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Smart people learn together

Changing Face of SMSF
September 2019

Contents

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Prepared as at 18 September 2019

1. Bills & Treasury

1.1 Reintroduction of lapsed measures

Earlier in 2019 against the backdrop of an election, there were a range of measures impacting SMSFs and superannuation more broadly that we on a knife's edge as to whether they would proceed – refer to our blog post 'Super measures – what made it and what didn't' to read further.

With the Coalition re-instated into Government, it was expected that these measures would re-appear into Parliament with a view to finalise at some stage in 2019. Well, we have now seen Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 re-introduced into parliament on 24 July 2019.

Reintroduced super measures

The Bill focuses on three key measures:

1. Amending the Superannuation Guarantee (Administration) Act (SGAA) 1992 to allow individuals to avoid unintentionally breaching their concessional contributions cap when they receive superannuation contributions from multiple employers. Instead of receiving contributions into superannuation, an employee may apply to the Commissioner to opt out of the SG regime in respect of an employer and negotiate with the employer to receive additional cash or non-cash remuneration.

2. To extend the purpose of the non-arm's length income provisions to prevent the inflating of fund earnings through non-arm's length dealings (e.g. schemes involving non-commercial arrangements that stream income to a SMSF). The strategy is used by some individuals to increase superannuation savings in a way that is not caught by the concessional contributions (CC) cap and non-concessional contributions (NCC) cap.

3. To include within a member's total superannuation balance (TSB) the outstanding loan amount of a limited recourse borrowing arrangement (LRBA) entered into by an SMSF after 1 July 2018. However, the increase only applies to members who have satisfied a condition of release with a nil cashing restriction, or those whose interests are supported by assets that are subject to a LRBA between the fund and its associate (i.e. related party borrowing).

A detailed summary of the above measures is included below:

1.1.1 Superannuation – employees with multiple employers

In the 2018-19 Budget, the Government announced that from 1 July 2018, individuals with multiple employers would be able to nominate to opt out of the SG system in respect of their wages from certain employers. The opt-out means that eligible individuals can avoid inadvertently breaching their annual concessional contributions cap as a result of multiple employers making contributions into superannuation on their behalf.

The amendments allow certain individuals with multiple employers to apply to the Commissioner for an employer shortfall exemption certificate. An employer's maximum contribution base for an employee for a quarter is nil if the employer is covered by an employer shortfall exemption certificate issued by the Commissioner in relation to the employee for that quarter.

Importantly, an employer shortfall exemption certificate does not prevent an employer from making contributions into superannuation on behalf of the employee. The effect of the certificate is only to remove the consequences of failing to make any contributions for the quarter covered by the certificate. This means an employer may choose to disregard a certificate and continue to make contributions. For example, this may be relevant where an employee and employer do not reach agreement on the terms of an alternative remuneration package for the relevant quarter, or if there has not been enough time for an employer to adjust payroll or other business software to discontinue contributions for the employee.

Conditions for issuing an employer shortfall exemption certificate (ESEC)

The Commissioner may issue an employer shortfall exemption certificate in relation to a person that has made an application to the Commissioner (in the approved form) and their employer for a quarter if all of the following conditions are satisfied:

- the Commissioner considers that, disregarding the effect of issuing the certificate, the person is likely to exceed their concessional contributions cap for the financial year that includes the relevant quarter;
- the Commissioner is satisfied after issuing the certificate, the employee will have at least one employer that would either have an individual SG shortfall in relation to the employee, or have such a shortfall if they did not make any contributions for the benefit of the employee; and
- the Commissioner considers that it is appropriate to issue the certificate in the circumstances.

Application for the employer shortfall exemption certificate can only be made to the Commissioner by the request of the individual to be covered by the certificate, not the employer.

Application must be lodged with the Commissioner in the approved form, which allows the ATO to seek evidence of things that the Commissioner may require to be satisfied of before issuing the certificate.

The due date for lodging an application is 60 days before the first day of the quarter to which the application relates. It is expected that for the first quarter of the 2018-19 financial year, the Commissioner will defer the due date for all applications to allow employees time to apply for an exemption following the commencement of these amendments.

Commissioner's decision to issue an ESEC

If the Commissioner decides to issue an ESEC, the Commissioner must specify in the notice the following matters that are covered by the certificate:

- the employer
- the employee; and
- the quarter

For further information, refer to the explanatory memorandum (EM) available on the Parliament of Australia website.

1.1.2 Non-arm's length income (NALI) of superannuation entities

The Bill intends to remove the ambiguity surrounding a technical deficiency with the non-arm's length income provisions within Subdivision 295-H of the ITAA 1997 as it relates to:

- **Acquiring assets at less than market value** – in these circumstances it may not have been clear whether the ordinary and statutory income from these assets falls within the scope of the subdivision in all cases.
- **Non-arm's length expenditure** – e.g. where expenses incurred by a superannuation entity in respect of an asset are not on arm's length terms, but the amount of ordinary income or statutory income from the scheme is the same as might be expected had the dealing been at arm's length. This may be the case, for example, where real property is acquired under a limited recourse borrowing arrangement and where the rent derived under the scheme is at market rates, but the interest paid on the loan is not.
- **Net capital gains** – it is unclear under the current laws as to whether net capital gains would fall under the policy intent of Subdivision 295-H; e.g. a fund acquires an asset at less than its market value through non-arm's length dealings and then disposes of the asset for market value consideration. The resulting net capital may arguably be the same as the gain that would have resulted had the parties been dealing with each other at arm's length when the asset was acquired, due to the operation of the cost base market value substitution rules in section 112-20 of the ITAA 1997. This means that the current non-arm's length income rules may have no effect, even though the transaction diverts more wealth into the concessionally taxed superannuation entity than would have been possible had the relevant dealings been at arm's length.

