SMSF INVESTMENT RULES

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We invite you to meet with one of our authorised representative to discuss what it was you were hoping to achieve when you downloaded this eBook and to establish if they can help you achieve your goals and objectives.

At the rear of this book you will find the details on how to book an appointment with one of our experts.

We look forward to meeting you soon.

Wealth Today

Contents

The sole purpose test

The purpose of any super fund, including an SMSF must be for one or more of the core purposes; or one or more of the core purposes and one or more of the ancillary purposes, which include:

Sole Purpose Test – Core Purpose

- provision of retirement benefits
- provision of benefits after reaching an age specified in the regulations (such as preservation age)
- provision of death benefits if the member's death occurred prior to retirement or attaining an age specified in the regulations.

Sole Purpose Test – Ancillary Purposes

These include:

- provision of benefits after termination of employment
- provision of benefits after leaving work due to ill-health
- provision of benefits in respect of a deceased member, to the member's legal personal representative and/or to dependants of the member, where the member dies after retirement or after reaching an age prescribed in the regulations
- Provision of other benefits as approved by the regulator, such as terminal illness, severe financial hardship or compassionate grounds.

Breaches of the sole purpose test will generally occur where the member and/ or their associates are receiving a benefit, either directly or indirectly, from the fund's investment before they would normally be able to draw a benefit from the fund.

EXAMPLE

Situations which may constitute a breach of the sole purpose test include:

- the assets of the SMSF used as a security for a loan made to a member or related party of the SMSF
- paying fees to a financial adviser where the advice relates to a member's personal investments outside of the SMSF
- a member or related party lives at a property owned by the SMSF rent-free.

TIP

Where an SMSF trustee makes an investment which results in an incidental and minor benefit to a member, the fund is unlikely to be in breach of the sole purpose test. An example of this might be where a fund trustee purchases a parcel of 500 bank shares and the member receives a fee waiver on a credit card provided they have a minimum annual spend of $5,000. Such a benefit is similar to, or perhaps slightly more favourable, than credit card fee waivers available to bank customers in general. The benefit is relatively insignificant and is an inherent feature of investing in the shares available to all investors in a similar size marketable parcel.

Collectable and personal use assets

Collectables and personal use assets include artwork, jewellery, antiques, for example, and are ordinarily used or kept mainly for personal use or enjoyment.

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 where they are used or otherwise enjoyed by a member without compensation.

Restricted assets

Collectables and personal use assets, as outlined in the relevant super laws, include:

- artwork, defined as a painting, sculpture, drawings, engraving or photograph, or a reproduction of these items, or property of a similar description or use
- jewellery
- antiques
- coins, medallions or bank notes
- postage stamps or first day covers
- rare folios, manuscripts or books
- memorabilia
- wine or spirits
- motor vehicles
- recreational boats
- memberships of sporting or social clubs.

Where the trustee of an SMSF acquired one of the above assets after 1 July 2011, the following additional restrictions apply:

- must not be leased to any related party of the SMSF. This applies regardless of the 5% allowable in-house assets rule
- must not be stored or displayed in the private residence of any related party of the SMSF (although it can be stored, but not displayed, in business premises)
- a written record is kept for ten years for the reasons for the decision on where to store the item
- the asset is insured in the name of the fund within seven days of acquisition
- must not be used by any related party of the SMSF (which means you can't hang the SMSF's artwork in your home or business premises)
- transfer of ownership of any collectables and personal use assets to a related party of an SMSF must be done at a market price determined by a qualified independent valuer.

Who is a related party of a self-managed super fund?

Understanding who are related parties of an SMSF is important for compliance with the super rules. The rules impose certain restrictions on trustees undertaking investments and certain arrangements that involve a related party of the fund. These rules include the:

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

A related party of an SMSF include:

- members
- a standard employer-sponsor
- an associate of a fund member or of a standard employer-sponsor of the fund.

A standard employer sponsor of a fund is an employer who contributes to the fund due to an agreement between the employer and the trustee of the fund. For example, corporate and industry super funds are generally standard employer sponsored funds. Where an employer only contributes to a fund due to an agreement between the member and the employer such as under a salary sacrifice arrangement, this will not be considered a standard employer sponsor. It is uncommon to have a standard employer sponsor of an SMSF.

Associates of a member include:

- a relative of the member (parent, grandparent, brother, sister, uncle, aunt, nephew, niece, direct descendant or adopted child of the member)
- the spouse of the member or relatives of the spouse (as above)
- other members of the SMSF (and other trustees/ directors of a corporate trustee of the fund)
- the non-member trustee or non-member director of a corporate trustee, of a single member SMSF
- a partner of the member or a partnership in which the member is a partner (and their spouses and children)
- a trustee of a trust where the member controls that trust
- a company sufficiently influenced by, or in which majority voting interest is held by the member and the member's associates.

