Nexia Australia

Superannuation Solutions

Edition 4

Welcome

Welcome to the latest edition of our Superannuation Solution Newsletter.

2018 saw the implementation of the contributing the proceeds of downsizing into superannuation measure from the 2017 budget. We have included an article in this month's Newsletter, providing a summary of downsizer contributions, which explains in simple language if these new changes apply to you.

We have also included an article on SMSF investment strategies following a letter sent from the ATO; as well, as changes to SMSF Non-arm's length income.

We hope you find this newsletter informative. Should you have any questions in relation to how these changes may impact you, please contact one of our SMSF Specialists

Important Dates

25 November 2019
September Quarter Activity Statements lodged electronically

1 December 2019
Payment of income tax for taxable large/medium Super Funds and Super Funds which had their Annual Returns due for lodgement on 31 October 2019.

15January 2019
Annual Returns due for taxable large/medium Super Funds

Making Downsizer Contributions

Introduction

From 1 July 2018, people aged over 65 who sell their main residence can make a "downsizer" contribution of up to $300,000 to super (or $600,000 for a couple) provided they meet certain rules. Downsizer contributions have proved very popular, because:

- they are not counted against your concessional or non-concessional caps;
- they can be made regardless of the member's total superannuation balance, and
- they are not subject to the "work test", which otherwise requires a member over 65 to have worked a minimum of 40 hours in any period of 30 consecutive days before a contribution is made.

However, it is essential to understand the rules before making any contribution.

Who can make a downsizer contribution?

Broadly, a person can make a downsizer contribution where:

- The contribution is made to a complying super fund by a member aged 65 or older;
- The amount of the contribution is equal to, or part of, the capital proceeds received from the disposal of an ownership interest in an Australian main residence. A caravan, houseboat or other mobile home does not qualify;
- The capital proceeds qualify in whole, or in part, for the main residence exemption under the capital gains tax law, or in the case of a pre-CGT property, would have qualified if it was not a pre-CGT property;
- The member or the member's spouse had an interest in the main residence just before the disposal;
- An ownership interest in the main residence has been held by the member, the member's spouse, the member's former spouse or a trustee of the estate of the member's deceased spouse (or some combination of these) during the 10 years prior to the disposal, and
- The member has not previously made downsizer contributions in relation to an earlier disposal of a main residence. However, subject to the $300,000 cap, a number of contributions may be made from the capital proceeds of one main residence.

Upon disposal of a main residence, a member can contribute up to a maximum of $300,000. Despite the name "downsizer", it is not necessary to purchase a replacement main residence in order to qualify. The contribution must be made within 90 days after ownership of the main residence changes (usually 90 days after settlement).

As the $300,000 limit applies per member, owners and their spouses are both eligible to each make downsizer contributions. This means it is possible for a couple to contribute a total of $600,000 from the sale of a main residence owned by either or both of them.

The member must complete an ATO form to advise the super fund that the contribution is a downsizer contribution.

Super fund must report to the ATO

The receipt of a downsizer contribution by the super fund will be reported in its annual return to the ATO. If the ATO decides that the contribution does not qualify as a downsizer, the ATO will notify the super fund and the contribution will be treated as a non-concessional contribution. There are special rules relating to the withdrawal of non-concessional contributions, so please contact your Nexia advisor if you ever find yourself in this position.

Other matters to think about

There are other factors which clients should consider before they make downsizer contributions:

- a person's family home is generally not included in the Centrelink assets test, but superannuation savings are included once a person reaches age pension age. So disposing of you main residence and making a downsizer contribution might reduce or eliminate eligibility to the age pension;
- ensure that you understand how the capital gains tax might apply to the sale of your family home, especially if it has been rented out at any time during your ownership;
- be aware that downsizer contributions are not tax deductible, and
- check that the trust deed of your SMSF allows the fund to accept downsizer contributions. As this is a recent change to the law, many existing trust deeds will need to be amended before a downsizer contribution is made.

Please contact your Nexia advisor if you are over 65 and have recently or may soon sell your main residence, as there are time limits, which must be complied with in order to take advantage of downsizer contributions.