The new laws contained within the Bill will clarify the operation of subdivision 295-H to ensure that complying super entities cannot circumvent the NALI rules by entering into a scheme involving non-arm's length expenditure.

Importantly, the NALI framework will broadly remain the same where:

- There must be a scheme; and

- The parties to the scheme must incur less (or nil) expenditure than would otherwise be expected if the parties were dealing with each other on an arm's length basis in relation to the scheme.

Expenses may be of a revenue or capital nature, in the same way that non-arm's length income may be statutory or ordinary income.

Example 1 – non-arm's length expenditure of a super fund
An SMSF acquired a commercial property from a third party at its market value of \$1,000,000 on 1 July 2015. The SMSF derives rental income of \$1,500 per week from the property (\$78,000 per annum).

The SMSF financed the purchase of the property using a LRBA from a related party on terms consistent with s.67A of the SIS Act. The LRBA was entered into on terms that include no interest, no repayments until the end of the 25-year term and borrowing of the full purchase price of the commercial real property (i.e. 100 per cent gearing).

The SMSF was in a financial position to enter into the LRBA on commercial terms with an interest rate of approximately 5.8%. The SMSF has not incurred expenses that it might have been expected to incur in an arm's length dealing in deriving the rental income. As such, the income that it derived from the non-arm's length scheme is non-arm's length income. The rental income of \$78,000 (less deductions attributable to the income) therefore forms part of the SMSF's non-arm's length component and is taxed at the highest marginal rate. However, there will be no deduction for interest, which under the scheme was nil.

Non-arm's length interest on borrowings to acquire an asset will result in any eventual capital gain on disposal of the rental property also being treated as non-arm's length income.

Expenses relating to a super fund as beneficiary of a trust

When a super fund holds a fixed entitlement to the income of a trust and derives income as a beneficiary of that trust, non-arm's length expenses incurred in acquiring the entitlement or in gaining or producing the income result in the income forming part of the fund's non-arm's length component.

These changes ensure that the amendments apply consistently between the general NALI rules for the income directly derived by a super fund and where the fund derives income through its fixed entitlement to the income of a trust.

Non-arm's length schemes and internal arrangements

For the NALI rules to apply to a scheme, it is necessary that the parties to the scheme were not dealing with each other at arm's length.

The requirement that parties not be dealing with each other at arm's length means that the NALI rules do not apply in respect of a super fund's arrangements that are purely internal. This is because a fund's internal functions are not undertaken with another party on any terms, non-arm's length or otherwise.

For example, an SMSF trustee may undertake bookkeeping activities for no charge in performing their trustee duties. Such internal arrangements are outside the scope of the NALI rules as they do not constitute a scheme between parties dealing with one another on an arm's length basis.

In certain cases, the trustee may undertake particular activities in performing its duties or choose to outsource those functions to third parties (e.g. to an agent where the fund holds real estate). The question of whether the non-arm's length income rules apply in respect of services or functions that are undertaken by the trustee depends on the capacity in which the trustee undertakes those activities.

As a general rule, the trustee of an SMSF is prevented from charging for the services or functions that it undertakes in its capacity as trustee by paragraph 17A(1)(f) of the SIS Act. Services of this kind do not involve a scheme between parties as they fundamentally relate to the trustee's obligations in respect of the fund.

If the trustee is not acting as a trustee but is instead providing services that are procured as a third-party, the NALI rules are intended to apply. Provided that the amount charged for any such services is not less than that which would be expected to be charged between parties dealing at arm's length, the dealings will not be subject to the NALI rules. In such cases, the trustee of an SMSF may also be prevented from charging any more than the arm's length price because of the regulatory requirements in the SIS Act (see section 17B of the SIS Act, which permits a trustee to charge up to an arm's length amount for duties or services performed other than in the capacity as trustee).

Attributing non-arm's length expenses to particular amounts of income

Where there is a scheme that produced NALI by applying non-arm's length expenses, there must also be a sufficient nexus between the expense/s and the income, that is, the expenditure must have been incurred 'in' gaining or producing the relevant income. This reflects the analysis that must be undertaken in determining whether an expense is deductible under section 8-1 or can be included in the entity's cost base for the transaction if the expense is of a capital nature.

For example, where the non-arm's length expense is an interest payment, identifying the relevant amount of income should be relatively straightforward. That is, because a super fund can only borrow under an LRBA, it means that the borrowed funds must be used to acquire a single, separately identifiable asset (subsection 67A(1) of the SIS Act). Where such an asset is used in deriving assessable income (including any capital gain on disposal), the income so derived will be NALI (as per (as per Example 1 above). However, income derived from other assets that the SMSF holds – e.g. dividend income from publicly listed shares – would not be NALI merely because the fund incurred a non-arm's length interest expense under the LRBA.

To calculate a fund's non-arm's length component (that is, the amount of taxable income that is taxed at the highest marginal rate), it is also necessary to identify any other deductions that are attributable to non-arm's length income. Those deductions may include the non-arm's length expense that caused an amount of an income to be non-arm's length income (e.g. interest expenses as per Example 1).

Non-arm's length capital expenditure that results in NALI

In some circumstances, non-arm's length capital expenditure can result in a fund earning NALI. Where a fund acquires an asset for less than market value through non-arm's length dealings, the revenue generated by that asset may NALI, as well as any statutory income (that is, net capital gains) resulting from the disposal of that asset.

This ensures that trustees of funds do not have an incentive to acquire assets at less than market value for the purpose of generating potentially significant ongoing amounts of income which would be sheltered from marginal rates of tax. It further ensures that such income cannot escape taxation entirely where the assets are held in the retirement phase (that is, the income would no longer be treated as exempt current pension income).

Section 66 of the SIS Act specifically prohibits the acquisition of assets by the trustee of a fund from related parties. However, there is no prohibition against a trustee of a fund acquiring business real property and listed securities from related parties at market value.

