of the arrangement for a specified period, up to a maximum of 5 years. The fixed rate is the rate published for May (the rate for the May before the relevant financial year). For current rates, refer to the FirstTech Pocket Guide. The 2015–16 rate of 5.75% may be used for LRBAs in existence on publication of these guidelines, if the total period for which the interest rate is fixed does not exceed five years (see 'Loan term').
Loan term	Variable interest rate loan (original) – 15 year maximum loan term (for both residential and commercial). Variable interest rate loan (re-financing) – maximum loan term is 15 years less the duration(s) of any previous loan(s) relating to the asset (for both residential and commercial). Fixed interest rate loan – a new LRBA commencing after publication of these guidelines may involve a loan with a fixed interest rate set at the beginning of the arrangement. The rate may be fixed for a maximum period of five years and must convert to a variable interest rate loan at the end of the nominated period. The total loan term cannot exceed 15 years. For an LRBA in existence on publication of these guidelines, the trustees may adopt the rate of 5.75% as their fixed rate, provided that the total fixed-rate period does not exceed five years. The interest rate must convert to a variable interest rate loan at the end of the nominated period. The total loan cannot exceed 15 years.

Loan terms & conditions	Safe harbour requirements
Maximum loan to value ratio	Maximum 70% LVR for both commercial and residential property. If more than one loan is taken out to acquire (or refinance) the asset, the total amount of all those loans must not exceed 70% LVR. The market value of the asset is to be established when the loan (original or re-financing) is entered into. For an LRBA in existence on publication of these guidelines, the trustees may use the market value of the asset at 1 July 2015.
Security	A registered mortgage over the property is required.
Personal guarantee	Not required.
Nature and frequency of payments	Each repayment is of both principal and interest. Repayments are monthly.
Loan agreement	A written and executed loan agreement is required.

The ATO also confirms in PCG 2016/5 that where trustees have entered into an arrangement that does not comply with all the safe harbour guidelines, it does not mean the arrangement is deemed not to be on arm's length terms. In this case, the ATO outlines the trustee will simply not be able to rely on the certainty provided by PCG 2016/5. Instead, the onus will be on the trustees to be able to demonstrate their arrangement was entered into and maintained on terms consistent with an arm's length dealing.

For example, a trustee may be able to enter into a related party borrowing under different terms than those outlined in the PCG, where the trustee has obtained evidence that demonstrates the terms and conditions of their arrangement replicates those of a commercial loan that was available in the same circumstances.

Complex related party loan arrangements

While PCG 2016/5 outlines the practical compliance guidelines for loans on property and stock exchange listed shares and units, it does not outline any safe harbour parameters for more complex borrowing arrangements, such as borrowing arrangements involving:

- multiple loans from different lenders, or
- loans to acquire units or shares in unlisted companies and trusts, such as a related 13.22C trust.

In this case, trustees with a complex LRBA will not be able to rely on PCG 2016/5. Instead, trustees will need to maintain sufficient evidence to demonstrate the terms of their arrangement replicate those of a commercial loan that was available in the same circumstances. Where this is not possible, trustees would need to consider not entering into such arrangements or having to unwind a pre-existing arrangement.

Replacement asset restrictions

Once an asset has been acquired under a limited recourse borrowing arrangement, the trustees will not generally be permitted to replace that asset with another asset other than in certain limited circumstances. These are summarised in Table 4.2.

Table 4.2 Allowable replacement assets

Original asset	Allowable replacement asset
A share (or a collection of shares) in a company	A share (or a collection of shares) in that company of the same market value
A unit (or a collection of units) in a unit trust	A unit (or a collection of units) in that trust of the same market value
An instalment receipt that confers a beneficial interest in a share in a company or a collection of shares in a company	The share or collection of shares in the company
A share (or a collection of shares) in a company or a unit (or a collection of units) in a unit trust	A share (or a collection of shares) in another company or a unit (or a collection of units) in another unit trust where the replacement occurred as a result of a takeover, merger, demerger or restructure
A share (or a collection of shares) in a company	A stapled security, or a collection of stapled securities where: • each of the stapled securities consists of a single share, or a single collection of shares of the same class, stapled together with a single unit, or a single collection of units of the same class, in a unit trust, and • the replacement occurs under a scheme of arrangement of the company.
A unit (or a collection of units) in a unit trust	A unit in the unit trust, or a collection of units in the unit trust, and the replacement occurs as a result of an exercise of a discretion granted under the trust deed of the unit trust to the trustee of the unit trust.

The ATO has confirmed in SMSF Ruling SMSFR 2012/1 that if an asset is replaced in its entirety with a different asset (even if of the same type) and that replacement is not covered by one of the specified exemptions, the LRBA exemption will cease to apply and the borrowing will be prohibited.

For example, if an SMSF trustee acquired 100 shares in a company under an LRBA it would not be permitted to sell those shares and then use the proceeds to acquire shares in a different company under the same borrowing arrangement. In this case, the trustee would need to use the proceeds to extinguish the loan and then establish a new LRBA to acquire the shares in the different company.

When do changes or alterations to an asset result in a different asset being held on trust?

The ATO also confirmed in SMSFR 2012/1 that any alterations or additions to an asset that fundamentally change the character of the asset will result in a different asset being held on trust. Unless one of the replacement asset exemptions applies, the change or alteration would result in the arrangement ceasing to satisfy the LRBA requirements.

Examples of alterations or additions to an asset that would fundamentally change the character of an asset include the:

- subdivision of a block of land on a single title resulting in multiple titles
- construction of a residential house on a vacant block of land
- rezoning or conversion of a residential property to a commercial property
- reinvestment of company dividends resulting in an increase in the number of shares held under an LRBA.

Case study (Part 1 of 2):

The trustees of Big Builders SMSF acquired a residential house on a large block of land through an LRBA, which they then leased to unrelated tenants. Two years later the house was severely damaged by fire and was subsequently demolished.

The trustees then saw this as a good opportunity to subdivide the property and to use the insurance proceeds to construct two separate houses on each title. If the trustees subdivided the property it would result in a fundamental change to the character of the asset from a single property to multiple properties and would therefore constitute a non-allowable replacement asset.

Permitted use of borrowings

Under the LRBA provisions, a trustee is permitted to use borrowings to acquire a single acquirable asset and to pay for borrowing and transaction costs and to fund any repairs and maintenance to the asset acquired with the borrowings. However, the provisions specifically prohibit the borrowings from being used to improve the asset.

The distinction between what is maintenance and repairs and what is an improvement is therefore extremely important where borrowings will be used to fund work on a property. In SMSFR 2012/1, the ATO provides guidance about the meaning of these terms in relation to an LRBA.

Meaning of maintenance

The ruling clarifies that maintenance in the context of the borrowing rules includes work done to prevent defects in, damage to, or deterioration of an asset and contemplates the continued existence of the asset.

For example, maintenance would generally include the repainting of walls, the treatment of a property to prevent termite attack and the installation of mains connected smoke alarms.

Meaning of repair

The ruling defines a repair for the purpose of the borrowing rules to include work to remedy or make good defects in, damage to, or deterioration of an asset and contemplates the continued existence of the asset. The ruling further clarifies that a repair is usually occasional and partial and involves replacing a part of something that is already there that has become worn out, dilapidated or damaged. However, the ruling also confirms that a repair would not involve anything that replaced the asset entirely or that changed the character of the asset.

For example, a repair would generally include the replacement of rusted guttering or a roof that was badly damaged in a storm. Repairs would also involve work done to replace part of the timber frame of a house that has been attacked by termites.

FirstTech comment

Additional drawdowns

In SMSFR 2012/1, the ATO confirms that where a trustee wishes to drawdown on an existing loan to fund repairs, the drawdown will only be permitted where the drawdowns are provided for under the terms of the LRBA.

Therefore, before drawing down on a loan to fund any maintenance or repairs, the trustees should check to ensure that additional drawdowns are provided for under the terms of their specific LRBA.

Meaning of improvement

In contrast, the ruling outlines that an asset is improved if the state or function of the asset is significantly altered for the better, through substantial alterations, or the addition of further substantial features or rights to the asset.

In the ruling, the ATO confirms that whether work constitutes a repair or an improvement is a question of fact and degree that takes into account the appearance, form, state and condition of the asset as at the time of acquisition. However, the ATO does confirm that it is possible to use borrowings to repair the asset acquired with the borrowings even where the damage occurred and was known about before the trustee acquiring the asset. However, it also points out that the greater the state of deterioration, the more likely the subsequent alterations or changes will be considered improvements.

Case study (Part 2 of 2):

The trustees of the Big Builders SMSF recently purchased another residential house on a single block of land and now want to add an in-ground pool and a second storey to the house.

This would constitute an improvement as it significantly alters the property for the better through the addition of further substantial features.

Minor and trifling improvements

In the ruling, the ATO confirms that alterations to the acquirable asset will not amount to an improvement if the state or function of the acquirable asset is only bettered to a minor or trifling extent as compared to the asset as a whole.

Case study

Doug and Doris as trustees of their SMSF purchased a residential property for $1 million via an LRBA and have been renting it out for a number of years. Doug and Doris have recently decided to make a drawdown under the loan to fund an update to the kitchen which, although functional, is significantly out of date and showing significant signs of wear and tear. During the update the kitchen is improved with modern equivalent, rather than superior materials and appliances. Doug and Doris also add a new dishwasher, which was not previously part of the kitchen.

In this case, the kitchen update would unlikely amount to an improvement as it did not significantly improve the state or function of the property as a whole.

Other money used to fund improvements

Although borrowed money cannot generally be used to improve an asset, the ATO has confirmed that money from other sources (that is, non-borrowed money) can be used to improve the asset. However, this will only be possible where the scale and nature of the improvements do not fundamentally change the character of the asset and therefore effectively create a non-allowable replacement asset.

For example, in SMSFR 2012/1, the ATO confirms that an SMSF trustee may be able to use the fund's own cash reserves to renovate a residential property to add bedrooms and a swimming pool as these changes would not fundamentally change the residential character of the asset.

Conversely, the ruling also confirms that subdividing a property or converting a residential property into a commercial property would fundamentally change the character of the asset and create a non-allowable replacement asset.

Other related expenses and refinancing

The rules also allow the borrowing to be used to cover any expenses incurred in connection with the borrowing or acquisition of the acquirable asset. For example, a borrowing could be used to fund the following expenses:

- legal costs, such as conveyance fees and charges
- state government stamp duty
- lender fees and charges, such as loan establishment costs.

A trustee is also permitted to refinance an allowable borrowing arrangement.

Pre-7 July 2010 arrangements grandfathered

Before 7 July 2010, trustees were permitted to borrow to acquire multiple assets under the instalment warrant borrowing rules, which came into effect from September 2007. However, to help those funds that had borrowed before 7 July 2010 from having to restructure to satisfy the new single acquirable asset rules, the ATO confirmed in SMSFR 2012/1 that the new rules will only apply to funds entering into a new borrowing arrangement on or after 7 July 2010.

However, the ATO has also confirmed that where any significant changes are made to a pre-7 July 2010 borrowing arrangement on or after 7 July 2010, the original arrangement will come to an end and a new arrangement will come into place. As a result, the new rules would then apply to that arrangement.

Significant changes to the terms and conditions of a borrowing arrangement that would result in a new arrangement include:

- the loan being refinanced
- there is an additional drawdown on the borrowing that is inconsistent with the arrangement; for example, a drawdown to acquire an asset or class of asset clearly not contemplated under the original arrangement
- there has been a change to the ultimate beneficiaries of the arrangement resulting from selling a structure involving a pre-existing arrangement.

However, not every variation to the terms of an LRBA will result in a refinancing or a new arrangement coming into place. For example, the ATO has indicated a change to the term of a borrowing arrangement may not result in a new arrangement coming into place if:

- the loan extension did not discharge the original obligation to pay and create a new obligation in its place
- the original loan agreement provided for the parties to agree to extend the term
- the period of the extension in relation to the period of the original loan was not significant
- no other terms of the loan were changed by the later agreement.

FirstTech comment

Caution refinancing pre-7 July 2010 arrangements

Where an SMSF trustee implemented a borrowing arrangement before 7 July 2010 to acquire multiple assets, such as a real property on multiple titles, the trustees should exercise significant caution before making any changes to the terms and conditions of the loan arrangement as it could result in a new arrangement which would then fail the single acquirable asset requirements.

Trust deed and investment strategy

For a fund to be permitted to enter into an LRBA the ATO has confirmed that both the fund's trust deed and investment strategy must allow the fund to borrow for investment purposes. Trustees should therefore review their deed to confirm that it allows the trustees to borrow and consider updating the fund's investment strategy accordingly.

Income and capital gains tax

Under the Tax Act[57] 'look-through' provisions apply to confirm a holding trust that is part of a complying LRBA is ignored for income tax law purposes and the SMSF trustee as the investor and beneficiary is considered the owner of the asset.

As a result, the SMSF will be assessed on any assessable capital gains, rent, dividends (including franking credits) or other income generated from the asset held under the borrowing arrangement. In addition, any capital gains realised on the transfer of the asset from the holding trust to the SMSF on the expiry of the LRBA will be disregarded.

Stamp duty

The SMSF trustee will generally be liable for stamp duty on any asset acquired via an LRBA. However, a range of concessions is generally available to avoid stamp duty applying a second time on the declaration of trust over the asset and when the asset is transferred to the SMSF after the loan is repaid.

Unfortunately, these rules can be complex and vary depending on which state the property is located. Specialist legal advice should therefore be sought to ensure the borrowing arrangement is structured to comply with the requirements of the relevant state concession.

Certain LRBA repayments are a transfer balance account credit

Where an LRBA is entered into on or after 1 July 2017, a credit to a retirement phase income stream recipient's transfer balance account will arise where their retirement phase income stream interest is increased due to an LRBA loan repayment.

For further information, see section 7.8.

LRBAs and total superannuation balance

A proportion of the outstanding balance of certain LRBAs established after 30 June 2018 are included in the calculation of a member's total superannuation balance if:

- the member's interests in the fund are supported by assets subject to an LRBA and the member has satisfied a condition of release with nil cashing restrictions (retirement, reaching age 65, terminal medical condition, permanent incapacity), or
- the member's interests in the fund are supported by assets subject to an LRBA between the SMSF and its associates.

57 See Sub-division 235 – I Instalment trusts of the Income Tax Assessment Act 1997

The amount by which an impacted member's total superannuation balance is increased is a proportion of the LRBA balance based on the member's share of the total superannuation interests that are supported by the asset that is subject to the LRBA.

This measure will only apply to LRBAs commenced on or after 1 July 2018. LRBAs entered into before that date (including the refinancing of existing loans originally commenced before that date) are excluded.

This measure is intended to address the issue of people using LRBAs to facilitate a re-contribution strategy.

4.12 Invest on arm's length basis

Section 109 of the SIS Act requires that any investments made by (or on behalf of) the trustee of a superannuation fund either must be conducted on an arm's length basis or on terms that are no more favourable to the other party than would reasonably be expected if the transaction was at arm's length in the same circumstances.

To determine whether a transaction has been undertaken on an arm's length basis requires an objective assessment of all the facts involved. In particular, the test to apply would be to consider whether a prudent person acting with due regard to their commercial interests would have made such an investment.

Other factors that should be considered when determining if a transaction is on an arm's length basis include whether:

- the asking price reflects the expected return of the asset, the risks to which the asset is exposed and the relative liquidity of the asset
- the contract or agreement adequately protects the interests of the superannuation fund, with clear legal identification of all parties and their rights and obligations
- valuations have been obtained where appropriate
- an investment in depreciating assets factors in an amount to recover the depreciation.

FirstTech comment

Non-arm's length transactions, NALE and contributions caps

Although the SIS non-arm's length rules do not prevent the trustee of a superannuation fund from acquiring an asset from a related party for a value less than market rate, trustees should be aware that where an SMSF acquires an asset for less than its true market value, the fund may be considered to have incurred a non-arm's length expense (NALE), which in turn could result in any future income (including assessable capital gains) received from the asset being taxed as non-arm's length income (which is taxed at the top marginal rate). For more information on non-arm's length income and non-arm's length expenses, please see section 5.7.

Maintain investments on arm's length basis

Importantly, the non-arm's length rules also require that where a trustee deals with a related party regarding an investment of the fund, the dealing must be on an arm's length basis. For example, where an SMSF leased a commercial property to a related party under the in-house asset rules, the lease arrangement between the trustee and the related party would need to be set and maintained at an arm's length commercial rate.

SMSF Ruling SMSFR 2009/3[58] also clarifies that where an SMSF is presently entitled to a distribution from a related trust and the fund does not seek payment of the distribution within a reasonable time, and no interest is paid or compensation given, the dealing would not be on an arm's length basis and would be a breach of the non-arm's length rules.

Where an SMSF received more income than it would otherwise be entitled under a non-arm's length arrangement, that income would also generally be categorised as non-arm's length income and would be taxed at 45%. For more information on the taxation of non-arm's length income, please see *Chapter 5: Taxation of SMSFs*.

4.13 Prohibition on charging member benefits or fund assets

Under SIS Regulations 13.12 and 13.13 and the operating standards in section 31 of the SIS Act, the trustee of a superannuation fund must not recognise, or in any way encourage or sanction, an assignment of or charge over a member's benefits or interest in the fund.

SIS Regulation 13.14 also prohibits the trustee of a fund from giving a charge over or in relation to, an asset of the fund. For example, a trustee would be prohibited from allowing an asset of a fund to be used as a security for a loan made to a member or other related party of the fund.

58 SMSFR 2009/3: *Application of the Superannuation Industry (Supervision) Act 1993 to unpaid trust distributions payable to a self managed superannuation fund.*

Exemption to charging benefits or assets

SIS Regulation 13.15 clarifies that the prohibition on allowing the charging or assignment of member benefits or the charging of fund assets does not apply where the assignment or charge is permitted, expressly or by necessary implication, by the SIS Act or Regulations.

Limited recourse borrowing arrangements

A trustee will not be prohibited from allowing a charge or right of recourse to be placed over an asset acquired under an allowable limited recourse borrowing arrangement as the charge is required by the SIS Act.

Exception for derivative investments

Under SIS Regulation 13.15A, a trustee will be exempt from the prohibition on allowing a charge over a fund asset where the charge relates to a derivatives contract entered into by the trustee, and:

- the charge is given in order to comply with the rules of an approved body (such as the Australian Securities Exchange) that requires the performance of obligations in relation to the derivatives contract to be secured, and
- the fund has in place a derivatives risk statement that sets out:
  - policies for the use of derivatives that include an analysis of the risks associated with the use of derivatives within the investment strategy of the fund, and
  - restrictions and controls on the use of derivatives, and
  - compliance processes to ensure that the controls are effective, and
- the investment to which the charge relates is made in accordance with the derivatives risk statement.

The SIS Regulations define a derivatives contract as an options contract or a futures contract relating to any right, liability or thing. The regulations also define a derivative to mean a financial asset or liability the value of which depends on, or is derived from, other assets, liabilities or indices.

Therefore, where a trustee wishes to acquire a derivative that requires a charge to be placed over a fund's assets, the derivative must be acquired through the Australian Securities Exchange (or another approved body, such as the New York Stock Exchange) and the trustee must put in place a derivatives risk statement.

However, where a trustee acquires a derivative that does not require such a charge to be placed over a fund asset, the trustee will not need to put in place a derivatives risk statement. In addition, where a trustee borrows via an LRBA to acquire a property, the trustee will also not need to put in place a derivatives risk statement as the trustee will not have entered into a derivatives contract.

5 Taxation of SMSFs

5.1 Eligibility for concessional tax treatment

In general, complying superannuation funds, including complying SMSFs, are subject to concessional tax treatment under Division 295 of the Tax Act.

To be a complying superannuation fund, an SMSF must have been given a notice by the ATO confirming that it is a complying superannuation fund. This notice is generally provided when the fund applies to be registered as a complying superannuation fund (upon being established) and continues to apply until it is revoked.

For an SMSF to be a complying superannuation fund, it must:

- be a resident regulated fund at all times during the year that it was in existence, and
- have complied with the relevant regulatory provisions that apply to superannuation funds, including the SIS Act, at all times during the year, or if it has breached a regulatory provision, the ATO must not have revoked the fund's complying status.

To be a resident regulated fund, an SMSF must:

- have a corporate trustee or individual trustees, and the corporate or individual trustees must have made an irrevocable election for the SIS Act to apply to the fund, and
- satisfy the definition of an Australian superannuation fund in the Tax Act.

For more information on the requirements to satisfy the definition of an Australian superannuation fund, see section 5.8 of this chapter.

Taxation of complying superannuation funds

In general, complying superannuation funds are subject to taxation under the Tax Act, the same as other taxpayers. However, the Tax Act also contains some provisions that apply specifically to superannuation funds, which outline:

- amounts that are included in a superannuation fund's assessable income
- deductions that are available to superannuation funds
- the tax rates that apply to a superannuation fund's taxable income
- the tax treatment of a superannuation fund that loses its complying status.

This chapter looks at how these rules apply to SMSFs in general.

Government proposal: Additional 15% 'Division 296' tax on earnings for TSB over $3 million

The Government has proposed introducing a new 15% tax on the portion of a member's earnings that are attributable to their total superannuation balance over $3 million. Under the proposal, a member's earnings will be calculated based on the difference in their total superannuation balance from one year to the next, with adjustments made for contributions and withdrawals made during the year.

The tax is proposed to apply from the 2025–26 financial year, and be levied on members personally. Members could then choose to pay the tax from their own pocket, or elect to have it released from super. As part of this proposal, the way a member's total superannuation balance is calculated (for all purposes) would change from 30 June 2025. For further information, see section 5.3 of the FirstTech Super and Retirement Income Streams guide.

At the time of writing, a Bill to implement this proposal had been introduced into parliament but it had not been legislated. Please contact FirstTech for more information on this proposal. FirstTech also expects to release a detailed article, including strategy implications, if and when this proposal becomes law.

5.2 Assessable income

The assessable income of complying superannuation funds will generally include amounts of ordinary and statutory income, such as interest, dividends (including franking credits), rent, trust distributions and realised capital gains.

In addition, Division 295 of the Tax Act also includes certain contributions in the assessable income of a complying superannuation fund.

Assessable and non-assessable contributions

Superannuation funds can accept different types of contributions. For the purposes of taxation, these can be split into assessable and non-assessable contributions. Table 5.1 summarises the different types of contributions and whether they are included in a fund's assessable income:

Table 5.1 Assessable and non-assessable contributions

Assessable contributions	Non-assessable contributions
Employer contributions including superannuation guarantee and salary sacrifice	Personal contributions where the member has not provided a valid deduction notice to the trustee (includes amounts remitted to the SMSF from the member's after-tax salary by an employer)
Personal contributions where the member has submitted a valid notice of intent to claim a tax deduction under section 290–170 of the Tax Act	Eligible spouse contributions
Contributions made by a third party other than by a member's spouse or on behalf of a child	Government co-contributions
Amounts transferred from a foreign superannuation fund that the member has elected to be assessable to the fund (commonly the amount of earnings since the member became an Australian tax resident)	Contributions on behalf of a child that are not made by the child's employer
Payments of superannuation guarantee shortfall amounts from the ATO	Taxable component – taxed element and tax-free component of a rollover
An amount of taxable component (untaxed element) up to the untaxed plan cap included in a rollover to a fund[1]	Amounts transferred from a foreign superannuation fund (excluding an amount that the member has elected to be assessable to the fund)
	Amounts contributed that count towards the lifetime CGT cap (including amounts contributed on behalf of the member by a third party).
	Downsizer contributions

1 Excludes untaxed element (created as a result of a death benefit containing insurance proceeds) that forms part of a death benefit rollover. See section 6.7 for further information.

Transfers from foreign superannuation funds

If an SMSF member is transferring an amount from a foreign superannuation fund directly to their SMSF, they may elect (under section 305–80 of the Tax Act) for any applicable fund earnings to be taxed by their SMSF instead of being assessable to them personally.

Applicable fund earnings are generally calculated as either:

- earnings (excluding contributions) that accrued in the foreign fund between the date the member first became an Australian tax resident and the date of transfer, or
- if an Australian tax resident at all times, the total earnings (excluding contributions) generated within the fund.

Applicable fund earnings for which the member has made a valid election under section 305–80 of the Tax Act are an assessable contribution of the SMSF and form part of the taxable component. Any remaining amount transferred is a non-assessable contribution and forms part of the tax-free component (it also counts against the member's non-concessional contributions cap).

Foreign laws

In addition, while Australian law allows foreign superannuation transfers to be accepted, the law in the foreign country may not permit superannuation to be transferred directly to an Australian superannuation fund.

Where these transfers are allowed, any applicable foreign law requirements must be adhered to.

Historically, the majority of overseas superannuation transfers came from UK pension schemes. However, on 6 April 2015, rules came into effect to restrict transfers to funds with Qualifying Recognised Overseas Pension Schemes (QROPS) status unless the fund could also comply with the UK pension age test. That test requires the payment of benefits to members under the age of 55 to be prohibited other than in the case of incapacity. Unfortunately, this disqualified most large funds in Australia from being able to qualify as a QROPS fund as there are a range of conditions of release under the SIS Act, such as financial hardship and the release of benefits on compassionate grounds, which do not comply with the pension age test.

However, some SMSFs have subsequently been able to qualify as QROPS by restricting fund membership to people over age 55 only.

Trustees wishing to explore this possibility should seek specialist legal advice.

Further changes to UK pension rules in 2017 have, for some transfers, extended the timeframe during which the UK can tax unauthorised payments from a QROPS. Refer to the FirstTech Super and Retirement Income Streams guide for further information.

Rollover of taxable component (untaxed element)

Where a member rolls over an amount from an untaxed superannuation fund to an SMSF, the rollover will generally include an amount of taxable component (untaxed element). While not technically a contribution, any amount of taxable component (untaxed element) up to the untaxed plan cap will be included in the SMSF's assessable income.

Refer to the FirstTech Pocket Guide for the current value of the untaxed plan cap.

Excess concessional contributions and assessable income

Where a member exceeds their concessional contributions cap, the excessive amount will be included in their assessable income, but with the option to have up to 85% of the excess amount released to them. However, regardless of whether the client opts to release up to 85% of the excess amount, the total concessional contributions made for the client will be counted as assessable income of the fund.

For example, Jack (30) has made total superannuation guarantee and salary sacrifice contributions of $45,000 to his SMSF in a financial year, resulting in $15,000 of excess concessional contributions. The fund would be required to include the full $45,000 of concessional contributions in its assessable income. Meanwhile, the $15,000 of excess contributions is included in Jack's assessable income and taxed at his marginal rate, less a non-refundable tax offset of 15% to account for the income tax paid by the fund.

For more information on the excess concessional contributions regime, please see the FirstTech Super and Retirement Income Streams guide.

If a member exceeds their concessional cap, they may direct the ATO to issue a release authority to their fund(s) to have up to 85% of the excess contributions released; the choice of how much to release is entirely at the discretion of the member.

5.3 Capital gains tax and SMSFs

The capital gains tax (CGT) provisions in the Tax Act apply to complying superannuation funds in the same way as they apply to other taxpayers, with some important modifications.

CGT provisions primary code for calculating gains and losses

Under section 295–85 of the Tax Act, where a superannuation fund disposes of a CGT asset, any gain or loss will generally be required to be calculated using the CGT provisions rather than any other tax provisions which could potentially have applied.

The only exception to this requirement is where:

- the gain or loss is attributable to currency exchange rate fluctuations, or
- the asset is a debenture, bond, certificate of entitlement, bill of exchange, promissory note, a secured or unsecured loan, bank deposit or some other contract under which the fund is liable to pay an amount
- a capital gain or loss relating to certain assets would otherwise have been disregarded under the CGT provisions (that is, if a gain on the sale of an asset would be exempt under the CGT provisions, such as a gain on a car or collectable or film right, but would be taxable under another provision of the Tax Act, the other provision can apply).

In addition, where a trustee of a complying superannuation fund held trading stock before 10 May 2011, any gains on the disposal of those assets may be able to be taxed on revenue account.

However, the government has announced that certain assets (particularly shares, units in a unit trust and land) acquired by complying superannuation funds (including SMSFs) after 10 May 2011 that could otherwise have qualified as trading stock are specifically excluded from being trading stock.

Therefore, where an SMSF disposes of assets, such as listed shares or property, that were acquired after 10 May 2011 and used as part of operating a share trading or property development business, the CGT provisions will apply to calculate any gains or losses.

CGT discount

Under section 115–100 of the Tax Act, the trustee of a complying superannuation fund is entitled to a discount percentage of 33⅓ on any realised capital gain on an asset held for longer than 12 months. Therefore, where an SMSF held a CGT asset for at least 12 months prior to disposal, only two-thirds of any realised capital gain must be included in the fund's assessable income.

For assets acquired prior to 21 September 1999, an SMSF may instead choose to use the indexed cost base method for calculating the capital gain, in which case the CGT discount mentioned above will not apply.

Assets acquired prior to 1 July 1988 (30 June 1988 assets)

Under section 295–90 of the Tax Act, where a superannuation fund holds an asset that was acquired before 1 July 1988, it will be deemed for CGT purposes to have acquired the asset on 30 June 1988. This means that an SMSF will not have any pre-CGT assets that are ignored for CGT purposes.

For capital gains purposes, the cost base of a 30 June 1988 asset will be the greater of:

- its market value at 30 June 1988, or
- its cost base at 30 June 1988.

For capital loss purposes, the reduced cost base of a 30 June 1988 asset will instead be the lesser of these two values.

Insurance proceeds

Under section 118–300 of the Tax Act, any capital gain or loss made by the trustee of a complying superannuation fund on a life insurance policy or a policy of insurance against an individual suffering an illness or injury is disregarded.

TD 2007/4[59] confirms that this also applies to terminal illness proceeds.

59 Taxation Determination TD 2007/4: *Income tax: Capital gains tax: Is a 'policy of insurance on the life of an individual' in section 118–300 of the Income Tax Assessment Act 1997 limited to a life insurance policy within the common law meaning of that expression?*

Capital gains on assets set aside to pay a pension liability

Under section 118–320 of the Tax Act, any capital gains or capital losses made on segregated current pension assets are disregarded and therefore tax-free. However, this also means any capital losses on these assets cannot be carried forward to future income years.

For more information on the tax treatment of assets used to pay a pension liability, see section 5.5.

5.4 Transitional CGT relief for 1 July 2017 transfer balance cap and transition to retirement reforms

Transitional CGT relief provisions allowed a complying superannuation fund to reset the cost base of an asset to its current market value without having to sell and reacquire the asset.

The relief applied to allow trustees to preserve the tax exemption that applied to assets supporting pensions with accrued capital gains, where those gains would otherwise become taxable from 1 July 2017 due to:

- a member needing to commute their pension and transfer benefits to the accumulation phase due to the introduction of a transfer balance cap, or
- the changes to the taxation of assets supporting TTR income streams.

There were a range of requirements that had to be met to claim transitional CGT relief (many of which had to occur before 1 July 2017), which depended on the fund's circumstances and asset segregation method. The fund trustee must have also elected to claim the relief as part of the fund's 2016–17 income tax return. Therefore, when calculating any capital gain on the disposal of an asset, it will be important to confirm whether the asset's cost base has been reset under these rules and whether the disposal may also crystalise any notional gains that accrued under the rules.

For a summary of the eligiblity requirements that applied to qualify for transitional CGT relief when using the unsegregated assets method and the strategic considerations when disposing of assets with deferred gains, refer to the FirstTech article 'Transitional CGT Relief: Disposal of Assets with Deferred Capital Gains' available on the FirstTech page of FirstNet Adviser at cfs.com.au.

5.5 Exempt current pension income (ECPI)

Under subdivision 295–F of the Tax Act, the ordinary and statutory income of a complying superannuation fund that is set aside to allow the fund to pay a retirement phase income stream liability is exempt from income tax. This income is referred to as exempt current pension income (ECPI).

For information about retirement phase income streams, see section 7.7. For information about when a superannuation income stream commences and ceases, see later in this section.

The Tax Act provides two methods for calculating ECPI for an income year:

- The segregated assets method.
- The unsegregated assets method.

In some cases, an SMSF may apply both methods when calculating ECPI for an income year.

Note that only retirement phase income stream liabilities count towards determining a fund's pension liabilities (and therefore ECPI) under both the segregated and unsegregated assets methods. For example, a transition to retirement income stream that is not yet in retirement phase does not count as a pension liability for ECPI purposes.

Segregated assets method

Under the Tax Act[60], the ordinary or statutory income[61] of a complying superannuation fund is ECPI where it is derived from segregated current pension assets.

In addition, any capital gain or loss realised on segregated current pension assets is completely disregarded.[62]

FirstTech comment

An SMSF that has disregarded small fund assets for a year cannot use the segregated assets method. See '**Disregarded small fund assets**' later in this section for further information.

What is a segregated current pension asset?

In relation to account-based income streams (account-based pensions, allocated pensions and term allocated pensions), a segregated current pension asset is an asset that is invested, held in reserve or otherwise dealt with solely to enable the fund to discharge its liabilities in relation to retirement phase superannuation income streams.

There are two ways that assets supporting account-based income streams can qualify as segregated current pension assets.

60 *Income Tax Assessment Act 1997*, s295-385.
61 Excluding assessable contributions and non-arm's length income.
62 *Income Tax Assessment Act 1997*, s118-320.

Fund 100% in retirement phase

Where a fund is 100% in retirement phase at a time and all interests are account-based income streams, all the assets of the fund at that time are, by default, segregated current pension assets.

Where such a fund is 100% in retirement phase for a whole income year, the fund's assets are segregated current pension assets for that whole income year.

Example:

An SMSF has two members. Throughout an income year, each member has an account-based pension and no other superannuation interests.

All of the fund's assets are segregated current pension assets for all of the income year. As a result, all of the fund's investment income is ECPI, and any capital gains or losses realised by the fund during the income year are disregarded.

FirstTech comment

An SMSF being 100% in retirement phase for a whole year is ideal from a tax perspective, as all assets are segregated current pension assets for the whole income year and the fund's investment income (including capital gain) for the year is tax free.

However, it's important to be aware of transactions which lead to a fund no longer being 100% in retirement phase for a whole year. For example, if a fund only has account-based pensions during a year, but a small member contribution is made to the fund late in the income year, the fund would no longer be 100% in retirement phase (and would no longer automatically have segregated current pension assets) from that time.

