GFM
Wealth Advisory

SMSF SMART

SMSF

SMSF Investment Rules

Edition #6

190 Through Road, Camberwell VIC 3124 T: (03) 9809 1221 F: (03) 9809 2055 enquiry@gfmwealth.com.au

www.gfmwealth.com.au

Australian Financial Services Licence No. 229401 ABN 69 006 679 394

SMSF Investment Rules

Edition #6

IIn our earlier editions of SMSF Smart, we covered the following topics:

- An introduction to SMSFs;
- Being an SMSF Trustee;
- The Trust Deed;
- Contributing to Superannuation; and
- Withdrawing Money from Superannuation

In this edition of SMSF Smart, we look at SMSF Investment Rules.

As always, we encourage you to ask us any questions if you need further information or clarification.

The Sole Purpose Test

Underpinning all SMSFs is the Sole Purpose Test. The Sole Purpose Test requires an SMSF to be maintained exclusively to provide benefits for members, including:

- Retirement benefits;
- Benefits for members of the SMSF on reaching age 65; and
- The provision of benefits for the member's dependents or the member's legal personal representative in the event of the member's death.

Trustees must ensure that the SMSF does not undertake an investment that provides pre-retirement benefits to members or related parties.

An SMSF is not permitted to provide a direct or indirect financial benefit to a member or relative when making investment decisions and arrangements.

Unless the transaction complies with the specific exceptions and limited circumstances allowed by the superannuation legislation, Trustees need to ensure that they do not:

- Lend money or resources of the SMSF to related parties;
- Acquire assets or other investments from related parties, or
- Borrow money

Collectable and personal use assets

Collectables and personal use assets include artwork, jewellery and antiques, for example.

SMSFs can invest in collectables and personal-use assets; however, strict rules apply to SMSFs investing in and maintaining those assets. Investments in such items must be made for legitimate retirement purposes, not to provide any present-day benefit.

Collectables and personal use assets can't be:

- Leased to, or part of a lease arrangement with, a related party;
- Used by a related party; or
- Stored or displayed in a private residence of a related party

Also:

- The investment must comply with all other relevant investment restrictions, including the sole purpose test
- The decision on where the item is stored must be documented (for example, in the minutes of a meeting of Trustees) and the written record kept
- The article must be insured in the SMSF's name within seven days of acquiring it
- If the item is transferred to a related party, this must be at market price as determined by a qualified, independent valuer.

For collectables and personal use assets held before 1 July 2011, an SMSF had until 30 June 2016 to comply with these rules.

Also, investments into this asset type must also be in line with the Fund's investment strategy.

Investment strategy

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

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

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

- Investment objectives of the SMSF
- Likely return and risk associated with an investment
- Need for diversification given the level of risk and investment timeframe
- The expectation of when benefits would start to be paid (given the age of the members), the need for liquidity
- SMSF's ability to meet ongoing operating expenses from the investment income on the asset
- Need to hold a contract of insurance that provides cover for one or more members

Investment objectives

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

- The elements of the SMSF as a whole, e.g. liabilities, taxation obligations, size
- The status of the SMSF's members, e.g. age, risk profile, expected retirement date and requirements

Investment considerations

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

- How will certain asset classes be accessed, e.g. exchange-traded funds, direct shares, managed funds
- The process for the selection of specific assets, e.g. which shares to invest in
- Whether the investment is allowable under the SMSF's trust deed
- Whether the investment is permissible under the super investment rules
- Whether the SMSF Trustee wishes to invest in a single asset, such as a property
- Whether the SMSF wants to invest in or has existing collectables and personal use assets
- Segregation of SMSF assets for different pools of investment

Investment strategy review

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

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

Who is a related party of an SMSF?

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

- Sole purpose test
- In-house asset rules
- Restrictions on lending or providing financial assistance to members and relatives
- Prohibition of acquiring certain assets from a related party
- Arm's length rules

A 'related party' of an SMSF includes:

- all members of the SMSF
- associates of SMSF members, which include:
  - The relatives of each member
  - The business partners of each member
  - Any spouse or child of those business partners
  - Any company the member or their associate's control or influence
  - Any trust the member or their associate's control
- Standard employer–sponsors, which are employers who contribute to the SMSF for the benefit of a member, under an arrangement between the employer and the Trustee of the SMSF

- Associates of standard employer–sponsors, which include:
  - business partners and companies or trusts the employer controls (either alone or with their other associates)
  - companies and trusts that control the employer

A relative of a member means any of the following:

- A parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the member or their spouse
- A spouse of any individual specified above

Acquisition of assets from related parties

Generally, an SMSF is not able to acquire, purchase or transfer to the SMSF, assets from related parties.

However, there are exceptions including the following:

- Listed securities acquired at market value, for example, shares listed on the ASX.
- Business Real Property (sometimes very broadly referred to as commercial property) of the related party providing it is acquired at market value:
  - The property must be used wholly and exclusively in one or more businesses
  - Note that property that is used for residential purposes is unlikely to meet the definition of Business Real Property
- A farm or rural farming property
- Units in a widely-held unit trust (such as a managed fund) acquired at market value
- A term deposit acquired at market value
- An investment, loan or lease (referred to as an in-house asset) acquired at market value and where the total value of all in-house assets does not exceed 5% of the market value of the SMSF's overall investment

Invest on arm's length basis

Where a Trustee deals with a related party, the dealing must be on an arm's length basis. The purchase and sale price of SMSF assets should always reflect the true market value for the asset.