As such, if the trustee of a fund were to acquire an asset from a related party on non-arm's length terms (even when in contravention of section 66 of the SIS Act), any income that is generated from the asset would also be NALI.

A superannuation fund may acquire an asset by purchasing an asset or by way of an in-specie contribution. Where a fund purchases an asset at less than market value or reports the in-specie contribution at less than market value, then the acquisition may form part of a non-arm's length scheme such that any ordinary or statutory income derived from the asset and the disposal of the asset will be treated as NALI.

The market value substitution rules in section 112-20 may apply in respect of an asset that is acquired by a superannuation fund under a scheme that is subject to the NALI rules. The market value substitution rules adjust the first element of the cost base and reduced cost base of a CGT asset that is acquired by an entity to the market value of the asset.

The NALI rules continue to apply to an asset that has its cost base increased by the market substitution rule. This approach reflects that both sets of rules may apply as a consequence of an asset being acquired at a non-arm's length price.

For example, where real property is acquired (not as a contribution) by the fund for less than market value as part of a scheme where the parties were not dealing at arm's length, any income generated from that asset (for example, rental income) will be non-arm's length income. When the property is ultimately disposed of, the resulting capital gain will also be NALI. However, in calculating the resulting capital gain, the market value substitution rule may apply such that any capital gain on the disposal of the asset is reduced as a result of the asset's increased cost base to the market value at the time of acquisition.

1.1.3 Total Super Balance and LRBAs

The Bill will introduce changes to support the operation and integrity of the total superannuation balance (TSB) rules to ensure that, in certain circumstances involving limited recourse borrowing arrangements (LRBAs), the total value of the SMSF's assets is considered in working out the individual's TSB.

Where an SMSF has entered into an LRBA from 1 July 2018, a member's TSB may be increased by the share of the outstanding balance of the LRBA, related to the assets that support their super interest. However, the increase only applies to members:

- Who have satisfied a condition of release with a nil cashing restriction (specified in paragraph 307-80(2)(c) of the ITAA 1997; or
- Whose interests are supported by assets that are subject to an LRBA between the SMSF and its associate.

It should also be noted that artificially manipulating the allocation of assets that are subject to LRBAs against particular superannuation interests at a particular time may be subject to the general anti-avoidance rules in Part IVA of the ITAA 1936 where such allocations formed part of a scheme that had the dominant purpose of obtaining a tax benefit.

Members with a nil condition of release

Applying the amendment in the case of an LRBA that involves a member that has satisfied a nil condition of release addresses the risk of using an LRBA to facilitate a re-contribution strategy. In this context, a member who does not wish to exceed one of the TSB tests could withdraw an amount of their interests from superannuation and then, in their capacity as trustee, arrange for the fund to borrow an equivalent amount under the LRBA.

Where the increase applies solely because one or more members have satisfied a nil condition of release, the increase is only applied in respect of those members. This means that the increase does not apply to other members who have not satisfied such a condition, despite the fact that their interests may be supported by the same assets to which the LRBA relates.

However, if a member has satisfied a condition of release with a nil cashing restriction, they are required to take into account each LRBA that their SMSF has in respect of assets that support their superannuation interests (where entered into after 1 July 2018).

LRBAs with associates

Applying the amendments in the case of LRBAs that is with an associate of the SMSF ensures that the additional amount is included in a member's TSB where there is an increased risk that the terms of the LRBA are inconsistent with those that would have been entered into between independent parties.

Where the adjustment applies because the LRBA is with an associate, all members whose interests are supported by the assets to which the LRBA0 relates will have their TSB adjusted.

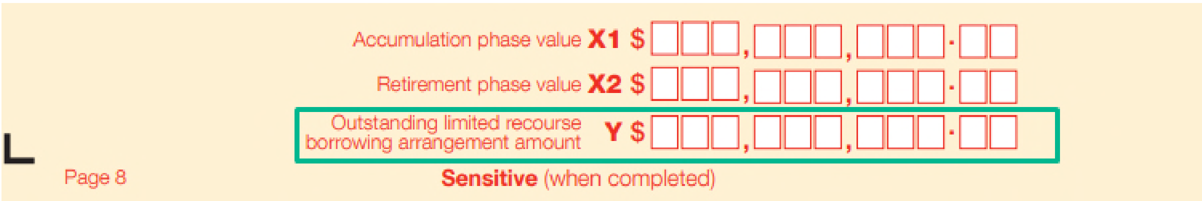
> ***Example 3 – TSB where there is more than one member***
> *Sue and Peter are the only members of their SMSF. The value of Peter's superannuation interests in the fund is $1.2 million. The value of Sue's superannuation interests is $1.8 million. All of the assets of the fund that support their interests are cash.*
>
> *Sue and Peter have both retired and therefore satisfy a condition of a release with a nil cashing restriction.*
>
> *The SMSF acquires a $3.5 million property. The SMSF purchases the property using $1.5 million of its own cash and borrows an additional $2 million using limited recourse borrowing arrangements.*
>
> *The SMSF now holds assets worth $5 million (being the sum of the $1.5 million in cash and the $3.5 million property). The fund also has a liability of $2 million under the LRBA. Of its own cash that it used, 40 per cent ($600,000) was supporting Peter's superannuation interests and the other 60 per cent ($900,000) was supporting Sue's interests. These percentages also reflect the extent to which the asset supports Peter and Sue's superannuation interests.*
>
> *Peter's TSB is $2 million. This is comprised of the:*
> - *$600,000 of cash that still supports his superannuation interest,*
> - *40% share of the net value of the property (being $600,000), and*
> - *40 % share of the outstanding balance of the LRBA (being $800,000).*

Sue's total superannuation balance is $3 million. This is comprised of the:

- *$900,000 of cash that still supports her superannuation interest,*
- *60% share of the net value of the property (being $900,000), and*
- *60% share of the outstanding balance of the LRBA (being $1.2 million).*

Reporting the outstanding balance of the LRBA

The amendments also require the trustee to report to the ATO such LRBA amounts that relate to an individual's TSB. Because the information relates to the liabilities that a fund has in respect of its assets, the outstanding balance of the LRBA is information that will be already known by the fund trustee(s). However, although this information will now need to be identified on a member basis, trustees will only have to do so in respect of the end of a particular income year.
The following is an extract from the 2019 SMSF Annual Return that will require reporting of any outstanding LRBA amount for certain members.