Where the fund is instead only 100% in retirement phase for part of an income year, all the fund's assets are, by default, segregated current pension assets for that part of the income year. However, in this situation, the trustee can choose for those assets to not be considered segregated current pension assets during that time, effectively allowing the unsegregated assets method to apply instead for the whole income year.

See 'Choice to apply unsegregated assets method' later in this section for further information and an example about this choice.

Fund partially in retirement phase

Where part of the fund is in retirement phase at a time and those income streams are account-based income streams, and the fund's records evidence that specific assets are set aside solely for the purpose of discharging liabilities for those income streams, the assets at that time are segregated current pension assets. This effectively means that the fund then has two pools of assets – a segregated pension asset pool and a pool of the fund's remaining assets.

This would generally occur via a trustee resolution/minute at the time of commencing a retirement phase income stream. In practice, it's rare for SMSFs to choose the segregated assets method where only part of the fund is in retirement phase due to the additional administrative complexity and costs involved.

Example:

An SMSF has two members. At the start of an income year, one member commences an account-based pension with a starting balance of $500,000.

At the time of commencing the pension, the trustees determine (via trustee resolution) that a portfolio of specific listed shares and a cash account will be set aside solely for the purpose of discharging liabilities relating to the account-based pension.

Assuming the account-based pension continues throughout the income year, all investment income generated from the listed share portfolio and cash account is ECPI, and any capital gains or losses realised in relation to these investments during the income year are disregarded.

Conversely, earnings and realised capital gains during the income year on the fund's other investments would not qualify for any exemption for ECPI purposes.

Can't segregate part of an asset

The ATO has long held the view that part of an individual asset cannot be a segregated current pension asset.

For example, where an SMSF holds an investment property worth $1 million, and a fund member is about to commence a $700,000 account-based pension, it is not possible to use the segregated assets method by classifying 70% of the property as a segregated current pension asset.

For some SMSFs with a large portion of the fund invested in a single asset, this may limit access to the segregated assets method.

This issue is unlikely to arise for most financial assets such as shares and managed funds, as each share or unit is its own asset.

For example, if the fund mentioned above instead held a $1 million listed share portfolio, it would be possible to identify specific shares from that portfolio worth $700,000 and determine them to be segregated current pension assets.

Segregation and bank accounts

Historically, many had the view that an SMSF that had both segregated current pension assets and other assets needed to operate two separate bank accounts – one for the pension pool and one for the other asset pool.

However in ATO Tax Determination TD 2014/7, the ATO confirms that in this situation a trustee can alternatively maintain one bank account, where the bank offers the ability to separate the balance into separate sub-accounts or where the trustee is able to administer 'notional' sub-accounts.

Segregated current pension assets and non-account-based income streams

An asset is also a segregated current pension asset at a time if it is invested, held in reserve or otherwise dealt with solely to enable the fund to discharge its liabilities in relation to a retirement phase superannuation income stream, and the trustee obtains an actuarial certificate by the time the fund lodges its income tax return for the year, confirming that the income from the fund's segregated current pension assets will be sufficient to allow the fund to pay its retirement phase income stream liabilities for the year.

This allows SMSFs paying non-account-based income streams (e.g. complying lifetime pensions, complying life-expectancy pensions and flexi-pensions) to use the segregated assets method, with the actuarial certificate essentially determining the level of assets supporting the pensions that can qualify as segregated current pension assets.

Unsegregated assets method

The unsegregated assets method is an alternative to the segregated assets method. It is also sometimes referred to as the proportionate method.

Rather than specific assets being segregated to support retirement phase superannuation income streams, under the unsegregated assets method a percentage of the fund's income that relates to retirement phase income streams is ECPI.

Under the unsegregated assets method[63], ECPI is calculated as a percentage of a complying superannuation fund's ordinary or statutory income[64] (that doesn't relate to segregated current pension assets) including net capital gains.

This percentage is calculated by determining the proportion of an SMSF's total liabilities that relate to retirement phase interests and then applying that proportion to either all of the fund's income for the whole year, or all of the fund's income derived during a certain period of the year, depending on the circumstances.

This calculation is performed by an actuary – a fund using the unsegregated assets method for an income year must obtain an actuarial certificate confirming the percentage of the fund's income that is ECPI.[65]

63 *Income Tax Assessment Act 1997*, s295-390.
64 Excluding income from segregated non-current assets (e.g. assets solely supporting accumulation liabilities), assessable contributions and non-arm's length income.
65 *Income Tax Assessment Act 1997*, s295-390(4).

The formula used to determine the fund's ECPI under the unsegregated method is as follows:

$$\text{Exempt income} = \text{Income} \times \frac{\text{Average value of current pension liabilities}}{\text{Average value of superannuation liabilities}}$$

Where:

- **Income** = any ordinary and statutory income of the fund during the year, less income from segregated current pension assets.[66]
- **Average value of current pension liabilities** = the average value for the income year of the SMSFs current pension liabilities (contingent or not) for retirement phase income stream benefits payable in that year; this does not include liabilities that are met by segregated current pension assets.
- **Average value of superannuation liabilities** = the average value for the income year of the SMSF's current and future liabilities (contingent or not) for superannuation benefits in respect of which contributions have, or were liable to have, been made. This does not include liabilities for segregated current pension assets or segregated non-current assets (for example, assets solely supporting accumulation liabilities).

Example:

An SMSF has two members. At the start of an income year, one member commences an account-based pension with a starting balance of $500,000. The other member has $500,000 in accumulation phase at that time.

The trustees choose not to segregate assets in relation to the account-based pension.

Assuming the superannuation and pension balances remain the same throughout the income year[67], the average value of current pension liabilities would be 50% of the average value of superannuation liabilities. Therefore, 50% of the fund's ordinary and statutory investment income for the income year would be ECPI.

As the above formula involves average values, the fund's actuary will calculate the average member benefit values taking into account contributions and benefit payments made during the year.

66 Also excluding income from segregated non-current assets (e.g. assets solely supporting accumulation liabilities), assessable contributions and non-arm's length income.
67 This is a simplistic example – in reality, the fund's actuary would calculate these average values allowing for contributions and benefit payments made during the year.

In addition, where a member commences or ceases a retirement phase income stream part way through an income year, the actuary will also need to pro-rata the pension liability, based on the number of days during the year the pension was actually paid. For information about when an income stream commences and ceases, see section 7.7.

Choice to apply unsegregated assets method

As discussed in 'Segregated assets method' earlier in this section, an SMSF that is 100% in retirement phase for part of an income year will, by default, have segregated current pension assets for that part of the income year.

This could occur where, part-way through an income year a fund started to be, or ceased to be, 100% in retirement phase. Such an SMSF may therefore have to use multiple asset segregation methods for that income year.

To address this issue, a choice is available from the 2021–22 income year onwards, where an SMSF that would otherwise have segregated current pension assets for part of an income year due to the fund being 100% in retirement phase for that part of the year, can choose to simply use the unsegregated assets method for the whole income year.

Example:

At the start of an income year, an SMSF has two members:

- Member 1 has an accumulation account.
- Member 2 has an account-based pension.

The trustees have chosen not to segregate the assets supporting the account-based pension.

On 6 December in the income year, Member 1 satisfies a full condition of release and commences an account-based pension with 100% of their benefits in the fund. The SMSF is then 100% in retirement phase for the rest of the income year.

When calculating the fund's exempt income for the income year, the default approach would be:

- From 1 July to 5 December: the unsegregated assets method applies as the fund has not chosen to segregate assets supporting the account-based pension.
- From 6 December to 30 June: the segregated assets method applies as the fund is 100% in retirement phase.

However, to avoid the complexity and cost of applying multiple different asset segregation methods in the one year, the trustee could instead make the choice for the unsegregated assets method to apply for the entire income year.

When to make the choice – strategy considerations

Where an SMSF's income is spread relatively evenly throughout an income year, there is generally little difference from a tax perspective between the default approach and making the choice to apply the unsegregated assets method for the whole income year.

However, where income is not spread evenly throughout the income year (for example a large capital gain is realised at one point), there can be a big difference between the default approach and choosing to use the unsegregated assets method.

For example:

- Where most of the fund's income will be received during the period the fund is 100% in retirement phase, the default approach will provide a better ECPI outcome.
- Where most of the fund's income will be received during the period the fund is not 100% in retirement phase, making the choice to use the unsegregated assets method for the whole income year will provide a better ECPI outcome.

However, in both cases the extent of any tax savings will very much depend on the fund's particular circumstances.

Disregarded small fund assets

Where an SMSF has disregarded small fund assets for an income year, it cannot use the segregated assets method for that income year and must instead use the unsegregated assets method to calculate ECPI.

All an SMSF's assets are disregarded small fund assets for an income year if:

- the SMSF pays a retirement phase income stream at any time during the income year, and
- a member of the SMSF:
    - has an interest in the SMSF at any time during the income year, and
    - has a total superannuation balance of more than $1.6 million just before the start of the income year, and
    - is receiving a retirement phase income stream from any fund just before the start of the income year.

FirstTech comment

If there are members of an SMSF that had a total superannuation balance of more than $1.6 million just before the start of an income year, but none of those members had a retirement phase income stream (in any fund) just before the start of that income year, the SMSF will not have disregarded small fund assets for the income year – even if the SMSF starts to pay a retirement phase income stream during the income year.

Assuming an SMSF does have members with a total superannuation balance of more than $1.6 million, but those members have no retirement phase income streams in other funds, this means that:

- The SMSF can choose to apply either the segregated or unsegregated approach in the income year that one of those members first commences an account-based pension.
  - This includes being able to apply the default approach during years when a choice is available, see 'Choice to apply unsegregated assets method' earlier in this section for further information.
- The SMSF must then apply the unsegregated assets approach in future income years[68] (except where the fund is 100% in retirement phase for the whole of those future years – see below).

However, from the 2021–22 income year onwards, an exception applies if such a fund is 100% in retirement phase for a whole year (for example, the only interests in the fund for the whole year are account-based income streams). In that case:

- the fund's assets will not be disregarded small fund assets for the year, and
- all the fund's assets will be segregated current pension assets for the whole income year.

Whether to choose segregated or unsegregated

While the unsegregated assets method is the most popular method for SMSFs due to administrative simplicity, whether a fund should use a particular method should include an analysis of a range of factors. These include:

- Whether the fund is prevented from using the segregated assets method due to having disregarded small fund assets.
- The additional administration cost of using the segregated assets method (e.g., maintaining two separate asset pools and needing to account for each pool separately).
- The cost of an annual actuarial certificate if using the unsegregated assets method.

68 Assuming that the relevant member continues to have a total superannuation balance above $1.6 million just prior to the start of those future years.

- Whether there are any potential differences in tax outcomes depending on what assets are held and what method is used.
- A range of CGT considerations – see the next section for further information.
- The desire for administrative simplicity.

CGT considerations

Capital losses

Any capital losses that arise on a segregated current pension asset are disregarded. They are therefore not included when calculating the fund's net capital gain or loss for the income year, and do not count towards any net capital loss available to be carried forward to future years.

In contrast, where a fund uses the unsegregated assets method, the fund's realised capital gains or losses from all assets[69] are used to determine its net capital gain or loss.

While any net capital gain is then apportioned for ECPI purposes under the unsegregated approach, any net capital loss is not apportioned and is fully available to carry forward and use in future years.

Using the unsegregated assets method may therefore provide better future CGT outcomes where an SMSF expects to realise capital losses.

For example, some funds may choose to retain very small accumulation balances to allow the fund to use the unsegregated method. This can then allow the trustees to calculate and carry forward any realised capital losses just in case the fund may end up with assessable capital gains in the future, such as due to the admission of younger members (i.e. adult children) with accumulation interests.

Assets to be sold with large gains

Where an SMSF has assets with large unrealised capital gains that it may wish to dispose of in a future income year, and one or more members will be commencing a retirement phase income stream, CGT may be minimised by using the segregated assets method (and including those assets in the segregated current pension asset pool).

This strategy ensures that any capital gain realised on those assets are disregarded and tax free, rather than any net capital gain being apportioned for ECPI purposes.

69 Except where any gain or loss is disregarded or reduced under another provision of the Tax Act.

Capital gains timing in year a pension starts or stops

Where an SMSF is commencing or ceasing a retirement phase income stream during an income year and also plans to dispose of assets and realise a capital gain during that income year, timing is important to minimise tax. However, different timing considerations apply depending on whether the fund is using the segregated or unsegregated assets method.

For information about when an income stream commences and ceases, see later in this section.

If the fund is commencing or ceasing a retirement phase income stream using the segregated assets method, the timing of the disposal is key – it should occur either after the pension commences or before the pension ceases to ensure that the assets are segregated current pension assets at the time of disposal.

Example:

An SMSF has two members. At the start of an income year, two members both have $500,000 in accumulation phase.

On 1 January in the income year one member uses their entire $500,000 balance to commence an account-based pension.

The trustees choose to segregate the assets supporting the account-based pension.

On 1 February in the income year, one of the assets supporting the pension is sold, realising a capital gain of $100,000. However, as the asset is a segregated current pension asset at the time of disposal, any capital gain is ignored and does not increase the fund's tax liability.

If the fund is commencing or ceasing a retirement phase income stream and using the unsegregated assets method for that whole year, the timing of asset disposal is not relevant. Instead, the timing during the income year when the pension commences or ceases is generally important as it impacts the 'average value of current pension liabilities' for the year – one of the components in the unsegregated assets method ECPI formula. At a high level, the longer the pension runs during the income year, the more capital gain that will be ECPI.

Example:

An SMSF has two members. At the start of an income year, both members have $500,000 in accumulation phase.

On 24 July in the income year, the fund disposes of an asset, realising a capital gain of $100,000 ($66,667 after discounting).

On 1 April in the income year, one member uses their entire $500,000 balance to commence an account-based pension. The fund elects to use the unsegregated assets method for the income year.

As the pension only runs for approximately 25% of the income year, assuming the superannuation and pension balances remain the same throughout the income year[70], the amount of discounted capital gain that is ECPI is calculated as follows:

$66,667 × $125,000[71] / $1m = $8,333

However, if the member instead commenced their account-based pension on 1 October in the income year, the pension would instead run for approximately 75% of the income year. Again assuming the superannuation and pension balances remain the same throughout the income year, the amount of discounted capital gain that is ECPI is calculated as follows:

$66,667 × $375,000[72] / $1m = $25,000

However, the timing in the income year that a retirement phase income stream ceases via commutation will be largely irrelevant where the commuted amount is then immediately removed from the fund (via rollover or lump sum withdrawal).

In this case, both the average value of current pension liabilities and average value of superannuation liabilities experience a comparable reduction, meaning the fund's ECPI percentage should be largely the same regardless of when the pension ceases during the income year.

In contrast, where a retirement phase income stream is fully commuted and the commuted amount is left in accumulation phase within the fund, the timing of the commutation during the income year can have a large impact on the fund's ECPI percentage for the income year under the unsegregated assets method.

70 This is a simplistic example – in reality the fund's actuary would calculate these average values allowing for contributions and benefit payments made during the year.
71 $500,000 pension × one quarter of the income year. Note that an actual calculation would look at the specific number of days during the year that the pension runs for.
72 $500,000 pension × three quarters of the income year. Note that an actual calculation would look at the specific number of days during the year that the pension runs for.

FirstTech comment: withdrawals from accumulation phase

Where a fund with accumulation phase interests and retirement phase income streams is using the unsegregated assets method to calculate ECPI, the timing of any withdrawals from accumulation phase is also important as it impacts the 'average value of superannuation liabilities' for the year – one of the components in the unsegregated assets method ECPI formula.

In this case, generally the earlier during an income year any withdrawals are made from accumulation phase, the more beneficial for the fund's ECPI calculation for that year.

Can an SMSF segregate assets for purposes other than ECPI?

Yes. While this article discusses the segregated assets method for ECPI purposes, it is possible (subject to an SMSF's governing rules) for the fund to segregate assets for accounting or investment purposes.

This type of assets segregation would most commonly include segregating pools of assets for specific members or groups of members, and may be considered where:

- Fund members have different risk profiles (the fund may segregate assets into multiple pools with their own investment strategies – effectively a type of member investment choice).
- The fund has multiple generations of members (the fund may maintain a separate asset pool for parents and children).

Under this method, the earnings and costs specifically relating to each pool of assets would be allocated to / against that asset pool.

Where an SMSF has disregarded small fund assets (see 'Disregarded small fund assets' earlier in this section), it cannot use the segregated assets method for ECPI purposes. However, there's nothing preventing such a fund segregating assets for accounting or investment purposes.

Importantly, segregating assets for other purposes has no effect on the calculation of ECPI – if the fund does not have segregated current pension assets for ECPI purposes, it would need to use the unsegregated assets approach to calculate ECPI.

Is it possible to switch segregation methods?

Where either segregation method is available to an SMSF, there is no restriction requiring the same method to be used for all income years.

An SMSF may therefore switch from the segregated assets method to unsegregated assets method (or vice versa) in a future income year.

However, where the sole or dominant purpose of switching segregation methods is to obtain a tax advantage, it is possible that the ATO could seek to apply Part IVA anti-avoidance provisions to the fund. A trustee should therefore seek professional tax advice before switching segregation methods.

When a superannuation income stream commences and ceases

Identifying when a retirement phase income stream commences or ceases is important as it will allow the trustee to:

- identify the time and value of credits and debits that need to be reported for transfer balance cap purposes
- identify whether an amount of income (including realised capital gains) received by a trustee using the segregated assets method will be either assessable or exempt income (or disregarded in the case of a realised capital gain)
- calculate the overall average value of the fund's pension and superannuation liabilities during a year where the trustee is using the unsegregated assets method.

To assist in identifying the points in time when an account-based pension starts and stops the ATO released TR 2013/5.[73]

For information about retirement phase income streams, see section 7.7.

When an income stream commences

In the ruling the ATO confirm that:

- a superannuation income stream cannot commence until all capital which is to support the income stream has been added to the relevant superannuation interest
- the commencement date must be determined with reference to the terms and conditions of the income stream, as agreed between the member and the trustee
- the commencement date may occur before the date of the first payment, but cannot be before the member's request or application.

Therefore, a retirement phase income stream can only commence after the member has made a request and the trustee has consented to it and has all the assets that will be used to commence the income stream. As a result, it will not be possible to backdate the income stream commencement to a date earlier than when the request was made.

When an income stream ceases

In TR 2013/5 the ATO outlined its view that an income stream will cease when there is no longer a member who is entitled, or a dependant beneficiary of a member who is automatically entitled, to be paid a superannuation income stream. The ruling then outlines the common circumstances where this will occur.

These include:

- where the income stream failed to satisfy the requirements for a superannuation pension in the SIS Regulations. For example, an account-based pension will have ceased at the beginning of a financial year where the pension failed to satisfy the requirements for an account-based pension at any time during the year.
- where the capital supporting the income stream has been exhausted.

73 TR 2013/5 Income tax: when a superannuation income stream commences and ceases.

- where the member has made a request to fully commute the income stream and the request has taken effect. In this case the ruling confirms that the request must take effect before the time the lump sum is paid. Note – the ruling also confirms that an income stream will not cease where a partial commutation occurs.
- in the event of the death of a member receiving a superannuation income stream, unless a dependent beneficiary is automatically entitled to receive an income stream on the death of the member. In this case, the income stream will be considered to continue.

Exception where retirement phase income stream ceases due to death

If a member dies while receiving a retirement phase income stream, and that income stream then automatically reverts to a reversionary beneficiary (or an income stream must continue to be paid to a beneficiary under a binding death nomination), it will not cease.

This allows the earnings tax exemption to continue at all times during the transition from paying the original pensioner to paying the reversionary beneficiary, and payments from the pension will maintain the same tax free proportion in the beneficiary's hands.[74]

In other situations, including where a lump sum death benefit is paid or a new retirement phase income stream is commenced, TR 2013/5 provides that the original income stream will have ceased at the time of the recipient's death. Therefore, this could have resulted in significant CGT implications when selling or transferring superannuation fund assets to pay a death benefit lump sum.

To avoid this situation, regulations now allow the superannuation balance of a retirement phase income stream recipient who has died to continue to be treated as a retirement phase income stream for tax purposes between the date of death and the date a lump sum death benefit is paid (or a new retirement phase income stream is commenced).

These regulations also allow funds to calculate the tax-free and taxable component of such superannuation balances differently. For more information, please see section 8.7.

What amount will the tax exemption apply to?

The pension tax exemption will apply to the deceased member's balance at the date of death, plus any investment earnings that accrue on this balance. The following amounts are specifically excluded:

- insurance proceeds (for example, life insurance that forms part of the deceased member's benefits in the fund)
- amounts arising from self-insurance.

Therefore, care should be taken where amounts other than investment earnings are added to the original superannuation interest, for example life insurance proceeds. These amounts will not be treated as a superannuation income stream for earnings tax exemption or proportioning purposes.

74 However, tax consequences can arise where the reversionary beneficiary wants to immediately commute part or all of their pension to a lump sum.

5.6 Deductions available

Under section 8–1 of the Tax Act, a taxpayer can claim an outgoing as a deduction where it was incurred in the course of gaining or producing assessable income. A taxpayer is also generally able to deduct an outgoing where it was necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. Under section 25–5 of the Tax Act, a taxpayer is also able to claim a deduction for expenditure in respect of managing their tax affairs.

Tax ruling TR 93/17[75] sets out the ATO's views on how these rules apply to superannuation funds.

Ongoing operating expenses

Where a fund incurs expenses in gaining or producing the fund's assessable income, or to carry on the fund's operations, those expenses will generally be deductible.

These expenses could include:

- the cost of any advice relating to the review and management of the fund's existing investment strategy
- ongoing investment management fees and charges
- accountancy, tax agent and auditor fees
- actuarial costs
- any costs incurred in connection with the calculation and payment of benefits to members in the fund
- the cost incurred in amending a fund's trust deed to comply with changes in government regulations[76]
- any interest incurred on a limited recourse borrowing used to acquire an income producing asset
- the cost incurred directly in association with obtaining assessable contributions.

However, in order for any ongoing management fees or charges to be deductible, the trustee must incur those expenses directly. For example, where a trustee invested in a managed fund which distributed income net of ongoing fees and charges, those fees and charges would not be deductible, as the trustee will not have incurred the fees directly.

Alternatively, where a fund pays an ongoing adviser service fee that is paid directly by the trustee, the fee will generally be deductible to the fund to the extent that it relates to the fund producing assessable income. However, care should be taken where an adviser service fee relates to advice given to the investor both as an individual and as the trustee of their SMSF. In this case, the trustee should be mindful of the sole purpose test and the prohibition on providing financial assistance to a member or a relative.

For more information on the sole purpose test, see *Chapter 3: Trustee responsibilities* and *Chapter 4: Superannuation investment rules*.

75 Taxation Ruling TR 93/17: *Income Tax: Income tax deductions available to superannuation funds.*
76 TR 93/17 Income tax: *Income tax deductions available to superannuation funds*

Capital expenses

Section 8–1 of the Tax Act also confirms that any expenses that are of a capital nature are not deductible.

Capital expenses

Expenses of a capital nature generally include any expenditure incurred in establishing, replacing or enlarging a profit making enterprise. Therefore, any costs or outgoings to establish an SMSF would generally be of a capital nature and would not be deductible to the fund or to its members.[77] These outgoings could include:

- the cost of any advice relating to the establishment of an SMSF, including the costs of obtaining and executing a trust deed
- the cost of establishing an investment strategy for the fund
- any upfront fees or other charges incurred in investing the fund's assets.

Where an SMSF trustee pays upfront fees or charges to acquire an asset, such as managed fund application fees, the trustee can include those outgoings in the asset's cost base, or reduced cost base, for the purpose of calculating any net capital gains or losses on the disposal of the asset.

Expenses relating to non-assessable income

Under section 8–1 of the Tax Act, any outgoings incurred in gaining or producing non-assessable income are not deductible. Therefore, any expenses (including any ongoing adviser service fees charged for a member's retirement phase interests) incurred by a superannuation fund in gaining or producing income that is exempt from income tax, such as income derived from segregated current pension assets, are not deductible.

TR 93/17 confirms that where a fund has incurred expenses that relate to the production of both assessable and non-assessable income, the expenses, including any general administration expenses related to managing a superannuation fund, must be apportioned so that only the proportion that relates to the production of assessable income is claimed as a deduction.[78]

Apportionment methodology

In TR 93/17, the ATO confirms that if a distinct or severable part of the expense relates to gaining or producing assessable income, the expenditure can be apportioned accordingly.

The ATO confirms that this method should be used to apportion expenditure where possible.

77 Where an SMSF is carrying on a business, the trustee may be able deduct certain capital costs over 5 years under section 40-880 of the Tax Act.

78 Alternatively, under subsection 8-1(1)(b) of the Tax Act, expenditure may also be deductible where it is an essential part of the cost of the fund's business operations.

Alternatively, where an expense relates to gaining and producing assessable income and non-assessable income generally (that is, it is not possible to identify a component that relates specifically to either assessable or non-assessable income), the expense must be apportioned in a way that results in a fair and reasonable assessment of the extent to which it relates to the fund's assessable income.

TR 93/17 sets out two methods for apportioning a fund's expenses which are considered generally acceptable, which are:

Non-capital expenditure incurred in gaining or producing investment income (for example, investment manager fees) can be apportioned using the following formula:

$$\text{Expenditure} \times \frac{\text{Assessable investment income}}{\text{Total investment income}}$$

Where:

- assessable investment income for apportionment purposes includes ordinary and statutory income (other than exempt current pension income) received from investments, such as net capital gains and imputation credits and also income from units in a pooled superannuation trust, life insurance policies issued by a life insurance company or interests in a trust whose assets consist only of life insurance policies issued by a life insurance company
- total investment income means assessable investment income (as above) plus non-assessable investment income (whether exempt income or non-assessable non-exempt income).

General administrative expenses relevant to the operation of the fund as a whole can be apportioned as follows:

$$\text{General administrative expense} \times \frac{\text{Assessable income}}{\text{Total income}}$$

Where:

- assessable income for apportionment purposes includes (but is not limited to) all contributions to the fund (including those that are not assessable to the fund and rollovers), and assessable investment income (as discussed above)
- total income means assessable income plus exempt income and non-assessable non-exempt income.

Alternative apportionment methodology based on actuary's certificate

In TR 93/17, the ATO confirms that where an unsegregated fund obtains (as required) an actuary's certificate, specifying the proportion of the fund's income that is exempt from tax, it may be fair and reasonable for the fund to use the exempt income percentage from the actuary's certificate as an alternative method to the methods above to determine the deductible portion of expenses that cannot be divided into distinct and severable parts.

The deductible portion of the fund's expenses using the actuary's certificate is calculated as follows:

Expenses × Assessable income percentage

Where:

- **Assessable income percentage** is 100%, minus the exempt income percentage specified on the actuary's certificate.

FirstTech comment

Changing apportionment methods

Where an SMSF trustee elects to use a particular method of apportionment, the ATO indicates in TR 93/17 that it expects that such a method would be used consistently over time for that type of expenditure unless there were specific reasons for departure in a given year, and that any decision to change to another method would be applied consistently into the future.

Where the method of apportionment for a particular type of expenditure is changed several times over a small number of years, the ATO indicates that it may bring into question the appropriateness of the methodology being used in each of those years.

Apportionment not required for expenses solely relating to obtaining contributions

In TR 93/17, the ATO confirms that non-capital expenses incurred solely in gaining contributions made to the fund are tax-deductible and do not need to be apportioned.

Apportionment not required for expenses deductible under section 25-5 of Tax Act

In TR 93/17, the ATO confirms that where expenses are deductible under section 25–5 of the Tax Act, they remain fully tax deductible and do not need to be apportioned based on the fund's assessable and non-assessable income. Non capital expenses that are deductible under section 25-5 of the Tax Act are those that relate to:

- the cost of the trustee managing the fund's tax affairs
- the SMSF supervisory levy
- the cost of complying with a Commonwealth law that relates to the fund's tax affairs
- the general interest charge or shortfall interest charge
- penalties imposed by Subdivision 162D of the GST Act[79]
- the cost of obtaining valuations by the Commissioner in certain circumstances.

79 *A New Tax System (Goods and Services Tax) Act 1999.*

Other specific deductions available

Under the Tax Act, complying superannuation funds are also entitled to a range of statutory deductions.

These deductions are summarised as follows.

Insurance premiums and arrangements

Under section 295–465 of the Tax Act, a fund can deduct the part of any insurance premium that is specified as being wholly for the liability to pay:

- a superannuation death benefit (including a terminal illness benefit)
- a disability superannuation benefit
- a temporary disability benefit paid in the form of an income stream.

This means trustees will generally be able to claim 100% of the cost of any life, total and permanent disability (TPD) or salary continuance policy held to provide insurance cover for one or more members.

Special rules for deductibility of TPD own occupation policies

Tax Ruling TR 2012/6[80], confirms that a superannuation fund will only be able to claim a tax deduction for a TPD insurance premium where:

- there is a connection between that payment and a current or contingent liability of the fund to provide a disability superannuation benefit, and
- upon the occurrence of an insured event, the trustee would have a current or contingent obligation to pay a disability superannuation benefit under the terms of the fund's trust deed.

A disability superannuation benefit is defined in the Tax Act as a superannuation benefit paid to an individual because they suffer ill-health and two legally qualified medical practitioners have certified that they are unlikely to ever become gainfully employed in a capacity for which they are reasonably qualified through education, training or experience.

Importantly, TR 2012/6 confirms that the degree of ill-health that must be suffered to qualify for a disability superannuation benefit under the Tax Act is identical to the degree of ill-health that must be suffered to satisfy a condition of release under the grounds of permanent incapacity under the SIS Regulations.

Therefore, the premiums for a TPD insurance policy which covers events that align with the permanent incapacity condition of release will generally be deductible.

80 Taxation Ruling TR 2012/6: *Income Tax: Deductibility under subsection 295–465(1) of the Income Tax Assessment Act 1997 of premiums paid by a complying superannuation fund for an insurance policy providing Total and Permanent Disability cover in respect of its members.*

Meaning of permanent incapacity

Permanent incapacity means ill-health (whether physical or mental), where the trustee is reasonably satisfied that the member is unlikely, because of the ill-health, to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

However, the ruling also confirms that certain policies may cover a range of events, only some of which would align with the definition of a disability superannuation benefit. For example, a grandfathered own occupation TPD policy[81], which also covers any occupation TPD events would cover a range of events, of which only some would align with the definition of a disability superannuation benefit. In these situations, the ruling confirms that the fund will only be able to claim part of the premium as a deduction:

- where the insurer has identified the part of the premium that relates to a liability to pay a disability superannuation benefit – that part of the premium
- where the insurer has not identified a part of the premium that relates to a liability to pay a disability superannuation benefit by:
  - applying a set percentage depending on the type of policy (and inclusions) as specified in the Tax Regulations – see Table 5.2, or
  - obtaining an actuarial certificate which identifies the part of the premium that is attributable to events that would give rise to a liability to provide a disability superannuation benefit.

81 Please see section 6.2 Ability to acquire insurance policies, for more information on grandfathered insurance policies.

Table 5.2 Standard deductions available for TPD insurance

Insurance policy	Specified deductible proportion
TPD – any occupation	100%
TPD – any occupation with one or more of the following inclusions: • activities of daily living • cognitive loss • loss of limb • domestic (home) duties	100%
TPD – own occupation	67%
TPD – own occupation with one or more of the following inclusions: • activities of daily living • cognitive loss • loss of limb • domestic (home) duties	67%
TPD – own occupation bundled with death (life) cover	80%
TPD – own occupation bundled with death (life) cover with one or more of the following inclusions: • activities of daily living • cognitive loss • loss of limb • domestic (home) duties	80%

Case study – deduction for own occupation TPD policy

As a trustee of his fund, Thomas paid $1,000 for a premium for a grandfathered own occupation TPD policy acquired before 1 July 2014. At the end of the year, the insurer sent Thomas a statement specifying that $800 of the total premium related to events that would lead to a liability to pay a disability superannuation benefit. In this case, Thomas' fund could claim $800 as a deduction.

Alternatively, if the insurer had not specified any proportion, Thomas could have either claimed a deduction of $670 under the Tax Regulations or he could have engaged an actuary to determine the amount of the premium that is deductible.

Deduction for a future liability to pay benefits

Alternatively, a trustee can claim a deduction under section 295–470 of the Tax Act for the future liability to pay benefits based on the actual cost of providing the death or disability benefits which arise in each year.

However, the deduction allowable under section 295–470 of the Tax Act is only available if the trustee chooses not to claim a deduction for the cost of death or disability insurance premiums for that year and the fund pays a superannuation death or disability benefit in consequence of a member's termination of employment (or pays a benefit because of a temporary inability to work).

That is, for the fund to be eligible to claim a deduction, the member must have been employed and the payment must have been made in consequence of their termination through death or their inability to work. The deduction available to a fund is calculated using the following formula:

$$\textbf{Deduction} = \textbf{Benefit amount} \times \frac{\textbf{Future service days}}{\textbf{Total service days}}$$

where:

- **Benefit amount** = the value of the superannuation interest used to pay a lump sum or pension, or in the case of income protection benefits paid to the member, the amount of payments received during the financial year
- **Future service days** = days from the date of employment terminating to the member's last retirement date (generally age 65)
- **Total service days** = future service days plus the member's existing service days.

Where an event has occurred which may entitle a trustee to choose to claim a future liability to pay benefits deduction, they may wish to consider:

- the deduction will generally not be available where the relevant member was over age 65
- where the trustee elects to claim the deduction, they will not be able to claim a deduction for any insurance premiums paid by the fund in that year or future years
- as the deduction reduces with age, it may be better to claim the cost of the premiums where the member is approaching age 65
- where the member's benefit is large compared to the level of insurance, the future liability deduction should provide a relatively larger deduction
- where the deduction exceeds the fund's income, the resulting tax loss can be carried forward to future years.

FirstTech comment

Ability to claim future liability deduction uncertain

The requirement for a trustee to pay a superannuation death or disability benefit in consequence of a member's termination of employment may render the deduction difficult to claim in most circumstances.

For example, the ATO considers[82] that a payment is made in consequence of the termination of the employment of a taxpayer if the payment 'follows as an effect or result of' the termination. That is, but for the termination of employment, the payment would not have been made to the taxpayer. Therefore, if the member or their beneficiaries would receive a superannuation death or disability benefit regardless of whether they were employed before their death or disability, which they generally would, it is hard to see how the trustee would be able to satisfy the eligibility criteria to be able to claim the deduction.