Your SMSF Investment Strategy

Introduction

In late August, the ATO sent out 17,700 letters to SMSFs (and their auditors) commenting on the fact that these funds hold 90% or more of their funds in a single asset or asset class. The letters go on to suggest that the funds might be subject to a $4,200 penalty if they do not have investment strategies that meet the diversification requirements of the super law. Such correspondence can be unnerving for SMSF trustees, so we take this opportunity to explain the background and the requirements referred to by the ATO.

The requirement for an investment strategy

Superannuation Industry (Supervision) Regulation 4.09 provides as an operating standard for SMSFs that the trustee of each SMSF must formulate, regularly review and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:

a. the risk involved in making, holding and realising, and the likely return from, the entity's investments, having regard to its objectives and expected cash flow requirements;

b. the composition of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification;

c. the liquidity of the entity's investments, having regard to its expected cash flow requirements;

d. the ability of the entity to discharge its existing and prospective liabilities;

e. whether the trustees of the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.

In more general terms, this requires the trustees to consider the risk profile of the fund's investments, the need for diversification of investments, the future cash flow of the fund, the fund's continuing solvency, and the desirability of providing insurance cover (life, TPD, terminal medical condition or income protection) for members.

To ensure compliance of our SMSF clients at Nexia, we ask them to complete an investment strategy document each year as part of our annual work in preparing the financial statements, annual return and other reports. If you are concerned that you may not be compliant please contact one of our Nexia advisors to discuss your circumstances.

The ATO letter

The actual wording of the ATO letter is, perhaps, a little misleading. The ATO has since confirmed that the focus of its review is not just SMSFs with a high proportion of funds in one asset class, but SMSFs with portfolios highly concentrated in property investments which are financed by limited recourse borrowing arrangements. It appears that the ATO has sent letters to many SMSFs which have leveraged assets other than property.

There are many situations in which it would be entirely appropriate for an SMSF to have a highly concentrated leveraged property portfolio. For example, as superannuation is only one of many possible investment structures, a member may achieve adequate liquidity by maintaining a portfolio of liquid assets (e.g. cash and listed shares) outside superannuation, but choose to hold a leveraged property within their SMSF.

It is also important to note that Regulation 4.09 does not give the ATO the power to determine what an SMSF should invest in. It only requires the trustees to document the fact that they have considered all relevant issues in deciding on the fund's investment portfolio.

This is an important distinction. The ATO is a **compliance** regulator, and its role is to ensure that SMSF's comply with the law. In contrast, for example, the Australian **Prudential** Regulation Authority (APRA), which is the regulator in charge of large industry and retail super funds, is a prudential regulator. Its role is to closely supervise such funds to prevent them failing financially. Although the financial failure of an SMSF is clearly not desirable, there is no similar obligation on the ATO to prevent this.

It is important to ensure that your SMSF has a documented investment strategy which addresses all the matters specified in the regulation above, that it is reviewed regularly (at least annually), and that it is actually implemented.

If you have any concerns relating to your SMSF investment strategy or any other issue, please contact your Nexia advisor.

Changes to SMSF Non-Arms Length Income

Introduction

The income and capital gains of super funds are generally taxed at the concessional rate of 15%. However, amounts which are regarded as "non-arm's length income" (or "NALI") are taxed at 45%. NALI includes income or capital gains which are greater that would be the case in an arm's-length transaction. Recent amendments to the law now also include as NALI income or capital gains where fund **expenses** incurred in producing the income or gains are **less** than arm's length amounts. These changes apply to income or gains derived from 1 July 2018.

Currently, there are several categories of NALI, including:

- income or capital gains derived where the parties are not dealing with each other at arm's length and the amount of the income or gain is greater than it would have been otherwise;
- dividends from private companies unless the amount is consistent with an arm's length dealing (according to a number of factors detailed in the legislation);
- trust distributions from sources other than a fixed trust, and
- trust distributions from a fixed trust where the parties were not dealing with each other at arm's length and the amount of the distribution is more than it would have been otherwise.

The amendments expand the categories of NALI to include income or gains where, in deriving the income or gains, the fund incurs a loss, outgoing or expenditure less than it would have been if the parties had been dealing with each other at arm's length. It will also cover situations where the Fund does not incur a loss, outgoing or expenditure, that the fund might have been expected to incur if the parties had been dealing with each other at arm's length.