Financial assistance and loans to members prohibited

The super laws specifically prohibit an SMSF lending money or providing any form of financial assistance to members of the fund or their relatives (note that this is a narrower definition than a related party).

Possible reasons for breaches occurring may be due to:

- administration errors whereby money in the funds bank account has been used, rather than the individual member's bank account.
- the fund's cash being used as a source of cash flow or liquidity for the individual member.

Note that breaches may result in a fund being made non-compliant.

Providing financial assistance

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.

EXAMPLE

The following arrangements will constitute the provision of financial assistance:

- gifting an SMSF 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 a relative of a member
- forgiving debt owed to the SMSF by a member or relative of a member.

WARNING

An acquisition of an asset may also be prohibited under another provision of the super laws.

Loans to member and relatives and the in-house asset rules

Under the in-house asset rules, a trustee can generally lend up to 5% of the value of the fund to a related party.

The super rules specifically state that the rules prohibiting the lending or provision of financial assistance to members and relatives overrides the in-house asset rules.

WARNING

An acquisition of an asset may also be prohibited under another provision of the super laws.

Investment strategy

An SMSF investment strategy generally outlines the investment plan the trustees will aim to follow to achieve the funds stated investment objective(s). The aim of the investment strategy requirements is to ensure that all investment decisions are carefully considered and are not made without reference to the funds circumstances.

The strategy should detail what asset classes the fund will invest in and the relative percentage weightings and benchmarks of each asset class.

When formulating an investment strategy trustees are required to take into account the circumstances of the fund as a whole and consider the:

- investment objectives of the fund
- likely return and risk associated with an investment
- need for diversification given the investment timeframe and level of risk.
- need for liquidity given the age of the members and the expected time when benefits would start to be paid
- funds ability to meet ongoing operating expenses from the investment income on the asset.
- need to hold a contract of insurance that provides cover for one or more members.

Investment objectives

The fund's investment objectives should take into account the circumstances of the fund, including:

- the circumstances of the fund as a whole e.g. liabilities, taxation obligations, size
- the circumstance of the funds individual members e.g. age, risk profile, expected retirement date and requirements.

Investment considerations

Implementation of the investment strategy requires consideration to the following issues:

- how will certain asset classes be accessed e.g. exchange traded funds, direct shares, managed funds
- the process for the selection of specific assets e.g. which shares to invest in
- whether the investment is allowable under the funds trust deed
- whether the investment is allowable under the super investment rules
- whether the SMSF trustee wishes to invest in a single asset, such as a single property
- whether the fund wishes to invest in or has existing collectables and personal use assets
- segregation of fund assets for different pools of investment.

Investment strategy review

The investment strategy should also contain details on how often and in what circumstances the investment strategy should be reviewed by the trustees. The strategy should be reviewed annually as a minimum and potentially upon the occurrence of a significant event such as:

- New or departing members
- The commencement of an income stream for a member previously in accumulation phase
- A change in the needs of members e.g. insurance needs of the members, benefits taken due to ill health.

Acquisition of assets from related parties

SMSFs are generally prohibited from acquiring *assets* from related parties of the fund. There are limited exceptions to this rule.

Super laws define an asset to be any form of property, including money (whether Australian or foreign currency) and anything that has economic value. This includes every type of right, interest or thing of value that is legally capable of ownership and can be alienated or transferred to an SMSF. The property may be personal or proprietary, legal, equitable or statutory, or tangible or intangible.

EXAMPLE

An asset could be an estate, interest in land, a car, machinery, shares, a mining lease and intellectual property rights.

Permitted exceptions to the rules

SMSFs can acquire the following assets from related parties, provided they are acquired at market value:

- money
- listed securities, which include share, bonds, debentures, rights or options listed for quotation on the ASX or on certain approved international stock exchanges
- business Real Property (BRP) – this is property used wholly and exclusively in one or more business, and does not need to be the trustee's business.
- a life insurance policy 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)
- an investment in a widely held unit trust (e.g. a managed fund)
- an in-house asset acquired at market value where the acquisition of the asset would not result in the total level of in-house assets of the fund exceeding 5% of the value of the fund's assets

If the asset falls under any of the above exceptions, then the fund can purchase the asset or accept it as a super contribution from the member or related party. The acquisition must be at market value.

TIP

There are no equivalent restrictions on disposals *to* members or related parties. Such a transaction would need to occur on an arm's length basis however. This means, where an SMSF owns a residential property, they could sell that property to a member or a related party at market value. If the member had access to their super (by meeting a prescribed condition of release such as retirement), the trustee could transfer the property as a benefit payment to that member.

Invest on arm's length basis

The arm's length investment rule states that an SMSF trustee must deal with the other party to an investment transaction at arm's length or where they aren't dealing at arm's length, the terms of the transaction are no more favourable to the other party than they would have been if they were dealing at arm's length.