Trustees wishing to claim the deduction may therefore wish to consider applying for a private binding ruling to confirm eligibility.

For more information on future liability deductions see *Chapter 6: SMSFs and insurance*.

Tax losses

Tax losses from previous years can be carried forward to future years and used to offset taxable income in that year, including tax on assessable contributions. Unused tax losses carried forward to a future year must first be used to reduce net exempt income in that year, before being used to reduce taxable income.

In general, a tax loss occurs where the total deductions the SMSF can claim for an income year exceed the total of the fund's assessable income and exempt income.[83]

Tax losses vs capital losses

It is important to distinguish between a tax loss and a capital loss. A capital loss can only be offset against any capital gains in the same income year, or carried forward to be offset against future capital gains – it cannot be offset against other income.

82 TR 2003/13 *Income tax: eligible termination payments (ETP): payments made in consequence of the termination of any employment: meaning of the phrase 'in consequence of'.*
83 See section 36–10 of the Tax Act for calculation of tax losses.

5.7 Tax rates applicable to SMSFs

A complying superannuation fund's assessable income may have two components, which are subject to different rates of tax:

- low tax component, taxed at 15%
- non-arm's length component, taxed at 45%.

Low tax component

The low tax component is defined in section 295–545 of the Tax Act and is calculated as follows:

Low tax component = Total taxable income – Non-arm's length component

Where a fund has no non-arm's length component, all of its taxable income will be taxed at 15%.

Non-arm's length component

The non-arm's length component is defined as non-arm's length income (NALI) less any deductions attributable to that income. However, an SMSF's total non-arm's length component for an income year is capped at an amount equal to the fund's total taxable income for the year other than assessable contributions and excluding deductions against assessable contributions.

Non-arm's length income is defined in section 295–550 of the Tax Act and includes amounts of ordinary or statutory income of a complying superannuation fund that is:

- derived from a scheme where the superannuation fund and another party are not dealing with each other on an arm's length basis, and the amount of income received by the fund is more than it would have received if they were dealing on an arm's length basis
- a dividend from a private company where the amount is not consistent with an arm's length dealing
- a distribution from a discretionary or non-fixed trust
- a distribution from a unit trust where the income was derived under a scheme where the parties were not dealing at arm's length and the amount of income is more than the amount that the superannuation fund would have received if they were dealing on an arm's length basis.

To provide further clarity around the circumstances in which a superannuation fund will derive non-arm's length income, the ATO released a number of rulings and guides. These include TR 2006/7[84] which provides numerous examples of situations where a fund's income will be non-arm's length income. These include where a trustee:

- received higher than reasonable dividends from a private company
- received any income as the beneficiary of a discretionary trust
- leased a commercial property to a related party and received a higher than market value amount of rental income
- was issued with units in an unrelated trust that conferred a fixed entitlement to the income of this trust for less than their market value but received distributions of income in proportion to its unit holding
- received distributions of income in proportion to its unit holding in a unit trust but the trust's income was inflated via the distribution of income from a discretionary trust.

The ATO also released PCG 2016/16,[85] which outlines the factors it will take into account to determine when a trust is a fixed trust.

Amount of non-arm's length income

Where a fund earns NALI, the whole of the income derived under that arrangement will be NALI. Therefore, the whole amount will be taxed as non-arm's length income and not just the amount above what would have been earned if the parties had been dealing with each other on an arm's length basis.

For example, where a trustee leased a commercial property to a related party for double the market rate of rent, the full amount of the rent received from the related party would be non-arm's length income, rather than just the amount received in excess of an arm's length amount.

However, NALI that arises due to a non-arm's length expense (NALE) may be calculated differently and depend on whether the expense related to a specific asset or is a general fund expense. See later in this section for further information.

84 TR 2006/7 *Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income.*
85 Practical Compliance Guidelines PCG 2016/16: Fixed entitlements and fixed trusts

Non-arm's length expenses (NALE)

FirstTech comment: Recent amendments to NALE rules

The following changes to non-arm's length expense (NALE) rules have recently passed parliament[86]:

- Capping the level of NALI arising from a general fund expense that is NALE to twice the difference between the actual amount of the expense incurred and the amount of the expense that might have been expected if the parties had been dealing at arm's length.
- Exempting large super funds from the NALE rules completely.

These changes apply retrospectively to income derived from the 2018–19 income year. In addition, non-arm's length expenses derived by an SMSF prior to 1 July 2018 will not cause NALI to arise.

Under the Tax Act an amount of ordinary or statutory income of an SMSF can also be NALI where, due to a scheme, the fund incurs a non-arm's length expense (NALE) in relation to the derivation of that income.

For example, an amount of an SMSF's ordinary or statutory income will be NALI where:

- there is a scheme in which the parties were not dealing with each other at arm's length, and
- the fund incurred a loss, outgoing or expenditure of an amount in gaining or producing the income, but the amount of the loss, outgoing or expenditure was less than the amount that the fund might have been expected to incur had those parties been dealing with each other at arm's length in relation to the scheme, or
- the fund did not incur a loss, outgoing or expenditure that the fund might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.

In addition, other income derived by an SMSF as a beneficiary of a trust through holding a fixed entitlement to the income of the trust will also be NALI where:

- there is a scheme in which the parties were not dealing with each other at arm's length, and
- the fund incurs a loss, outgoing or expenditure of an amount in acquiring the entitlement or in gaining or producing the income, and the amount of the loss, outgoing or expenditure is less than the amount that the fund might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme, or
- the fund did not incur a loss, outgoing or expenditure that the fund might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.

86 Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023. At the time of writing, this Bill has passed both houses of parliament and awaits Royal Assent.

However, the amount of NALI that arises from a NALE depends on whether the expense relates to a one or more specific assets, or is a general fund expense.

NALE relating to one or more specific assets

In Law Companion Ruling (LCR) 2021/2, the ATO confirms the NALI provisions will apply where there is a sufficient nexus between a NALE and in gaining or producing the relevant income or in acquiring the relevant entitlement.

Importantly, the ruling also confirms that any expenditure does not need to be deductible for the NALE provisions to apply and that it may be of a revenue or capital nature.

However, note that a NALE incurred prior to 1 July 2018 is not taken into account when determining whether an SMSF has derived NALI.

Expenses of a recurrent nature not relating to the acquisition of an asset

Where a fund incurs a NALE (relating to a specific asset) of a revenue or recurrent nature that does not relate to the acquisition of an asset, the NALE will have a sufficient nexus to all of the income derived from that asset in the relevant year (excluding any realised capital gains).[87]

Therefore, if a fund incurred a NALE of a revenue nature in one year and not in any future years, the NALI provisions would only apply to the income derived from that asset in that particular year and would not impact any future capital gains.

Expenses relating to the acquisition of an asset

Where a fund incurs a NALE of a capital nature to acquire an asset, or it incurs a NALE of a recurrent nature that relates to the acquisition of an asset (such as financing costs), the NALE will have a sufficient nexus to all income derived by the fund in respect of the asset both in the year of acquisition as well as in all future years.

For example, where a fund acquired units in a private unit trust for less than market value, or it borrowed on non-arm's length terms (e.g. nil interest rate) from a related party to acquire a property from a third party at market value, the NALI provisions would apply to all future income (including any future realised capital gains) derived from the asset.

In addition, it's important to note the ATO (in LCR 2021/2) also indicates that a NALE of a capital nature incurred in a year in relation to an existing asset, such as for renovations to an existing property, could permanently taint all of the income in that year and future years, including 100% of any future capital gains, derived from the property even though the property was originally acquired on arm's length terms.[88]

87 See Example 11 (specifically paragraph 75) of LCR 2021/2.
88 See example 9 (specifically paragraph 69) of LCR 2021/2.

FirstTech comment: In-specie contributions and NALI

Where an asset is purchased by an SMSF for less than market value, the ATO has indicated in LCR 2021/2 that where the terms of a contract between the fund and the asset seller make it clear that the fund is purchasing the asset, the difference between the consideration paid by the fund and the market value of the asset purchased under the contract cannot represent the value of an in-specie contribution made by the other party. Such situations will result in the fund deriving NALI.

In contrast, NALI will not arise where market value is paid for the purchase of part of an asset, and the market value of the remainder of the asset is properly characterised as an in-specie contribution. The ATO indicates that an in-specie contribution would involve the contract and records of the fund making clear that the fund:

- is only purchasing part of the asset, and
- is receiving the remaining interest in the asset as an in-specie contribution.

SMSF members and trustee should therefore ensure that any in-specie contributions are properly characterised and recorded to ensure that the NALI provisions do not apply. For further information about in-specie contributions, refer to section 7.2.

NALE that is general fund expense

An SMSF may also incur a NALE (from 2018–19 onwards) that has sufficient nexus to all of the ordinary and/or statutory income derived by the fund (general fund expense). For example, this may occur where a fund incurs a NALE that does not specifically relate to any particular amount being derived by the fund but instead to a generally deductible fund expense.

Examples of general fund expenses could include:

- actuarial costs
- accountancy and administration costs
- cost of pre-retirement financial advice provided to members
- audit and legal costs.

Amount of NALI where NALE which is general fund expense is incurred

Due to recent legislative changes[89] which apply retrospectively from the 2018–19 income year onwards, where a fund incurs a NALE that is a general fund expense, the amount of NALI relating to that expense is capped at twice the difference between the amount of the actual expense incurred and the amount of the expense that might have been expected if the parties had been dealing at arm's length. Where no expense was incurred, the amount would be twice the amount that might have been expected if the parties had been dealing at arm's length.

As mentioned above, however, an SMSF's total non-arm's length income component for an income year is limited to its total taxable income for the year other than assessable contributions and excluding deductions against assessable contributions.

Services provided in capacity as trustee – no NALE

In LCR 2021/2, the ATO confirms the NALE rules will not apply where a trustee (or director of a corporate trustee) provides services (which may relate to a specific asset or the fund in general) in the capacity of trustee, as trustees and corporate trustee directors of SMSFs are prohibited from being remunerated for any duties or services they perform in that capacity.[90]

However, it's important to note that the SIS Act provides an exemption which allows trustees or corporate trustee directors to receive remuneration for duties or services performed by them in a different capacity where they satisfy the requirements under section 17B of the SIS Act. These rules allow a trustee / director to receive remuneration where:

- they perform the duties or services in a non-trustee capacity, and
- they are appropriately qualified and licenced to perform the work, and
- they operate a business of providing the services to the public, i.e. they are not just an employee, and
- the amount charged is on arm's length terms.

Therefore, in circumstances where a trustee is permitted to charge their fund for their services it will be important to determine if an arm's length amount has been charged (in which case the NALE rules will not apply), and if not, in what capacity they were acting when providing the services.

In this case, the ruling confirms it will be appropriate to presume an individual is acting in their capacity as a trustee, or director of a corporate trustee, where their actions are consistent with a duty, obligation or power imposed on them by:

- a specific law, such as the SIS Act, or Corporations Act, or
- the fund's trust deed, or
- their fiduciary obligations under general law,

and there are no factors to suggest they are acting in a different capacity.[91]

89 Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023. At the time of writing, this Bill has passed both houses of parliament and awaits Royal Assent.
90 SIS Act 17A(1)(f) and (g), and (2)(c) and (d).
91 LCR 2021/2 paragraph 44.

In this case, the ruling confirms that where a trustee / director uses any skills or knowledge they obtained through their business, profession or employment to assist them to perform their trustee duties, that, on its own, would be insufficient to conclude the person was not acting in their capacity as trustee.[92] For example, the ruling confirms that a financial adviser could still be acting as trustee where they utilise their professional skills and knowledge to formulate, implement and regularly review their fund's investment strategy.

Services provided in a different capacity – NALE rules can apply

Conversely, LCR 2021/2 confirms the factors that may indicate a trustee / director is acting in a different capacity (and therefore NALE rules could apply) include:

- they charge the fund for their services.
- they use equipment and other assets of their business or used in their profession or employment in a material manner when providing the services, i.e. minor, infrequent or irregular use may not result in the trustee / director being deemed to be acting in a different capacity.
- the service is of a type that can only be performed by a person that holds the relevant licence and/or qualification.
- the activity is covered by an insurance policy relating to their business, or their profession or employment (for example, professional indemnity insurance).

For example, the NALE rules could apply to a financial adviser formulating an investment strategy for their fund for no charge where the adviser:

- was acting as a licenced financial adviser when formulating the investment strategy, and
- undertook the work during normal office hours using their firm's financial planning software to prepare an SOA which included a recommendation to the trustee to adopt a specific investment strategy, and
- would be covered by their professional indemnity insurance policy in relation to their advice.

In contrast, the ruling does outline that an SMSF may receive discounted prices without the NALE rules being triggered where the arrangement is consistent with normal commercial practices.

For example, this could include an individual trustee who is an employee of an SMSF administration business being entitled to discounted SMSF admin fees under their employer's employee benefits policy where the same discount is available to all employees.

The ruling also confirms services provided to a fund on a pro bono basis will be on arm's length terms where the trustee of the fund is not able to influence the service provider's decision to supply the services on a pro bono basis.

92 LCR 2021/2 paragraph 46.

NALE doesn't apply to expenses incurred in complying with, managing tax affairs

In LCR 2021/2 (para 19), the ATO confirms the NALE provisions do not apply to any actuarial or accountancy fees incurred in complying with, or managing, the fund's income tax affairs and obligations which are ordinarily deductible under section 25-5 of the Tax Act.

For example, the NALE rules will not apply to the fee charged by an accountant to calculate the fund's exempt income where the fund is paying retirement phase pensions. However, where an accountant (or actuary) charges a fund one overall fee in relation to a number of services, such as tax and administration services, and they do not split their fee into different components, it may be prudent to assume the NALE rules will apply to the overall fee.

Related party LRBAs and non-arm's length income

In TD 2016/16,[93] the ATO confirms that, for tax purposes, the income derived by an SMSF from an asset acquired under an LRBA where some or all of the terms of the arrangement were not established on purely commercial terms, and the terms are more favourable to the SMSF than commercial terms, will be non-arm's length income.

While this determination was prior to the introduction of NALE rules (and doesn't rely on NALE), it is important to note that recent legislative changes exclude any NALE incurred prior to 2018–19 when determining whether NALI arises.

It is therefore unclear whether an LRBA established prior to 1 July 2018 on non-commercial terms, but which was corrected to be on commercial terms by 2018–19, will lead to NALI. Impacted clients may wish to seek a private binding ruling to confirm their position.

For more information on related party LRBAs and non-arm's length income, please see section 4.11.

Tax rate for non-complying SMSFs

The taxable income of a non-complying SMSF is not separated into components. Instead, a tax rate of 45% is applied to the entire taxable income of a non-complying SMSF.

Special rule applies during first income year of being a non-complying fund

Where a previously complying SMSF becomes non-complying during an income year, an additional amount is included in its assessable income for that year. This amount is effectively used to recoup the tax concessions previously received by the fund due to its complying status.

93 Tax Determination TD 2016/16: *Income tax: will the ordinary or statutory income of a self managed superannuation fund be non-arm's length income under subsection 295-550(1) of the Income Tax Assessment Act 1997 (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?*

The additional amount included in a fund's assessable income where a fund has become non-complying is calculated using the following formula:

Additional amount	=	**Market value of fund assets at 1 July in year fund becomes non-complying**	–	**Tax-free component minus crystallised pre 1 July 1983 component**

Case study – tax treatment of non-complying SMSF

Jill established the JJ SMSF in 2008. As at 1 July this tax year, the fund had a balance of $800,000 with Jill's member balance made up of the following tax components:

- $200,000 tax-free component (none of which is attributable to a crystallised pre 1 July 1983 amount)
- $600,000 taxable component.

At the start of the tax year, Jill moved overseas (becoming a non-tax resident), and then continued to make contributions to her SMSF throughout the year. As a result, Jill's SMSF failed the definition of an Australian superannuation fund (see section 5.8) and has had its complying status revoked. The applicable tax rate for this tax year is now 45%.

Assuming Jill's SMSF earned $50,000 of assessable income this year, it will be subject to the following tax:

- $50,000 × 45% = $22,500
- $600,000 × 45% = $270,000.

Additional tax for assessable contributions where member's TFN not received

Under subdivision 295–I of the Tax Act, where a complying superannuation fund receives employer contributions after 1 July 2007 for a member and the member's TFN has not been quoted to the fund by the end of the income year, the contributions will be considered No-TFN contributions income.

Any No-TFN contributions income received by a complying superannuation fund are subject to an additional tax of 32%. The aim of this additional tax is to bring the total tax rate paid on No-TFN contributions (including the standard tax rate payable on assessable income) to 47%.

However, an exception applies where a person was a member of an SMSF before 1 July 2007. In this case, employer contributions of up to $1,000 during an income year can be received without being considered No-TFN contributions.

No-TFN contributions income will not include member contributions (made by the member or by a third party such as a spouse). SMSFs are unable to accept any member contributions where the member's TFN has not been provided to the fund.

Tax offset may apply where TFN subsequently provided

Where an SMSF pays additional tax on No-TFN contributions income and the member subsequently provides their TFN to the fund, the fund is entitled to a tax offset up to the amount of no-TFN contributions income tax paid in the last 3 years.

5.8 Australian superannuation fund status

As outlined in section 5.1, to be eligible to receive concessional tax treatment a superannuation fund must be a complying superannuation fund. To be a complying fund the fund must satisfy the definition of an Australian superannuation fund in section 295–95 of the Tax Act.

Definition of Australian superannuation fund

An SMSF will be an Australian superannuation fund in a year of income where it satisfies the following three tests at all times during that year of income:

- the fund was established in Australia or one of its assets is held in Australia
- the fund's central management and control is ordinarily in Australia
- the fund satisfies the active member test.

Where any of these conditions is not met at any point during an income year, the SMSF will cease to be an Australian superannuation fund and will therefore immediately become a non-complying SMSF, triggering potentially severe tax penalties.

The requirements to satisfy the definition of an Australian superannuation fund are outlined in TR 2008/9[94] and are summarised as follows.

Fund established in Australia or holds assets in Australia

The ATO has confirmed that the first test will be satisfied if either an SMSF was established in Australia or at any particular time an asset of the fund is situated in Australia.

A fund will be established in Australia if the initial contribution made to establish the fund is paid to and accepted by the trustee of the fund in Australia. It is not necessary for the trust deed of the fund to be signed and executed in Australia.

Once a fund has been established in Australia, it will always be considered to have passed this test.

A fund will hold assets in Australia where at least one the fund's assets is situated in Australia. The location of where an asset is situated is determined by reference to common law rules for where assets are situated. These rules can be complex and vary depending on the type of asset. For example, the following assets will generally be considered to be situated in the following locations:

- land – where the land is physically located

94 Taxation Ruling 2008/9: *Income Tax: Meaning of 'Australian superannuation fund' in subsection 295– 95(2) of the Income Tax Assessment Act 1997.*

- shares – the location of where the shares can be dealt with, in other words, where the share register is kept
- an interest in a trust – where the assets of the trust are located or where the trustee resides depending on the rights and interests of the beneficiaries.

Where an SMSF was not established in Australia, it must always hold at least one asset situated in Australia, otherwise it will fail the first test and become non-complying.

Central management and control ordinarily in Australia

The second test requires that the central management and control of the fund must ordinarily be located in Australia.

Meaning of central management and control

The central management and control of an SMSF refers to the high level and strategic decisions made for the fund. These will generally include:

- formulating, reviewing and updating the fund's investment strategy
- reviewing and monitoring of the fund's investments
- formulating and reviewing the fund's strategy for managing reserves
- determining how the fund's assets will be used to fund benefit payments.

The ATO has confirmed that other day-to-day administrative functions, such as accepting contributions and rollovers, maintaining fund assets and paying fund liabilities, do not constitute the central management and control of a fund.

In general, the central management and control of a fund will be exercised by its trustee(s) where they are involved in making the high level and strategic decisions for the fund. The location of an SMSF's central management and control is therefore determined by where the trustees meet to make the high level strategic decisions for the fund.

Meaning of ordinarily

In TR 2008/9, the ATO has confirmed the central management and control of a fund will ordinarily be located in Australia where the central management and control of the fund is regularly, usually or customarily exercised in Australia. Therefore, to satisfy this test there must be some element of continuity or permanence if the central management and control of the fund is to be regarded as being ordinarily in Australia.

Where the central management and control is temporarily exercised by the trustees outside Australia, this will not prevent the central management and control from ordinarily being located in Australia. However, it is crucial to note that where the central management and control of a fund is exercised by the trustees outside Australia, that absence must only be temporary.

To provide certainty, the Tax Act confirms that a temporary absence from Australia of two years or less will not cause the central management and control to be ordinarily outside Australia. In addition, TR 2008/9 clarifies that temporary absences that exceed two years may also be acceptable, but the trustees will need to clearly demonstrate that their absence was only temporary.

However, TR 2008/9 also confirms that where the trustees depart on a permanent basis, the two-year safe harbour rule will not apply, as the central management and control will no longer ordinarily be in Australia. In this case, the members may wish to consider winding up their fund or converting to a small APRA fund before departure, otherwise their fund will have its complying status revoked and will be subject to tax penalties.

2021 Federal Budget proposal: Relaxing SMSF residency requirements

The previous Federal Government proposed extending the central management and control safe harbour rule for temporary absences from two to five years from an expected date of 1 July 2022. This proposal would provide more certainty that the central management and control will remain ordinarily in Australia where a client is temporarily outside Australia for more than two years but less than five years.

At the time of writing, this proposal had not been legislated and it is unclear whether the current Federal Government will proceed with this proposal.

The previous government also proposed abolishing the active member test – see below for further information.

What if some but not all of the trustees live overseas?

TR 2008/9 confirms that where there is an equal number of individual trustees or directors of the corporate trustee located in Australia and overseas and each of the trustees substantially and actively participates in the central management and control of the fund from those locations, the central management and control of the fund may ordinarily be located in Australia.

Active member test

The third test is the active member test, which will be satisfied where:

- the fund has no active members, or
- at least 50% of the total market value of the fund's assets attributable to superannuation interests held by active members is attributable to active members who are Australian residents, or
- at least 50% of the sum of the amounts that would be payable to or in respect of active members if they voluntarily ceased to be members is attributable to active members who are Australian residents.

An active member is defined in section 295–95 of the Tax Act as a member who is a contributor to the fund at a particular time or who has had contributions made to the fund on their behalf. TR 2008/9 also confirms that for the purpose of the active member test a contribution includes a rollover from another complying superannuation fund.

Whether a member is a contributor at a point in time requires an assessment of all of the relevant circumstances. In this case, TR 2008/9 confirms that particular regard should be given to the member's intention established by reference to objective evidence. Such evidence would include the member's pattern of conduct having regard to contributions that were made and contributions that may be made to the fund by the member.

Therefore, a member could still be considered to be a contributor despite not having contributed to the fund at a particular time, if it could be established the member normally made regular contributions at certain times of the year and it could not be objectively demonstrated that they had intended to cease making those contributions.

FirstTech comment

Preventative actions to avoid failing active member test

To avoid any potential risk that a fund could fail the active member test, a trustee may wish to consider amending the fund's trust deed to prohibit trustees making contributions while they're a non-resident.

In addition, a member departing Australia may consider notifying the trustee that they will be moving overseas and becoming a non-resident and that they do not intend to make any contributions to the fund while overseas. The member should ensure they also cancel any automatic transfers to the fund and the trustee should then record in the minutes of a trustee meeting that they received and acknowledged the notification and keep a copy of the notification with the fund's records.

2021 Federal Budget proposal: Relaxing SMSF residency requirements

The previous Federal Government proposed abolishing the active member test for both SMSFs and SAFs from an expected date of 1 July 2022. This would allow clients to continue to contribute to their fund while overseas (and a non-resident for tax purposes) without failing to be an Australian superannuation fund, and therefore reduce the need for contributing clients to also use another superannuation fund during that period.

If this proposal becomes law, clients who have put in place measures to prevent failing the active member test (for example, deed amendments to prevent non-residents contributing or notifications to the trustee about the intention not to contribute while a non-resident) may need to take action to allow contributions to be made while overseas.

At the time of writing, this proposal had not been legislated and it is unclear whether the current Federal Government will proceed with this proposal.

The previous government also proposed changes to the central management and control test – see above for further information.

5.9 Submitting annual tax return and paying tax

An SMSF must submit an annual return for each financial year, which combines a tax return with financial information about the fund, evidence that it has complied with SIS legislation and information about contributions made during the year. A return is also required during the final part year if an SMSF is wound up.

5.10 Submitting Activity Statements

An SMSF may need to submit an Activity Statement with the ATO on a regular (usually quarterly) basis, which combines the GST, PAYG withholding obligations and any PAYG instalment income information, and may require a payment be made to the ATO. A brief summary of each of the obligations is below.

Goods & Services Tax

Where an SMSF is required to be registered for GST (see section 2.7), the SMSF will need to calculate its GST obligations arising from income derived and expenses paid. This amount may result in a net amount payable or refunded depending on cash flows of an SMSF during the relevant period.

PAYG Withholding Tax

In certain circumstances, an SMSF may be required to withhold PAYG amounts on behalf of fund members. For example, certain benefit payments, such as pension payments made before the member turned age 60 or payments made from a capped defined benefit income stream in excess of the defined benefit income cap, may require PAYG to be withheld. The SMSF must calculate and pay these amounts.

PAYG registration/withholding for capped defined benefit income streams

Where a fund is paying a capped defined benefit income stream it must register for PAYG withholding. This applies regardless of whether the fund is required to withhold any amounts from the pension payments.

> **Note**
>
> PAYG withholding may apply regardless of age where the income from the income stream (and any other capped defined benefit income streams payable to the member) exceeds the defined benefit income cap of $118,750 p.a.

PAYG Instalment Tax

Based on the last lodged income tax return, an SMSF may be required to calculate and pay PAYG instalments through the lodgement of its Activity Statements. The payment of the PAYG instalments effectively represents a pre-payment of income tax and can be used to offset any tax liability that arises upon lodgement of an SMSF's annual tax return.

5.11 Pay annual supervisory levy

Trustees must also pay an annual SMSF supervisory levy when the fund lodges its annual return. The levy paid is for the financial year in which the return is due – for example where a trustee lodges their 2023–24 annual return they are required to pay the 2024–25 levy.

New SMSFs are also required to pay the levy for their year of establishment in their first annual return.

6 SMSFs and insurance

6.1 Use of insurances in an SMSF context

Trustees can use insurances within an SMSF for a variety of reasons, as summarised here.

To provide additional death or disability benefits

The main purpose of holding insurance inside an SMSF is to provide the members or their beneficiaries with increased benefits to compensate them in the event the member dies or becomes permanently or temporarily incapacitated.

SMSF trustees acquiring life and disability policies may also be eligible to claim tax deductions for the cost of the premium, which may reduce their effective cost. However, trustees should also be aware that the proceeds of an insurance policy may also be subject to superannuation benefits tax depending on the member's circumstances and who the proceeds are paid to. Trustees should therefore take these factors into account when determining the level of insurance required and the overall cost of the policy.

See below for further discussion on the deductibility of insurance premiums and the taxation of insurance proceeds.

To protect the fund's physical assets from loss or destruction

Trustees have a duty under the superannuation covenants to exercise the same degree of care, skill and diligence as an ordinary prudent person when dealing with property of the fund. Therefore, trustees acquiring physical assets have an obligation to properly insure those assets against the risk of loss or destruction.

Trustees owning property, such as residential or commercial investment property, should also ensure they obtain adequate levels of public liability insurance as a trustee could be held liable for any loss or damage suffered by a person under both general law and the SIS Covenants due to an act of negligence by the trustee or for a breach of the SIS Covenants.

For example, in 2010 a property owner was held to be negligent and therefore partly liable for the death of a handyman who was hired to carry out work on the property[95] and was ordered to pay damages to the widow of the deceased.

95 Giovenco v Dick (2010) NSWDC 4.

Acquisition of collectables

Where a trustee acquires certain collectable type assets as specified in SIS Regulation 13.18AA[96], such as artwork, vintage cars and wine, they must insure the asset in the fund's name within seven days of acquisition.

For more information on how the superannuation investment rules apply to collectables, please see *Chapter 4: Superannuation investment rules*.

6.2 Ability to acquire insurance policies

Before 1 July 2014, a trustee of a complying superannuation fund, including an SMSF, was generally able to acquire a range of different types of life and disability insurance policies issued by a life insurance company. These included:

- Life insurance including terminal illness insurance
- Total and Permanent Disability (TPD) insurance (both any and own occupation definitions)
- Income protection insurance
- Trauma insurance.

The only requirement was that a trustee needed to ensure the acquisition of the policy would not cause the fund to breach the acquisition of assets from related party rules and would be permitted under the sole purpose test and the fund's governing rules.

Restriction on permitted policies

From 1 July 2014, new rules came into effect[97] to prohibit a trustee of a superannuation fund from providing an insured benefit in relation to a member unless the relevant insurance policy terms and conditions align with one of the superannuation conditions of release for:

- death (including a terminal medical condition),
- permanent incapacity, or
- temporary incapacity.

Under the SIS Regulations[98], an insured benefit in relation to a member is defined to mean a right[99] for the member's benefits to be increased on the realisation of a risk. Therefore, from 1 July 2014, a trustee of an SMSF will be prohibited from acquiring new insurance cover for a member where the member would have the right to have their benefits increased if an insured event happened that did not align with one of the specified conditions of release.

96 Specified collectable assets include artwork, jewellery, antiques, artefacts, coins, medallions or bank notes, postage stamps or first day covers, rare folios, manuscripts or books, memorabilia, wine or spirits, motor vehicles or recreational boats.
97 SIS Regulation 4.07D
98 SIS Regulation 4.07D
99 Other than an anti-detriment payment

However, the government has confirmed that the insurance policy definitions do not need to adopt the condition of release definitions as specified in the SIS Regulations, but that they must be consistent with those definitions and that the insured benefits must be able to be released to members.

The impact these changes have on the types of insurance that can be held via an SMSF are summarised as follows.

Life insurance

Death is one of the specified conditions of release; therefore the ability for a trustee to acquire a life insurance policy for a member will generally be unaffected by these changes.

However, where the policy also includes a terminal medical condition benefit, the policy terms and conditions must align with the SIS condition of release for terminal illness. That is, a benefit must only be payable under the policy where:

- two registered medical practitioners have certified, jointly or separately, that the person is suffering from an injury or illness that is likely to result in their death within 24 months from that date, and
- at least one of the registered medical practitioners is a specialist practicing in an area related to the injury or illness suffered by the person, and
- the benefit is paid within 24 months of the date of the certificate.

For example, a trustee would be prohibited from holding a life insurance policy for a member which included a terminal illness benefit where the policy terms and conditions would pay a terminal illness benefit based on a certificate provided by only one registered medical practitioner or where the expected life expectancy period diagnosed was for a period greater than 24 months.

Total and permanent disability (TPD) insurance

For an SMSF trustee to be permitted to acquire a TPD policy in relation to a member, the terms and conditions of the policy must align with the permanent incapacity condition of release. That is, the policy must only pay a benefit where a member is unlikely, because of ill-health, to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

As a result, a trustee will generally be prohibited from acquiring an 'own occupation' TPD policy for a member on or after 1 July 2014, as a benefit may become payable even though the member may still be able to engage in some other employment for which they were qualified by education, training or experience.

Furthermore, a trustee will be prohibited from acquiring an 'any occupation' TPD policy for a member where the policy provides any ancillary lump sum benefits, such as loss of limb or sight benefits, without requiring the member to also satisfy the permanent incapacity requirement.

Note

Some insurers have responded to these changes by offering linked 'own occupation' and 'any occupation' TPD cover. In this case, the own occupation cover is held by a member outside super while the 'any occupation' cover is held by the trustee of the SMSF. Depending on which policy triggers if an insured event happens, the insurer will then pay either the member or the SMSF and then cancel the other policy.

Income protection insurance

Under the temporary incapacity condition of release a benefit may only be paid in the form of a non-commutable income stream paid for the purpose of continuing (in whole or part) the gain or reward which the member was receiving immediately before the temporary incapacity.

Therefore, a trustee will be prohibited from acquiring an income protection policy to provide cover for a member where the policy terms and conditions provide any ancillary lump sum benefits, such as redundancy, crisis, rehabilitation, specific injury or home care benefits.

In addition, to satisfy the definition of temporary incapacity in the SIS Regulations, a member must:

- have ceased to be gainfully employed due to ill-health, or
- have temporarily ceased to receive any gain or reward under a continuing employment arrangement due to ill-health.

Therefore, a trustee will only be permitted to provide cover under an income protection policy where the policy terms and conditions required the member to be gainfully employed (including self-employed) at the time of suffering the incapacity. For example, a trustee will be prohibited from holding an income protection policy for a member that would provide benefits to the member who was unemployed at the time of suffering an invalidity.

Finally, the new rules also mean a trustee will be prohibited from holding an income protection policy for a member that would pay a partial benefit where a member only reduced their hours of work due to incapacity rather than ceasing them completely. However, a policy that provided a partial benefit to a member who returned to work on a part-time basis after first completely ceasing to work will be permitted.

Trauma insurance

Under the new rules trustees will generally be prohibited from acquiring trauma insurance in relation to a member on or after 1 July 2014, as the terms and conditions of these policies do not align with one of the specified conditions of release.

For example, a trauma policy will pay benefits in the event that the life insured is diagnosed as suffering a specified injury or illness regardless of whether that injury or illness resulted in the member's death or them becoming permanently or temporarily incapacitated.

Grandfathering of pre-existing policies

Grandfathering rules apply to existing policies taken out for a member before 1 July 2014. Therefore, trustees will be able to continue to provide cover under an existing policy where the member was covered under that policy before 1 July 2014. This applies regardless of the type of cover or benefits provided.

The government has also confirmed that a trustee will be able to vary the level of cover under a grandfathered policy. For example, where a trustee held a pre-existing policy it could increase or decrease the level of cover held for the member.

However, what is not clear is whether other significant changes, such as converting an existing salary continuance policy from an indemnity to an agreed level of cover, would continue to be covered under the grandfathering rules.

Implications for SMSF trustees

Trustees of SMSFs will need to be aware of these requirements where acquiring insurance policies in relation to a member on or after 1 July 2014 and should ensure that any policy they acquire does not provide any benefits that would not align with one of the specified conditions of release.