Accumulation phase value **X1** $ ☐☐☐,☐☐☐,☐☐☐.☐☐
Retirement phase value **X2** $ ☐☐☐,☐☐☐,☐☐☐.☐☐
Outstanding limited recourse borrowing arrangement amount **Y** $ ☐☐☐,☐☐☐,☐☐☐.☐☐
Page 8
Sensitive (when completed)

The changes to the TSB test apply to borrowings arising under contracts entered into on or after 1 July 2018. They do not apply to the refinancing of the outstanding balance of borrowings arising under contracts entered into prior to 1 July 2018, or to borrowings arising under a contract that was entered into prior to 1 July 2018.

Reference:
https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r6368

1.2 Miscellaneous amendments Bill impacting downsizer contributions

Treasury has released for consultation a range of miscellaneous amendments that includes making three changes to the downsizer contribution rules within section 292-102 of the ITAA 1997. These changes are designed to ensure that the provisions relating to downsizer contributions operate as intended.

The three proposed changes are to ensure that:

1. An individual can make a downsizer contribution in respect of the proceeds from a property that was held by their spouse where the property is a pre-CGT asset that would have been subject to the main residence CGT exemption if it had been acquired after 1 September 1985;

2. The cap on the amount of downsizer contributions that at an individual can make is calculated correctly where their spouse has previously made a downsizer contribution in relation to another property; and
3. For working out the maximum amount of downsizer contributions that an individual can make, the market valuation substitution rule (s.116-30 of the ITAA 1997), which applies generally in working out an amount of capital proceeds, cannot increase the amount of capital proceeds received in relation to the disposal of their ownership interests in a dwelling.

Spouse held pre-CGT property

One of the eligibility requirements to make a downsizer contribution is that the individual for whom the contribution is made must satisfy a main residence test. This test is satisfied where the capital gain or loss made by an individual in respect of the disposal of the interest in the dwelling is effectively exempted by the main residence provisions under Subdivision 118-B of the ITAA 1997.

The downsizer rules apply two legislative assumptions to ensure that individuals can satisfy this test where the interests in a dwelling are:

- not subject to capital gains tax (including Subdivision 118-B of the Income Tax Assessment Act 1997) because they were acquired prior to 20 September 1985; or
- held by the individual's souse, rather than by the individual.

However, the existing assumptions do not apply correctly for disposals of interests in a dwelling that were both acquired prior to 20 September 1985 and held by the individual's spouse.

The amendments address this issue by updating the assumption for interests held by an individual's spouse. In such cases, the individual is assumed to have acquired the interest on or after 20 September 1985 in working out whether any capital gain or loss from the interest would be disregarded under Subdivision 118-B of the Income Tax Assessment.

Correct cap calculation

An individual can make downsizer contributions up to the lesser of $300,000 and the amount of the capital proceeds that they or their spouse received from the disposal of their property. Although both spouses can make contributions from the disposal of one property, the total contributions they make between them cannot be more than the capital proceeds from the disposal of their interests in that property (for example, if a couple receives $500,000 for the disposal of their property and one spouse makes a downsizer contribution of $300,000, the other spouse can only make a downsizer contribution of up to $200,000).

However, there is a technical issue with the way the maximum contributions are calculated where an individual's spouse has already made a downsizer contribution in relation to the disposal of an interest in another property. Specifically, such contributions are treated in the same way as disposals from the same property, and as such reduce the maximum amount of the downsizer contributions that an individual can make.

The amendments correct this issue by ensuring that the maximum amount of downsizer contributions that an individual can make are only reduced by their spouse's downsizer contributions if their spouse's contributions were made in respect of the disposal of interests in the same property.

The first two changes above apply in relation to a disposal of an ownership interest in a dwelling if the contract for the disposal is entered into on or after 1 July 2018.

The third change addresses a different issue with the way that the maximum amount of downsizer contributions are calculated.

Calculating the maximum amount of downsizer contributions

This outcome is consistent with the original intent of the cap on downsizer contributions, which were intended to be based on the actual proceeds received from the sale of an individual's home. The market value substitution rule continues to apply more generally in working out any actual tax liability that an individual or their spouse has in respect of the disposal of their interest in a dwelling (although such disposals will generally be exempt because of the main residence exemption in Subdivision 118-B of the Income Tax Assessment Act 1997).

The change applies in relation to a disposal of an ownership interest in a dwelling if the contract for the disposal is entered into on or after the day the amendments receive Royal Assent.

This ensures that the amendments apply on a prospective basis only, which is appropriate as they can reduce the maximum amount of downsizer contributions that an individual can make.

Reference:
http://www.treasury.gov.au/consultation/c2019-407016

1.3 Deferral announced for SuperStream

Senator Jane Hume (Assistant Minister for Superannuation, Financial Services & Financial Technology) announced on 28 June 2019 that the Government has formally proceeded with the deferral of the extension of SuperStream for SMSF rollovers from 30 November 2019 to 31 March 2021.

This deferral means that system changes to update SuperStream will only need to be undertaken once, for both sets of changes. The deferral reduces administrative costs for funds and allows for a more integrated design of SuperStream.

The extension of SuperStream to SMSF rollovers allows SMSF members to initiate and receive rollovers electronically between an APRA fund and their SMSF. Currently, only rollovers between APRA funds can be transferred electronically using SuperStream. The inclusion of release authorities into the SuperStream standard will allow the ATO to send electronic requests to superannuation funds for the release of superannuation, further reducing administrative costs.

