New Ways for High Net Worth Individuals And Business Owners to Build Wealth Tax Effectively With Introduction A SMSF

"It may be that the SMSF is the absolute way of the future" March 2010
Jeremy Cooper – Head of the Cooper Review into The Superannuation System

In recent years, Self Managed Superannuation Funds ("SMSFs") have become increasingly popular. According to the Cooper Review, the SMSF sector is the largest part of the superannuation field in terms of the number of funds.

As at 31 March 2010 there were...

- Around 422,687 SMSFs (99% of all superannuation funds)
- Assets in SMSFs of over $400 billion
- About 806,464 members of SMSFs (7% of total members of superannuation funds)

And it's not surprising given the benefits that SMSFs offer

- Greater Control – the members, who must also be trustees (or directors of the SMSF corporate trustee), have complete control over the investment strategy of the fund.
- Tax Efficiency And Savings – the tax advantages of superannuation funds are well known but SMSFs have further advantages that may allow for even greater savings and efficiency
- Flexibility over asset allocation and the management of the fund
- Despite all this, the full range of opportunities that SMSFs provide, particularly for high net worth individuals and business owners, is not well understood.

As a result many members with superannuation are missing out on significant opportunities SMSFs offer to both build their wealth more quickly and to gain greater security and control in their financial affairs.

The purpose of this paper is to explain these opportunities and illustrate what's possible with a series of case studies that cover:

- Maximising superannuation contributions in a tax effective manner without cash available
- Strategies for business owners to acquire property
- Reducing or even completely eliminating capital gains tax liabilities
- First, to set the scene, we'll briefly recap the key characteristics of a Self Managed Super Fund.

What Is A SMSF?

A SMSF (sometimes known as a “DIY Super Fund”) is a form of superannuation fund that provides an alternative for individuals who prefer not to use the larger superannuation funds such as retail and industry superannuation funds.

The *Superannuation Industry (Supervision) Act* 1993 (the SIS Act) sets out the requirements for a fund to be regarded as a SMSF

- It has 1 – 4 members
- No member of the fund is an employee of another member of the fund unless they are related
- If the fund has individuals as its trustees, each member of the fund must be a trustee and each trustee a member (exception applies for single member funds).
- If the fund has a company as its trustee, each member of the fund needs to be a director of the corporate trustee and each director a member.
- No individual trustee or corporate trustee of the fund receives any payment for services provided as a trustee

The essential feature of a SMSF is that the decisions on investment and other matters are the responsibility of the trustees who are the members of the fund, rather than being taken by an external manager.

The operation of a SMSF is governed by the following;

1. The clauses of the Fund trust deed
2. The provisions of the *Superannuation Industry (Supervision) Act* 1993
3. The *Superannuation Industry (Supervision) Regulations* 1994
4. Any requirements of the *Family Law Act* 1975 relating to the division of member benefits
5. The *Income Tax Assessment Act* 1936 and the *Income Tax Assessment Act 1997*
6. The *Corporations Act* 2001
7. Other general rules such as those imposed under tax and trust law

Certain covenants under the SIS Act are taken to be incorporated in the SMSF trust deed. The principal regulatory authority from SMSFs is the Australian Tax Office (ATO)

The Benefits of A Self Managed Super Fund

The following are the major benefits of a SMSF compared to other forms of superannuation.

Control

The members, who must also be the trustees, decide on the fund's investment strategy and choose the fund's investments. A SMSF can bank with any bank, insure with any insurer and, subject to the sole purpose test, invest in practically most investments.

The trustees also select which professionals they want to help them administer the SMSF, including the financial planner, tax accountant & auditor.

Flexibility

The fund's investments can be tailored to suit the member's specific needs before and after retirement. This flexibility allows for more specialised investment selections and can produce significant taxation advantages over public off er funds.

Also, in retirement the trustees have greater flexibility in paying tailored income streams to suit the member's income and taxation needs subject to superannuation legislation.

For example, the SMSF can pay an account based pension.

Taxation

The SMSFs investments may be rolled over from accumulation phase to fund an account-based pension without incurring capital gains tax. This is an option not always available to members of public offer funds.