This will be particularly important for SMSF trustees as in many cases they may be purchasing a policy that is not specifically designed to be held within a superannuation fund and therefore could include benefit terms and conditions that may not align with a condition of release. Note – some insurers have responded to these changes by designing policies specifically for SMSFs that take into account these rules.

SMSF trustees should also ensure any grandfathered policies acquired pre-1 July 2014 do not lapse, as any replacement policy commenced on or after that date would not qualify under the grandfathering rules.

FirstTech comment

1 July 2014 rules and insurance liquidity strategies

Before 1 July 2014, some SMSF trustees sought to implement cross-member and insurance reserving strategies to provide sufficient liquidity so trustees could pay out a member's death benefit and extinguish any LRBA liabilities without having to dispose of any assets.

Specifically, the cross-member strategy effectively involved the members paying for an insurance policy over each other through the SMSF with the intention that any proceeds would be allocated to the surviving member's benefits. This would then allow the trustee to use the fund's cash to pay out the death benefit and extinguish any loans without needing to sell any assets. Alternatively, some trustees have attempted to achieve the same outcome through holding the insurance policy in a reserve account with the premiums being paid from the reserve and any proceeds being allocated back to the reserve.

However, in 2015 the ATO confirmed that cross-member strategies are not permitted from 1 July 2014, as it is a requirement under the new rules that the proceeds of an insurance policy must be released to the member who is the insured under the policy. Therefore, trustees should avoid implementing any new cross-member arrangements from 1 July 2014. Note – pre-existing arrangements can be maintained under grandfathering arrangements.

Note: A potential alternative to this strategy was to source the premiums for an insurance policy from a reserve and then to pay any insurance proceeds to that reserve. This would then allow the trustee to use the cash proceeds in the reserve to extinguish any outstanding loan amounts without being forced to sell the asset acquired with the borrowing, potentially realising a loss. However, in March 2018 the ATO outlined[100] a number of concerns about this arrangement, including:

- the strategy appears to circumvent the policy intent of the rules that prohibit a trustee of a super fund from holding an insurance policy unless the policy terms and conditions align with one of the superannuation conditions of release, and
- the strategy would be inconsistent with the sole purpose test as it would not result in the increase of member benefits but to ensure the trustee can satisfy its obligations.

100 SMSF Regulators Bulletin SMSFRB 2018/1: *The use of reserves by self managed superannuation funds.*

Acquisition of life insurance policies from members and relatives

Under the acquisition of assets from related party rules, a trustee is prohibited from acquiring a life insurance policy issued by a life insurance company from a member of the fund or a relative of a member of the fund.[101] Therefore, a trustee would not be able to accept the assignment of a life or disability policy owned by a member or a relative of a member of the fund.

However, where a trustee/member is seeking to place their existing insurance cover in their SMSF, they could consider approaching their insurer to inquire whether they would be prepared to cancel the existing policy and to issue a new and identical policy in the name of the trustee of the SMSF. Depending on the circumstances, the insurer may agree to do so without any additional medicals or underwriting on the basis that it is already on risk for the life insured.

For more information on how the investment rules apply to insurance policies, please see *Chapter 4: Superannuation investment rules*.

The sole purpose test and insurance

Before acquiring any life or disability policy the trustees will need to consider the sole purpose test. The sole purpose test requires that the fund be maintained only for:

- one or more core purposes, or
- one or more core purposes and one or more ancillary purposes.

Most insurance arrangements fall within either a core purpose or an ancillary purpose (or both). The following table summarises how different insurance policies interact with the sole purpose test.

Table 6.1 Insurance and the sole purpose test

Type of insurance	Type of purpose (Core/Ancillary)	Purpose
Life	Core	Provision of benefits in the event of death before either retirement or age 65
Life	Ancillary	Provision of benefits in the event of death after retirement or age 65
TPD	Ancillary	Provision of benefits after cessation of work due to ill health
Income protection	Ancillary	Provision of benefits after temporary cessation of work due to ill health

Given that TPD and income protection insurance policies are only considered to align with ancillary purposes, an SMSF would also need to hold some other assets or also hold a life insurance policy for the members. Failing this, the fund would be considered to have breached the sole purpose test as it would not be being maintained for at least one core purpose.

While there is no core or ancillary purpose specifically related to terminal illness benefits, it is likely to meet the sole purpose test due to its close alignment to death benefits and because many who suffer from a terminal illness will also have ceased

101 SIS Act section 66(2A)(a)(iii)

work due to ill health. The fact that terminal medical condition is provided with a specific condition of release under the SIS Regulations supports this view.

Life insurance, buy/sell arrangements and the sole purpose test

In May 2015, the ATO confirmed that an SMSF trustee had breached the sole purpose tests where it acquired a life insurance policy pursuant to the terms of a buy/sell agreement.

The case (outlined in ATO ID 2015/10) involved a trustee acquiring a life insurance policy as part of a member's buy/sell agreement involving their family business. The ATO found the acquisition of the policy breached both the sole purpose test (and the ban on providing financial assistance to a member or relative) as the specific purpose of the policy was to facilitate the transfer of a member's share in a family business to their brother for no consideration in the event of their death rather than to provide retirement benefits or death benefits to the member's beneficiaries.

FirstTech comment

Implications of ATO ID 2015/10

Trustees considering acquiring an insurance policy in connection with buy/sell arrangements should be warned of the potential implications for their fund and may wish to seek specialist legal advice before doing so. Trustees who have already acquired a policy in these circumstances should also seek legal advice as their fund, and insurance arrangements, may need to be restructured.

Life insurance, liquidity strategies and the sole purpose test

Post the introduction of the limited recourse borrowing rules some funds sought to implement insurance strategies to protect the members' interests from any potential loss where a member of the fund died and as a result the fund could no longer meet its debt obligations and was forced to sell.

One such strategy involved the fund paying life insurance premiums from a reserve so it could then allocate any insurance proceeds received back to that reserve if an insured event happened. The fund could then use the cash proceeds in the reserve to extinguish any outstanding loan liabilities without being forced to sell the asset acquired with the borrowing.

However, in March 2018[102] the ATO outlined its concerns that this strategy would be inconsistent with the sole purpose test as it would not result in the increase of member benefits but instead to ensure the trustee could satisfy its obligations.

102 SMSFRB 2018/1: *The use of reserves by self managed superannuation funds.*

Trust deed considerations

While trustees have the power to enter into contracts, such as insurance contracts, under general law, a trustee should always check to confirm that the fund's trust deed provides the appropriate powers to allow the trustee to acquire insurances and to pay the premiums. Trustees should also check the deed to confirm how any proceeds are required to be treated.

Some important considerations for the trust deed include:

- Does the trustee trust deed contain any restrictions on a trustee acquiring a policy of insurance?
- Does the trustee have the power to pay benefits in accordance with the SIS conditions of release?

Where the trust deed does not include the required power for a trustee to obtain insurances and to pay premiums, the trustee may wish to consider arranging for the deed to be amended.

6.3 Policy ownership and allocation of insurance premiums and proceeds

Policy ownership

Where a trustee of an SMSF wishes to acquire an insurance policy for a member it is important that the policy is owned by the trustees on behalf of the fund and that the fund pays the premiums and the fund receives any proceeds.

Allocation of premium costs

Under SIS Regulation 5.02 trustees must determine the costs to be charged against a member's interest in the fund on a fair and reasonable basis. These costs include the cost of any insurance policies held by the trustee for particular members.

For example, where a trustee holds a life insurance policy to provide death benefits for a member, the trustee would be required to deduct the cost of the premiums from the member's account.

Allocation of insurance proceeds

Under SIS Regulation 5.03, where a trustee receives the proceeds from an insurance policy held for a particular member, the trustee will be required to allocate those proceeds on a fair and reasonable basis. The ATO has confirmed that the proceeds of an insurance policy should be allocated to the interest against which any premiums payable under the policy were charged.[103]

Therefore, where the cost of any insurance premiums held by a trustee are deducted from a particular member's interest in the fund, any proceeds received for that policy must be allocated to that member's interest and cannot be allocated to another member's interest or to a different interest of the same member.

103 National Tax Liaison Group Superannuation Technical minutes, June 2012.

Case study

Jim and Doreen are business partners and have an SMSF together. Jim has also arranged to hold life insurance through his SMSF to ensure his family would not be financially impacted in the event of his death. As the cost of the premiums specifically relate to Jim they are required to be deducted from his interest in the fund.

If Jim then died, Doreen would be required to allocate the proceeds on a fair and reasonable basis. In this case, Doreen would need to allocate 100% of the proceeds to Jim's interest (as this is the interest from which premiums were deducted).

6.4 Requirement for trustees to consider insurance

Responding to concerns that less than 13% of SMSFs held insurance cover for members,[104] the Federal Government amended the SIS Regulations in 2012 to require trustees of SMSFs to consider whether to hold insurance for members as part of formulating or reviewing the fund's investment strategy.

The government also confirmed when implementing these changes that trustees should be self-reliant when determining the type and level of insurances required and that to meet this requirement trustees should consider the personal circumstances of fund members as well as other legislative requirements, such as the sole purpose test.

Therefore, when implementing or reviewing the fund's investment strategy, a trustee will need to consider a range of issues when determining each member's insurance needs and whether they should hold a death or disability policy for them. These issues include:

- the member's age, health, assets, liabilities, income level and whether they have any dependants
- whether the member has any existing insurance cover held inside the SMSF, in another superannuation fund, or outside superannuation and the level and type of those insurances
- whether the member, and/or their dependants, would be able to maintain their current quality of life in the event of the member's death, or in the event that the member was unable to work due to their temporary or permanent incapacity.

The trustees should document their decision in the fund's investment strategy, or alternatively in the minutes of a trustee meeting.

104 Self managed super solutions: *Review into the governance, efficiency, structure and operation of Australia's superannuation system.*

Note

From a practical perspective it would generally be much simpler to document the trustee's resolution in the minutes of a trustee meeting, otherwise the trustee would be required to amend the fund's investment strategy each year to specify whether the trustee will acquire a new policy or maintain, increase or decrease a member's existing level of cover. However, the trustee minute or resolution should specifically reference the fund's investment strategy to avoid any doubt.

FirstTech comment

No requirement to hold a minimum level of insurance

This rule only requires trustees to consider the need to hold insurances for members. It does not require a trustee of an SMSF to provide a minimum or default level of insurance for each member. For example, a trustee may decide not to hold any insurance policies for a range of reasons, such as the:

- members have adequate insurances in place elsewhere, i.e. outside of superannuation or held via another superannuation fund
- members do not require insurance
- members are willing to accept the risk of being uninsured and don't want the insurance premiums impacting their retirement savings
- trustee would be unable to obtain affordable life insurances due to the age or health of the members.

As long as the fund's investment strategy specifies that the trustees of the fund will consider the need to hold insurances for members, and that the trustees can show they properly considered the issue and documented their decision in the minutes of a trustee meeting, they will generally have complied with their obligations under this requirement.

Risks of failing to properly consider the need to hold insurance for members

The requirement to consider the need to hold insurance for members is included in the SIS operating standards. A trustee who fails to comply with this requirement can be issued with an ATO administrative penalty.

Failure to properly consider the need to hold insurance could also result in the surviving trustees being liable to a deceased member's beneficiaries for any losses or damages they suffer as a result of the member being uninsured, or under-insured. This would be a significant risk where it transpires the member should have had cover.

FirstTech comment

Impact on provision of investment strategy advice

Under the best interest requirements, an adviser engaged to formulate or review an SMSF's investment strategy will be required to discuss the trustee's obligation to also consider the need to hold insurance. In this case, an adviser may wish to consider offering to undertake an insurance needs analysis and to make a recommendation in relation to the members' insurance needs to assist with this requirement.

In situations where a client declines such an offer, an adviser may wish to consider discussing this further with the client to ensure they fully understand this requirement, their obligations and the risks of not properly considering the insurance needs of the members. In this case, an adviser may then wish to record the details of the conversation in a file note and outline in their statement of advice that the:

- client was made aware of the trustees' responsibility to consider the need to hold insurances for members when formulating or reviewing the fund's investment strategy
- adviser offered to conduct an insurance needs analysis and to provide insurance advice to assist the trustee to comply with their obligations, but the client declined the offer
- client understands it is their responsibility to consider whether to provide insurance cover for members and they understand the risks of not properly complying with that requirement.

6.5 Requirement for adviser to consider insurance when recommending an SMSF

ASIC has outlined in a report on the quality of SMSF advice,[105] that an advice provider must consider a client's insurance needs and the issues associated with holding insurance in an SMSF as part of recommending an SMSF. In particular, ASIC confirmed that before setting up an SMSF an adviser should discuss the following issues with the client:

- their current level of insurance
- their required level of insurance both now and in the future
- the potential loss of any insurance benefits where they switched some or all of their benefits out of a large fund and into an SMSF, and
- how best to implement an insurance strategy – which may include retaining their insurances in a large fund.

105 ASIC Report 337: SMSFs: Improving the quality of advice given to investors.

When considering holding insurance via an SMSF, ASIC also confirmed that it will be necessary to consider and discuss with the client that:

- as a member of an SMSF they may not have access to the same competitive insurance premium rates and discounts that are offered to members of large funds, and
- they may need to be individually assessed for insurance purposes, which may lead to potentially higher premiums, loadings, exclusions or even the refusal of insurance.

In relation to providing advice to establish an SMSF, ASIC also confirmed that advisers should not inappropriately exclude insurance advice from the scope of advice and that any insurance advice should be provided before, or at the time, the advice is provided to establish the fund.

In addition, ASIC also confirmed that where an adviser has insufficient insurance expertise to provide the advice, the adviser should refer the client to an appropriately qualified insurance adviser and wait until that advice is provided before recommending the establishment of an SMSF.

Finally, the ASIC report confirms that maintaining insurance cover through a large fund may be an appropriate strategy in some circumstances. However, before considering this approach, an adviser should consider and explain to the client:

- the costs and disadvantages associated with being a member of more than one superannuation fund (that is, an SMSF and an APRA-regulated fund)
- that insurance cover in the large fund may have eligibility requirements that may be compromised by transferring benefits or redirecting employer contributions to an SMSF. For example, some large funds may require a minimum balance or require the trustee to continue to receive the member's employer contributions for any insurance cover to remain in place
- that they may need to make contributions to the large fund (or arrange rollovers) to prevent the balance in a large fund falling to a point where it invalidates the insurance cover in that fund.

FirstTech comment

Protecting your super – insurance and inactive accounts

From 1 July 2019, trustees of large APRA-regulated funds are prohibited from providing insurance where the member's account is inactive (that is, no contributions or rollovers received) for a continuous period of 16 months or more, unless the member has made an election to obtain or maintain insurance in that fund.

While these rules only apply to large APRA-regulated funds (SMSFs are excluded), where a member of an SMSF has maintained benefits in a large fund for the purpose of maintaining life insurance cover through the fund, there is a risk the large fund could cancel the policy if the member's account has remained inactive for 16 months. In this case, members should notify the trustee in writing that they wish to retain their insurance in the account even if it becomes inactive.

6.6 Insurance and tax at the fund level

Taxation of insurance proceeds received by the trustee

Under the Tax Act, insurance proceeds will generally be subject to tax under the capital gains tax (CGT) provisions and will be included in a taxpayer's assessable income. However, certain exemptions apply, including for the trustee of a complying superannuation fund.

Taxation of life and disability insurance proceeds

Under section 118–300 of the Tax Act, any capital gain or loss made by the trustee of a complying superannuation fund on a life or disability insurance policy is disregarded. TD 2007/4[106] also confirms that this applies to terminal illness proceeds. Therefore, trustees will not have to pay capital gains tax on the receipt of any life or disability insurance proceeds.

106 TD 2007/4: *Income tax: capital gains tax: is a 'policy of insurance on the life of an individual' in section 118-300 of the Income Tax Assessment Act 1997 limited to a life insurance policy within the common law meaning of that expression?*

Insurance proceeds and the pension assets tax exemption

In Tax Ruling TR 2013/5,[107] the ATO expresses the view that a superannuation income stream ceases as soon as a member in receipt of the superannuation income stream dies, unless a dependant beneficiary of the deceased member is automatically entitled to receive an income stream on the death of the member.

This could potentially have meant significant CGT implications when selling or transferring superannuation fund assets to pay a deceased pensioner's death benefit from the fund.

However, the tax regulations[108] allow a deceased member's non-reversionary retirement phase income stream interest to continue to be treated as a retirement phase income stream for tax exemption purposes between the date of death and the date a lump sum death benefit is paid, or a new retirement phase income stream commenced.

The pension tax exemption will then apply to the deceased member's balance at the date of death, plus any investment earnings that accrue on this balance up until the payment of the death benefit as a lump sum or income stream. However, the following amounts are specifically excluded from being part of the fund's exempt pension income:

- insurance proceeds
- amounts arising from self-insurance.

Therefore, where the fund uses the segregated assets method, any assets acquired with the proceeds of an insurance policy will not be included as part of the fund's exempt current pension assets and any investment earnings on those assets will be fully assessable.

Alternatively, where the fund uses the unsegregated assets method, the insurance proceeds will be excluded from the average value of the fund's pension liabilities as per the ECPI calculation in section 295–390 of the Tax Act. As a result, the receipt of insurance proceeds in this situation would result in a reduced ECPI percentage.

107 TR 2013/5 *Income tax: when a superannuation income stream commences and ceases.*
108 Income Tax Assessment (1997 Act) Regulations 2021, reg 307-70.02.

Case study

Fred and Wilma were married and members of their SMSF. Fred had a non-reversionary account based pension with an account balance of $100,000 and Wilma had an accumulation account balance of $100,000. Fred then died on 1 January in a financial year.

On 30 June in the same financial year, Wilma paid a $312,521 death benefit to herself from Fred's superannuation interest, which included:

- Fred's pension balance of $100,000 at the date of death
- the proceeds of a life insurance policy held by the fund over Fred's life for $200,000 – which were received by the fund on 15 January after Fred's death
- Fred's 50% share of the fund's total investment income received during the financial year up until the time his death benefit was paid of $12,521[109] (which includes $2,521[110] bank interest from the insurance proceeds).

Where the fund used the segregated assets method, the fund's exempt income would be calculated as $10,000, being income from the fund's segregated current pension assets based on Fred's pension value (excluding the insurance proceeds) of $100,000. The interest earned on the insurance proceeds ($2,521) would then be included in the fund's assessable income.

However, where the fund used the unsegregated assets method, the exempt income proportion would be calculated in accordance with the formula specified in section 295–390 of the Tax Act. In this case, the insurance proceeds would be excluded from the calculation of the fund's average pension liabilities, but included in the average value of the fund's superannuation liabilities. Therefore, assuming the fund's pension and superannuation liabilities were calculated using time weighted averages and the fund received the insurance proceeds on 15 January following Fred's death, the fund's exempt income proportion would be calculated as 34%.[111] Assuming the fund then had total investment income for the year of $22,521, the fund's exempt income would be $7,657.

In this case, the use of the unsegregated assets method in the year that the fund received insurance proceeds has resulted in a watering down of the tax-free proportion and resulted in an increased tax liability for the fund.

109 Share of investment income assumes Fred's account allocated 50% of fund's total investment income of $20,000 (excluding interest on insurance proceeds) based on 50/50 split of account balance at start of year plus 100% of interest on insurance proceeds i.e. ($20,000 × 0.5) + $2,521 = $12,521

110 $2,521 interest based on $200,000 cash proceeds invested on 15 January earning 2.75% pa.

111 Assumes no contributions made to Wilma's accumulation account and that Fred had elected to receive one annual payment which he had not taken before his death.

Deductibility of insurance premiums

Under section 295–465 of the Tax Act a fund can deduct the part of any insurance premium that is specified as being wholly for the liability to pay a:

- superannuation death benefit (including a terminal illness benefit)
- disability superannuation benefit
- temporary disability benefit paid in the form of an income stream.

This means trustees will generally be able to claim 100% of the cost of any life, 'any occupation' TPD or income protection policy held to provide insurance cover for one or more members.

For more information on the deductibility of insurance policies and the special rules that apply for grandfathered own occupation TPD policies, please see the deductions section of *Chapter 5: Taxation of SMSFs*.

6.7 Insurance and the taxation of member benefits

Taxation of life insurance proceeds included in death benefits – accumulation phase

Where the proceeds of a life insurance policy are allocated to the deceased member's superannuation interest, they will form part of the taxable component of that interest. This occurs by default as the insurance proceeds are not included in the calculation of the tax-free component[112] and therefore must form part of the member's taxable component.

Where a member's death benefit is paid as an income stream, the insurance proceeds will be added to the taxable component of the income stream. The taxation of the income stream payments will then depend on the circumstances of both the recipient and the deceased member as at the time of death. For more information on the taxation of death benefit income streams, please see section 8.7.

Where a deceased member's interest is then paid as a lump sum death benefit to a dependant for tax purposes, such as a spouse or minor child, the whole of the amount of the payment (including the insurance component) will be tax-free (that is, non-assessable, non-exempt income). Therefore, a trustee will generally not be required to calculate the tax components or withhold any tax from the payment or issue a PAYG payment summary to the dependant.

However, where a fund pays a death benefit as a lump sum from accumulation phase to a non-dependant for tax purposes, the trustee will need to withhold tax from the taxable component included in the payment as per the following table and provide them a PAYG payment summary reflecting these amounts.[113]

112 For more information on the calculation of tax-free component, please see *Chapter 7: Contributions and benefit payments*.

113 Medicare levy is also payable on the amount except where the death benefit is paid to the member's estate.

Table 6.2 Taxation of lump sum death benefits paid to a non-dependant for tax purposes

Tax component	Tax rate
Tax-free component	Nil (non-assessable, non-exempt income)
Taxable component (taxed element)	15%*
Taxable component (untaxed element)	30%*

* Exclusive of Medicare levy.

Where the trustee has claimed, or will claim a deduction for the cost of the insurance premiums (or claim a deduction for a future liability to pay benefits), the taxable component will also include an untaxed element.

The process to calculate untaxed element is specified in section 307–290 of the Tax Act and is as follows:

Step 1 Calculate the taxable component (taxed element)

$$\text{Taxed element} = \left[\text{Amount of lump sum} \times \frac{\text{Service days}}{\text{Service days} + \text{Days to retirement}}\right] - \text{Tax free component}$$

Where:

- **Days to retirement** = the number of days between the date of death and the deceased's last retirement date (generally age 65)
- **Service days** = the number of days from the day the member joined the fund (or if a rollover amount was received by the fund with an earlier service period start date, that earlier start date) to the date of death. For an employer sponsored fund, service days may commence when the member's employment commenced, if that was before the start of their fund membership.

> **Note**
>
> If the calculated result is negative (i.e. where the tax-free component is large compared to the total benefit), the taxed element in the fund is nil and the whole of the taxable component is an untaxed element.

Step 2 Calculate the taxable component (untaxed element)

$$\text{Untaxed element} = \text{taxable component} - \text{taxed element}$$

Case study

Sonya was a member of her SMSF and at the time of her death she had an accumulated superannuation interest of $300,000, which was made up of the following tax components:

- Tax-free component $100,000
- Taxable component $200,000

If the trustee then allocated the proceeds of a $200,000 life insurance policy held on her life to her account, the tax components of her superannuation interest would be as follows:

- Tax-free component $100,000
- Taxable component $400,000

Assuming the trustees of Sonya's fund had claimed the cost of her life insurance premiums as a deduction, and that at the time of her death Sonya's service period was five years (1,825 days) and her period to retirement was 15 years (5,475 days), the taxable component (untaxed element) included in her death benefit would be calculated as follows:[114]

$$\textbf{Taxed element} = \left[\$500{,}000 \times \frac{1{,}825}{1{,}825 + 5{,}475} \right] - \$100{,}000 = \$25{,}000$$

$$\textbf{Untaxed element} = \$400{,}000 - \$25{,}000 = \$375{,}000$$

In this case, Sonya's death benefit would be made up of the following tax components:

- Tax-free component $100,000
- Taxable component:
  - Taxed element $25,000
  - Untaxed element $375,000

In this example, the amount of untaxed element ($375,000) exceeds the value of the insurance proceeds received ($200,000).

Tax effectively handling receipt of life insurance proceeds

One of the implications of the untaxed element calculation is that a member with a long service period will have a relatively lower taxable component (untaxed element) than another member of the same age with a shorter service period.

In the above case study, if Sonya's service period was 15 years instead of five years, the amount of untaxed element would be reduced from $375,000 to $250,000. If her benefit was then paid to a non-tax dependant this would result in $18,750 less tax applying to the payment.

Therefore, extending a member's service period could result in less tax applying to a member's death benefit where it is paid to a non-tax dependant.

114 Number of days based on whole years and excludes leap years.

Calculation of service period

A member's service period is defined in section 307–400 of the Tax Act and generally commences on the earlier of the following dates:

- the date the member first joined the fund
- the date the member first commenced employment with an employer who has contributed to the fund on behalf of the member.[115]

In addition, section 307–400 of the Tax Act confirms that where a member rolls over a superannuation benefit with an earlier service date to another fund, the receiving fund must apply the earlier service date to the whole of the member's benefit in that fund.

Therefore, a member could potentially increase their service period and reduce the amount of untaxed element that would be created on their death by:

- using the date they commenced employment with an employer who contributed to the fund to calculate the service period where the start date predates their membership of the fund – this is more likely to be relevant to members who were employees before the introduction of the superannuation guarantee
- rolling over a benefit from another fund to an SMSF where the other fund has an earlier service date for the member.

The second point is particularly relevant for members that set up an SMSF later in life. In this case, their service period will relate to their period of membership of their SMSF, unless they rollover a benefit from another fund with an earlier service date.

In this situation, looking for old lost superannuation accounts such as from periods of part-time or casual employment could be beneficial as a rollover of just $1 could allow a recently established SMSF to use a much earlier service date.

However, depending on the circumstances, the use of the earlier service date could adversely impact the calculation of tax-free component where a member is paid a disability superannuation benefit due to satisfying the permanent incapacity condition of release. In this case, the benefit from using the earlier service date to minimise the untaxed element could be outweighed by the additional tax that would apply to a member who became TPD depending on their age. For more information see section 7.4 and below.

Tax treatment of life insurance proceeds included in a terminal medical condition benefit

The proceeds of a terminal illness benefit paid under a life insurance policy will be allocated to the member's taxable component where they are in accumulation phase or proportionally to both tax-free and taxable components where the member is in the pension phase (depending on the tax components of the pension).

115 Where a trustee wishes to use a member's employment start date (where that is earlier than the date the member joined the fund) they will need to be provided with evidence confirming the date they commenced employment with the employer and that the employer has contributed to the fund on their behalf.

Where the member withdraws their benefits out of the fund as a lump sum, the whole of the payment will be tax-free (regardless of the tax components) under section 303–10 of the Tax Act.

Taxation of life insurance proceeds included in death benefits – pension phase

The tax treatment of life insurance proceeds is different depending on whether a dependant beneficiary of the deceased member will be automatically entitled to receive an income stream on the death of the member, that is, the pension is reversionary.

Tax treatment of life insurance proceeds allocated to a reversionary pension

Where a member who had commenced a pension dies, their pension does not cease provided either:

- the pension is automatically reversionary
- a valid binding death nomination is in place, which requires the trustee to continue to pay the death benefit as an income stream to a specified person.[116]

In these circumstances, the existing pension proportioning rules will continue to apply to the superannuation interest. Therefore, any insurance proceeds allocated to the deceased member's reversionary pension interest would form part of the taxable and tax-free components of the pension, as per the tax component proportions calculated on commencement. The only requirement is that the premiums must have been deducted from that pension interest or, where they were treated as a general fund expense, the trustee was able to allocate the proceeds to any interest held in respect of the member under the trust deed.[117]

For example, if a member commenced a pension that would revert to their spouse on their death with 100% tax-free component, 100% of any insurance proceeds allocated to that pension interest would form part of the tax-free component.

Tax treatment of life insurance proceeds allocated to a non-reversionary pension

Where a pension is not reversionary (see above), special proportioning rules apply on the death of a pensioner if:

- no amounts other than investment earnings,or insurance proceeds have been added to their superannuation interest, and
- their death benefit is paid as a lump sum or income stream (or combination of both).

116 In Tax Ruling TR 2013/5 Income tax: when a superannuation income stream commences and ceases, the ATO confirms that for a pension to automatically transfer to a beneficiary without ceasing, it must transfer due to the rules governing the superannuation fund and/or the rules governing the income stream, and not due to the trustee exercising a discretion.

117 Minutes of National Tax Liaison Group: Superannuation technical sub-group meeting September 2009.

These special rules allow the deceased member's superannuation balance at the date of death (plus earnings on that balance between death and benefits being paid) to retain their existing tax-free proportion during the period between the member's death and the payment of the death benefit. However, any insurance proceeds will form part of the taxable component.

Case study

Gina dies on 1 July in a financial year with an existing non-reversionary account based pension balance of $300,000 with a tax-free proportion of 50%. Her death benefit is paid as a lump sum as soon as practicable on 1 January in the same financial year, at which time earnings have increased her existing balance to $310,000. Life insurance proceeds of $200,000 are also added to her benefit just before her death benefit being paid.

Under the special proportioning rules, the existing tax-free proportion of 50% applies to Gina's superannuation balance at her date of death plus investment earnings. This would provide for $155,000 of tax-free component and $155,000 of taxable component. The life insurance proceeds are then added to the taxable component.

If Gina's death benefit was paid as a lump sum to a non-dependant for tax purposes it would consist of $155,000 tax-free component and $355,000 taxable component – which would then be split into taxed element and untaxed element based on her service days and her days to retirement (see section 6.7 above).

However, if Gina's death benefit was paid to her spouse as an income stream instead, the tax component proportions of the new $510,000 pension would be 30% tax-free component and 70% taxable component.

Alternatively, if Gina's original pension had automatically reverted to her spouse on death, the tax component proportions of the $510,000 reversionary pension would be 50% taxable and 50% tax free

Tax treatment of disability insurance proceeds included in benefit payments

Depending on whether the proceeds of a disability insurance policy are allocated to a member's benefits in the accumulation or pension phase (including transition to retirement income streams), different tax treatments apply.

Tax treatment of disability insurance proceeds allocated to members in the accumulation phase

Like life insurance, the proceeds of a disability insurance policy allocated to a member in the accumulation phase will form part of the member's taxable component. However, where a member receives a lump sum disability superannuation benefit, a formula applies to modify the member's tax-free component for the future service benefit – broadly reflecting the period where they would have expected to have been gainfully employed.

A disability superannuation benefit is:

- a benefit paid to a person (including a rollover to another superannuation fund)[118] because he or she suffers from ill health (whether physical or mental)
- where two legally qualified medical practitioners[119] have certified that, because of the ill health, it is unlikely that the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

The formula to calculate the tax-free component of a disability superannuation benefit is as follows:

$$\text{Existing tax free component} + \left[\text{Amount of benefit} \times \frac{\text{Days to retirement}}{\text{Service days} + \text{Days to retirement}} \right]$$

Where:

- **Existing tax-free component** = the sum of the tax-free component of the benefit worked out apart from using the disability formula
- **Amount of benefit** = the amount of the disability benefit being paid, including any insurance proceeds
- **Days to retirement** = the number of days from the day on which the person stopped being capable of being gainfully employed to their last retirement date (generally age 65)
- **Service days** = the number of days in the service period for the lump sum.

Note

The tax-free component cannot exceed the amount of the benefit.

When calculating the modified tax-free component using this formula the ATO has confirmed that any days that are included in both ‘service days’ and ‘days to retirement’ in the denominator are to be counted only once. Therefore, the denominator will always be equal to the number of days in the period from the start of the ‘service period’ for the disability lump sum to the person’s ‘last retirement day’.

This ensures the proportion of tax-free component included in a member’s disability superannuation benefit payment will not change where a member either delays taking a benefit payment or takes their benefits as multiple smaller payments over an extended period of time.[120]

118 Excluding the commencement of a pension within the same fund.
119 ATO ID 2015/11 provides guidance on the meaning on 'legally qualified medical practitioners' for disability superannuation benefit purposes.
120 ATO Superannuation Client Relationship Team Alert 020/2015.

Case study

Assuming the same details for Sonya as in section 6.7 above, ie:

- Service period: 5 years (1825 days)
- Period to retirement: 15 years (5475 days)
- Tax-free component: $100,000
- Taxable component: $400,000 (including $200,000 TPD insurance proceeds).

If Sonya were paid a disability superannuation benefit, the tax component of her benefits would be modified as follows:

$$\text{Tax free component} = \$100{,}000 + \left[\$500{,}000 \times \frac{5{,}475}{1{,}825 + 5{,}475} \right] = \$475{,}000$$

However, note that under this formula, if Sonya had increased her service period by rolling over funds with a 15-year service period (see section 6.7), her tax-free component would only be increased to $350,000.

Tax treatment of disability insurance proceeds allocated to members in the pension phase

As previously discussed, where a trustee allocates disability insurance proceeds to the accumulation account of a member, the proceeds will generally form part of the member's taxable component. However, for members who have commenced a pension, such as a transition to retirement pension, the ATO has confirmed[121] that:

- any insurance proceeds would not form a separate interest and could be added to a member's pension account
- the tax components of any income stream or lump sum payments paid from the pension would be calculated (as per section 307–125(3) of the Tax Act) using the tax component proportions of the pension that were set at commencement.

For example, if a member had commenced a pension with 100% tax-free component, the proceeds of the disability insurance policy could be added to the pension and would form part of the member's tax-free component due to the 100% tax-free status of the pension.

The only requirement specified by the ATO is that the premiums must have been deducted from that interest or, where they were treated as a general fund expense, the trustee had the ability to allocate the proceeds to any interest held in respect of the member under the trust deed.

In addition, if the member was then to commute the pension and pay themselves a lump sum disability superannuation benefit, they could also apply the modification formula (see above) to increase the tax-free component of the benefit payment.

121 Minutes of the National Tax Liaison Group: Superannuation technical subgroup meeting, September 2009.

6.8 Insurance proceeds and transfer balance cap

The transfer balance cap treatment of insurance proceeds depends on whether the proceeds are allocated to a member's retirement phase income stream interest or accumulation/non-retirement phase income stream interest.

See section 6.3 for information about allocating insurance proceeds to members' interests, and section 7.8 for further information about the transfer balance cap.