Regulations to give effect to the deferral will be made as soon as practicable.

Reference:
http://ejh.ministers.treasury.gov.au/media-release/002-2019/
https://www.ato.gov.au/Super/APRA-regulated-funds/In-detail/News/CRT-Alerts/2019/CRT-Alert-037/2019---Media-statement-on-deferral-of-SMSF-rollovers-in-SuperStream/

2. ATO Updates

2.1 ATO letter – re: SMSF investment strategy and diversification requirement

The Australian Taxation Office (ATO) has written to approximately 17,700 SMSFs to highlight their concerns that the fund may hold more than 90% or more of its assets in one asset, or a single asset class. From this evidence, the letter from the Regulator raises the issue that the fund may be at risk of not meeting the diversification requirements within the fund's investment strategy that must comply with the operating standard in SIS Regulation 4.09.

The SMSFs contacted also used a limited recourse borrowing arrangement (LRBA) to acquire the single asset or asset class. In 99% of the SMSFs contacted, the asset in question was property.

While nearly a third (180,000) of the total population of SMSFs have invested 90% or more of their retirement savings in a single asset or asset class, those SMSFs contacted were selected based on a report to government in February by the Council of Financial Regulators and the ATO. The 'Leverage and Risk in the Superannuation System' report highlighted concerns that less diversified SMSFs with LRBAs are exposed to asset concentration risk, which in the event of a fall in the asset's price could lead to a significant loss in the value of the fund.

It is important to note that trustees do have a right to invest within a single asset class should they choose to do so. However, what the ATO is looking to do here is to ensure that the investment strategy adequately considers the decision made by the trustee(s) in concluding to invest within a single asset class (or has high asset concentration). This includes the trustee(s) having assessed and being aware of the risks associated with an undiversified investment portfolio.

Poorly developed investment strategies

Too often SMSF investment strategy documents are poorly developed and ultimately not worth the piece of paper their written on. A single page document, the investment strategy reflects what the operating standard says, where the trustees 'have' considered risk and return, liquidity, diversification, cash flow and insurance cover for one or more members. Some documents may extend this further providing asset allocation ranges of 0 – 100% to ensure that they don't breach the SIS requirements with their fund auditor – this requires an SMSF auditor to have sighted a documented investment strategy and ensuring that they are acting in accordance with it.

In reality the investment strategy has been seen as a compliance document, rather than a tool to help develop and meet retirement outcomes. The role of a financial adviser with SMSFs has certainly helped to develop more meaningful investment strategies, however in many cases, the poorly documented investment strategy is a by-product of accountants being scared-off by the limitations in their role they can play in helping trustees with the fund's investment strategy (i.e. risks of breach any licensing limitations).

Copies of the trustee is below that outline the Regulator's concerns around the diversification requirements:

<PO BOX 908 ALBURY NSW 2640>

Australian Government
Australian Taxation Office

<TITLE> <FIRST NAME> <SURNAME>
<ORGANISATION>
<ADDRESS LINE 1>
<ADDRESS LINE 2>
<LOCALITY> <STATE> <POSTCODE>
<COUNTRY>

Our Reference: <Investment strategy>
Phone: <13 10 20>
Client ID: <TFN/ABN>

<Letter Date>

Is your SMSF investment strategy meeting diversification requirements

Dear <Trustee>,

Our records indicate that your self-managed super fund (SMSF) may hold 90% or more of its funds in one asset, or a single asset class.

This means that your fund may be at risk of not meeting the diversification requirement for your investment strategy as outlined in the operating standard of the *Superannuation Industry (Supervision) Regulations 1994*.

As a trustee you are ultimately responsible for ensuring your investment strategy meets the requirements under the law. You could also be liable for an administrative penalty of $4,200 if your investment strategy fails to meet these requirements.

.What you need to do

You need to review your investment strategy to make sure it complies with the law. In particular, you need to be able to provide evidence, ideally within the written investment strategy itself, of how you considered the following:

- diversification of your fund investments;
- the risks associated with inadequate diversification within the context of your SMSF's investment portfolio;
- the making, holding and realising and the likely return from your investments having regard to your retirement objectives and expected cash flow requirements
- the liquidity of your investments, meaning ability of your fund to pay benefits as members retire and pay other costs incurred by your fund
- whether to hold insurance cover for one or more members of your SMSF.

Have your investment strategy ready to provide to your SMSF's approved auditor as part of your next audit. This will help your auditor form an opinion on your fund's compliance with these requirements.

What happens now

We will also be writing directly to the auditor of your fund to notify them of our concerns. You should be aware that if your auditor identifies that you have failed to comply with the requirements listed above, this could result in the imposition of the above mentioned penalties.

Yours faithfully
<Deputy Commissioner's Name>
Deputy Commissioner of Taxation

NEED HELP?

If you have any questions, you can phone us on <13 10 20> between <8:00am> and <6:00pm>, <Monday to Friday>.

MORE INFORMATION

For more information about investment strategies for SMSF's, visit our website ato.gov.au/smsfinveststrgy

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So, where do we as an industry head with this renewed level of guidance from the ATO?

Quality of SMSF advice

In June 2018, we saw ASIC release Report 575: SMSFs – improving quality of advice and member experiences (REP 575) following a large research project to examine:

- member experiences in setting up and running a self-managed superannuation fund (SMSF) (member research); and
- whether advice providers are complying with the law when providing personal advice to retail clients to set up an SMSF (advice review).

From this research, ASIC provided some practical tips that advice providers can use to improve the quality of SMSF advice they provide to SMSF clients, which included areas of high asset concentration as part of the fund's investment strategy.

What can we learn from REP 575 for a fund's investment strategy?

REP 575 provides some important insights into the expectations and considerations in the development of a fund's investment strategy, in particular where the fund invests within a single asset class or where heavy asset concentration exists.