The arm's length investment rule states that an SMSF Trustee must deal with the other party to an investment transaction at arm's length. An arm's length transaction is one where an agreement is made by the parties freely and independently of each other and on commercial terms. Where a Trustee is not dealing at arm's length, the terms of the transaction are no more favourable to the other party than they would have been if they were dealing at arm's length.

While a transaction may comply with the arm's length rule, it may be in contravention of another provision of the super laws or income tax laws.

In-house assets

SMSFs are prohibited from making an investment (in the form of an investment, loan or lease of assets) that represent in total, more than 5% of the market value of the total SMSF assets with any related parties. These related party investments are called 'in-house assets'.

Typically, a lease arrangement of a Business Real Property with a related party would also be an in-house asset, if it was not for a specific section in the superannuation laws that exclude Business Real Properties subject to a valid lease or lease arrangement that is enforceable by legal proceedings with a related party from being an in-house asset.

The in-house asset rules apply to restrict the number of the SMSF's investments with related parties and ensure that the investments are made on commercial terms. The in-house asset rules act as protection for members so that members will not lose all of their benefits in the SMSF if an in-house asset goes bad.

Financial assistance and loans to members

An SMSF is not permitted to lend money to a member, or the relative of a member, in any circumstances.

While an SMSF can lend to others, Trustees should consider the SMSF's investment strategy and Trust Deed to determine whether the investment is legal.

If the SMSF does lend money, the Trustees should:

- Have an appropriate loan agreement in place signed by all the parties involved
- Ensure the agreement specifies all the terms of the loan
- Ensure the SMSF receives the interest and repayments according to the loan agreement
- If the loan agreement is not followed, take appropriate action to protect the SMSF's investment
- Ensure the loan is sensible and does not put the members' benefits at risk
- Ensure the loan is conducted on an arm's length basis, or not be more favourable to the borrower than would be expected if the arrangement was conducted on an arm's length basis

Borrowing

An SMSF can borrow money only in very limited circumstances. These circumstances include:

- Borrowing money for a maximum of 90 days to meet benefit payments to members or to meet an outstanding surcharge liability (the borrowings can't exceed 10% of an SMSF's total assets):
    - The SIA Act also requires that the borrowing is to enable a payment that must be required by law or the governining rules of the SMSF i.e. the application is pretty limited and not for anything
- Borrowing money for a maximum of seven days to cover the settlement of security transactions (the borrowings can't exceed 10% of an SMSF's total assets):
    - Trustees can only borrow to settle security transactions if, at the time the transaction was entered into, it was likely that the borrowing would not be needed
- Borrowing using instalment warrants or Limited Recourse Borrowing Arrangements that meet certain conditions

A Trustee can use a limited recourse borrowing arrangement to fund the purchase of a single asset (or collection of identical assets that have the same market value) to be held in a separate trust.

A Limited Recourse Borrowing Arrangement ("LRBA") is a special borrowing arrangement that is permitted. A specific characteristic of an LRBA is that in case of default, the lender's rights are limited to the asset which is the subject of the LRBA. The lender will have no recourse to other assets owned by the Trustees of the SMSF. The loan agreement must specify that it is an LRBA.

Trustees need to ensure that the LRBA is correctly structured. The borrowing arrangement must also comply with all other ordinary provisions of super law.

Generally, the Trustee uses the borrowed funds to purchase a single asset, such as property on a single title to be held in trust on behalf of the SMSF. The SMSF accounts for all income and expenses relating to the asset held in trust.

Some particular considerations about borrowing to buy a property through an SMSF include:

- Higher costs – SMSF property loans tend to be more costly than other property loans which must be factored into the investment decision
- Cash flow – Loan repayments must be made from your SMSF which means the SMSF must always have sufficient liquidity or cash flow to meet the loan repayments
- Hard to cancel – If the SMSF property loan documentation and contract is not set up correctly unwinding the arrangement may not be allowed and the SMSF may be required to sell the property, potentially causing substantial losses to the SMSF
- Possible tax losses – Any tax losses from the property cannot be offset against taxable income outside the SMSF
- No alterations to the property – Until the SMSF property loan is paid off alterations to a property cannot be made if they change the character of the property

In Summary:

SMSFs are required to be established and operate solely for superannuation purposes.

This means that benefits must be maintained for the sole purpose of providing retirement benefits to members, or to their dependants if a member dies before retirement.

SMSFs must comply with the sole purpose test to be eligible for the tax concessions available to a complying super fund.

Involvement in a contravention may result in the disqualification of the Trustee, attract a civil or criminal penalty and may place the SMSF's status as a complying fund at risk.

Getting the right advice and expert guidance is crucial with SMSFs. The decision and rules for paying a benefit can be quite complex. While there is greater control with an SMSF, there is also more responsibility. The ATO encourages individuals to engage professionals to help establish and run their SMSF, and this is where GFM Wealth Advisory can help.