Proceeds allocated to existing retirement phase income stream interest

TPD or terminal illness insurance proceeds allocated to a member's existing retirement phase income stream interest are not a credit towards their transfer balance account. Therefore proceeds can be allocated to their interest without any transfer balance cap implications.

Life insurance proceeds allocated to a reversionary pension

Under the transfer balance cap rules, the value of a member's reversionary pension as at the date of death will count as a credit towards the beneficiary's transfer balance account (12 months after the date of death). Taking this into account, and the fact that any insurance proceeds will generally only be paid after the death of the life insured, the value of the credit towards the beneficiary's transfer balance cap may exclude the value of any insurance proceeds received.

However, trustees may wish to proceed with caution as this outcome appears contrary to the intention of the transfer balance cap rules and hence may be subject to change in the future. Trustees in this situation may wish to apply for a Private Binding Ruling.

Life insurance proceeds allocated to a non-reversionary pension

Where a retirement phase income stream is not reversionary and a deceased member's beneficiary elects to take their death benefit as a new retirement phase income stream, any insurance proceeds (which form part of the commencement value of the new death benefit income stream) will effectively count towards the beneficiary's transfer balance account.

Proceeds allocated to accumulation or non-retirement phase income stream interest

Life insurance proceeds allocated to a deceased member's accumulation/non-retirement phase income stream interest are not a credit towards their transfer balance account. However, where a death benefit income stream is paid to their beneficiary, the insurance proceeds (which form part of the commencement value of the new death benefit income stream) will effectively count towards the beneficiary's transfer balance account.

TPD or terminal illness insurance proceeds allocated to a member's accumulation interest do not count towards their transfer balance cap. However, where those proceeds are used to commence a retirement phase income stream, they will count as a credit towards their transfer balance account at that time.

> **Note**
>
> Where a member who has been declared TPD commences a retirement phase income stream before the fund receiving any insurance proceeds, the trustees should exercise caution and allocate the proceeds to the accumulation account from which the premiums were deducted.

If instead the trustees sought to allocate any proceeds to the member's retirement phase income stream, the trustees may be deemed to have participated in a tax avoidance scheme as the insurance credited to the retirement phase income stream account would not count towards the member's transfer balance cap.

7 Contributions and benefit payments

7.1 Accept and allocate contributions

Accept contributions

A trustee must only accept contributions made in accordance with the rules specified in SIS Regulation 7.04. These rules allow all personal contributions and voluntary employer contributions to be made up to age 75 (including up to 28 days after the end of the month in which the member turns 75).

However, individuals aged 67 to 74 years who want to claim a tax deduction for their personal contribution will need to satisfy the work test (or the work test exemption) to be eligible.

For more information on the types of contributions that can be made to a complying superannuation fund, please see the FirstTech Super and Retirement Income Streams guide.

Contributions a trustee must not accept

SIS Regulation 7.04 prohibits a trustee from accepting contributions made where:

- for member contributions and voluntary employer contributions, such as salary sacrifice contributions, the member is age 75 or over (other than contributions made within 28 days after the end of the month the member turned 75)
- no age limit or work test applies for mandated employer contributions, including superannuation guarantee contributions
- no upper age limit or work test applies for downsizer contributions, although the member must meet a range criteria to make a downsizer contribution including being aged 55 or over at the time of the contribution
- The contribution is a member contribution and the member has not quoted their TFN to the fund.

What are member contributions?

Member contributions are contributions made by, or on behalf of, a member of a fund, other than employer contributions.

No TFN contributions

A trustee must not accept a member contribution unless the member has quoted their TFN to the trustee, or unless the member quotes their TFN to the trustee within 30 days of the contribution being made.

For more information on no TFN contributions, please see the FirstTech Super and Retirement Income Streams guide.

Acknowledge deduction notices

Where a member provides a valid 'notice of intent to claim or vary a deduction for personal super contributions' form, the trustee must, without delay, give the member a written acknowledgement of the valid notice.

For more information on the requirements and process to claim a tax deduction for personal contributions, please see the FirstTech Super and Retirement Income Streams guide.

Allocate contributions

Under SIS Regulation 7.08(2), where a trustee receives a contribution for a member, it must be allocated to the member's account:

- within 28 days after the end of the month, or
- if it is not reasonably practicable to allocate the contribution to the member of the fund within 28 days after the end of the month – within such longer period as is reasonable in the circumstances.

Allocations count towards relevant contributions cap

Under the tax regulations,[122] where a trustee initially allocates a contribution to a contribution reserve (or an unallocated contributions account) before allocating it to a member's account within the required time period, the amount of the allocation will count towards the member's relevant contributions cap.

For example, where a trustee allocated a non-concessional contribution received from a member to a contributions reserve before allocating it to the member's account within the required time-frame, the amount of the allocation will count towards the member's non-concessional contribution cap.

Contribution allocated in a different financial year

The ATO has confirmed in TD 2013/22 that the amount of a contribution made to a superannuation fund in one financial year (year one) but allocated to the relevant member's interest in the subsequent financial year (year two) in accordance with SIS Regulation 7.08, is included in the member's concessional contributions for year two.

Case study – allocation of contributions in a different financial year (TD 2013/22)

The TD includes the following example:

Harry's concessional contributions cap for the 2013–14 financial year is $25,000. Harry is a member of an SMSF complying superannuation fund. He makes a personal deductible contribution of $25,000 which is received by his fund on 30 June 2014. The trustees apply this amount to an unallocated contributions account established in accordance with the governing rules of the fund. On 2 July 2014, the trustees allocate the amount of $25,000 to Harry's member account in the fund with effect from 2 July 2014.

122 Income Tax Regulations 291–25.01 and 292–90.01.

In this situation the ATO confirms the $25,000 contribution is included in the amount of Harry's concessional contributions for the 2014–15 financial year.

The ATO has subsequently confirmed[123] that regardless of TD 2013/22, trustees must still report contributions in the financial year in which they were made to the fund rather than in the year they are allocated to the member's interest. In addition, the SMSF annual return does not otherwise make provision for it, only allowing for the reporting of contributions that are both contributed and allocated in the same financial year.

To resolve this situation, the ATO released the request to adjust concessional contributions form that allows a trustee to notify the ATO that a member made concessional contributions in one financial year (year 1), but the fund did not allocate them to the member until the next financial year (year 2). Links to download the form and instructions on how to complete it are available on the ATO website at: www.ato.gov.au/Forms/Request-to-adjust-concessional-contributions/

FirstTech comment

Allocation of contributions and tax avoidance

Trustees considering allocating contributions over two separate financial years to avoid the tax impact of excess contributions may wish to carefully consider their actions.

For example, if a trustee divided a single contribution up into two separate amounts and then allocated those amounts over two separate financial years, they could risk being accused of entering into a scheme to avoid tax.

SuperStream and employer contributions

Under the SuperStream reforms[124] SMSF trustees are required to receive employer contributions from an unrelated employer and related messages electronically. However, SMSF trustees are not required to receive employer contributions electronically from an employer who is a related party of the fund.

To be able to receive the contribution messages from a member's employer, a trustee will need to register with an SMSF messaging provider to get an electronic service address for the fund. The impacted member must then provide their fund's electronic address along with the fund's ABN to their employer.

123 ATO SMSF News – edition 29 (March 2014).

124 The SuperStream reforms are part of the Government's superannuation reform package and are designed to improve the efficiency of the superannuation system by improving the timeliness of processing of rollovers and contributions, and to reduce the number of lost accounts and unclaimed money.

FirstTech comment

Impacted trustees should check with their administration service provider

Impacted trustees should check with their administration service provider as many providers have entered into arrangements with messaging providers and may be able to register the fund on the trustee's behalf. Alternatively, trustees will need to register with a messaging provider themselves.

7.2 Report contributions

Trustees must report contribution details for members in the SMSF annual return. The ATO then uses that information to determine:

- whether a member has exceeded a contributions cap
- a member's eligibility to claim a tax deduction for a personal contribution for a year
- a member's tax liability on any excess contributions
- a member's entitlement to a superannuation co-contribution or any other income-tested tax concession that takes into account reportable superannuation contributions or reportable employer superannuation contributions
- whether a member's employer has complied with their superannuation guarantee obligations
- whether a member has a Division 293 tax liability and the amount of the liability.

A trustee is only required to report the amount of member contributions and employer contributions received for a member. A trustee is not required to report whether the contributions received are concessional or non-concessional.

What is a contribution?

ATO tax ruling TR 2010/1,[125] outlines what amounts must be reported as a contribution and when they are deemed to have been made for tax purposes. The ruling confirms that a contribution is anything that increases the capital of a superannuation fund where the contributor's purpose was to benefit one, some, or all members of the fund.

Importantly, the ruling confirms that the capital of a superannuation fund may be increased by something of value being provided either directly or indirectly in a number of ways. Tables 7.1 and 7.2 summarise direct and indirect contributions.

125 Taxation Ruling TR 2010/1: *Income Tax: Superannuation Contributions.*

Table 7.1 Direct superannuation contributions

Direct contributions	Examples
Transfer of funds	An entity transfers money to a superannuation fund, via a cash transfer, cheque, money order, promissory note or electronic funds transfer where there is an actual transfer of funds
Transfer of an existing asset for no or inadequate consideration	An entity transfers an asset such as a listed share to a fund as an in-specie contribution

Table 7.2 Indirect superannuation contributions

Indirect contributions	Examples
Increasing the value of an existing fund asset	An entity pays for improvements to an existing fund asset without being reimbursed
Paying a fund expense	An entity pays a fund's accounting and administration fees without being reimbursed
Forgiving a debt owed by the fund	An entity forgives a loan made to a superannuation fund or a guarantor who makes a payment to a lender on behalf of a superannuation fund forgoes the right of indemnity against the fund as the principal debtor

In addition, where a superannuation fund receives a distribution of income or capital from a discretionary trust, the amount will be treated as a contribution. This is because the distribution cannot be characterised as being received due to the investment of the fund's capital and that the trustee of the discretionary trust must be taken to have appointed the trust's income or capital to the fund for the purpose of benefiting some or all of the members.

FirstTech comment

Partial in-specie contributions and NALI

Where an asset is purchased by an SMSF for less than market value, the ATO has indicated in LCR 2021/2 that where the terms of a contract between the fund and the seller of the asset make it clear that the asset is being purchased by the fund, the difference between the consideration paid by the fund and the market value of the asset purchased under the contract cannot represent the value of an in-specie contribution made by the other party. Such situations will result in the fund deriving non-arm's length income (NALI).

In contrast, NALI will not arise where market value is paid for the purchase of part of an asset, and the market value of the remainder of the asset is properly characterised as an in-specie contribution. The ATO indicates that an in-specie contribution would involve the contract and records of the fund making clear that the fund:

- is only purchasing part of the asset, and
- is receiving the remaining interest in the asset as an in-specie contribution.

SMSF members and trustee should therefore ensure that any in-specie contributions are properly characterised and recorded to ensure that the NALI provisions do not apply. For further information about NALI, refer to section 5.7.

FirstTech comment

In-specie contribution value and NALI

While LCR 2021/2 does not refer to the NALE provisions applying to in-specie contributions, paragraph 25B (draft updated) of TR 2010/1* confirms that in-specie contributions are required to be reflected at the asset's market value in the fund's accounts.

Therefore, it seems transferring an asset to the fund as an in-specie contribution will not trigger the NALE rules, as the trustee is required to use the asset's market value when recording the value of the contribution in the fund's accounts.

* Note – TR 2010/1 is currently being updated at the time of writing to take into account issues such as the change to the definition of NALI to include income derived via a non-arm's length dealing where a NALE was incurred.

Amounts that are not contributions

However, not every increase in capital will be treated as a contribution. That is, for there to be a contribution, the fund's capital must have been increased by a person (or entity) whose purpose was to benefit one or more members of the fund.

For example, the ruling clarifies that a person will not normally have the purpose of benefiting one or more members where:

- the transaction is in no way dependent on the identity of the other party being a superannuation fund, or
- where the transaction simply involves one party fulfilling the terms of a contract or arrangement entered into on an arm's length basis.

Examples of amounts that would not be deemed to be a contribution due to a lack of purpose to benefit a member include where:

- a fund's capital is increased by investment income (such as interest, rent, dividends and unit trust distributions) received in accordance with the terms of a contract
- a fund's capital is increased by the receipt of insurance proceeds due to the occurrence of an insured event under an insurance contract
- a tenant carries out capital improvements on a property owned by a fund for its own business purposes and not to benefit the fund members
- a lender forgives an arm's length loan for normal commercial reasons
- money is transferred to a fund in error, i.e. money is transferred to the incorrect bank account due to a processing error.

Provision of services to a fund

In TR 2010/1 the ATO confirms that where a member provides a service to the fund and invoices the fund for that service, but then forgives the liability, a contribution will be deemed to have been made as the assets of the fund will have been constructively increased for the purpose of benefiting members. Alternatively, if the member had simply provided their services free of charge and had not invoiced the fund, TR 2010/1 confirms that no contribution will have been made as no liability will have been extinguished and the capital of the fund will not have been increased.

There is one very important exception to this rule. In TR 2010/1 the ATO confirms that a member will have made a contribution where a:

- fund provides materials used to make improvements to an asset of the fund, and
- member of the fund provides the services needed to achieve the improvements.

For example, if a member who is a builder provided their services improve a property owned by an SMSF, the member will be deemed to have made a contribution to the fund. In this case, the ATO subsequently confirmed[126] that the value of the contribution would be the corresponding increase in the market value of the asset, rather than the market value of the services provided.

126 NTLG Superannuation Technical Sub-group meeting minutes, 3 September 2013.

FirstTech comment

Provision of services and NALI

Where a member or other related party provides services (other than services provided in their capacity as trustee) to a fund for no cost or at less than a commercial rate, this will generally lead to non-arm's length income (NALI) provisions applying.

However, in TR 2010/1DC the ATO confirm that:

"Where the person making the contribution and the superannuation provider are acting on an arm's length basis, the superannuation provider would record the market value of the increase in capital as a contribution to the relevant member or members of the fund as required under the SISR. In these circumstances, the 'non-arm's length income' provisions in section 295-550 will not apply to ordinary or statutory income that is derived with respect to the asset to which the contribution relates."

Therefore, it appears that a NALE will not be incurred in situations where services are provided to the fund for less than an arm's length value and the trustee records the market value of the increase in capital as a contribution.

However, it is important to note that at the time of writing the proposed changes to TR 2010/1 (as outlined in TR 2010/1DC) are still only draft and this is yet to be confirmed.

For further information about the provision of services and NALI, refer to section 5.7.

When is a contribution made?

The ruling confirms that, generally, a contribution will be deemed to have been made when the capital of the fund is increased. This will generally be when an amount is received by the fund, ownership of an asset is obtained by the fund or (in the case of indirect contributions) when a fund otherwise obtains a benefit of an amount.

It is important to identify when a contribution is made, as it determines the period for which the person making the contribution may be eligible to claim a tax deduction and is relevant for the operation of the superannuation contributions caps. Table 7.3 summarises when a contribution is deemed to be made.

Table 7.3 When is a contribution made?

Way in which contribution is made	When contribution is made
Cash payment	When cash is received by the fund
Electronic transfer	When the funds are credited to the fund's account
Personal cheque	Where the cheque is not post-dated: When the cheque is received, so long as it's promptly presented and not dishonoured Where the cheque is post-dated: When the cheque can be presented (i.e. the date on the cheque), as long as the cheque is promptly presented and not dishonoured
Giving a promissory note	When the promissory note is received by the fund as long as payment is promptly demanded and the note is not dishonoured
Giving a promissory note that is post-dated	When payment is able to be demanded or required to be made, as long as the demand is promptly made and the note is not dishonoured
Creating rights in the name of the superannuation fund that did not previously exist for no consideration	When the superannuation fund commences to hold the right
Increasing the value of an asset	When the ownership of the improvement passes to the superannuation fund
Paying a fund liability or expense	When a person satisfies a fund's liability
Forgiving a debt	When the lender executes a deed of release that relieves the superannuation fund from the obligation to repay a debt
Payment of debt by guarantor	If the guarantor has no right of indemnity: when the superannuation fund's liability is satisfied If the guarantor has a right of indemnity: when the indemnity expires or when the guarantor executes a deed of release

Where a fund has accepted any contribution, the trustee must generally provide supporting evidence, such as bank account statements, to the fund's administrator and auditor to facilitate the preparation and audit of the fund's accounts.

When in-specie contributions are made

An in-specie contribution will generally be made when the fund obtains ownership of the asset from the contributor. A fund will obtain ownership of an asset on the earlier of when the legal or beneficial ownership of the asset is acquired.

For classes of property where there is no formal registration process to evidence ownership, ownership of the property will generally pass when the fund acquires the legal or physical possession of the property. However, the ATO will accept that change of beneficial ownership can occur earlier than legal ownership, such as on execution of a transfer of property.

For classes of property where there is a formal registration process, such as Torrens Title land and shares in a listed company, the beneficial ownership can commence earlier than registration of legal ownership.

Where the asset is real property (land and attached buildings), beneficial ownership will generally transfer when the superannuation fund obtains possession of a properly executed transfer that is in registrable form together with any title deeds and other documents necessary to procure registration of the trustee as the legal owner of the land.

Where the asset is a listed security, beneficial ownership changes when the superannuation fund obtains a properly executed transfer form.

Case study

Trevor and Daisy own a business real property, which they would like to transfer to their SMSF as a contribution. As directors of their fund's corporate trustee, they resolve to accept the contribution on 1 June in a financial year.

After obtaining advice from their solicitor, Trevor and Daisy, as directors of their SMSF's corporate trustee, take possession of the necessary transfer forms and title deeds to procure registration as the legal owner of the asset on 29 June in the same financial year. The transfer forms are then lodged with the land titles office on 2 July in the following financial year, before the corporate trustee is registered as the legal owner of the property seven business days later.

In these circumstances, Trevor and Daisy's contribution will be deemed to have been made on 29 June.

Where the trustee has accepted an in-specie contribution, they should also retain all supporting documentation, such as valuation reports, sale contracts and off market transfer forms to evidence the value and timing of the contribution.

When a contribution is made – allocations from reserves

As outlined above (section 7.1), where a trustee receives a contribution for a member, must generally allocate it to the relevant member's account within 28 days after the end of the month in which the contribution was made.

The ATO has confirmed in TD 2013/22 that, for the purposes of the contributions caps only, a contribution will be received when it is allocated to the member's account – not when the amount was received by the trustee.

As a result, where a contribution is received in one financial year but not allocated to the member's account until the next financial year (but within the required time period), the contribution will count against the member's contributions cap in the year it was allocated.

Reserve allocations and the contributions caps

Under Tax Regulation 291–25.01, any amounts allocated from a reserve (other than amounts allocated from a contributions reserve) to a member's account will generally count towards the member's concessional contributions cap unless:

- the amount is allocated to all members (or class of members) of a fund on a fair and reasonable basis, and
- the total amount allocated did not cause the member's interest in the fund to increase by 5% or more.

The ATO has confirmed in the NTLG meeting minutes of September 2009[127] that a reserve allocation will be on a fair and reasonable basis where the amount allocated to each member's account is in proportion to their interest in the fund.

> **Note**
>
> This rule does not apply to amounts allocated from a contributions reserve as these amounts are already specifically included in the member's contributions cap.

FirstTech comment

ATO confirms no allocations from reserves to existing account based pensions

In SMSFRB 2018/1, the ATO confirmed that SMSF trustees cannot allocate from a reserve directly to an account based pension, as this strategy would allow amounts to be transferred to retirement phase without being a transfer balance cap credit. Therefore, with the exception of allocations from specific pension reserves discussed below (for example allowing an amount to be allocated from a solvency reserve to help the fund pay an existing lifetime pension), trustees should ensure that any reserve allocations are made to members' accumulation phase interests and not existing retirement phase interests.

For further details about the ATO's guidance on the use of reserves by SMSF trustees, refer to section 3.4.

127 National Tax Liaison Superannuation Technical Sub-Group meeting of 8 September 2009.

Exclusion for allocations from pension reserves

Under Tax Regulation 291–25.01, where a trustee allocates an amount from a reserve used solely for the purpose of enabling the fund to discharge all or part of its pension liabilities, that amount will not count as a concessional contribution where:

- the amount has been allocated to satisfy a pension liability of the fund – for example, where a trustee allocates an amount from a solvency reserve to help support the payment of a defined benefit pension, such as a guaranteed life-time pension
- on the commutation of a pension where:
  - the amount in the reserve is allocated to the member receiving the income stream and is used to pay another income stream to that member, or
  - on the death of the member receiving the pension, the amount is used to pay a death benefit in the form of an income stream or a lump sum to the member's dependants.

However, where a member commutes a complying lifetime pension, the ATO has confirmed in ATO ID 2015/22[128] that the exemption will only apply where the reserve is allocated to the member and is used to commence another complying income stream.

For example, where a member commuted a lifetime complying pension being paid from an SMSF and rolled it over to commence a term allocated pension (TAP) paid from the SMSF, all of the reserves backing the lifetime pension would need to be allocated to the member and used to commence the TAP for the exemption to apply.

Allocations from reserves on commutation of commutable pensions

The ATO takes the view[129] that where an SMSF commutes a defined benefit income stream that meets the requirements of SIS Regulation 1.06(6) (commonly known as a flexi-pension), any allocation of the commutation value (calculated under Schedule 1B of the SIS Regulations) from the reserve used to support the pension to commence a new income stream is exempt from counting towards the member's concessional contributions cap, under the pension reserve exemption in Tax Regulation 291–25.01.

However, the ATO has confirmed that the allocation of any reserve amount exceeding the commutation value of the income stream will not qualify for the pension reserve exemption. Instead, it will count towards the member's concessional cap (unless the '5%' exemption applies).

For more information on the commutation of defined benefit pensions in SMSFs, please see the article 'SMSF defined benefit pensions – commutation considerations', available on the FirstTech website.

128 ATO Interpretative Decision ATO ID 2015/22: *Superannuation: Excess contributions tax: concessional contributions – allocation from 'pension reserve account' supporting 'complying lifetime pension'.*

129 Paragraph 51–52 of ATO Regulator's Bulletin SMSFRB 2018/1.

7.3 Pay benefits

As with other types of superannuation funds, SMSFs can pay benefits as a lump sum and/or income stream subject to the provisions of the fund's trust deed. A lump sum may be paid from the accumulation phase or the pension phase.

However, a member's benefits should only ever be paid where they have satisfied a condition of release otherwise severe penalties can apply.

For a detailed summary of all the preservation rules, please see the FirstTech Super and Retirement Income Streams guide.

Confirm ability to pay benefit under the fund's trust deed

Before paying any benefit, the trustees should confirm that they can pay that kind of benefit under the provisions of the fund's trust deed. For example, where a member requests to commence an account based pension, the trustees should confirm that the fund's trust deed allows benefits to be paid in this form.

Where a trust deed does not allow a benefit to be paid in a particular manner, the trustees can generally arrange to have the trust deed amended accordingly.

7.4 Tax components of benefits payments

Where a trustee pays a benefit to a member, the trustee will be required to calculate the tax components of the benefit payment.

The tax components, i.e. the tax-free and taxable components of a superannuation benefit payment, are determined by the tax component proportions of the superannuation interest from which it is paid.

A superannuation interest is generally the total value of a member's interest in the fund.

> **Note**
>
> Amounts supporting income stream benefits are treated as separate interests immediately after the pension has commenced.
> See 'Meaning of superannuation interest' section of this chapter (below) for more information.

The tax-free and the taxable proportions of a member's superannuation interest are calculated as follows:

Tax-free component

The tax-free component of a superannuation interest is the sum of the:

- contributions segment, and
- crystallised segment.

Contributions segment

The contributions segment of a superannuation interest consists of the contributions made after 30 June 2007, to the extent that they have not been and will not be included in the assessable income of the superannuation provider, for example, non-concessional contributions.

Crystallised segment

The crystallised segment of a superannuation interest is a fixed dollar figure. It is the 30 June 2007 value of the following components:

- concessional
- post-June 1994 invalidity
- undeducted contributions
- CGT exempt, and
- pre July 1983.

> **Note**
>
> Where an income stream was commenced before 1 July 2007, a different calculation applies to determine the tax components until a trigger event occurs.[130] For further information about the tax arrangements for superannuation income streams commenced before 1 July 2007, contact the FirstTech team.

Rollovers and withdrawals of the tax-free component

Where a fund receives rollovers that include a tax-free component or where it has paid benefits that included a tax-free component, those amounts are taken into account when calculating the tax components of a member's superannuation interest.

Taxable component

The taxable component is simply the total value of the superannuation interest less the tax-free component. For example, if a member's superannuation interest was valued at $300,000, but the total of their contributions segment and their crystallised segment was valued at $200,000, their superannuation interest would be made up of a $200,000 tax-free component and a $100,000 taxable component.

Apply proportioning rules

A member's interest in the fund is valued at different times depending on whether their interest is in the accumulation phase or the pension phase. Here is a summary of these rules:

130 Trigger events include being age 60 or over on 1 July 2007, reaching age 60, partially or fully commuting the income stream and death.

Accumulation phase

A superannuation interest in the accumulation phase is valued immediately before the benefit payment is paid. The percentage of the tax-free and taxable components of the superannuation interest is then applied to the superannuation benefit being paid.

Case study – calculation of lump sum tax components

Just before taking a lump sum payment of $10,000, the components of a member's superannuation interest were:

- $60,000 tax-free
- $40,000 taxable component.

As the member's interest is 60% tax-free and 40% taxable, the components of the lump sum will also be 60% tax-free and 40% taxable.

Pension phase – income stream commenced on or after 1 July 2007

Where a member commences a superannuation income stream (including a transition to retirement income stream) on or after 1 July 2007, their superannuation interest is valued immediately before the income stream is commenced. The proportions of the tax-free and taxable components are then set at that time and apply to all future payments, including both income stream payments and lump sum payments.

Case study – calculation of income stream tax components

A superannuation interest used to purchase an account based pension after 1 July 2007 consisted of the following tax components at commencement:

- $60,000 tax-free
- $40,000 taxable component.

The pension is valued and proportioned at commencement as 60% tax-free and 40% taxable. If the member then commuted and withdrew $10,000 as a lump sum benefit payment three years later, the lump sum would be 60% tax-free and 40% taxable regardless of the current value of the pension interest.

Meaning of superannuation interest

Under regulation 307–200.02 of the Tax Regulations, a member's superannuation interest in an SMSF is defined as the combined value of every amount, benefit or entitlement that a member holds in the fund at that time. However, where a member starts an income stream, the Tax Regulations also confirm that the amount supporting the income stream is a separate interest and is not included in the value of the member's other interests in the fund.

Case study – calculation of a members interest in an SMSF

Wendy has $500,000 within her SMSF that consists of:

- term allocated pension: $100,000 (100% taxable component)
- account based pension: $150,000 (100% tax-free component)
- accumulation phase: $250,000 (100% taxable component).

In this case, Wendy has three separate super interests, her two income stream interests and her accumulation interest. If Wendy withdrew a lump sum from her accumulation interest the lump sum would be made up of 100% taxable component.

Valuing a member's superannuation interest

Where a member takes a benefit on 1 July in a financial year, such as commencing an income stream on that date, the trustee will be able to rely on the valuation of the member's superannuation interest as calculated in the audited financial accounts that must be prepared each year as at that date.

However, where a member takes a benefit, such as a lump sum, part way through a year, the trustee will generally need to arrange for an interim set of accounts to be completed to confirm the value of the member's superannuation interest in the fund. In this case, the trustee (or their administration service provider) will need to consider a number of factors that could impact the value of a member's superannuation interest in the fund including:

- market value of the fund's assets, including the value of any unallocated investment income as at the date of the lump sum payment
- value of any member contributions made during the year up to the date of the lump sum payment
- value of any benefit payments, such as lump sum or income stream payments, made during the year up to the date of the lump sum payment
- value of any expenses that relate specifically to that member's interest in the fund, such as the cost of any insurance premiums paid.

The trustee should also make provision for any general fund expenses and for any tax liabilities, including any realised and unrealised capital gains tax liabilities on the fund.

Modification for disability benefits

Under section 307-145 of the Tax Act, where a person receives a lump sum disability superannuation benefit, its tax-free component is increased for the future service benefit – broadly reflecting the period where they would have expected to have been gainfully employed.

A disability superannuation benefit is a benefit paid to a person where:

- he or she suffers from ill health (whether physical or mental), and
- two legally qualified medical practitioners have certified that, because of the ill health, it is unlikely that the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

For more information on the modification of the tax components where a lump sum disability super benefit has been paid, see section 6.7 of this Guide, and section 9.4 of the FirstTech Super and Retirement Income Streams guide.

Taxation of benefit payments

The tax rates that apply to superannuation benefit payments vary depending on the tax components included in the benefit payment and the age of the member. For more information on the taxation of superannuation benefit payments, please see the FirstTech Super and Retirement Income Streams guide.

Reporting

Where a trustee pays a benefit to a member, or their beneficiaries, they will need to withhold PAYG withholding tax (where applicable) and provide the beneficiary with a PAYG payment summary.

However, where the benefit is not subject to tax, for example because the member is aged 60 or over, the trustee will not be required to withhold PAYG withholding tax or to provide a PAYG payment summary to the member or their beneficiaries.[131]

7.5 Paying lump sums

Subject to the provisions of a fund's trust deed, where a member has satisfied a condition of release that allows a lump sum benefit to be paid, the trustee can pay the benefit in the form of cash or they can transfer an asset to the member as an in-specie benefit payment.

In either case, the trustee will need to arrange for the member's superannuation interest to be valued and to determine the tax-free and taxable proportions of the lump sum payment. For more information on the valuation of a member's superannuation interest and the calculation of the tax components of the lump sum benefit payment, please see section 7.4 of this chapter.

131 Withholding and PAYG payment summary may still be required in these circumstances where the income stream is a capped defined benefit income stream. For further information, refer to section 7.10.

In-specie lump sum benefit payments

Trustees can transfer assets to members in the form of an in-specie lump sum.

However, before transferring an asset to a member as an in-specie benefit payment, the trustee must value the assets at its current market value. This ensures the fund will have complied with the non-arm's length rules and will allow the trustee to calculate the tax components of the payment and withhold the correct amount of tax (where applicable).

CGT, stamp duty and GST

Where a trustee transfers a CGT asset to a related party as an in-specie benefit payment, the transfer will trigger a CGT event. Where the disposal will trigger a CGT liability, the trustee should ensure the fund will have sufficient cash reserves to pay the fund's tax liability at the end of the year.

The transfer of an asset to a member as an in-specie benefit payment may also trigger a stamp duty liability for the member depending on the type of asset being transferred.

Where the asset is used in a business, such as a commercial property, GST may also apply to the disposal.

Payment in response to release authorities – SuperStream

SMSF trustee may also be required to pay benefits where the ATO issues the trustee with a release authority. Release authorities can be issued in a number of situations, including:

- releasing up to 85% of excess concessional contributions
- releasing non-concessional contributions above the non-concessional cap (plus 85% of associated earnings)
- compulsory release of excess non-concessional contributions tax liability
- releasing a Division 293 tax liability.

Benefits in response to these release authorities are paid to the ATO (who then credits them to the member). The proportioning rule does not apply to the payment of these benefits.

The SuperStream data standard was extended to SMSF rollovers from 31 March 2021. SuperStream can also be used to accept and process release authorities. While it is not compulsory for SMSF trustees to process release authorities via SuperStream, they may eliminate delays in the release of benefits by electing to do so (particularly where a fund is already using SuperStream for rollovers and unrelated employer contributions).

7.6 Paying income streams

Where a member has satisfied a condition of release that allows an income stream to be paid, the trustee of a superannuation fund can, subject to the provisions of the fund's trust deed, pay the benefit as an income stream.

Types of income streams that can be paid from superannuation funds (large and small)

The five different types of superannuation income streams that can be commenced under current standards in the SIS Regulations are:

- Account-based income streams: flexible income streams which have an identifiable account balance, are commutable at any time and require at least minimum income payments.
    - Transition to retirement (TTR) income streams are a subset of these income streams, but have additional restrictions.
- Non-account-based (RCV) income streams: flexible income streams that do not have an identifiable account balance but may be commutable and have a residual capital value.
- Lifetime (nil RCV) income streams: may be either non-commutable or commutable income streams.
- Fixed term (nil RCV) income streams: a commutable income stream payable for a fixed term based on the recipient's age at commencement.
- Innovative income streams: payable for a beneficiary's remaining lifetime, with income stream payments that can be guaranteed in whole or part by the income stream provider, or determined in whole or part through returns on a collective pool of assets or the mortality experience of the beneficiaries of the asset pool.

In addition, income streams that were commenced prior to 20 September 2007 (when different SIS standards applied) are deemed to meet the current standards. These types of income streams include:

- Allocated pensions.
- Term allocated pensions (TAPs).
- Complying life-expectancy income streams.
- Flexi-pensions.

A TAP can also be commenced on or after 20 September 2007 with proceeds from the commutation of another complying income stream. The new income stream (generally referred to as a TAP clone) must satisfy both TAP payment standards and account-based income stream standards.

A complying life-expectancy income stream can also be commenced on or after 20 September 2007 with proceeds from the commutation of another complying income stream. The new income stream must satisfy both complying life-expectancy income stream payment standards and one of several current income stream standards.

For further information about the requirements that apply to these different types of superannuation income streams, see sections 14–19 of the FirstTech Super and Retirement Income Streams guide.

Types of income streams that can be paid from SMSFs

Since 12 May 2004 (or 1 January 2006 under transitional rules), SMSFs have been prohibited from commencing defined benefit pensions. However, defined benefit pensions commenced before those dates can continue to be paid.

A defined benefit pension includes all pensions, except:

- Account-based pensions.
- Allocated pensions.
- TAPs (and TAP clones).

An exemption allows SMSFs to continue to commence defined benefit pensions after the above dates provided the pension is wholly determined by reference to policies of life assurance purchased or obtained by the trustee solely for the purposes of providing benefits to members of that fund.

Table 7.4 shows the types of pensions that may be payable from an SMSF (provided also permitted by the fund's governing rules).