The table below is how I see that ASIC's guidance in REP 575 can be applied into trustee decisions with the investment strategy, in particular with a single asset class or heavy asset concentration:

REP 575	Trustee Considerations
Ensure that the Statement of Advice (SOA) adequately documents the basis in light of the client's financial situation, needs and objectives.	Ensure that the trustees in formulating the fund's investment strategy have considered the needs and objectives of the fund members.
Why investing in a single asset class is appropriate (rather than a diversified portfolio)	Why investing in a single asset class (or to be have heavy asset concentration) is considered appropriate in the circumstances, rather than a diversified portfolio.
Whether the investment will generate a sufficient return for the client's retirement needs (and if not, what the exit strategy is, and any costs or risks associated with this exit strategy)	Whether the investment will generate a sufficient return to meet the fund objectives set by trustees (e.g. specific objective of obtaining a target rate of return). In circumstances where not met, what steps the trustees will take to exit such an investment, along with the costs and risks associated in exiting to ensure that the trustees can meet the fund objectives.
Explain how investment strategy is likely to change as members approach retirement and their needs and circumstances change.	Explain based upon the age profile of the members how the fund will change over time (including through diversification) to meet the needs of the members as they approach retirement (e.g. liquidity and cashflow).
If property is the preference, consider whether property is appropriate.	Explain through the investment strategy as to why investing into property as a single asset class or where high asset concentration is an appropriate outcome to meet the fund's objectives. Also, how the trustee will devise a plan to reduce risk over time (e.g. through future contributions and fund earnings).

Where the SMSF is investing in property, REP 575 outlines the following advice requirements in advising SMSF clients:

- The needs and circumstances of the fund's members (age & retirement needs);
- If the recommendation involves an investment loan (LRBA), how long it will take for the client to repay the loan?
- The high upfront costs of purchasing property (e.g. stamp duty, loan fees, estate agent fees);
- The fund's ability to repay the loan if an unexpected event occurs (e.g. client becomes unemployed for a period of time);
- How the client's retirement will be funded by the property investment (i.e. through sale of property or through rental income);
- How likely it is that the property can be sold quickly (i.e. whether it's in a high demand area); and
- What the client will do if the property is not rented for a period of time?

All of these areas can be easily transferable into actions or requirements that trustees should be addressing as part of formulating their fund's investment strategy.

Role of fund auditor

The ATO has also written to the auditor of these funds to notify them of their concerns. A copy of this letter is below:

PO BOX 908 ALBURY NSW 2640

Australian Government
Australian Taxation Office

SMSF Auditor

Our Reference: **AA-Inv-Strategy**
Phone: **13 28 69**

4 September 2019

SMSF investment strategy and compliance with diversification requirements

Dear SMSF Auditor,

We have recently written to all SMSF trustees where our records show that their SMSF may hold more than 90% or more of its investments in one asset or a single asset class. This is because the fund's investment strategy may be at risk of not meeting the requirements in regulation 4.09 of the *Superannuation Industry (Supervision) Regulations 1994*.

The letter reminds trustees of the requirements under regulation 4.09 including the need to provide evidence in their investment strategy of having considered diversification of the fund's investments and the risks involved with inadequate diversification. It also advises the trustee to have their investment strategy containing evidence of these considerations, ready to provide to their auditor as part of their next audit. A copy of a generic letter that was mailed to trustees on 29 August 2019 is attached below for your information.

NEED HELP?

If you have any questions, you can phone us on **13 28 69** between 8:00am and 5:00pm, Monday to Friday. Ask for SMSF auditor team on extension **80716**.

What you need to do

One or more of your clients should have received this letter. In which case you should check that they have an investment strategy that complies with regulation 4.09.

In particular, you should expect to see documented evidence from the SMSF trustee which demonstrates that the following was considered:

- diversification of the fund's investments and the risks associated with inadequate diversification; and
- that other relevant factors were considered such as the risk involved in making, holding and realising and the likely return from the investments having regard to the fund's objectives and expected cash flow requirements;
- the liquidity of the SMSF's investments, having regard to its expected cash flow requirements and ability to discharge its existing and prospective liabilities; and
- whether the trustees considered holding insurance for one or more of the members.

It is up to you to determine whether any contravention of regulation 4.09 on the basis of non-compliance with the above listed factors would amount to a material contravention resulting in modification of the audit report.

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An Auditor-actuary Contravention Report (ACR) should be lodged where the ACR reporting criteria is met. In verifying the trustee's compliance with each of the above listed factors in regulation 4.09 we expect auditors to apply the trustee behaviour tests. This means that an ACR needs to be lodged if the contravention is one that the trustee has received advice about previously and has either breached it again or it has not been rectified at the time the audit is conducted.

If the trustee is receiving advice about the contravention for the first time you should notify them in writing. Best practice would be for the SMSF auditor to notify the trustees in the management letter of any further concerns about the fund's investment strategy.

Yours faithfully
James O'Halloran
Deputy Commissioner of Taxation

It will be up to the auditor to identify and determine whether the fund has failed to comply with the requirements outlined within SIR 4.09 which could result in administrative penalties applying of $4,200 (20 penalty units).

It is expected that the ATO will provide further guidance in respect to this topic to assist both trustees, auditors and other SMSF professionals to better understand and meet these investment strategy requirements within the SIS Regulations.

Reference:
https://www.ato.gov.au/Super/Sup/More-information-for-SMSF-trustees-on-investment-diversification/

2.2 Death benefit income streams – meeting minimum pension payment requirements

The Australian Taxation Office (ATO) has recently provided updated guidance on their website regarding the cashing requirements for a **reversionary pension** from a death benefit. In particular, this update provides some 'concession' for beneficiaries where for the minimum pension is failed during an income year.