Longevity And Estate Planning

A SMSF can operate before and after retirement and after the death of the original members, as long as additional members have joined.

Although a SMSF must comply with administrative and reporting requirements, which are as strict as administration rules found with public offer funds, the estate planning opportunities are much greater and more flexible.

For example, if the trustees of a SMSF invite their children to become members, the SMSF can continue for generations.

Collectables

The Cooper Report commented that collectables are not appropriate SMSF investments and made recommendations that funds should not acquire them and that existing holdings should be divested by 2020.

The Government have stated that they will not accept the Cooper recommendations in relation to collectables in SMSFs

Contribution Splitting

Concessional contributions made to a superannuation fund are able to be credited to your partner's account as long as the receiving partner is eligible to make contributions in their own right. This helps to avoid a situation where one partner accrues a very large benefit and the other has a lot less, and sets up the ability for both partners to draw more equal pensions.

Not all public offer funds are able to offer this benefit under their trust deeds, but a SMSF trust deed can provide this option.

Flexibility In The Payment Of Death Benefits

The trust deed can give the trustees the power to pay any death benefit as a lump sum, a pension or into a testamentary trust. This flexibility can save significant amounts of tax. Death benefits can be paid in any or all of the following ways:

- As a lump sum or pension to someone who is financially dependent on the member
- As a lump sum or pension to someone who has an interdependency relationship with the member
- As a lump sum or pension to the member's spouse or dependent children (to age 24)
- As a lump sum to the non dependant beneficiaries or the members estate

If the death benefit is payable to a non dependent, the taxable component would normally be subject to tax between 16.5% & 31.5%.

For a death benefit to be paid to a testamentary trust, it must first be paid to the member's estate. When paid to the member's estate the death benefit will be tax free to the extent that a tax dependant is expected to benefit from it.

If the testamentary trust is a discretionary trust and it is possible to distribute to a non dependant, the death benefit inherited by the testamentary trust will be subject to tax.

For the death benefit to be inherited tax free by the testamentary trust, the testamentary trust's beneficiaries must all be tax dependants of the deceased.

Protecting Assets Against Disaffected Family Members

A binding nomination can be changed or reaffirmed every 3 years or a trust deed can allow for a non-lapsing binding nomination as long as the beneficiary is a SIS dependant. The nomination can be challenged by a disaffected family member under Family Law provisions.

To overcome this, the SMSF trust deed can instruct the payment of death benefits in exactly the manner that the deceased member determines, subject to SIS regulations.

For example, the trust deed can exclude a certain person as beneficiary or could stipulate that the trustees pay a death benefit to two of the deceased member's children but nothing to a third. In this case it would be much more difficult for the third child to challenge the trustees than if this were just part of the will.

A public offer fund, on the other hand, cannot alter its trust deed for an individual member. The trustee has the power, unless a valid binding nomination exists, to decide who gets what from the deceased member's superannuation balance subject to SIS rules.

In Specie Contributions

Subject to certain investment rules, some assets can be contributed to a SMSF in specie instead of making cash contributions.

Examples of such assets include public company shares, business premises, and units in widely held unit trusts.

Cost Savings

Depending on individual circumstances, significant cost savings can be achieved compared to other types of superannuation funds. This is because normal superannuation funds typically charge administration fees as a percentage of assets invested rather than on the actual time spent on administration.

For example, a $300,000 portfolio managed by a SMSF with an all inclusive administration and trustee cost of $2,100 per annum would incur lower costs than a typical industry wrap platform. The cost advantage of the SMSF increases further the bigger the portfolio and the potential savings pass straight to the members.

Business Structures

It is possible to link the tax concessions available through superannuation with other business objectives or family considerations.

For example, an SMSF has maximum flexibility to allow it to purchase your business premises. Market based rents will have to be paid, but significant tax savings can be achieved due to the concessional rate of tax that applies within superannuation.

Insurance Benefits

By using a SMSF to hold insurance cover you remove the risk of having to discontinue your cover if you change public offer funds.