Table 7.4 Income streams payable from SMSFs

Type of pension	Payable by SMSF
Account based pension	Yes, where satisfies minimum standards for account-based pensions
Allocated pension (commenced before 20 Sep 2007)	Yes, where satisfies previous regulations for allocated pensions (note, trustees can also elect to convert allocated pensions to account-based pensions from 1 Jul 2007)
TAP (commenced before 20 Sep 2007)	Yes, where satisfies the previous regulations for TAPs
TAP clone (commenced on or after 20 Sep 2007)	Yes, but only where the purchase price is funded wholly from the commutation of an existing non-commutable income stream and the new TAP satisfies both the old regulations for TAPs and the minimum standards for account-based pensions.
The following pensions (commenced on or after 1 Jul 2007): • Non-account-based (RCV) pension • Lifetime (nil RCV commutable) pension • Fixed-term (nil RCV commutable) pension • Lifetime (nil RCV non-commutable) pension	No, unless a pension is fully funded by annuity purchased from a life office and satisfies minimum pension standards for these types of pensions.

Type of pension	Payable by SMSF
The following pensions (commenced before 20 Sep 2007) • Complying lifetime pension • Complying life-expectancy pension • Flexi-pension	No, unless: • the pension was commenced before 11 May 2004 (or before 1 January 2006 under transitional provisions) and the pension satisfies the previous regulations for these pensions, or • the pension was wholly determined by reference to policies of life assurance purchased or obtained by the trustee, solely for the purposes of providing benefits to members of that fund.
Innovative income streams (including deferred superannuation income streams)	No, unless fully backed by life office annuity and satisfies minimum pension standards for these types of pensions

Bespoke pensions

Importantly, provided the minimum pension payment standards set out in the SIS Regulations are met, SMSF trustees can tailor the terms and conditions of any pension agreement to provide additional features to meet the strategic needs of a member.

For example, this may allow a member and the trustee to place additional restrictions on an account-based pension. These may include a requirement:

- that an account-based pension have a maximum pension payment and that it cannot be commuted until the member reaches a certain age or dies
- for pension payments to be made more regularly than once per financial year.

While for most members placing additional restrictions on pensions may not be appropriate, they could be considered in cases where a member wanted their death benefit paid as a non-commutable income stream due to their beneficiary:

- being a child and the member does not want them to have access to a lump sum until after they turn 18 (note – a pension paid to a child is generally required to be commuted to a lump sum by the time they turn 25)
- having a drug or gambling addiction
- being mentally incapacitated.

In these situations trustees will need to work closely with the fund's trust deed provider to formulate pension terms and conditions that will achieve the member's strategic requirements.

7.7 Retirement phase income streams

The concept of a retirement phase income stream was introduced from 1 July 2017 to facilitate the introduction of tax on earnings on assets supporting transition to retirement and similar income streams, and to allow for the introduction of deferred superannuation income streams.

Retirement phase income streams include all superannuation income streams (refer to section 7.6), except:

- deferred income streams that have not yet become payable and where the recipient has not satisfied the retirement, reaching age 65, terminal medical condition or permanent incapacity condition of release
- transition to retirement income streams (and non-commutable allocated pensions and annuities) where:
  - the income stream has not automatically reverted due to the death of the original recipient, and
  - the recipient has not reached age 65, and has not satisfied another eligible condition of release (retirement, terminal medical condition, permanent incapacity) and formally notified the trustee
- income streams where a commutation authority has been issued for an excess transfer balance that a trustee has failed to comply with within the required 60-day period.

If an income stream is in the list of these exclusions, it is considered to be in the accumulation phase of superannuation for the purposes of the earnings tax exemption and the transfer balance cap. However, it is still considered an income stream for other purposes, including the proportioning of tax components and the taxation of benefit payments from the income stream.

7.8 Transfer balance cap on transfers to retirement phase income streams

Since 1 July 2017, a transfer balance cap applies to limit the amount of superannuation a client can transfer to retirement phase income streams.

The transfer balance cap operates by measuring the value of a client's transfer balance account (the value of existing retirement phase income streams at 30 June 2017, as well as the value of any retirement phase income streams the member has become entitled to receive on or after 1 July 2017), against their transfer balance cap.

An important key to understanding the transfer balance account is that it measures net transfers to retirement phase (for example, the purchase of retirement phase income streams and commutations from retirement phase income streams). It does not include earnings, losses or income stream payments that occur within a retirement phase income stream.

Where the value of a client's transfer balance account exceeds their transfer balance cap, they are generally subject to tax on a notional earnings amount, and are required to commute the excess out of retirement phase.

For more detail about the transfer balance cap and transfer balance account, refer to the FirstTech Super and Retirement Income Streams guide.

FirstTech comment

Indexation of transfer balance cap

The general transfer balance cap is $1.9 million in 2024–25. However, a member's 'personal' transfer balance cap determines the amount they can use to commence retirement phase income streams. A member's personal transfer balance cap equals the general transfer balance cap in the year they first have a transfer balance account.

Over time, a member's personal transfer balance cap may differ from the general transfer balance cap due to proportional indexation. With the general transfer balance cap having increased twice since commencement (2021–22 and 2023–24), members who had commenced to receive one or more retirement phase income streams before 1 July 2023 will now have a lower personal transfer balance cap than the $1.9 million general cap due to either one or two rounds of proportional indexation.

For further information about proportional indexation of personal transfer balance caps, please see section 21 of the FirstTech Super and Retirement Income Streams guide.

Reporting associated with transfer balance cap

See section 3.6 for information about the event-based reporting requirements associated with the transfer balance cap.

Certain LRBA repayments are transfer balance account credits

Where an SMSF trustee makes a payment in respect of an LRBA that increases the value of retirement phase superannuation income stream interest, a credit to the retirement phase income stream recipient's transfer balance account will arise for the value of the increase in their interest.

For example, where an SMSF has a segregated asset pool supporting a retirement phase income stream that consists of an asset subject an LRBA, and cash from the accumulation phase asset pool is used to make a loan repayment on the LRBA, a credit will arise for the amount of the loan repayment.

Importantly, these credits only arise for borrowings entered into on or after 1 July 2017 – repayments from borrowings entered into before this date are not a credit to a member's transfer balance account.

FirstTech comment

Avoiding LRBA repayment credits

SMSF clients can avoid transfer balance cap credits for LRBA repayments arising by ensuring that, where an asset subject to an LRBA is:

- part of a segregated asset pool supporting retirement phase income streams, loan repayments are always made using funds from that same asset pool.
- supporting both retirement phase income streams and other superannuation interests, any repayments should be allocated proportionally to those interests.

Trustees must comply with commutation authorities

Where a client has an excess transfer balance amount, the ATO will issue them a transfer balance determination. This will specify the excess amount that must be commuted and removed from retirement phase income streams.

The determination will also include a default commutation notice specifying the fund the ATO intends to issue a commutation authority to. However the client can make a valid election to nominate another retirement phase income stream in the approved form within 60 days of the date of the excess transfer balance determination.

Once the member has chosen a different fund or where the 60-day period has lapsed, the ATO will issue the commutation authority.

An SMSF trustee that receives a commutation authority must comply and commute the amount specified in the notice (the 'reduction amount') within 60 days. However, a trustee does not have to comply where:

- the relevant income stream is a capped defined benefit income stream, or
- the member has died.

Where the reduction amount is larger than the amount that can be commuted by the SMSF trustee, the trustee must commute as much of the reduction amount as possible.

The trustee is also required to notify the ATO of compliance with the notice within 60 days. During the 60 day period, there is an expectation that the trustee will make reasonable efforts to contact the member to seek instructions (for example, which investment option or product the member wants commuted). The commuted amount can then be rolled back to accumulation phase or paid as a superannuation lump sum benefit payment.

Failure to comply with commutation authority

Where a fund fails to comply with a commutation authority, the entire income stream will cease to be in retirement phase (and no longer qualify for the earnings tax exemption), from the start of the financial year in which the fund failed to comply with the commutation authority and all later financial years. In this case the client's transfer balance account will be debited by the value of the income stream.

7.9 Tax treatment of payments from pensions

Pension payments are super income stream benefits for tax purposes.

For further information about the tax treatment of super income stream benefits, refer to the FirstTech Super and Retirement Income Streams guide.

Tax treatment of partial and full commutations

Prior to 1 July 2017, partial commutations were superannuation income stream benefits by default for tax purposes, while full commutations were super lump sums for tax purposes.

From 1 July 2017, both partial commutations and full commutations are super lump sums for tax purposes.

For further information about the tax treatment of super lump sums, refer to the FirstTech Super and Retirement Income Streams guide.

> **FirstTech comment**
>
> While partial commutations are considered superannuation lump sums for most tax purposes, they are still considered income stream benefits for the purposes of determining whether a super fund can claim an earnings tax exemption when paying a retirement phase income stream.

7.10 Practical income stream commencement and payment issues

Transfer balance cap

Before electing to commence a retirement phase income stream, SMSF members should ensure that doing so will not lead to them exceeding their transfer balance cap.

For further information about the transfer balance cap, refer to section 7.8 and the FirstTech Super and Retirement Income Streams guide.

The trust deed

When considering commencing an income stream, the fund's trust deed should be checked to ensure it will allow the trustee to pay member benefits as an income stream. Where it is not clear, or the deed only allows benefits to be paid as a lump sum, the trustees will need to arrange for the deed to be amended to allow benefits to be paid as an income stream.

The trustee should also review the deed to see if it contains any rules (known as pension terms) for the payment of an income stream. In most cases, a deed will not contain pension terms, and a trustee will need to arrange for them to be acquired along with any other necessary documents. These may include:

- pension benefit application forms
- a product disclosure statement for the income stream
- pro-forma trustee minutes to allow the trustee to resolve to pay an income stream benefit to the member.

Product disclosure statement (PDS)

Under the Corporations Act 2001, an interest in a superannuation fund, including an SMSF, is defined as a financial product. Therefore, a trustee, or an adviser, must generally give a person a PDS for an SMSF when:

- giving personal advice to that person about the fund, or
- offering to issue (or to arrange to issue) an interest in the fund to the person, or issuing an interest in the fund to the person.

Commencing an income stream within an SMSF is also considered to be issuing a new superannuation interest in the fund. Therefore, an issuer or adviser will need to issue a PDS to a member as part of commencing an income stream that outlines the benefits, risks, features and costs relating to that interest.

However, under section 1012D of the Corporations Act 2001, there is an exemption from the requirement to provide a PDS where the member has, or has access to (and knows they have access to) all of the information that a PDS would contain.

In relation to this exemption, ASIC has confirmed that a trustee or adviser cannot simply rely on the fact that a member, as trustee, will have an obligation to know about the fund in order to fulfil their duties as a trustee (or director of the corporate trustee) to avoid having to provide a PDS.

Therefore, unless a trustee or adviser has some other reasonable basis to not do so, they will generally be required to issue a PDS to a member commencing an income stream in the fund. In most circumstances they can get a pension commencement kit from the fund's trust deed provider or administrator, which includes a standard PDS about the payment of an income stream from the fund.

Review investment strategy

Before commencing an income stream for a member, the trustee should review the fund's investment strategy to determine whether it is still appropriate for the fund given the fund's liquidity requirements and the member's risk tolerance given they have now commenced an income stream pension.

Pension asset segregation method

Where a fund commences paying an income stream, the income from the fund's assets used to pay it is exempt from tax. Depending on the fund's circumstances, the trustees will be able to use the segregated assets method or the unsegregated assets method to identify the fund's exempt pension income.

Where the commencement of a pension will result in 100% of the fund's assets being used to pay pensions, the fund must use the segregated assets method from the time the pension commenced unless the trustee makes the choice to apply the unsegregated method for the whole of the year.

Where after the commencement of a pension the fund will hold both pension and accumulation assets, the trustees can choose to use either the unsegregated method or the segregated method.

Where the trustees choose the unsegregated method, they will need to obtain an actuarial certificate confirming the tax-free proportion of the fund's income by the time the fund lodges its income tax return for the year.

Alternatively, where the trustees choose the segregated assets method, they will need to identify and document which assets will be set aside and used to meet the fund's pension liabilities. This should be done when the pension is commenced.

> **Note**
>
> Funds that have disregarded small fund assets are not permitted to use the segregated method and must use the unsegregated method.

For further information about asset segregation methods there a fund pays an income stream, see section *5.5: Exempt Current Pension Income (ECPI)*.

Register for PAYG

Where the SMSF will be required to withhold tax from the income stream (or from any other income stream or lump sum paid out of the fund), it must register with the ATO for PAYG withholding as soon as possible. If the trustee has to withhold tax from a benefit payment to a member, the trustee needs to:

- obtain a Tax File Number Declaration form (NAT 3092) from the member
- issue a PAYG payment summary form to the member
- lodge a PAYG withholding payment summary statement (NAT 3447) with the ATO.

When paying an income stream, an SMSF will generally be required to withhold tax and remit any PAYG withholding tax to the ATO within the required timeframe unless the member is over age 60 or the tax-free proportion of the income stream is 100%.

Note

PAYG withholding may be required, regardless of age, where the member is receiving a capped defined benefit income stream in excess of $118,750 per year (2024–25 threshold).

PAYG registration/withholding for capped defined benefit income streams

Where a fund is paying a capped defined benefit income stream it must register for PAYG withholding. This applies regardless of whether the fund is required to withhold any amounts from the pension payments.

PAYG withholding may apply where the income from the income stream (and any other capped defined benefit income streams payable to the member) exceeds the defined benefit income cap of $118,750 per year (2024–25 threshold) and is paid to someone age 60 or over, or is a death benefit income stream where the deceased beneficiary was age 60 or over at the time of death. Capped defined benefit income streams payable by SMSFs include:

Capped defined benefit income stream	Must meet SIS regulation
Lifetime pensions	1.06(2)
Lifetime annuities commenced before 1 July 2017	1.05(2)
Life expectancy pensions and annuities commenced before 1 July 2017	1.06(7) 1.05(9)
Term allocated pensions and annuities commenced before 1 July 2017	1.06(8) 1.05(10)
Any income streams set out in the regulations to be capped defined benefit income streams	As set out in the regulations

SMSFs are generally prohibited from commencing defined benefit pensions, including complying lifetime and fixed-term pensions, from 12 May 2004 or 1 January 2006 under transitional provisions. See section 7.6 for further information.

For further information about capped defined benefit income streams generally, refer to the FirstTech Super and Retirement Income Streams guide.

Deduction notices for personal contributions when commencing income streams

Where a member has provided an SMSF with a notice under section 290–170 of the Tax Act that they intend to claim a tax deduction for a contribution made during a financial year, the notice must be valid and provided and acknowledged in writing by the fund by no later than:

- the day that the member submits their tax return for the financial year
- the end of the following financial year.

However, some events make a notice (or a variation on an original notice) invalid. Among these is that the fund has commenced to pay an income stream based in whole or part on the contribution.

TR 2010/1[132] confirms the ATO's view that if an income stream is commenced with any part of a member's superannuation balance, a valid deduction notice can no longer be submitted in relation to contributions made previously.

It is therefore important that a member submit any deduction notices before they commence an income stream in a year.[133]

Satisfy minimum pension standards each year

The ATO has confirmed[134] that if the minimum standards for an account based pension as set out in the SIS Regulations are not satisfied in a year, the following will apply:

- the account based pension will be considered to have ceased for income tax purposes (in other words, it is no longer a retirement phase income stream)
- the fund will not be considered to have been paying an income stream at any time during the year, and any payments made during the year will be treated as lump sums for both income tax and superannuation purposes.

This means that where a trustee failed to comply with the minimum account based pension requirements in a year, the fund would be ineligible to claim ECPI on any income or realised capital gains derived during the year.

In addition, where the member wished to continue receiving an income stream in the following year, the trustee will need to recommence a new income stream for them. Therefore, the trustee will need to revalue the assets at market value and recalculate the tax component proportions and minimum income stream payment required for the new income stream.

132 Taxation Ruling TR 2010/1: *Income Tax: Superannuation contributions.*

133 A notice is also invalid where a member's benefits are fully rolled over or withdrawn from the fund. However, unlike on the commencement of an income stream, in the case of a partial withdrawal or rollover, a member may still (subject to the general time limits) submit a valid notice for the remaining portion of their contribution. For further information, refer to the FirstTech Super and Retirement Income Streams guide.

134 ATO website: Pension standards for self-managed superannuation funds. Available at www.ato. gov. au/Super/Self-managed-super-funds/In-detail/SMSF-resources/SMSF-technical/Pension-standards-for-self-managed-super-funds/

Exemptions for minor breaches

However, the ATO has also confirmed that an exemption will apply to allow trustees to continue to claim the current pension asset tax exemption, even where an account based pension failed to meet the minimum pension standards where:

- the trustee failed to pay the minimum pension amount in a year because:
  - an honest mistake made by the trustee resulted in a small underpayment (one twelfth or less) of the annual minimum payment amount, or
  - of matters outside their control, and
- the trustee would have otherwise satisfied the minimum pension standards but for the underpayment, and
- upon becoming aware of the underpayment they make a catch-up payment as soon as practicable in the following financial year ('as soon as practicable' is considered to be within 28 days of the trustee becoming aware of the underpayment), and
- had the trustee made the catch-up payment in the prior income year, the minimum pension standards would have been met, and
- the trustee treats the catch up payment, for all other purposes, as if it were made in the prior income year.

Where all these conditions are satisfied, and the trustee hasn't previously claimed the exemption, the trustee can self-assess their eligibility to claim the current pension asset tax exemption. Otherwise, a trustee will need to apply to the ATO to consider their circumstances.

Transfer balance account implications of failing to meet minimum pension standards

Since 1 July 2017, failing to meet the minimum standards will also result in the income stream ceasing to be in the retirement phase and will trigger a debit in the member's transfer balance account.

However, the timing of any debit will generally occur at a different time to when the superannuation income stream ceased for taxation purposes. That is, to determine whether a member has a transfer balance account and the timing of any credits and debits, the trustee is required to assume a superannuation income stream satisfied the minimum standards up until the time it's possible to determine, based on the relevant facts and circumstances available at that time, that it had failed those standards.

For example, where a fund failed to pay a member any pension payments during a year, the income stream will cease to be in the retirement phase for transfer balance cap purposes from the end of 30 June. This is because it's only possible to determine the income stream failed the minimum standards from that time. Alternatively, where a fund failed to pay a pro-rata pension payment before a member fully commuted their pension, the income stream would cease to be in the retirement phase from the time of the full commutation.

Where an income stream fails to satisfy the minimum standards in a year, an SMSF will need to report a debit to the ATO for that event via a Transfer Balance Account Report (TBAR) within the required timeframes.

SMSFs that hold illiquid assets

Many SMSFs choose to hold only one, or a small number of illiquid assets. For example, an SMSF might own a commercial property and a small bank account. While this strategy may not provide liquidity problems for an SMSF while all members are in the accumulation phase, once members commence an income stream this can create significant issues.

The account based pension rules are designed to force a member to draw down the capital of their pension over the life of the pension. When a member under age 65 commences an account based pension, the required minimum payment is only 4% of their account balance per financial year. As the member ages though, the required minimum percentage increases, so that by age 85, for example, a minimum payment of 9% of the member's account balance applies.

For SMSFs holding one illiquid direct property, this means that while rental income may fully fund income stream payments for relatively young members, capital will eventually need to be drawn down as members' ages increase. This may make the eventual sale of the property necessary. If an illiquid asset cannot be sold in time to enable the fund to pay the minimum income stream payment required, the pension may be deemed to have ceased and not to have been paid during the year. As a result, income received from the property would be assessable.

This problem can be minimised by adding other members to the SMSF. The trustee can then use the new members' contributions (or other cash or assets that they have transferred into the fund) to meet income stream payment requirements, while preserving the illiquid investment.

7.11 Rollovers of TAPs and complying lifetime and life expectancy income streams

Where members commenced a TAP or a lifetime or life expectancy income stream from an SMSF, sometimes they may need to commute and rollover those income streams, such as to allow the fund to be wound up.

However, strict rules apply to these rollovers from both superannuation and social security perspectives. Depending on the member's circumstances it may be important to consider both sets of rules before arranging to rollover any of these pensions.

2021 Federal Budget proposal: Legacy complying pension and annuity conversions

The previous Federal Government proposed a two-year period to allow members with certain complying income streams to commute and transfer the capital supporting their income stream (including any reserves) back into a superannuation account in the accumulation phase. Under this proposal, the member can then decide whether to commence a new income stream (for example, account based pension), take a lump sum benefit or retain the balance in the accumulation account.

Eligible income streams under this proposal include the following income streams held with any provider (including an SMSF) that were first commenced prior to 20 September 2007:[135]

- term allocated pensions (market linked income streams)
- complying life-expectancy income streams
- complying lifetime income streams

However, flexi-pensions (which are already commutable) and lifetime income streams offered by APRA-regulated defined benefit schemes or public sector defined benefit schemes would not be eligible.

Members would need to consider the transfer balance cap implications of converting their eligible income stream. Significant transfer balance cap implications could apply where the existing income stream is a capped defined benefit income stream.

Members would need to consider the social security asset and income test implications of converting their eligible income stream. Any social security concessions (such as asset-test exemption) would not apply to any new account based pension, however the previous Federal Government confirmed there will be no re-assessment of the social security treatment the product received prior to the commutation. Therefore, the member would not be required to pay back any overpaid entitlements.

Any commuted reserves will not be counted towards an individual's concessional contributions cap, but will instead be taxed as an assessable contribution of the fund. It is unclear at the time of writing how the value of the reserves of life expectancy or lifetime products will be calculated for these purposes.

This proposed opportunity is voluntary. The two-year window is proposed to start from the first financial year following Royal Assent of enabling legislation. At the time of writing, this proposal had not been legislated and it is unclear whether the current Federal Government will proceed with this proposal.

135 It is FirstTech's understanding that this proposal includes complying income streams commenced since 20 September 2007 with the full rollover of an existing pre-20 September 2007 complying income stream.

Rollovers of TAPs paid from SMSFs

Superannuation rollover requirements

Under the SIS Regulations, a TAP may be rolled over after 1 July 2007 provided it is rolled over to commence another income stream that:

- satisfies the minimum pension standards for account based income streams commenced after 1 July 2007, such as an account based pension, and
- also meets the standards set out in the old regulations for complying lifetime, fixed-term or term allocated income streams.

For example, a member who commenced a TAP in their SMSF for reasonable benefit limit (RBL) purposes could commute and rollover their TAP to commence a TAP paid from a large superannuation fund (where available) where they wanted to wind up their SMSF. In this case, the TAP paid from the large fund would need to satisfy both the account based pension standards as well as the TAP standards.

Social security rollover requirements

Where a member commenced a TAP between 20 September 2004 and 20 September 2007 to qualify for a 50% assets test exemption, the member may commute and rollover the TAP to commence a new TAP in another fund and retain the original income stream's 50% Assets Test Exempt (ATE) status where the:

- original TAP is commuted in full, and
- new income stream satisfies the requirements of an ATE market linked income stream (a TAP) under the Social Security Act, and
- new income stream is purchased using all of the assets supporting the original income stream.[136]

Therefore, where a member commuted and rolled over 100% of the assets supporting the TAP to commence a new TAP in a large superannuation fund, the new pension will retain the original TAP's 50% ATE status.

136 The new pension may also be purchased with only part of the assets backing the original income stream where the other part is used to pay an income stream payment split, a superannuation contributions surcharge debt or the payment of a hardship amount.

Rollovers of complying lifetime and fixed-term pensions paid from SMSFs

FirstTech comment: Check receiving fund will accept rollover funded by commutation of complying fixed-term or lifetime pensions

Before commuting a complying fixed-term or lifetime pension to rollover and commence a TAP with a large APRA fund, the member should check with the large fund to ensure it will accept a rollover funded by the commutation of a complying lifetime or fixed-term pension.

For example, many large funds that pay TAPs will only accept a rollover to commence a new TAP where the rollover proceeds were funded from the commutation of a 50% assets test exempt TAP. That is, they will not accept a rollover funded from the proceeds of the commutation of any other type of pension, such as a complying fixed-term or lifetime pension.

Superannuation requirements

Similar to TAPs, under the SIS Regulations, a lifetime or fixed-term pensions may be commuted and rolled over after 1 July 2007 provided it is rolled over to an income stream:

- that meets one of the new standards for income streams that can be commenced after 1 July 2007, and
- that also meets the standards set out in the old regulations for complying lifetime, fixed-term or term allocated income streams.

For example, where a member commenced a complying lifetime pension for RBL purposes, the member could commute and rollover the pension to commence a TAP that also satisfied the account based pension standards.

However, the ATO has confirmed that where a complying lifetime is commuted to commence another complying income stream, such as a TAP, any associated reserve must be allocated to the member and be included in the amount rolled over to commence the other complying income stream; otherwise, the amount allocated from the reserve may count towards the member's concessional contributions cap. For more information, please see ATO ID 2015/22.[137]

Social security rollover requirements

Where a member commenced a 50% or 100% lifetime or life expectancy ATE income stream in an SMSF, they may rollover that income stream to purchase a new ATE income stream and retain the original income stream's ATE status in certain situations. These are summarised as follows:

137 ATO Interpretative Decision ATO ID 2015/22: *ECT: Concessional contributions – allocation from 'pension reserve account' supporting 'complying lifetime pension'.*

50% ATE lifetime or life expectancy income streams – Closure of an SMSF

Where a member commenced a 50% lifetime or life expectancy income stream in an SMSF between 20 September 2004 and 1 January 2006, they may rollover that income stream and retain the original income stream's ATE status where the:

- SMSF is being wound up due to the death of a member or because the trustee's administrative responsibilities have become too onerous due to age or incapacity, and
- new income stream is purchased by the primary beneficiary using all the assets, including reserves, from the commutation of the original ATE income stream, and[138]
- new income stream meets the requirements for a lifetime or life expectancy ATE income stream or a market linked income stream (a TAP) under the Social Security Act 1991 (as those requirements applied before 20 September 2007).

Therefore, where a member commenced a 50% lifetime or life expectancy ATE income stream in their SMSF and they have decided to wind up the fund due to the death of a member or the fund becoming too onerous to manage because of age or incapacity, the member could rollover the income stream to purchase a TAP from a retail superannuation fund and retain the income stream's 50% ATE status.

50% ATE lifetime or life expectancy income streams – failure to satisfy high degree of probability requirements

Where a member commenced a 50% ATE lifetime or life expectancy income stream in an SMSF but the trustee has been unable to obtain the required actuarial certificate to retain the income stream's ATE status (maybe due to negative market returns), the member can commute and rollover to purchase a new income stream and retain the original income stream's ATE status where the:

- new income stream is purchased by the primary beneficiary using all the assets, including reserves, from the commutation of the original ATE income stream, and
- new income stream is a market linked income stream (a TAP) paid from the SMSF or from a retail superannuation fund, or
- new income stream is a lifetime or life expectancy ATE income stream paid from the SMSF where the payments are determined by reference to policies of insurance (an annuity) purchased by the trustee of the fund, or
- new income stream is purchased from a retail superannuation fund and meets the requirements for a lifetime or life expectancy ATE income stream under the Social Security Act.

In this situation, the only likely option for a client is to rollover their 50% ATE lifetime or life expectancy income stream to purchase a TAP from their SMSF or from a large superannuation fund. This is due to the general unavailability of lifetime and life expectancy ATE income streams paid from large superannuation funds or life offices.

138 The new pension may also be purchased with only part of the assets backing the original income stream where the other part is used to pay an income stream payment split, a superannuation contributions surcharge debt or the payment of a hardship amount.

100% ATE lifetime or life expectancy income streams – closure of an SMSF

Where a person commenced a 100% ATE lifetime or life expectancy income stream in an SMSF, they may purchase a new ATE income stream and retain the original income stream's ATE status in certain specific situations, as summarised below.

Where a member commenced a 100% ATE lifetime or life expectancy income stream in an SMSF prior to 20 September 2004, they may rollover that income stream and retain the original income stream's ATE status where the:

- SMSF is being wound up due to the death of a member or because the trustee administrative responsibilities have become too onerous due to age or incapacity, and
- new income stream is purchased by the primary beneficiary using all the assets, including reserves, from the commutation of the original ATE income stream, and[139]
- new income stream meets the requirements for a lifetime or life expectancy ATE income stream (as the requirements applied before 20 September 2007).

However, while this exemption is available, it may be difficult to use due to the lack of lifetime or life expectancy ATE income streams available in the market.

Alternatively, the member may consider rolling over their pension to commence a TAP paid from their SMSF or from a retail superannuation fund. However, note that this will result in the loss of the original income stream's ATE status. See below for more information.

100% ATE lifetime or life expectancy income streams – failure to satisfy high degree of probability requirements

Where a member commenced a 100% ATE lifetime or life expectancy income stream in an SMSF but the trustee has been unable to obtain the required actuarial certificate to retain the income stream's ATE status (maybe due to negative market returns), the member can commute and rollover to purchase a new income stream and retain the original income stream's ATE status where the:

- new income stream is purchased by the primary beneficiary using all the assets, including reserves, from the commutation of the original ATE income stream, and
- new income stream is purchased from a retail superannuation fund and meets the requirements for a lifetime or life expectancy ATE income stream under the Social Security Act, or
- new income stream is a lifetime or life expectancy ATE income stream paid from the SMSF where the payments are determined by reference to policies of insurance (an annuity) purchased by the trustee of the fund.

139 The new pension may also be purchased with only part of the assets backing the original income stream where the other part is used to pay an income stream payment split, a superannuation contributions surcharge debt or the payment of a hardship amount.

As with the exemption relating to the closure of an SMSF, while this exemption is available, it may be difficult to actually use due to the lack of lifetime or life expectancy ATE income streams available in the market. Alternatively, the member could consider rolling over their pension to commence a TAP paid from their SMSF or from a retail superannuation fund. However, note that this will result in the loss of the original income stream's ATE status. See below for more information.

Alternative for 100% ATE lifetime or life expectancy income streams – rollover to commence a TAP

Where a member commenced a 100% ATE lifetime or life expectancy income stream in an SMSF that they no longer wish to retain (for whatever reason), they can elect to commute and rollover that income stream to purchase a market linked income stream (TAP) from either their SMSF or from a retail superannuation fund.

However, in this case the TAP will not retain the original income stream's 100% ATE status and will be fully asset tested. In this situation the Federal Government has confirmed[140] that any social security debt in relation to the original lifetime or life expectancy income stream failing the commutation requirements for those types of income streams will be waived.

Therefore, although the member may lose some future Age Pension entitlement where they are subject to the assets test, they would not have any previous Age Pension payments clawed back.

140 Social Security (Waiver of Debts – Self Managed Superannuation Funds and Small APRA Funds) (DSS) Specification 2021.

FirstTech comment

Other rollover issues

When rolling over ATE income streams, advisers also need to be aware of the following issues:

Allocation of reserves

Where a member wishes to commute a complying ATE lifetime or life expectancy pension, they must be aware of both the social security rules outlined above and the rules relating to reserve allocation counting towards the concessional cap (see section 7.2).

For a detailed analysis of how these rules work for different types of defined benefit pensions, please see the article SMSF defined benefit pensions – commutation considerations, available on the FirstTech website.

Varying income levels

When rolling over the original lifetime or life expectancy income stream to commence a new income stream, the income payable will be determined based on the member's circumstances at the time of commencing the new income stream. In this case, the new income stream may have a longer term than the remaining term on the original income stream and therefore may pay less income.

For example, if an 80-year-old male member decided to rollover a life expectancy income stream that only had a remaining term of three years, the minimum term that would apply to the new TAP would be ten years, in other words, their life expectancy at age 80 (rounded up to the nearest whole number). As a result, the level of income they would receive could decrease.

Frozen funds

Where the SMSF holds assets in frozen investments, such as a frozen mortgage income fund, the trustees may not be able to liquidate 100% of the assets supporting the income stream to fund a rollover. In this case, the exemption to allow the new income stream to retain the original income stream's ATE status will not apply, as not all of the assets supporting the original income stream will be able to be rolled over to commence the new income stream. In this case, the trustee may wish to consider selling the frozen asset to a member or other related party via an off-market transfer (where permitted by the product issuer). This would then give the fund the liquidity to rollover all of the assets backing the original income stream.

If this is not possible, the member may consider retaining the income stream in the SMSF until the trustees are able to liquidate the investment and rollover 100% of the assets backing the income stream; otherwise, the new income stream would lose the original income stream's ATE status. In addition, in the case of a partial rollover, a social security debt will be raised to clawback any overpayment of social security benefits over the last five years.

Transfer balance cap implications of rolling over capped defined benefit income streams

The special value of capped defined benefit income streams commenced before 1 July 2017 was a credit towards the member's transfer balance account.

Where such income streams are rolled over on or after 1 July 2017 to commence a new lifetime annuity, life expectancy pension or annuity, or market linked pension or annuity, the new income stream will not qualify as a capped defined benefit income stream.[141] This may cause the following issues for transfer balance cap purposes.

Firstly, where an excess transfer balance is attributable to the new income stream, it must be commuted out of the retirement phase (in contrast, excess transfer balance amounts that are attributable only to a capped defined benefit income stream are disregarded and do not need to be commuted out of retirement phase).

Secondly, where a capped defined benefit income stream is fully commuted, modified transfer balance account debit rules apply:

- Where a lifetime pension or annuity is fully commuted, the transfer balance account debit is the amount of the original transfer balance account credit (that is, original special value), less any previous transfer balance account debits for that income stream (excluding debits due to a family law payment split).
- Where a life-expectancy or market-linked pension (TAP) or annuity is fully commuted, the transfer balance account debit is the amount of the original transfer balance account credit for the income stream, less the sum of:
  - the amount of any transfer balance account debits for the income stream (excluding debits due to a family law payment split), and
  - the total amount of superannuation income stream benefits (since 1 July 2017) the person was entitled to receive from the income stream before the start of the financial year in which the commutation takes place, and
  - the greater of the income stream benefits paid to the person from the income stream during the financial year of commutation, and the minimum amount required to be paid from the income stream during the part-financial year in which the commutation takes place.

141 Note, that complying lifetime pensions are capped defined benefit income streams, regardless of when they are commenced.

However, the commencement value of the new income stream (rather than its special value) is then a credit toward the member's transfer balance account. For example, where a capped defined benefit income stream is rolled over to commence a TAP on or after 1 July 2017, the starting account balance of the TAP (not its special value) is a credit toward the transfer balance account.

Members rolling over capped defined benefit income streams should therefore check to ensure that their rollover will not lead to an excess transfer balance, or to their available transfer balance cap being significantly reduced. For further information about the transfer balance cap, see section 7.8.

8 Death benefit payments and planning

8.1 SIS death benefit payment rules

Upon the death of a member, the trustee of a complying superannuation fund must pay out their death benefit according to the rules contained in the SIS Regulations, as summarised below.