Where the minimum pension has not been met for a financial year, the ATO has previously confirmed through TR 2013/5 (when a pension commences and ceases) that the pension will stop at the start of the financial year and any payments taken throughout the income year will be treated as lump sums. Furthermore, the fund will be denied any earnings tax exemption (ECPI) for the income year. For transfer balance cap (TBC) purposes, the fund will be required to lodge a TBAR to report the cessation of the pension at the end of the income year (not the start, when the tax exemption ceases).

Cashing rules

The industry view held was that where the minimum pension requirements have failed with a reversionary pension, the only alternative would be to take the death benefit as a lump sum. This could be a diabolical outcome in some circumstances where there is little or no scope to crystallise assets to pay out the death benefit.

It now appears however, that the Regulator is providing some leniency is these circumstances. If a contravention has occurred (i.e. failing to take the minimum pension), so long as the trustee(s) acts swiftly to cash the benefit 'as soon as practicable' to prevent further possible contraventions, an income stream can be re-established.

According to the ATO, this can be achieved by:

- immediately cashing the benefit in the form of a new retirement phase income stream as soon as they become aware of the breach (likely to be identified during the annual compliance process);
- cashing the benefit in the form of a lump sum (either as a single lump sum or as an interim and final lump sum); or
- rolling over the interest that supported the death benefit income stream pension to another complying super fund for immediate cashing as a new death benefit income stream.

Effectively what the ATO have advised is that in such a situation, the following process can be considered where a reversionary beneficiary fails to meet the minimum pension within an income year:

- See whether the pension shortfall qualifies to use the Commissioner's GPA
- Promptly purchase another income stream (further cashing event, following SISR 6.21)
- Otherwise, lump sum from the super system (cashing of death benefit)

It should be noted that these options are about preventing future contraventions of SISR. They won't remedy the breach that's already occurred for failing to meet the compulsory cashing requirements.

As long as one of these actions is taken immediately, the Commissioner will accept the trustee is meeting on a go-forward basis the requirement to cash the benefits 'as soon as practicable' and will not therefore have further contravened the SISR. Failure to resolve the matter may have significant compliance consequences.

The ATO has indicated that they will be reviewing all of their web content on this issue to ensure that messaging is consistent with these views.

(Unresolved) issues

The ATO has acknowledged that failure to meet the minimum pension would result in a loss of tax exemption and all payments are to be treated as lump sum amounts. For the purposes of a death benefit, SISR 6.21(a) only allows for a single lump sum death benefit payment, or an interim and final lump sum.

It is important to remember that just because the death benefit income stream failed and the ATO will allow for a new income stream to be commenced, it will retain the characteristics of being a death benefit. This follows the repeal of section 307-5(3) of the ITAA 1997 from 1 July 2017.

The ATO have indicated that this guidance only applies to reversionary income streams, not to death benefit income streams that have commenced by a tax dependant (non-reversionary). Given that SISR 6.21 (cashing rules) equally applies to both reversionary and non-reversionary income streams, this updated guidance needs further clarification from the ATO as to their reasoning why? Furthermore, it would appear that the result of this decision would mean that a reversionary pensioner would only get 'one chance' to fail the minimum pension as the beneficiary would be required to purchase a new death benefit income stream.

2.3 Fund status will change if SMSF annual returns are late

The ATO has advised that from 1 October 2019, if an SMSF is more than two weeks overdue on any annual return lodgment due date and hasn't requested a lodgment deferral, they will change their status on Super Fund Lookup (SFLU) to 'Regulation details removed'. The Regulator is taking this approach because non-lodgment combined with disengagement indicates that retirement savings may be at risk. This status will remain until any overdue lodgments have been brought up to date.

What is the new process?

On the first business day of each month, there is now a two-step process for updating SFLU.

Where an SMSF trustee hasn't lodged their SMSF annual return on time and they're more than two weeks overdue, the ATO will change their SMSF regulation status to 'Regulation details removed' on SFLU.

Where all overdue lodgments are received for an SMSF during the previous month, the ATO will update SFLU to reinstate the SMSF's 'complying' status.

How will this change affect SMSFs?

Having a status of 'Regulation details removed' means APRA funds won't roll over any member benefits to the SMSF and employers won't make any super guarantee (SG) contribution payments for members of the SMSF.

What can SMSF trustees/members do?

If SMSF trustees don't think they can meet the due date, the ATO requests being contacted before the due date, to seek a deferral to lodge. While the fund's status is 'Regulation details removed', members should alert their employer to make any SG payments into the employer's default super fund or a fund of the member's choice.

Once the SFLU status of the SMSF has been updated to 'complying', members can request a rollover to their SMSF of any member benefits that may be held outside their SMSF.

Reference:
https://www.ato.gov.au/Super/Sup/Your-fund-status-will-change-if-SMSF-annual-returns-are-late/

3. Case law

3.1 Dawson v Dawson [2019] NSWSC 826

The recent case of Dawson v Dawson [2019] NSWSC 826 recently handed down by the New South Wales Supreme court serves as a solemn reminder of what can go wrong when families, particularly blended families, with SMSFs, are in conflict with incomplete documentation. In this blogpost, we explore the circumstances of the case and what lessons can be learnt to avoid the cost and trauma that such case presents.

The Facts

The Dawson Superannuation Fund was established in 2005 by the late Peter Robert. Dawson and his wife, Estelle Dawson who were members and trustees of the Fund. Prior to Peter Dawson's death, and in June 2013 his son, Tony Dawson (the plaintiff), was appointed his father's Enduring Power of attorney (EPA). Due to the onset of Dementia, in March 2014 the plaintiff became a trustee of the Fund in Peter Dawson's place with the plaintiff and his mother Estelle Dawson as the trustees of the Fund.

In early 2012, Peter and Estelle Dawson separated which resulted in family court proceedings. Those proceedings were resolved by Consent Orders made in March 2014 that involved the sale of certain property within the Fund and with the intention that Estelle Dawson would rollover her interests in the fund of approx. $800,000 to another fund.