The purchase price of an investment should always reflect the true market value. In addition, the agreed or expected return from that investment should be at no less than a true market rate.

Where a trustee deals with a related party, the dealing must be on an arm's length basis.

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.

WARNING

While a transaction may comply with the arm's length rule, it may be in contravention of another provision of the super laws (e.g. financial assistance) or income tax laws (e.g. non-arm's length income). Where an SMSF receives non-arm's length income this is taxed at the highest marginal tax rate.

In-house assets

While a fund is allowed to acquire and hold in-house assets, the total market value of all in-house assets must be no more than the threshold of 5%.

An in-house asset of an SMSF is:

- a loan to or an investment in a related party of the fund
- an investment in a related trust of the fund, or
- an asset of the fund subject to a lease or lease arrangement between the trustee of the fund and a related party of the fund.

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

This test is applied at 30 June, but more importantly also applies during the year when new in-house assets are acquired or established.

A trustee is not permitted to acquire an in-house asset that would cause the total market value of the fund's in-house assets to exceed the 5% in-house asset limit. In this case the breach will occur at the time of the acquisition not at the end of the income year.

EXAMPLE

For example, the trustee of an SMSF with $1million in assets would be permitted to acquire up to $50,000 worth of shares or units in a related company or trust (assuming the fund had no other in-house assets). However, where the trustees invested more than $50,000 in a related company or trust, the fund would have breached the prohibition on a fund acquiring in-house assets from a related party.

EXAMPLE

The trustee of an SMSF would be prohibited from leasing an existing residential property that made up 50% of the assets of the fund to a related party, as the trustee would be deemed to have acquired an in-house asset in excess of the 5% in-house asset limit.

What if the 5% in-house asset limit is exceeded?

Where an SMSF exceeds the 5% in-house asset limit at 30 June of any year, the trustee is required to prepare a written plan to dispose of one or more of the in-house assets to reduce the overall in-house asset value back to the 5% limit. The trustee is then obligated to ensure that the steps in the plan are carried out.

Exceptions to the in-house asset definition

The in-house asset rules contain a number of exemptions which specifically exclude certain assets of a fund from being an in-house asset. These include:

- business real property subject to a legally enforceable lease to a related party
- an investment in a widely held trust such as a retail managed fund
- property owned by the SMSF and the related party as tenants in common
- deposits with Approved Deposit-taking Institutions (i.e. Banks)
- a life insurance policy
- arrangements set up under complying limited recourse borrowing provisions
- investments in certain related trusts and companies under specific transitional arrangements.

Borrowing restrictions

The super rules prohibit a trustee of a super fund from borrowing money or maintaining a borrowing of money, subject to specific exceptions. Borrowing arrangements that are not allowed under the borrowing rules include:

- a loan of money to the fund, whether secured or unsecured
- margin lending
- a bank overdraft facility

Exceptions to the prohibition on borrowing

Certain circumstances and transactions are not prohibited from the general borrowing prohibition. These include:

- borrowing of money to pay benefits to members or their beneficiaries (the period of borrowing cannot exceed 90 days and the amount borrowed does not exceed 10% of the assets of the fund)
- to cover the settlement of a range of securities, where at the time the investment decision was made the borrowing was not needed (the period of borrowing cannot exceed 7 days and the amount borrowed does not exceed 10% of the assets of the fund)
- borrowing to acquire assets under a limited recourse borrowing arrangement (discussed in more details in the following section)

EXAMPLE

If a member paid an invoice for accounting services provided to their SMSF, the payment would not be treated as a borrowing if the member was immediately reimbursed by the fund.

On the other hand, if this expense is to be repaid at a later time in the future or over a certain period of time, the amount would be classed as borrowing and a contravention of the super rules occurred.

TIP

Your SMSF can indirectly borrow money to invest such as geared managed funds, instalment warrants, warrants, options or contracts for differences (CFDs).

Limited recourse borrowing arrangements

A limited recourse borrowing arrangements is a specific type of borrowing arrangement that allows an SMSF trustee to borrow for investment purposes in a single asset. These borrowing arrangements are mainly suited to those seeking to invest in real, physical property (commercial or residential); and less so to gearing into direct shares.

Similar to taking on a mortgage, lenders will require a deposit for the purchase of an asset, to meet each lender's specific loan valuation ratio (LVR) requirements before lending the balance of the purchase price of the asset.

Limited recourse loan means the lender's recourse in the event of default is limited to the single asset acquired with the borrowed funds and not to other assets of the SMSFs.

WARNING

The limited recourse borrowing rules require that the asset purchased must be a single asset, such as a house or apartment. Hence, a borrowing arrangement could be implemented to acquire a single parcel of shares of the same type, in the same company and purchased at the same price.

So to invest in a diversified parcel of shares would not be permitted, unless a separate borrowing arrangement is in place for each parcel.

Reader Notes

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