Compulsory cashing of death benefits

Under SIS Regulation 6.21, a member's benefit in a superannuation fund, including an SMSF, must be cashed as soon as practicable after the member dies.

Meaning of cashed

'Cashed' refers to the payment of a benefit from the superannuation system. A benefit is cashed when the beneficiary accepts money (or in the case of lump sums, other assets representing the benefit), banks a cheque which is subsequently honoured or receives a credit by way of an electronic transfer from a fund in payment of benefits.

Where the benefits of a deceased member are paid as a death benefit, the ATO has confirmed[142] that the benefit cannot be transferred to a beneficiary's member account by way of journal entries. Cashing necessarily involves the actual payment of the cash, assets or other consideration for the benefit of the beneficiary.

Requirement for death benefits to remain cashed

Where a death benefit income stream commences to be paid, the ongoing requirement for death benefits to remain cashed prevents the death benefit income stream interest from:

- being rolled back to accumulation phase or to an income stream that is not in the retirement phase, or
- being mixed with the beneficiary's other superannuation interests.

142 ATO Interpretative Decision ATO ID 2015/23: Superannuation: Member's benefits in a regulated superannuation fund must be 'cashed' upon death by being paid - mere journal entries insufficient.

Who can a death benefit be paid to?

Under section 55A of the SIS Act, the governing rules of a superannuation fund must not permit a member's death benefit to be cashed in a way that would contravene the death benefit payment rules outlined in SIS Regulation 6.22.

Under SIS Regulation 6.22, a trustee of a superannuation fund, including an SMSF, can only pay a member's death benefit to the following:

- one or more of the member's dependants
- the member's Legal Personal Representative (LPR)
- some other person where, after making reasonable enquiries, the trustee has been unable to find either a legal personal representative or a dependant of the member.[143]

What is a Legal Personal Representative?

Section 10 of the SIS Act defines an LPR of a member to mean the executor of the will or administrator of the estate of a deceased member, the trustee of the estate of a member under a legal disability or a person who holds an enduring power of attorney granted by a member.

A SMSF's trust deed may be more restrictive about who a death benefit can be paid than the SIS rules. Therefore, trustees must also refer to the fund's trust deed to determine whether any additional restrictions apply.

Who is a dependant?

A member's dependants are defined in section 10 of the SIS Act to include:

- a member's spouse
- any child of the person, and
- any person with whom the member is in an interdependency relationship.

While not specifically defined in the SIS Act as a dependant, persons who were financially dependent on a deceased member at the time of death are another category of dependants to whom a death benefit can be paid.

SIS dependant vs Tax Act dependant

That the definition of dependant differs for superannuation and tax purposes. The SIS Act definition of dependant applies to determine who a member's death benefit can be paid to, while the Tax Act definition of a death benefits dependant applies to determine how a death benefit will be taxed.

143 Under the SIS cashing regulations, a trustee of a superannuation fund can also pay a member's death benefit to the ATO to discharge an excess contributions tax liability or where the member is a lost member or to the Commonwealth or a state or territory where a court has made a forfeiture order where the benefits have been determined to be the proceeds of crime.

The differences between the SIS Act and Tax Act definitions of dependant are summarised in Table 8.1.

Table 8.1 SIS Act vs Tax Act dependants

Relationship to member	Dependant (SIS Act)	Death benefits dependant (Tax Act)
Spouse	✔	✔
Former spouse	✘	✔
Child under age 18	✔	✔
Child aged 18 or over	✔	✘
Financial dependant	✔	✔
Interdependent relation	✔	✔
Beneficiary of a person who died in the line of duty as a member of the Defence Force, Australian Federal Police, the police force of a State or Territory; or a protective service officer.	✘	✔

Spouse

A spouse of a member includes both a:

- legal spouse – that is, another person (whether same sex or different sex) with whom the deceased member was legally married or with whom the deceased member was in a relationship that was registered under a state or territory law at the time of death, and
- de facto spouse – that is, another person, who although not legally married to the person, lived with the person on a genuine domestic basis as a couple at the time of death.

Child

A child of a member is defined in both the SIS and Tax Acts to include any person, regardless of age, who at the time of the member's death was the member's natural, step, adopted or ex-nuptial child or a child of the member's spouse.

A child also includes a child who was born through artificial conception procedures or under surrogacy arrangements with the member's current or then spouse.

A person ceases to be a stepchild of a member from the time the member's marriage to the child's natural parent ends via divorce. However, there is uncertainty about whether a person continues to be a stepchild of a member if the child's natural parent dies while still married to the member. For example, in ATO ID 2011/77[144],

144 ATO Interpretative Decision ATO ID 2011/77: *Superannuation: Payment of death benefit to former step child: meaning of 'child' and 'dependant'.*

the ATO takes the view that a stepchild / step-parent relationship is severed when the marriage between the natural parent and the step-parent ends due to the death of the natural parent. In contrast, a more recent determination[145] and several court cases[146] suggest that this relationship continues following the death of the natural parent if the marital relationship was still in place at the time of their death. Given this uncertainty, SMSF trustees may need to seek guidance from the ATO or legal advice to confirm which approach should apply.

Financial dependant

For the purposes of the SIS Act, a person will also qualify as a financial dependant of a member under general law if they were receiving financial support from the member at the time of death. There is no requirement for the person to be fully dependent on that financial support, or for the person to need the financial support that was being provided by the deceased.

In contrast, for tax purposes, the ATO has taken the view in a number of private rulings that a potential beneficiary would only qualify as a financial dependant of a member if they were unable to meet their basic daily necessities (for example, shelter, food, clothing, etc) without the financial support provided by the deceased member at the time of death. In the ATO's view, financial support that merely supplements a beneficiary's income and improves their quality of life would not qualify the beneficiary as a financial dependant.

It is therefore possible that some partially dependent beneficiaries may qualify as a dependant for SIS purposes, but would not qualify as a death benefits dependant for tax purposes.

Interdependency relationships

A dependant includes a person who was in an interdependency relationship with the deceased member at the time of death. An interdependency relationship between two people is characterised by:

- a close personal relationship
- living together
- financial support
- domestic support
- personal care of a type and quality above the care and support that might be provided by a mere friend or flatmate.

An interdependency relationship may include a partner who does not meet the definition of a 'spouse'.

145 [2019] SCTA 149 (1 September 2019).
146 For example, Scott-Mackenzie v Bail [2017] VSCA 108 (10 May 2017).

An interdependency relationship may also exist where there is a close personal relationship between two people but:

- they do not satisfy the other requirements above (for example, living together, financial support, domestic support and personal care) because one or both of them suffer from a physical, intellectual or psychiatric disability, or
- they do not satisfy the other requirements above (for example, living together, financial support, domestic support and personal care) because they are temporarily living apart, for example where one person is temporarily working overseas or serving a jail sentence.

Examples include an adult child residing with and caring for an elderly parent and sisters residing together.

In establishing whether such a relationship exists, all of the circumstances of the relationship are taken into account, including (where relevant):

- the duration of the relationship
- whether or not a sexual relationship exists
- the ownership, use and acquisition of property
- the degree of mutual commitment to a shared life
- the care and support of children
- the reputation and public aspects of the relationship (such as whether the relationship is publicly acknowledged)
- the degree of emotional support
- the extent to which the relationship is one of mere convenience
- any evidence suggesting that the parties intend the relationship to be permanent
- the existence of a statutory declaration signed by one of the persons to the effect that the person is, or (in the case of a statutory declaration made after the end of the relationship) was, in an interdependency relationship with the other person.

Form in which death benefits can be cashed

Under SIS Regulation 6.21, a member's death benefit may only be cashed in any one or more of the following forms (for each recipient):

- a single lump sum
- an interim lump sum (not exceeding the amount of the benefits ascertained at the date of death) and a final lump sum (not exceeding the balance of the benefits as ascertained in relation to the member's death)
- one or more pensions or annuities, each of which is:
  - a superannuation income stream that is in the retirement phase
  - paid to a person permitted to receive a death benefit income stream.

For the definition of retirement phase income streams, see section 7.7.

In addition, under SIS subregulation 6.21(3), a death benefit may be rolled over to satisfy the immediate cashing requirement, for example as an income stream. This is discussed in more detail below.

Restrictions on death benefit income streams

Where a member dies, their benefits may only be paid in the form of a pension or annuity (that meets the definition of a retirement phase income stream) to a dependent beneficiary of the member (subject to certain restrictions for children).

Child beneficiaries and death benefit income streams

A child cannot receive a member's death benefit as an income stream unless, at the time of death, they were:

- under 18, or
- under age 25 and financially dependent on the member, or
- have a disability that:
  - is attributable to an intellectual, psychiatric, sensory or physical impairment or a combination of such impairments
  - is permanent or likely to be permanent, and
  - results in a substantially reduced capacity of the person for communication, learning or mobility; and the need for ongoing support services.

Where a death benefit is paid as a retirement phase income stream to a child who is eligible to receive the income stream at the time of death, the income stream must be cashed as a tax-free lump sum on the earlier of the day on which the:

- annuity or pension is commuted, or the term of the annuity or pension expires, and
- the child attains age 25,

unless the child has a disability as described above.

Where a child remains disabled (see above), they are not required to cash their income stream by age 25 – it can continue for as long as they remain disabled.

In-specie death benefit payments

Death benefit lump sums can be paid as either cash or via the transfer of an asset from the fund to the member's beneficiary. When making an in-specie payment, trustees must be able to substantiate the value of the relevant asset or assets for both SIS and taxation purposes. Death benefit income stream payments cannot be paid in-specie.

CGT and stamp duty

Where an asset is transferred to a member's beneficiary as an in-specie lump sum death benefit payment, the transfer will trigger a CGT event which may then have CGT implications for the fund. In addition, state government stamp duty may also apply.

Rollovers of super death benefits

From 1 July 2017, the taxation definition of a 'roll over superannuation benefit' has been amended to allow a superannuation lump sum death benefit to be rolled over where the beneficiary of a deceased member's superannuation interest is a dependant eligible to receive a death benefit income stream.

This change allows an eligible beneficiary to:

- rollover a death benefit entitlement to another superannuation fund for the commencement of a death benefit income stream
- commute and rollover an existing death benefit income stream to commence a new death benefit income stream.

However, as mentioned earlier in section 8.1, the compulsory cashing rules prevent a death benefit from being rolled to accumulation phase or to an income stream that is not in the retirement phase.

Death benefits paid to beneficiaries not eligible to receive a death benefit income stream are not included within the meaning of roll over superannuation benefit. These beneficiaries can only receive a death benefit lump sum cashed out of the superannuation system.

Where an individual's superannuation death benefit interest is rolled over, the superannuation provider that originally held the superannuation interest is required to provide the receiving fund with specified information about the superannuation interest and the individual (including identifying the rollover as a superannuation death benefit) electronically via the SuperStream data standard. This ensures that these rollovers continue to receive death benefit treatment under both regulatory and tax provisions in the receiving fund.

The ATO has confirmed that a member in receipt of two death benefit income streams may commute both income streams and start a new, consolidated death benefit income stream.

An exception to this would be if one of the death benefit income streams was an old complying income stream (e.g. a TAP) and the other death benefit income stream was an account-based pension. These could not be combined since complying income streams can only be commuted to start other complying income streams. It is also unlikely that multiple child death benefit income streams can be commuted and combined into a new child death benefit income stream.

8.2 Fund death benefit payment rules

Under general law, the payment of a member's death benefit is determined in accordance with a fund's governing rules and not according to the deceased's will.[147] Therefore, a trustee will be required to pay a member's death benefit according to the provisions of the fund's trust deed. In this case, the provisions of a member's will are only relevant where the trustee elects, or is required, under the trust deed, to pay the death benefit to the member's LPR.

Importance of the trust deed

The rules contained in a fund's trust deed about the payment of death benefits are fundamentally important, as they prescribe how a trustee must deal with a member's death benefit. For example, an SMSF's trust deed may contain a number of different rules about the payment of a death benefit, including:

- allowing the trustee to exercise their discretion about the payment
- requiring trustees to pay a death benefit to certain named beneficiaries or to require the death benefit to be paid to the member's legal personal representative
- allowing a member to give a death benefit nomination to the trustee, which binds the trustee to pay their death benefit in a particular way.

In the event of the death of a member, the trustee of an SMSF will therefore need to refer to the fund's trust deed to determine what rules apply to the payment of death benefits from the fund. Some of these rules are now discussed in more detail.

Trustee discretion

Where a trust deed allows for trustee discretion in relation to the payment of death benefits, the trustees will need to confirm what rules apply to the making of trustee resolutions, including:

- what the requirements are to hold a trustee meeting
- what the voting entitlements of each trustee are
- whether the voting rules are modified in any way regarding the payment of a death benefit
- whether the deceased member's legal personal representative is automatically appointed to act as a trustee in place of the deceased member.

For example, a trust deed may contain rules confirming that when making a resolution, each trustee will have one vote on any issue (or a number of votes based on their benefit value) other than about the payment of a death benefit. In this case, the deed may require a unanimous decision of all trustees, which would then require all trustees to agree on how the death benefit is to be paid.

147 Self-Managed Superannuation Funds Determination SMSFD 2008/3: Self Managed Superannuation Funds: Is there any restriction in the Superannuation Industry (Supervision) legislation on a self managed superannuation fund trustee accepting from a member a binding nomination of the recipients of any benefits payable in the event of the member's death?

Restrictions on trustee discretion

When exercising their discretionary powers regarding the payment of a death benefit, a trustee will need to take into account the cashing rules in the SIS Regulations as well as their trustee requirements under general law. These include that a trustee must exercise their discretionary powers:

- honestly and in good faith
- upon real and genuine consideration, that is, to take an informed view and not to act irresponsibly, capriciously or wantonly, and
- with due consideration for the purpose for which it was conferred and not for some ulterior purpose.

Where a trustee can demonstrate that they have exercised their discretionary powers in accordance with these requirements, a court will generally not seek to interfere with their decision.

However, where it can be shown that a trustee has not exercised their discretion in accordance with these requirements, a court may intervene to set aside their decision and potentially remove them as a trustee of the fund. An example of this occurring was the case of Marsella; Marsella v Wareham (No.2) [2019] VSC 65.

Marsella; Marsella v Wareham (No 2) [2019] VSC 65

The Marsella case involved a member of an SMSF who had a spouse and a daughter and son from a previous marriage. The SMSF was a single member SMSF and the trustees were the member and the member's daughter.

The member died in April 2016 with no valid binding death benefit nomination in place, and the fund's trust deed allowed the trustee to exercise discretion regarding the payment of her death benefit.

In April 2017, the member's daughter (as trustee) appointed her husband as a second trustee, and the trustees then exercised discretion to pay 100% of the member's death benefit to the daughter.

In the Marsella case, the deceased member's husband sought the removal of the daughter and her husband as trustees and their replacement with a new trustee, and the repayment of the death benefit with interest by the daughter, on the basis that that the trustees did not give real and genuine consideration to the interests of the dependants of the deceased member.

The court found that the trustee's decision was made without real and genuine consideration and therefore set aside the decision, as well as removing the daughter and her husband as trustees of the fund. Factors taken into account by the court in coming to this decision included:

- the daughter did not seek specialist advice regarding uncertainties about the fund's trust deed
- the evidence inferred that the daughter acted arbitrarily in distributing the fund, with ignorance of, or insolence toward, her duties. She acted in the context of uncertainty, misapprehensions as to the identity of a beneficiary, her duties as trustee, and her position of conflict
- the ill-informed arbitrariness with which the daughter approached her duties amounted to bad faith. This included the dismissive tenor of the correspondence from the daughter's lawyers to the member's husband's lawyers, the willingness to proceed with the appointment and distribution in the context of uncertainties and significant conflict.

This decision was subsequently confirmed when an appeal brought by the daughter was disallowed (see Wareham v Marsella [2020] VSCA 92).

Therefore, where an SMSF allows trustee discretion regarding the payment of death benefits, trustees exercising that discretion may wish to seek specialist legal advice in relation to their obligations and what process they should follow in relation to exercising that discretion.

Risks when death benefit is paid to a dependant who is also the deceased member's LPR

A deceased member's LPR (ie the executor of their estate) will often also be a dependant of the member in their personal capacity. In such situations, it is possible under the SIS cashing rules for a death benefit to be paid to that person either personally, or in their capacity as LPR (in which case it would form part of the deceased member's estate). In an SMSF context, this may also include the LPR acting as trustee and deciding whether a death benefit is paid to them in their personal capacity or in their capacity as LPR.

A number of cases have considered whether, due to the fiduciary duty owed by an LPR, that person can claim and receive a death benefit in their personal capacity rather than as LPR on behalf of the deceased member's estate.

For example, in **Burgess v Burgess**,[148] a deceased member's widow was his LPR as the administrator of his intestate estate, but had claimed death benefits from his three superannuation funds in her personal capacity rather than on behalf of the estate. The court found that an administrator of an estate is bound to claim any death benefits for the estate rather than personally (a personal claim conflicted with the obligations to the estate). In this case, there was no conflict in relation to the death benefit paid by the first superannuation fund as the widow had not at that time been appointed administrator. However, the court found that there was a conflict regarding the death benefits paid by the other superannuation funds, as the widow was the administrator at the time the benefits were claimed and paid, and the widow was bound to claim those benefits on behalf of the estate rather than in her personal capacity.

In **McIntosh v McIntosh**,[149] a mother was appointed as administrator of her deceased son's estate. She subsequently applied for and claimed death benefits from three superannuation funds, all in her personal capacity. The court found that her actions were contrary to her fiduciary duties as the administrator of her son's estate as she put her own interests ahead of her duty as LPR. As a result, the mother was required to account for the death benefits she had received as part of the estate.

These cases highlight the risk that where an LPR can claim and receive a death benefit personally, or as LPR on behalf of the member's estate, benefits would need to be paid to the member's estate.

In addition, conflict may arise where the LPR is appointed as trustee of an SMSF and exercises discretion regarding the payment of death benefits. For example, where the LPR (as trustee) exercised discretion to pay a death benefit to themselves personally rather than to themselves as LPR for the deceased member's estate, they may breach the fiduciary duty they owe to the estate by electing to pay the benefit to themselves in their personal capacity.

148 Burgess v Burgess [2018] WASC 279
149 McIntosh v McIntosh [2014] QSC 99

To avoid this issue, SMSF clients could consider:

- putting in place binding death benefit nominations making clear who the death benefit must be paid to (and whether in their personal capacity or as LPR)
- nominating an independent LPR to be executor of a member's estate.

No trustee discretion – specific deed provisions

Where a fund's trust deed includes specific death benefit rules which require the payment of a member's death benefit in a certain way, for example to a member's legal personal representative or to certain individuals, the trustees will need to satisfy themselves that they will be able to pay the member's death benefit in accordance with the rules.

For example, a trustee would need to confirm that the persons named under a trust deed to receive a member's death benefit:

- satisfy the definition of a dependant and are able to be paid the member's death benefit under the SIS Regulations, and
- are available to be paid the death benefit, ie they have not pre-deceased the member.

Where a trustee would not be permitted to pay the death benefit as specified in the trust deed, for example because the nominated person was not a dependant of the member, the trustee should seek legal advice as to the options available.

No trustee discretion – binding death benefit nominations

Where a fund's trust deed includes rules that allow a member to give a trustee a binding death benefit nomination, the trustees will need to confirm the nomination is valid at the time of death.

For example, a trustee would need to confirm that the nomination was made in accordance with the requirements specified in the trust deed and that the nominated persons were able to be paid a member's death benefit under the SIS death benefit cashing rules. To confirm this a trustee should seek legal advice.

Where a binding nomination is found to be invalid, the trustee would need to refer to the trust deed to determine what default provisions apply in that situation. For example, on the failure of a binding death benefit nomination, the trust deed may allow a trustee to exercise their discretion regarding the payment or it could require the member's death benefit to be paid to their legal personal representative.

8.3 Death benefit planning

When establishing an SMSF or undertaking any SMSF death benefit planning, it is important to consider the different death benefit payment provisions that can be included in a deed, as they each have their own benefits and disadvantages.

Trustee discretion

Trustee discretion involves the trustees of a fund being permitted to exercise their discretion regarding the payment of a death benefit. Trustee discretion is the default setting in most SMSF trust deeds.

Advantages of trustee discretion

The advantage of trustee discretion is that it gives the trustee the flexibility to pay out a member's death benefit in the most appropriate way depending on the member's circumstances at the time of their death. For example, trustee discretion could allow a death benefit to be paid:

- as per a member's wishes as at the time of death
- in the most tax-effective manner based on the circumstances of the member's beneficiaries as at the time of the member's death
- to a minor child as a non-commutable income stream, with a lump sum only payable once the child turns age 25 (or some earlier age as determined by the member)
- in a way that avoids adversely impacting a beneficiary. For example, a trustee could avoid paying any death benefits to a dependant who was receiving a social security entitlement which would be impacted by the receipt of a superannuation death benefit lump sum or income stream.

Given the flexibility that trustee discretion allows it is the preferred option for many funds where there is a high level of trust between members.

> FirstTech comment
>
> **Ensure that trustee discretion is exercised with real and genuine consideration**
>
> The recent Marsella case (see above) involved the overturning of a trustee discretion exercised without real and genuine consideration and the removal of the trustees who exercised that discretion. The case highlights the need for trustee discretion to be exercised with real and genuine consideration and that specialist legal advice should be sought by trustees exercising discretion when paying death benefits. For further information on the Marsella case, refer to Section 8.2.

Disadvantages of trustee discretion

The main disadvantage of trustee discretion is that it can lead to significant and costly disputes and result in a member's death benefit not being paid in a way they would have wanted or intended. This can particularly be the case where the surviving trustee of a fund satisfies the definition of a SIS dependant and therefore has a vested interest in the payment of any death benefits.

For example, where one of a deceased member's children got control of their parent's SMSF following their death, they could potentially seek to exploit their position by paying 100% of the parent's death benefit to themselves to the exclusion of all other potential beneficiaries, such as their siblings.

While a disgruntled beneficiary could potentially take legal action against a trustee in situations like these, such as in the Marsella case (above) or if the trustee was also the executor of the deceased member's estate and there was grounds to claim the executor breached their fiduciary duties by paying a benefit to themselves, it can be costly and time consuming and the final outcome can never be certain given each case will be determined, based on their own specific facts.

An example of the courts refusing to interfere with a trustee exercising their discretion to pay a death benefit in their favour is the case of Katz v Grossman [2005] NSWSC 934.

Katz vs Grossman [2005] NSWSC 934

Here is a summary of the case:

Mr and Mrs Katz were husband and wife and individual trustees of their own SMSF. They also had two adult children, Linda and Daniel.

On the death of Mrs Katz in 1998, Mr Katz as trustee appointed his daughter, Linda, to act as an additional trustee of his (now) single-member SMSF to ensure the fund continued to satisfy the SMSF definition. At the same time, Mr Katz amended his non-binding death benefit nomination, requesting the trustee pay his death benefit to both his son Daniel and daughter Linda equally.

In August 2003, Linda used her position as trustee to accept herself as a member of the fund. One month later, Mr Katz died, leaving Linda as the sole surviving trustee. Linda then appointed her husband to act as a second trustee of the fund.

As trustees of the fund, Linda and her husband then exercised their discretion to disregard her father's wishes as expressed in the non-binding death benefit nomination and instead elected to pay 100% of his death benefit to Linda.

In response, Daniel took legal action on the grounds that Linda and her husband's appointments as trustees were not valid. However, the court upheld their appointment as trustees and did not interfere with their decision regarding the payment of the death benefit.

Trustee discretion and control

Where the members of an SMSF wish to use a trust deed that allows for trustee discretion, they may wish to consider who will control the fund after any member's death, as that person will be able to exercise their discretion regarding the payment of any death benefits.

Depending on the terms of a fund's trust deed, the surviving trustees (or the surviving directors of the fund's corporate trustee) will generally retain control of the fund and will be able to exercise the trustee's discretionary powers regarding the payment of a death benefit.

However, in certain situations the deed may also automatically appoint someone else, such as the member's legal personal representative, to act as a trustee of the fund in place of the member. In this case, that person, as a trustee of the fund, would also generally have a say in any resolutions relating to the payment of the member's death benefit.

Legal personal representative may be appointed as trustee

Under the definition of an SMSF in section 17A of the SIS Act, a member's legal personal representative may be appointed to act as a trustee of the fund (or a director of the corporate trustee) in place of the member from the time of death until the time a death benefit commences to be paid.

Therefore, this could allow a deceased member's legal personal representative to step in to act as a trustee and to have a say in any death benefit decisions. However, this provision only confirms that an SMSF will still satisfy the definition of an SMSF where this occurs. It does not automatically result in the appointment of the member's LPR as a trustee of the fund unless the trust deed contains provisions to that effect.

Therefore, a member's LPR may have no ability to participate in any decisions relating to how the member's death benefit is paid unless the existing members/trustees agree to their appointment, which they may not.

An example of both the difficulty of having a trustee decision overturned and that the SIS Act does not automatically appoint a deceased member's LPR as a trustee of their SMSF is the case of Ioppolo v Conti [2013] WASC 389.

Ioppolo v Conti [2013] WASC 389

The case involved a husband and wife that were both the members and trustees of an SMSF. In 2010, the wife died and her daughters were then appointed as executers of her estate in accordance with the terms of her will. At the time of her death there was no valid binding death benefit nomination in place in respect of her interest in the SMSF; however she had made provision in her will that her superannuation entitlements were to be paid to her children and not to her husband.

Upon his wife's death the surviving member/trustee converted the fund to a corporate trustee structure, of which he was appointed the sole director. As the director of the corporate trustee he sought advice and then exercised the trustee's discretion under the deed to pay his wife's death benefit to himself.

The daughters commenced legal proceedings against the trustee of the SMSF on the basis that:

- as their mother's LPRs they were required to be appointed as trustees of the fund to allow the fund to satisfy the definition of an SMSF under section 17A of the SIS Act, and
- the trustee had not acted in good faith in respect of the payment of the wife's death benefits as it had ignored the deceased's instructions in her will.

In handing down their decision, the judge found against the daughters on both grounds on the basis that:

- while section 17A of the SIS Act allows for the appointment of an executor as a trustee of an SMSF it does not require such an appointment, and
- the trustee was entitled to ignore the direction in the will and the mere fact it did so was not in and of itself evidence that the trustee had not acted in good faith.

Members wanting to control the payment of their death benefit should therefore consider using a binding death benefit nomination as well as consider who will control the fund on their death.

Absence of control – individual trustees

In some situations, the death of a member may result in a fund being left without any members or trustees. For example, this could occur where both individual trustees of a two-member SMSF were killed in an accident or where a surviving trustee lacks capacity.

In these situations, someone would need to be appointed as a trustee of the fund. However, depending on the terms of the deed, this may not be possible. For example, where a deed required a trustee to be appointed by a majority of the members, this would not be possible where the sole surviving trustee lacked capacity.

In these situations, it will be necessary to refer to the relevant state Trustee Act to determine whether another trustee can be appointed. For example, under the Trustees Act (NSW), where an individual trustee has died or is incapable of acting as trustee, a new trustee may be appointed by:

- a person nominated for the purpose of appointing new trustees by the instrument, if any, creating the trust, or
- if there is no such person, or there is no such person able and willing to act, then by the surviving or continuing trustees or trustee for the time being, or by the legal representative of the last surviving or continuing trustee.

Therefore, in the event that following the death of a member/trustee the last surviving trustee of the fund had dementia and lacked legal capacity, assuming the Trustee Act (NSW) applied, the legal personal representative of the last surviving individual trustee would be able to appoint someone, including themselves, to act as a trustee of the fund. That person could then potentially exercise their discretion regarding the payment of any death benefits.

Absence of control – corporate trustee

Alternatively, where the directors of a fund's corporate trustee died or became incapacitated, new replacement directors will need to be appointed in accordance with the rules in the company's constitution.

In this situation, the shareholders of the corporate trustee will generally be able to appoint the new directors. However, where the deceased directors were also the shareholders, their LPR would generally be able to appoint replacement directors. Depending on who was appointed, that person, or those persons, could then potentially exercise their discretion regarding the payment of any death benefits.

Considerations where potential for dispute

While trustee discretion can provide flexibility, where there is some potential for dispute regarding the payment of a death benefit, members may wish to consider removing the trustee's discretion by inserting specific death benefit rules in the trust deed or by putting in place binding death benefit nominations.

Alternatively, trustees could put in place plans to ensure that control of the fund passed to a trustworthy or independent person.

Specific death benefit rules

Where trustee discretion is not appropriate or desired, the members of an SMSF could arrange for specific death benefit rules to be written into the fund's trust deed to pay a member's death benefit in a particular way.

For example, a deed could be worded to require a member's death benefit to be paid to certain specified beneficiaries or to their legal personal representative to be paid in accordance with their will.

The benefit of 'hard wiring' a trust deed to pay specified beneficiaries in this way is that it would technically bind the trustee to pay a member's death benefit in accordance with those rules – effectively creating a form of binding nomination.

The main disadvantage of including specific death benefit rules in a trust deed is that they generally remove a trustee's discretion about the payment of a member's death benefit and therefore remove any flexibility the trustee may have had to pay the death benefit in the most tax-effective manner, or in a way that would have better corresponded with the member's wishes at the time of their death.

Other disadvantages of including specific death benefit clauses in a deed include:

- they can be expensive to establish when compared to alternatives, such as putting in place a binding death benefit nomination
- they are inflexible and may require the deed to be amended whenever the member's intentions or circumstances change
- they may not provide the level of certainty expected, as a surviving trustee may seek to amend the trust deed to remove the rules or to claim the rules are invalid and don't apply – in which case the rules may be practically difficult to enforce.

Binding death benefit nominations

Binding nominations are written directions that a member of a fund can make to the trustee under the fund's trust deed which, if valid at the time of death, legally bind the trustee to pay their death benefit in accordance with their nomination.

Advantages of binding death benefit nominations

An advantage of a binding death benefit nomination is that they bind a trustee to pay a death benefit as instructed. Therefore they can provide certainty that a death benefit will be paid as intended and avoid the potential for any disputes. They are also generally much easier and cheaper to make and change than inserting specific death benefit instructions in a trust deed.

Binding death benefit nominations in SMSFs not subject to rules in SIS Regulations

In SMSFD 2008/3, the ATO outlined that, in its view, binding death benefit nominations made to the trustee of an SMSF are not subject to the same requirements as binding death benefit nominations made to the trustees of large APRA-regulated funds. Therefore, a binding nomination made to an SMSF can be non-lapsing and will not need to be renewed every three years.

The ATO bases this view on the fact that the rules which require binding death benefit nominations to be made in accordance with the requirements specified in SIS Regulation 6.17A, ie that they must be witnessed and renewed every three years, do not apply to SMSFs.

Until recently, there had been varying views about the ATO's position in SMSFD 2008/3. However, in Hill v Zuda Pty Ltd as Trustee for the Holly Superannuation Fund & Ors [2022] HCA 21, the High Court confirmed that Regulation 6.17A does not apply to SMSFs.

Note that even though SIS Regulation 6.17A doesn't automatically apply to SMSFs, some SMSF trust deeds may directly or indirectly reference the legislation that relates to binding death nominations, in which case the requirements would apply to that fund.

For more information on the requirements of binding death benefit nominations established under SIS Regulation 6.17A, please see the FirstTech super and retirement income streams guide.

Disadvantages of binding death benefit nominations

The main disadvantage of binding nominations is that they remove the trustee's discretion regarding the payment of the member's death benefit and therefore remove any flexibility the trustee may have had to pay the member's death benefit in the most tax effective manner, or in a way that would have better corresponded with the member's wishes at the time of their death.

For example, where a member made a binding death benefit nomination to pay 100% of their death benefit to their spouse, but they were separated but not yet divorced from their spouse at the time of death, the nomination would still be valid and binding on the trustee. The trustee would therefore have no discretion to pay the benefit to a more appropriate beneficiary, such as a child of the deceased member.

Binding nominations may also be difficult to enforce where the nomination has been lost or destroyed or where the trustee takes the view that the nomination is invalid. Therefore, members should consider whether a binding death benefit nomination is necessary or whether allowing the trustee to exercise their discretion would provide a more flexible outcome. Where members require a binding nomination, they should ensure that it is properly established, regularly reviewed and updated whenever circumstances require.

Example: difficulty enforcing a binding death benefit nomination – Wooster v Morris [2013] VSC 594

The case of Wooster v Morris in the Victorian Supreme Court provides a good example of how difficult it can be for a beneficiary to enforce a valid binding death benefit nomination.

The case involved a member of an SMSF putting in place a binding death benefit nomination to require the trustee to pay the whole of his benefit in the fund to his two daughters. Two years after making the nomination the member died, leaving his second wife as the surviving member and trustee of the fund. The second wife then changed the trustee structure of the fund to a corporate trustee, of which she was appointed a director. As the sole director of the corporate trustee she then resolved that the binding nomination was not valid and instead exercised the trustee's discretion under the deed to pay the benefit to herself.

The daughters then commenced legal proceedings against the corporate trustee in the Victorian Supreme Court, which subsequently found that the deceased member's nomination was valid and binding on the trustee and that the daughters were entitled to be paid the death benefit amount. In addition, the judge ordered that the corporate trustee and the second wife (as an individual) were jointly and severally liable to pay the daughter's legal and Court costs.

While this case ultimately upheld a member's binding death benefit nomination, note that it took almost four years and involved significant cost for the daughters to finally have the nomination enforced. Therefore, members wanting to use a binding death benefit nomination should also consider who will control the fund after any member's death, as that person will effectively control the payment of any death benefits.

Reversionary pension nominations

Depending on the terms of the trust deed, a member commencing an income stream may be able to nominate a reversionary beneficiary to automatically receive their pension on death. In the event of the member's death, the trustee would then generally be bound to continue to pay the pension to the reversionary beneficiary (subject to the SIS cashing restrictions).

FirstTech comment: Binding nominations on reversionary pensions

In rare cases, a member's income stream may be subject to both a reversionary pension nomination and a binding death benefit nomination (potentially with different beneficiaries nominated in each). In the event of the member's death in this situation, there is uncertainty about which nomination should take precedence over the other. In such cases, trustees may wish to refer to the trust deed for any clarification, or seek specialist legal advice to determine the appropriate course of action.