Peter Dawson died on 24 November 2015. At the time of his death he left a Will (made in October 2012) leaving all of his estate to Estelle and appointing Estelle's son in law George Holland as executor, a fact that Peter Dawson had apparently overlooked up until his death.

As far as the Fund was concerned, George Holland's role as executor was not discovered until April 2018 when the accountants for the Fund invited the plaintiff to sign a Deed of Confirmation. Up until then, they mistakenly assumed that the plaintiff (son) was the executor of the estate. The Deed purported to ratify the appointment of the Executor, George Holland as a trustee of the Fund and to replace the plaintiff with retrospective effect from the date of Peter Dawson's death – an appointment that the plaintiff disputed. Despite the plaintiff's refusal to resign as trustee, the executor and Estelle Dawson signed the Deed of Confirmation with the intention of taking control of the Fund.

Let the legal proceedings begin…

As a consequence, the plaintiff issued legal proceedings against his mother and the executor out of the NSW Supreme court to challenge their attempted appointment as trustees of the Fund, arguing that the executor's appointment was invalid. The plaintiff also issued a family provision claim challenging his father's Will and his estate being paid entirely to his (estranged) mother.
What was at the heart of the dispute was control of the Fund and the payment of Peter Dawson's death benefits totalling approximately $1,400,000. At the time of his death, Peter Dawson

had not made a Binding Death Benefit Nomination which would have stipulated how his superannuation interests in the Fund were paid.

The executor's position was that he and Estelle Dawson were the correct trustees of the Fund since Peter Dawson's death. They argued that as the EPA ceased on death, the plaintiff's appointment as trustee also ended and that the executor's appointment as trustee was necessary in order to satisfy the requirement of s.17A of the SIS Act and this appointment continued until all of the death benefits had been paid out (Peter Dawson's death benefits in the Fund had not been paid out earlier because of the apparent delay associated with selling a number of land holdings and a dispute in relation to the sale of a hotel property within the Fund).

The decision

At the conclusion of the case the court agreed with the plaintiff. It undertook a detailed review of the Fund's trust deed and how it managed the process for the appointment of a trustee to the Fund.

As a result, it came the following conclusions:

1. Consistent with the Fund's deed and the SIS Act, the plaintiff was by definition a *"Legal Personal Representative"* (LPR) as he held the role of EPA for the deceased member;
2. The plaintiff's appointment as trustee was a personal role which did not cease on the death of the member, even though the EPA ceased on death.
3. There was no express power in the trust deed that ended this role on the death of a member, nor was there any other power in the deed that would operate to terminate the plaintiff's role as trustee. The deed allowed for a LPR to be appointed in the circumstance of the member becoming of unsound mind or on death with the same powers as the member who ceased the office of trustee;
4. The plaintiff was entitled to hold the office as trustee for the deceased member until he ceased office or when he died or became of unsound mind.
5. The role of trustee of the Fund is a separate roll to that of an Attorney, appointed under an EPA;
6. The court agreed with the defendants that although not strictly relevant to the outcome of the case, the fund remained a two-member fund until the death benefits commenced to be paid out and this had not occurred at the time the case was presented to the court. The court agreed with the plaintiff that if the fund was a two-member fund, the plaintiff remained as trustee as the deceased member's "legal personal representative" for the payment of his father's death benefits; and
7. Estelle Dawson did not have the power under the trust deed to appoint her son in law executor as a trustee, without the consent of the plaintiff.

Important lessons from the case

The Dawson case is a salient reminder of the way courts will approach disputes relating to SMSFs and the importance of the fund's trust deed and associated documentation.

The Dawson case has again shown that a court will carefully review the provisions of the trust deed relating to the appointment of trustees as a matter of strict trust law. Consistent with the case of *Ioppolo v Conti [2015] WASCA 45*, the Dawson case has found that the provisions in section 17A of the SIS Act relating to the appointment of an executor as replacement trustee on the death of a member is permissive and not mandatory.

Also consistent with the Cases of *Re Narumon*, *Cantor Management and Perry v Nicholson,* the court will carefully review the SMSF documentary trail and the validity of previous deed upgrades, trustee resolutions (decisions) and how they impact on the validity of any current death benefit nomination.

Practically, what this means is that if an Attorney appointed by an EPA is appointed as replacement trustee during the period of incapacity of a member, and the member later dies, unless the trust deed of the Fund specifically terminates the attorney's role as trustee, they will remain in office as trustee for the purposes of the payment of the deceased member's death benefits. In circumstances where there is no valid BDBN, they will be able to exercise a discretion, made in good faith and for a proper purpose, to pay out the death benefits to any person who qualifies as a "dependant" for SIS purposes, which can include themselves.

What the Dawson case also shows is how important it is for clients to ensure that the person who is to benefit most from their super on death should be able to have effective control of the fund following the death of that member. While Peter Dawson had not made a Binding Death Benefit Nomination, advisers and fund members should also be aware that cases have previously shown just how easy it is for a BDBN to become invalid as a result of a simple clerical error or not following procedure.

This a key reasons why the appointment of a 'Fund Guardian', for example (as provided in the Smarter SMSF deed) can be one means of safeguarding a rogue attorney from exercising control of the fund on death.

Further, we continue to see many clients assume that their executor will control superannuation death benefits as part of the administration of their estate, but the Dawson case shows how these intentions can fail, particularly if the Attorney and executor are different persons.

And finally, the Dawson case is also an important reminder that individuals should be reviewing their Will following separation or divorce and that they ensure that they have a current and valid Binding death Benefit nomination in place, made strictly in accordance with the current rules of the Fund, particularly where there is family conflict surrounding an SMSF.

Reference:

Dawson v Dawson [2019] NSWSC 826

smarter smsf

What the best
practitioners use

T 1300 95 94 76 team@smartersmsf.com