If a member cannot obtain such policies due to previous illness or occupation, a SMSF can "self-insure" and even obtain a tax deduction equivalent to the premium that would have been paid.

For example, the SMSF sets up a self insurance reserve into which the members contribute. The reserve is available to be drawn on if the member dies or suffers an insured event.

Gearing In Super

A SMSF can use leverage and gear its investments in contrast to many public off er superannuation funds. This may be achieved in various ways, using instalment warrants or other specialised products. There are also specialist property loans available to gear residential property within a SMSF.

Case Studies

The following case studies are designed to illustrate some of the powerful, but surprisingly little known, ways that SMSFs can be used to build and create wealth.

They are all based on real life situations. However, for reasons of confidentiality, names and specific details of the transactions have been amended.

The situations described are in no way unusual or unique and with the proper advice and SMSF structure in place, the strategies described could be used by a wide range of individuals.

Background

Jack and Margaret Smith were in their early 60s and retiring. Over the years Jack and Margaret had created a portfolio of Listed Shares and Managed Funds of $1,200,000 in their own names together with the assistance of their financial planner.

Problem

They did not have many assets accumulated in superannuation to maximise their after tax income stream and did not have any cash to contribute.

During the global financial crisis the portfolio dropped in value from $1,200,000 to $950,000.

Jack and Margaret knew their portfolio would improve in the future together with the assistance of their financial planner.

What Happened

Jack and Margaret established the J & M Smith Superannuation Fund and transferred their entire portfolio into the SMSF without breaching the contribution limits or having to sell the investments on the market.

As the market value of the portfolio was reduced they had a much smaller capital gain on transferring their investment portfolio to the SMSF. They reduced their capital gain by claiming an income tax deduction for superannuation contributions made under the substantially self employed test.

They then commenced account based pensions with their super benefits and they paid no tax on their pension. Their SMSF received a refund of the franking credits from the investments and no tax was paid on the income.
All future capital gains on their investments in their superannuation fund are tax free.

Case Study #1

Transferring Investments Into A SMSF

Background

Like many business owners, John and Mary Anderson had for years chafed at having to pay rent on their business premises. They had occupied the premises for many years and seen the rent steadily increase over time.

Additionally, the capital value of the property had appreciated as well.

The premises were well sited and John and Mary had no plans to move their business. When the property came on the market, they decided to explore their options to acquire the premises for themselves.

Not only would it most likely be a good investment, but they would also have greater security of tenancy.

What Happened

John and Mary had been thinking about setting up their own SMSF for some time but up until this point had been undecided about whether it was really worthwhile for them.

After consulting with their experienced advisers, they decided that it was the best way for them to go ahead with their plan to purchase their business premises.

The business would still have to pay a commercial rent, but instead of that money going to an outside landlord, it would contribute to creating additional benefits in their own superannuation fund.

They set up their own new SMSF and transferred their existing super into the new fund.

Their SMSF successfully acquired the business premises for $750,000 funded 50% from their super balances and 50% with an interest only bank loan using the property as security. Until the loan is fully repaid legal ownership of the property is held by a bare trust with the SMSF as beneficial owner. The SMSF has full entitlement to rental income from the property.

The bank was very helpful, having recently established a specialist area to lend for transactions exactly like this one. The interest rate was 7.75% and these payments were a tax deduction for the SMSF against the rental income received.

The rental to be charged by the SMSF continued at the same rate and the same terms as before. Of course, the rental payments were a tax deduction for the business.

Looking back, John and Mary are delighted with their decision.

The property has appreciated in value, making a nice addition to their retirement funds. At the same time they're able to claim a tax deduction for the rental payments at the top rate of 46.5% while the SMSF only pays 15% on the rental income (after a deduction for the loan payments).

All in all, a very effective wealth building transaction.

Case Study #2

Business Real Property Acquisition

Background

George Higgins had been an enthusiastic investor in rental properties for many years and had acquired a substantial portfolio of well sited properties. The total value of the portfolio was around $10m.