Where non-arm's length revenue expenditure or capital expenditure is incurred in producing either income or capital gains, the entire income stream from an asset, and the ultimate capital gain from its sale, can be treated as NALI. There are certain situations where a fund may acquire an asset from a member, such as business real property or stock exchange listed investments.

If the fund pays only part of the market value of the asset and the member wishes the balance of the value of the asset to be treated as an in-specie contribution, this must be specified in the relevant agreement.

Where a fund borrows money under a Limited Recourse Borrowing Arrangement (LRBA), the terms of the arrangement, including term of the loan, interest rate, payment frequency, and loan to market value ratio, must be consistent with an arm's length dealing. If not, any income from the asset acquired and any capital gain on the ultimate sale will be NALI. In 2016 the ATO issued "safe harbour" guidelines for LRBAs in Practical Compliance Guideline PCG 2016/5, and the Explanatory Memorandum relating to the amendments states that LRBAs that meeting these will not be affected by the changes.

The ATO has issued Draft Law Companion Ruling LCR 2019/D3 to clarify the application of the changes to specific circumstances. This Draft Ruling highlights that it is important to identify if there is a "sufficient nexus" between the non-arm's length expenditure and the relevant income or gain.

This ruling raises the possibility that certain non-arm's length expenditure, such as discounted accounting fees, may be considered to have a "sufficient nexus" with the entire income of a fund, with the result that all income and gains would be regarded as NALI. Within Draft Practical Compliance Guideline PCG 2019/D6 the ATO concedes that trustees "may not have realised" that these amendments would apply to render all income and gains to be NALI where non-arm's length expenditure of a general nature is incurred by a fund, and advises that trustees will be given until 30 June 2020 to alter their arrangements. However, the deferral does not apply to non-arm's length expenditure that directly relates to deriving particular income or gains.

Another potentially troublesome aspect of the changes arises if is the situation whereif trustees (or trustee directors) provide services to their fund for no fee or a reduced fee. The ATO makes a distinction between services which are a usual part of the trustee's responsibilities as trustee, as trustee, such as bookkeeping or accounting services provided for a reduced or nil fee, and other services such as investment management, property management or property maintenance.

The Explanatory Memorandum released with the amendments states that the new NALI provisions will be applied where the fund is not charged an arm's length fee and the trustee is "not acting as a trustee but is instead providing services that are procured as a third party". There is no clear explanation of how to recognise such a situation, but LCR 2019/D3 suggests that the following factors would indicate a person is performing activities other than in their capacity as a trustee:

- the person charges the fund for performing the services;
- the person uses the equipment or other assets of their business, profession or employment;
- the person performs the activities pursuant to a licence and/or qualification relating to their business, profession or employment, or
- the activity is covered by an insurance policy relating to their business, other their profession or employment, such as a professional indemnity policy.

To complicate matters further, the trustees of SMSFs are prohibted from receiving any remuneration for services performed for the fund, unless they are performing the services in the ordinary course of a business of providing those services to the public, and are appropriately qualified and licensed to provide those services to the public. So there is a range of services which a trustee might provide to an SMSF where the trustee is not permitted to charge a fee: for example, a trustee who wants to carry out maintenance on fund properties but who does not conduct a property maintenance business, or a trustee who is an employee of an investment manager but who is not themselves licenced to provide investment management services.

It might be that the new NALI provisions are only intended to apply to services performed by a trustee where they could charge a fee but do not charge an arm's-length fee. Hopefully, this uncertainty will be clarified, to enable SMSF trustees to structure their affairs in accordance with the proposed new rules. If you have any questions about how the changes to NALI affect your fund please contact a Nexia Advisor.

Examples

Example 1

An SMSF purchases listed shares at less than the market value from a related party. The SMSF has incurred capital expenditure less than would be expected if the parties were dealing with each other at arm's length. Any dividend income from the shares and any capital gain on the eventual sale of the shares by the SMSF would be NALI and taxed at 45%.

Example 2

Todd is a trustee of his SMSF and is also a licenced real estate agent. He acts for the SMSF in the purchase of a property but does not charge the SMSF a fee. It appears that the ATO would apply the proposed new provisions so that any rent and any capital gain on the eventual sale of the property by the SMSF would be treated as NALI.

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