Superannuation death benefits and family provision claims

Legislation exists in all Australian states and territories which enables certain eligible persons to challenge the will of a testator that makes inadequate provision for the maintenance and support of the person. However, as previously stated, the payment of a member's death benefit is determined firstly in accordance with the governing rules of the fund rather than the deceased's will. Therefore, any challenge to a member's will would generally have no impact on their superannuation death benefit unless it is paid to the legal personal representative to be included in the member's estate.

However, the Family Provision Act 1982 (NSW) includes notional estate provisions which can allow a court to make family provision orders out of assets that do not form part of a person's estate. This can include superannuation benefits, including benefits over which there is a binding death benefit nomination.

Therefore, a NSW court could potentially take a death benefit amount already paid from a superannuation fund into account, when determining a family provision claim.

Only certain people are eligible to make a family provision claim under the different state acts. Depending on which state rules apply these may include a deceased person's:

- spouse (including defacto)
- ex-spouse
- children
- grandchildren
- a member of the household, and
- anyone with whom the member had a close personal relationship.

In addition, the claimant must be able to demonstrate that inadequate provision has been made for them in the will. For examples of the courts including a super death benefit paid directly to beneficiaries in the deceased member's notional estate, see Kelly v Deluchi [2012] NSWSC 841 and Benz v Armstrong [2022] NSWSC 534.

Need for legal advice

Members wishing to achieve specific death benefit planning outcomes should seek specialist legal advice, to ensure the fund's trust deed and/or any binding nominations or reversionary nominations are properly constructed and allow the members to achieve their specific objectives.

It is also important that any superannuation death benefit planning is undertaken in conjunction with, and takes into account, non-superannuation estate planning requirements.

8.4 Transfer balance cap treatment of death benefit income streams

Where a death benefit income stream is commenced by a beneficiary, or an income stream reverts automatically to a beneficiary upon death, a credit arises in the beneficiary's transfer balance account. However, the timing and value of the credit varies depending on when the death benefit income stream commenced and whether it automatically reverted to the beneficiary.

Table 8.2 summarises the transfer balance cap assessment of death benefit income streams.

Table 8.2 Transfer Balance Cap treatment of death benefit income steams

Commencement date	Value	Time of credit to transfer balance cap
Non-reversionary death benefit income stream		
Existing before 1 July 2017	Value at 30 June 2017	1 July 2017
Commencing on or after 1 July 2017	Commencement value of death benefit income stream	Death benefit income stream commencement date
Reversionary death benefit income stream		
If reverted before 1 July 2016	Value at 30 June 2017	1 July 2017
If reverted between 1 July 2016 and 30 June 2017	Value at 30 June 2017	12 months after date of death
If reverted on or after 1 July 2017	Value at date of death	12 months after date of death

For comprehensive information about the transfer balance cap rules, see section 21 of the FirstTech Super and Retirement Income Streams guide.

Where death benefit income stream credits lead to a transfer balance cap breach

Where the value of the transfer balance credit due to the death benefit income stream causes the beneficiary to exceed their personal transfer balance cap, the excess will need to be cashed out of the superannuation environment (as a death benefit income stream cannot be rolled back to accumulation phase – see section 8.1).

Alternatively, a member can elect to commute the excess from a retirement phase income stream that is not a death benefit income stream. In this case they can elect for the excess amount to be transferred back to accumulation phase and remain within the superannuation environment.

8.5 SMSF tax issues on death

The death of a member can impact the taxation of an SMSF the following ways:

CGT on death

Where a member of a fund dies, the trustees must pay out the death benefit in accordance with the compulsory cashing rules. Where the trustee is required, or chooses, to pay a death benefit as a lump sum, trustees may need to dispose of CGT assets to fund the death benefit payment. As a result, the death of a member may trigger a CGT liability at the fund level, which should be taken into account when calculating the member's final death benefit amount.

CGT and pension assets on death

In Tax Ruling TR 2013/5,[150] the ATO expresses the view that a superannuation income stream ceases as soon as a member in receipt of the superannuation income stream dies, unless a dependent beneficiary of the deceased member is automatically entitled to receive an income stream on the death of the member.

As a result, this could potentially result in significant CGT implications when selling or transferring superannuation fund assets to pay a deceased retirement phase income stream recipient's death benefit from the fund.

However, the tax regulations[151] allow a deceased member's non-reversionary retirement phase income stream interest to continue to be treated as a pension for tax exemption purposes between the date of death and the date a lump sum death benefit is paid or a new pension commenced.

The pension tax exemption will then apply to the deceased member's balance at the date of death, plus any investment earnings that accrue on this balance up until the payment of the death benefit as a lump sum or income stream. However, the following amounts are specifically excluded from being part of the pension assets:

- insurance proceeds
- amounts arising from self-insurance.

150 TR 2013/5: *Income tax: When a superannuation income stream commences and ceases.*
151 *Income Tax Assessment (1997 Act) Regulations 2021, reg 307-70.02.*

Therefore, where the fund uses the segregated assets method, any cash or other assets purchased with the proceeds of an insurance policy will not be included as part of the fund's exempt current pension assets, and any investment earnings on those proceeds will be fully assessable.

Alternatively, where the fund uses the unsegregated assets method, the insurance proceeds will be excluded from the average value of the fund's pension liabilities as per the exempt pension income calculation in section 295–390 in the Tax Act. However, the proceeds would be included in the average value of the fund's superannuation liabilities under that section. As a result, the receipt of insurance proceeds in this situation would result in a smaller tax-free percentage.

Case study

Fred and Wilma were married and members of their SMSF. Fred had a non-reversionary account based pension with an account balance of $100,000 and Wilma had an accumulation account balance of $100,000. Fred then died on 1 January in a year.

On 30 June in that year (which in this case was as soon as practical after Fred's death), Wilma paid a $312,521 death benefit to herself of from Fred's superannuation interest, which included:

- Fred's pension balance of $100,000 at the date of death
- the proceeds of a life insurance policy held by the fund over Fred's life for $200,000 – which were received by the fund two weeks later on 15 January in that year
- Fred's 50% share of the fund's total investment income received during the financial year up until the time his death benefit was paid of $12,521[152] (which includes $2,521[153] bank interest from the insurance proceeds).

If the fund used the segregated assets method, the fund's exempt income would be calculated as $10,000, being income from the fund's segregated current pension assets based on Fred's pension value (excluding the insurance proceeds) of $100,000. The interest earned on the insurance proceeds would then be included in the fund's assessable income.

However, if the fund used the unsegregated assets method, the tax-free proportion would be calculated in accordance with the formula specified in section 295–390 of the Tax Act. In this case, the insurance proceeds would be excluded from the calculation of the fund's average pension liabilities but included in the average value of the fund's superannuation liabilities. Therefore, assuming the fund's pension and superannuation liabilities were calculated using time weighted averages and the fund received the insurance proceeds on 15 January, the fund's exempt income proportion would be calculated as 34%.[154] Assuming the fund then had total investment income for the year of $22,521, the fund's exempt income would be $7,657.

152 Share of investment income assumes Fred's account allocated 50% of the fund's total investment income of $20,000 (excluding interest on insurance proceeds) based on 50/50 split of account balance at start of year plus 100% of interest on insurance proceeds, ie ($20,000 × 0.5) + $2,521 = $12,521.

153 $2,521 interest based on $200,000 cash proceeds invested on 15 January earning 2.75% pa.

154 Assumes no contributions made to Wilma's accumulation account and that Fred had elected to receive one annual payment which he had not taken before his death.

In this case, the use of the unsegregated assets method in the year that the fund received insurance proceeds has resulted in a watering down of the tax-free proportion and resulted in an increased tax liability for the fund.

Deduction for future liability to pay benefits

Where a fund paid a superannuation death, terminal illness or disability benefit the trustee may claim a deduction under section 295–470 of the Tax Act based on the cost of providing death or disability benefits in a year.

However, for the deduction to be allowable, the trustee must:

- choose to claim the deduction as an alternative to claiming the cost of any life or disability insurance premiums paid in that year (and all future years), and
- pay a superannuation death or disability benefit in consequence of a member's termination of employment or pay a benefit due to their temporary inability to work.

For more information of the deduction for the future liability to pay benefits please see *Chapter 6: SMSFs and insurance*.

8.6 Paying superannuation death benefit lump sums

Where a trustee is paying a member's death benefit to their beneficiaries as a lump sum, they will need to calculate the value of the member's interest in the fund and determine the tax components of the member's death benefit in accordance with the proportioning rules that apply to the payment of death benefits. These rules are summarised as follows:

Payment of lump sum death benefits – accumulation phase

Where a lump sum death benefit is paid to a death benefits dependant (that is, a dependant for tax purposes), the trustee will not be required to deduct any tax from the payment. Therefore, a trustee will generally not be required to calculate the tax components of the payment and issue a PAYG payment summary.

However, where a fund pays a death benefit as a lump sum from accumulation phase to a non-death benefits dependant, the trustee will need to calculate the value of the member's superannuation interest in the fund and the tax components of that interest immediately before payment of the death benefit. The percentage of tax-free and taxable components of the superannuation interest is then applied to the superannuation death benefit being paid.

Case study – tax components of a death benefit

Just before paying a superannuation lump sum death benefit payment of $1 million, the trustee calculated the components of the deceased member's interest in the fund as follows:

- 60% tax-free component
- 40% taxable component.

In this case, the lump sum death benefit payment would be made up of $600,000 tax-free component and $400,000 taxable component.

Lump sum death benefits to include taxable component untaxed element

Where a trustee pays a lump sum superannuation death benefit to a non-death benefits dependant that was sourced wholly or partly from insurance proceeds and the trustee has claimed or will claim a deduction for either the cost of the premiums paid or for a future liability to pay benefits, the taxable component will generally be calculated to include an untaxed element.

The amount of untaxed element included in a death benefit payment is based on the following formula:

Calculating the untaxed element

The process to calculate untaxed element is specified in section 307–290 of the Tax Act and is as follows:

Step 1 Calculate the taxable component (taxed element)

$$\textbf{Taxed element} = \left[\textbf{Amount of lump sum} \times \frac{\textbf{Service days}}{\textbf{Service days} + \textbf{Days to retirement}}\right] - \textbf{Tax free component}$$

Where:

- Days to retirement = the number of days between the date of death and the deceased's last retirement date (generally age 65)
- Service days = the number of days from the day the member joined the fund (or if a rollover amount was received by the fund with an earlier service period start date, that earlier start date) to the date of death. For an employer-sponsored fund, service days may commence when the member's employment commenced, if that was before their membership commenced.

Note

If the calculated result is negative (that is, where the tax-free component is large in relation to the total benefit), the taxed element in the fund is nil and the whole of the taxable component is an untaxed element.

Step 2 Calculate the taxable component (untaxed element)

$$\textbf{Untaxed element} = \textbf{taxable component} - \textbf{taxed element}$$

Case study – calculation of untaxed element

Beth was a member of her SMSF and at the time of her death she had a superannuation benefit valued at $500,000, which was made up of the following components:

- tax-free component $100,000
- taxable component $400,000.

The $400,000 taxable component also included $200,000 from the proceeds of a life insurance policy held for Beth, for which the fund had claimed the cost of the premiums as a deduction.

If at the time of her death Beth's service was 15 years (5,475 days) and her period to retirement was 30 years (10,950 days), the untaxed element would be calculated as follows:

$$\textbf{Taxed element} = \left[\$500{,}000 \times \frac{5{,}475}{5{,}475 + 10{,}950} \right] - \$100{,}000 = \$66{,}666$$

$$\textbf{Untaxed element} = \$400{,}000 - \$66{,}666 = \$333{,}334$$

Beth's death benefit would therefore be made up of the following tax components:

- Tax-free component $100,000
- Taxable component
  - taxed element $66,666
  - untaxed element $333,334.

Payment of lump sum death benefits – pension phase

Tax Ruling TR 2013/5 provides that a superannuation income stream will cease at the time of death, unless:

- the pension is an automatically reversionary income stream, or
- a valid binding death nomination is in place, which requires the trustee to continue to pay the death benefit as an income stream.

Where no such reversion or nomination is in place, however, special proportioning rules apply on the death of a pensioner, provided:

- no amounts other than investment earnings or insurance proceeds have been added to their superannuation interest, and
- their death benefit is paid as a lump sum or retirement phase income stream (or combination of both).

These special rules allow the deceased member's superannuation balance at the date of death (plus earnings on that balance) to retain their existing tax-free proportion during the period between the member's death and the payment of their death benefit as a lump sum. However, any insurance proceeds will form part of the taxable component.

Case study – Death of member receiving a pension that will not automatically revert to their beneficiary

Gina dies on 1 July in a financial year with an existing account based pension balance of $300,000 and a tax-free proportion of 50%. Her death benefit is paid as a lump sum as soon as practicable on 1 January in the same financial year, at which time earnings have increased her existing balance to $350,000. Life insurance proceeds of $250,000 are also then added to her benefit just before her death benefit is paid.

Under the special proportioning rules, the existing tax-free proportion of 50% applies to Gina's superannuation balance at her date of death plus investment earnings. This would provide for $175,000 of tax-free component and $175,000 of taxable component. The life insurance proceeds are then added to the taxable component.

The lump sum death benefit paid will therefore consist of $175,000 tax-free component and $425,000 taxable component.

Taxation of lump sum death benefit payments

Where a lump sum death benefit is paid to a death benefits dependant, it will always be tax-free (non-assessable non-exempt income). Table 8.3 summarises the tax treatment of lump sum death benefits paid to non-tax dependants.[155]

Table 8.3 Taxation of lump sum death benefits paid to non-dependants for tax purposes

Tax component	Tax rate
Tax-free component	Nil (non-assessable, non-exempt income)
Taxable component (taxed element)	15%
Taxable component (untaxed element)	30%

Where a trustee is required to withhold tax from a benefit payment, including a death benefit payment, the trustee will be required to give the recipient a PAYG payment summary for a superannuation lump sum no later than 21 days before the end of the financial year. If the recipient requests for a PAYG payment summary in writing earlier, the trustee will need to issue one within 14 days.

155 Medicare levy is also payable on the assessable amount except where the death benefit is paid to the member's estate or a non-resident beneficiary whose death benefit is assessable in Australia.

Timing of death benefit payments – member benefit or death benefit?

Where a member aged over 60 (or who was suffering a terminal medical condition) requested their benefits be withdrawn from super as a lump sum but they then died before the amount was paid, there has been some uncertainty as to whether any payment made should be treated as member benefit or a death benefit. This is important because if the payment is treated as a member benefit it will be tax free, whilst if it is required to be treated as a death benefit, it could be subject to death benefits tax (at the above rates) depending on the death benefits dependent status of the beneficiary and the tax components of the payment.

In February 2023 the ATO resolved this uncertainty by confirming that a trustee must assess whether a payment is a member benefit or death benefit based on the facts known at the time of the payment.[156] These include:

- terms of the request from the member
- terms of the trust deed and any other governing rules
- knowledge at the time the payment is made (including whether they are aware that the member has died)
- the entity that the payment is being paid to
- circumstances and timing of the payment
- whether the payment is made because of and in line with the request made by the member.

After confirming its position, the ATO subsequently issued several Private Binding Rulings (PBRs) confirming that payments requested before death but paid after death should be treated as a death benefit on the basis the trustee was aware the member had already died at the time of making the payment.

As a result, where the trustee becomes aware that a member has died, it should carefully consider whether it can continue to comply with any pre-existing withdrawal requests or whether it should not proceed with the payment and instead administer the member's account in accordance with the super and tax death benefit payment rules.

Note: while the ATO has not ruled out that a payment in these circumstances could still be treated as a member benefit, it would be prudent to seek specialist legal advice and/or apply for a PBR before doing so.

156 See ATO webpage: https://www.ato.gov.au/tax-and-super-professionals/for-superannuation-professionals/apra-regulated-funds/paying-benefits/paying-superannuation-death-benefits

8.7 Paying death benefit income streams

Where a trustee is paying a member's death benefit to their beneficiaries as a death benefit income stream, they will need to calculate the value of the member's interest in the fund and determine the tax components of the member's death benefit in accordance with the proportioning rules that apply to the payment of death benefits. These rules are summarised as follows:

Where deceased died in accumulation phase

Where a death benefit of a member who died in the accumulation phase is paid in the form of a retirement phase income stream, the tax component proportions of the income stream are based on the tax component proportions of the deceased member's interest from which the pension is commenced.

Case study – tax components of a death benefit income stream

Barry died on 1 July. Three months later, Barry's wife, Tilly, commenced a death benefit income stream with Barry's benefit in their SMSF. At the time of commencement of the pension, the value of Barry's interest in the fund was $500,000, which was made up of 90% taxable component and 10% tax-free component.

In this case, Tilly's pension would inherit the same tax component proportions as Barry's interest. That is, the pension would be 90% taxable component and 10% tax-free component.

Deceased died in pension phase, no automatic reversion

Tax Ruling TR 2013/5 provides that a superannuation income stream will cease at the time of death, unless:

- the pension is an automatically reversionary income stream, or
- a valid binding death nomination is in place which requires the trustee to continue to pay the death benefit as an income stream.

Where no such reversion or nomination is in place, however, special proportioning rules apply on the death of a pensioner, provided:

- no amounts other than investment earnings or insurance proceeds have been added to their superannuation interest, and
- their death benefit is paid as a lump sum or retirement phase income stream (or combination of both).

These special rules allow the deceased member's superannuation balance at the date of death (plus earnings on that balance) to retain their existing tax-free proportion during the period between the member's death and the payment of their new death benefit income stream. However, any insurance proceeds will form part of the taxable component.

Automatic reversion of existing pensions

Where an income stream that was commenced on or after 1 July 2007 reverts to someone else due to the death of the member, the reversionary pension retains the same tax component proportions as the original pension.

For more information on the calculation of the tax-free and taxable components of a pension commenced prior to 1 July 2007, please see the FirstTech Super and Retirement Income Streams guide.

Taxation of death benefit income streams

The tax treatment of a death benefit income stream depends on both the age of the member on death and the age of the beneficiary. Table 8.4 summarises the tax treatment of death benefit income streams.[157]

Table 8.4 Tax treatment of death benefit income streams

Component	Deceased or beneficiary over 60	Both under 60
Tax-free component	Nil (non-assessable non-exempt income)	Nil (non-assessable non-exempt income)
Taxable component (taxed element)	Nil (non-assessable non-exempt income)	Marginal rate with 15% offset

157 Different tax treatment may apply to death benefit income streams that are capped defined benefit income streams (these include some non-commutable lifetime and term income streams). Please refer to the FirstTech Super and Retirement Income Streams guide for further information.

9 Winding up an SMSF

9.1 Reasons for winding up an SMSF

Here is a summary of reasons why the members of an SMSF may want, or need, to wind up their SMSF:

Fund no longer viable

Due to the fixed costs associated with running an SMSF, it will generally need to have a minimum level of assets to be viable when compared with large APRA-regulated funds. Where the value of an SMSF has fallen, perhaps due to negative investment returns or because of the impact of benefit payments made from the fund, it may be more cost effective to wind up the SMSF and rollover member benefits to a large APRA fund.

However, as with a decision to establish an SMSF, cost should not be the only consideration as there may be other strategic reasons to maintain the fund.

Ceasing membership

A person may cease to be a member of an SMSF for many reasons. These include:

- death
- divorce
- disqualification as trustee
- family or business relationship disagreements.

The cessation of membership can have a number of impacts on an SMSF. For example, it could trigger the sale of assets to fund rollover or benefit payments, which may result in the fund no longer being necessary or viable.

SMSF not appropriate or required

After establishing an SMSF, some people find that they don't have the time or inclination to manage their own SMSF and don't need or require the additional control or flexibility it provides.

Age and capacity of members

As the members of an SMSF age, their capacity to act as a trustee may start to decline to a point where they are no longer able to fulfil their duties and obligations. Where this has started to occur, it may be appropriate to consider winding up an SMSF while all members still have the capacity to make decisions.

Alternatively, a member could decide to appoint their legal personal representative to act as a trustee on their behalf. However, that person will need to take on the responsibility of being a trustee and may end up having control of the fund after the member's death, which may result in disputes in relation to the payment of any death benefits.

Trustees moving overseas

To be a complying superannuation fund, an SMSF must satisfy the definition of an Australian Superannuation Fund (ASF). To be an ASF, a fund must:

- have been established in Australia or hold an asset located in Australia, and
- satisfy a central management and control test, and
- satisfy an active member test.

Where a fund fails any of these requirements in a year, it will cease to be an ASF and therefore cease to be a complying fund. To avoid this situation, one option is to wind up the fund and rollover the members' benefits to a large superannuation fund.

For more information about the definition of an Australian Superannuation Fund, please see *Chapter 5: Taxation of SMSFs*.

Disqualification of trustee

Where one or more trustees have become a disqualified, they will be prohibited from acting as a trustee of the fund or as a director of the fund's corporate trustee. Given that the definition of an SMSF requires all members of an SMSF to also act as trustees, or directors of the corporate trustee, this may result in some or all of the members needing to transfer their benefits out of the fund and could result in the fund needing to be wound up.

9.2 Pre-wind up checklist

Before a trustee decides to wind up an SMSF, they may need to consider a range of issues to ensure they understand the implications of the decision to wind up the fund and that there is nothing that may prevent or stall the fund being wound up.

Fund CGT position

As the disposal of an SMSF's CGT assets to facilitate wind up will generally trigger a CGT event, a trustee should understand the potential CGT implications of deciding to wind up the fund.

Capital gains

Where the disposal will crystallise a capital gains tax liability, the trustee should be aware of what the liability will be and what impact it may have on the members' benefits.

Capital losses

Where a disposal will crystallise a capital loss, the trustee should be aware that capital losses will remain with the SMSF and will be extinguished when the fund is wound up. Therefore, the members will lose the benefit of the trustee being able to carry those losses forward and to use them to offset any future capital gains.

Existence of reserves

Where an SMSF holds reserves, such as the residual of a solvency reserve left over from the payment of a fixed-term complying pension, the trustee will need to allocate those amounts to member accounts prior to the members rolling over or withdrawing their benefits in the fund.

Trustees should also be aware that any allocations from a reserve in this situation may count against the members' concessional contributions caps and may result in the members having excess contributions.

For more information on the allocation of reserves counting towards the contributions caps, please see *Chapter 7: Contributions and benefit payments*.

Existence of frozen assets

Where a fund holds frozen assets it will generally not be able to dispose of those assets to fund a rollover or benefit payment. This could prevent a trustee from being able to wind up a fund.

In this situation, trustees should check to see what hardship provisions are available to facilitate disposal of the fund's investments. Alternatively, trustees could consider transferring the legal ownership of the frozen asset to members as an in-specie transfer where possible.

If a pension is being paid

Where a fund is paying an income stream, the trustees will need to consider a range of issues before deciding to wind up an SMSF. These include the type of pension being paid and the potential CGT implications of commuting the income stream to facilitate wind up.

Capital gains tax issues

In 2013, the ATO released tax ruling TR 2013/5[158] which outlined that a superannuation income stream ceases when a request from a member to fully commute their pension takes effect. Therefore, where a fund is paying one or more retirement phase income streams, from a CGT perspective the trustees will need to consider the timing of any commutation request regarding the sale or transfer of the fund's assets.

Segregated assets method

Where a trustee has elected to use the segregated assets method, the timing of the disposal of any assets supporting retirement phase income streams relative to the timing of the member making a request to fully commute the income stream will be important.

158 Taxation Ruling TR 2013/5: *Income Tax: When a superannuation income stream commences and ceases.*

Where the member makes the request to fully commute before the trustee disposes of the assets, the ATO's view is that the income stream will have ceased on the commutation request taking effect. Any subsequent capital gains or losses will then be taken into account when calculating the fund's assessable income.

Alternatively, where a trustee disposed of all assets for cash before the commutation request being made, the assets would have been supporting retirement phase income streams and would therefore be segregated pension assets on disposal and any capital gains or losses would be disregarded. For more information on the timing of CGT events where a fund is paying a retirement phase income stream, please see *Chapter 5: Taxation of SMSFs*.

Unsegregated assets method

Where the trustee has elected to use the unsegregated assets method to identify the fund's exempt income, the timing of the commutation request relative to the disposal of the assets is irrelevant, as the fund will be entitled to an exemption based on the period of the year that a retirement phase income stream was being paid, regardless of when the asset was actually disposed of.

However, the timing of when the commutation request is made during the year relative to when the fund is wound up is important, as the value of the fund's retirement phase income stream liabilities used to determine the amount of the fund's exempt income is pro-rated, based on the number of days in the year the income stream was running.

Minimum pension payment issues

Where a member intends to fully commute their account based pension as part of winding up their SMSF, including where their interest will then be rolled over to another fund, the trustee must ensure the member is paid their pro-rata minimum pension payment before the lump sum commutation being paid.

> **Note**
>
> Payments resulting from a full commutation or a partial commutation do not count towards the minimum.

The pro-rata minimum pension payment is calculated as follows:

Annual minimum amount × Days in payment period ÷ Days in financial year

Where:

- days in payment period means the number of days in the period that:
  - for pensions commenced in the financial year the commutation takes place – begins on the commencement date and ends on the commutation date
  - for pensions that were commenced in a prior year – begins on 1 July and ends on the commutation date
- days in financial year means 365 (or 366 in leap years).

Where a member fully commutes a TAP (for example, to rollover to a TAP in another fund), a pro-rata minimum payment is also required calculated as follows:

Annual amount × Days in payment period / days in financial year

Where:

- annual amount is the annual pension payment required for the financial year (varied to the minimum level of 90% where allowed under the rules of the TAP), rounded to the nearest $10.
- days in payment period means the number of days in the period that:
  - for pensions commenced in the financial year the commutation takes place – begins on the commencement date and ends on the commutation date
  - for pensions that were commenced in a prior year – begins on 1 July and ends on the commutation date
- days in financial year means 365 (or 366 in leap years).

Deeming of account based pensions

Where an account based pension that was commenced before 1 January 2015 (and qualifies as a grandfathered account based pension for social security income test purposes) is rolled over and a new account based pension is commenced in a new fund, the new account based pension will no longer be excluded from the deeming of account based pension rules that came into effect from 1 January 2015. Therefore, the new pension account balance will be treated as a financial asset and will be subject to deeming.

Complying pension issues

Where the fund is paying a complying pension, such as a TAP, the trustees will need to identify another fund that will accept the rollover and commence a new TAP for the member.

Where the pension is also eligible to a social security assets test exemption, the trustee will also need to ensure the pension is rolled over according to the rules specified for the rollover of assets test exempt income streams to ensure the new income stream retains the original income stream's assets test exempt status.

For more information on the rules relating to the rollover of assets test exempt income streams from an SMSF, please see *Chapter 7: Contributions and benefit payments* and/or the article 'SMSF defined benefit pensions – commutation considerations', available on the FirstTech website.

2021 Federal Budget proposal: Legacy complying pension and annuity conversions

The previous Federal Government proposed a two-year period to allow members with certain complying income streams (including term allocated pensions, complying lifetime and complying life-expectancy pensions held in SMSFs) to choose to exit their income stream.

Refer to Section 7.11 for further information about this proposal.

If contributions have been made during the year

If any members of the SMSF have made personal contributions for which they wish to claim a tax deduction, they must provide the SMSF with a 'notice of intent to claim or vary a deduction for personal super contributions' form under section 290–170 of the Tax Act before the trustee rolling over their benefit to another fund, otherwise any notice they provide will be invalid.

If the fund holds life insurance policies for members

Where a fund holds life insurance policies for members, the trustees may wish to consider confirming whether the members will be able to obtain a similar level of insurance for the same cost in the new fund. Where this is not possible, the trustees may wish to consider transferring the policy into the individual's name, subject to them being able to afford it.

UK pension transfer considerations

Where an SMSF is a Qualifying Recognised Overseas Pension Scheme (QROPS) or former QROPS under UK pension legislation, and has previously received a UK pension transfer (or rollover of benefits from another QROPS consisting of UK pension sourced funds) for a member, it is important to consider whether rolling or cashing out the member's benefits as part of winding up the SMSF will:

- Trigger a requirement to report the payment to His Majesty's Revenue and Customs (HMRC) in the UK.
- Involve 'member payment charges' applying under UK rules which can trigger significant UK taxation (for example if the payment is an unauthorised payment).

Whether the above will apply can depend on a range of factors, including when the original UK transfer was received and how long it has been since the last time the member was a UK tax resident.

While a brief summary of the UK pension transfer rules can be found in section 13.4 of the FirstTech Super and Retirement Income Streams guide, it is important for trustees to confirm any reporting obligations or potential UK tax consequences with a UK pension / tax expert.

Outstanding returns

Where a fund is being wound up, the ATO will require the fund to lodge all outstanding returns before agreeing to allow the fund to be wound up.

Where an SMSF has failed to lodge returns in previous years, the trustees will need to arrange for them to be prepared and lodged as part of winding up the fund.

9.3 Steps in winding up an SMSF

Here is a summary of the steps trustees will need to follow to wind up an SMSF:

Review trust deed for wind-up provisions

The trustees, and the fund's administrator, should review the fund's trust deed to identify the fund's wind-up rules and whether any particular steps must be followed. Wind-up rules in a deed could deal with:

- when the fund may, or must, be wound up
- trustee resolutions to wind up the fund
- communication with members or employer sponsors
- distribution of unallocated money to members
- valuation of assets
- maintaining a balance for the payment of final expenses and tax liability
- record keeping after the wind up has occurred.

Review and dispose of fund assets

Trustees should review all fund assets and determine how they should be dealt with. Where assets will be transferred in-specie to a member (as a benefit payment) or another fund (as a rollover), they will need to be valued at market value for the purposes of completing the fund's financial statements.

Where assets are to be sold, the trustee should arrange for the sale. Proceeds should then be credited to the fund's bank account.

Trustees should also identify any frozen assets and decide how they will be dealt with.

Submit and acknowledge any deduction notices

If any members of the SMSF have made personal contributions for which they wish to claim a tax deduction, they must provide the SMSF with a notice of intent under section 290–170 of the Tax Act before their benefits are paid or rolled over to another fund.

Trustees must, without delay, acknowledge any valid notices of intent provided.

Commute pensions

Where members are receiving pensions, the members will need to commute them. Trustees should ensure the commutation is made in accordance with the minimum pension standards and that a pro-rata minimum income payment is paid before the commutation is made.

For more information on the commutation requirements of pensions paid from SMSFs, please see *Chapter 7: Contributions and benefit payments*.

Commuting a pension will generally trigger transfer balance cap reporting requirements. See section 3.6 for further information about transfer balance cap reporting requirements.

Allocate any reserves and prepare interim set of accounts

The trustee will need to arrange for a set of interim financial accounts to be completed to value the members' interests and determine the tax components of their benefits.

As part of preparing the fund's financial accounts, trustees should ensure that provision is made for any wind up costs. These costs could include:

- administration, accounting and audit fees
- legal costs
- final tax liability
- SMSF Supervisory Levy.

As part of preparing the set of financial accounts, the trustees should also arrange for any fund reserves to be allocated back to members on a fair and reasonable basis.

Sign trustee resolutions and report to the ATO

Trustees should hold a trustee meeting and resolve to wind up the fund as at a particular date. The trustees must then notify the ATO within 28 days of the date of wind up by providing the following information:

- the name of the SMSF
- the fund's ABN
- details of a contact person for the fund (eg one of the trustees)
- the date that the fund has been wound up.

In many cases, the notification occurs as part of lodging the fund's final annual return.

Pay out/rollover members' benefits

Once the fund's assets have been sold and the member balances have been calculated, the trustee can arrange for the members' benefits to be rolled over to another fund or paid out as a lump sum benefit (where a member has satisfied a condition of release).

Where a member's benefit is paid as a lump sum, the trustee will generally be required to provide a PAYG payment summary for superannuation lump sums. Refer to section 7.4 for more information on the PAYG payment summary.

Where benefits are rolled to another complying superannuation fund, the trustee must issue a rollover benefits statement to the receiving fund[159] and also provide a copy to the member.

See *Chapter 3: Trustee responsibilities* for more information on the requirements for a rollover benefit payment.

Prepare final annual return

Before lodging the fund's final annual return, the trustee will need to prepare a set of final financial statements. The financial statements should be updated from the interim accounts to show member balances at zero after taking into account rollovers and benefit payments, final wind up costs and tax liabilities.

> **Note**
>
> The fund bank account should be left open with sufficient funds to pay these liabilities.

The trustees must then arrange for a final financial and compliance audit before submitting the final return.

Submit final annual return to the ATO and pay outstanding tax liabilities

The trustee must submit the final annual return for the year in which the SMSF is wound up. The trustee must indicate where prompted in the final return that:

- the fund has been wound up and the date the fund was wound up
- the trustee has paid all outstanding debts and paid or transferred all member benefits
- the trustee has submitted all previous SMSF annual returns.

Confirmation from ATO

Once the reporting requirements to the ATO have been completed successfully, the ATO will send the trustee a letter confirming that the fund's ABN has been cancelled and the SMSF's records have been closed on the ATO's systems.

159 Where a rollover is processed via SuperStream, the information forming the rollover benefits statement is instead provided to the receiving fund electronically at the time of the rollover.

Pay final liabilities and close bank account

Once the trustee has received notification from the ATO that the fund is closed the trustees can proceed to close the fund's bank account.

Where a fund receives a tax refund, the trustees will need to either pay the proceeds as a benefit or roll them over to a new superannuation fund before closing the fund's bank account.

Where a liability of the trustee arises after the closure of the fund (for example, the trustee had outstanding accounting fees which are now due), it is no longer possible to meet those liabilities out of the fund's assets. In this case, the now former trustees may need to pay those liabilities personally.

9.4 Record keeping after an SMSF has been wound up

SMSF trustees must keep certain records for specific time frames, including:

- copies of trustee minutes and changes of trustees (10 years)
- copies of all reports given to members (10 years)
- accounting records (five years)
- operating statement and statement of financial position (five years).

Where an SMSF has been wound up, trustees should still retain those records for the required time period, as this may assist in resolving any issues that arise after the closure of the fund.

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FirstWrap Service and Support	1300 769 619
Australian Taxation Office Superannuation enquiries For superannuation benefits, lost members register, and superannuation guarantee	13 10 20 www.ato.gov.au
Centrelink	www.servicesaustralia.gov.au
Employment services	13 28 50
Retirement services	13 23 00
Department of Veterans' Affairs	www.dva.gov.au
General enquiries	1800 555 254
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