George had also set up his own SMSF some years before and held most of his property portfolio in the fund. The rental properties formed a large part of the fund's assets and also enjoyed significant capital appreciation over the years.

George was an experienced property investor and had generally bought at good prices at opportune times in the property cycle.

The unrealised capital gain was around $5m.

That meant, however, that there was a significant potential capital gains tax liability if George was ever to sell the properties.

What Happened

Approaching retirement, George decided that he wanted to reduce the weighting of property in his SMSF portfolio.

With the help of his advisors, George commenced drawing an account-based pension from his SMSF interest when he reached age 65. Once the account-based pension was properly established, George sold most of the rental properties that the SMSF held.

Because George was already drawing an account-based pension, the proceeds of the sale of the properties did not attract any capital gains tax liability.

The result was a saving in tax of hundreds of thousands of dollars, compared to selling the properties outside of the SMSF.

That tax saving was a welcome boost to the fund and meant that George had greater security and a higher standard of living in his retirement.

Case Study #3

How A Smart Property Investor Made A Handsome Profit But Legally Paid NO Capital Gains Tax

1) Super issue that made a Big Difference to Children's Future

It's unfortunate, but spouses often fall out over money, especially in the case of second marriages and where multiple families are involved.

That's what happened to Colin Thompson. When Colin remarried several years ago, he was clear that the children from his first marriage should be the primary beneficiaries in the event of his death. Colin wife wished the same intention for her children.

However, he neglected to make a new will (his original will having lapsed on the event of marrying again). When Colin suffered a severe stroke that left him incapacitated, his second wife acted aggressively to thwart his wishes and direct funds to favour her and her children.

However, the bulk of Colin's funds were held in his SMSF and these were NOT subject to the usual rules for estates. Colin's second wife was unable to interfere with the clear directions in the SMSF.

As a result, Colin's wishes were protected, even in such tragic and unfortunate circumstances.

2) Life Assurance without Needless Underwriting

Jennie Adams had taken advantage of tax concessions to arrange her life assurance policy through her superannuation scheme.

Unfortunately, when she changed schemes at the time of changing jobs, she found that she had to undergo the underwriting process again and the new rates turned out to be less favourable than before. In the meantime, since establishing her first life insurance policy, she had developed a condition which meant the underwriter would not insure her for the same level of care and added a premium loading making her insurance more expensive.

Had Jennie taken the opportunity to establish her own SMSF, one of the advantages that she would have quickly appreciated was that once a life assurance policy was established in the SMSF, there would be no need to repeat the underwriting process unless she increased her cover.

3) Bankruptcy Protection

It's an unfortunate fact of modern life, but the risk of bankruptcy is something that every business owner confronts. And in many cases, bankruptcy can occur through no fault of the business owner, for example, in cases of fraud and predatory legal actions.

SMSFs offer the business owner a way to protect their hard earned wealth. In the event of bankruptcy, fund assets are generally protected from creditors.

Once discharged from bankruptcy (which will happen at most after 3 years) the fund assets are available to provide member benefits, subject to the normal SIS regulations.

Mini Case Studies

Examples of Some Other Benefits of A SMSF

The Keys to Safely and Effectively Use A SMSF For Maximum Benefit

As this paper has described, SMSFs off er many benefits.

However, this is a specialised field with a considerable body of legislation that must be mastered in order to take advantage of these benefits safely.
SMSF administration requires compliance including preparation of balance sheets, profit and loss statements and reporting on past issues.

The essentials are dealing with compliance, future planning, superannuation components and future dates and timing.

Before an SMSF can reach its full potential as a vehicle for wealth creation, it's essential that SIS and other legal requirements are fully satisfied.

That's because the COSTS of failing to comply are SERIOUS.

You could suffer a penalty of 46.5% of fund assets. So it's essential to select the right SMSF adviser. They should possess both the specialised skills and knowledge AND long experience in the field.

So you'll have the peace of mind that…
1) The SMSF is properly established to take full advantage of the benefits are available
2) The fund is in compliance with required legal regulations on an ongoing basis
3) As circumstances (and legislation) changes, you'll be kept up to date of new opportunities that arise