# **Explanatory** Memorandum

## Self Managed Superannuation Funds

October 2023

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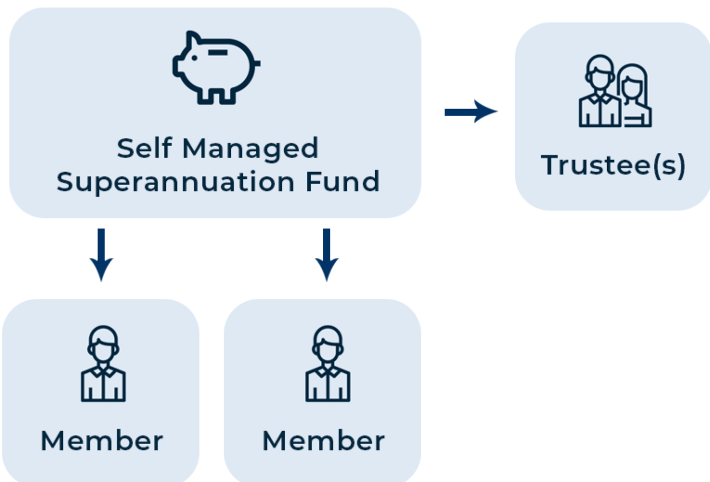
| Subject | Self Managed Superannuation Funds |
| Alert Status | **High** |
| Topic | Superannuation |
| Legislation | Superannuation Industry (Supervision) Act 1993<br>Superannuation Industry (Supervision) Regs 1994<br>Income Tax Assessment Act 1936 and 1997 |
| Case Law | N/A |
| Comments | Self managed superannuation funds can now borrow to invest in real estate. Much care needs to be taken in setting up and running a self managed superannuation fund. |
| More info | www.macquariegs.com.au |

### Explanatory Memorandums – Self Managed Super Funds (SMSF)

A Self-Managed Superannuation Fund ("SMSF") is an excellent tool, both for retirees who are looking to convert their superannuation into an income stream, as well as for those who still accumulating superannuation for their retirement. SMSFs offer individuals a unique combination of flexibility and control over their superannuation affairs at a reasonable price. However, they are subject to strict rules and abiding with the legislation is critical to their effectiveness. Further, failing to comply with the relevant laws can result in significant fines and even gaol terms. As with any financial structure, it is important to get professional advice to ensure you are able to benefit from the advantages of having your own superannuation fund without suffering the potential pitfalls.

This Explanatory Memorandum is not meant to be professional advice and is intended to merely provide a brief outline of the issues that should be considered in the establishment and future management of an SMSF.




**Macquarie Group Services Pty Ltd**
Level 7, 77 Castlereagh St, Sydney NSW 2000
(02) 9231 5111 contact@macquariegs.com.au www.macquariegs.com.au

## Legislative Framework

The main item of legislation regulating SMSFs is the *Superannuation Industry (Supervision) Act 1993* (Cth) and associated regulations ("the *SIS Act*" and "the *SIS Regulations*").

The *SIS Act* and *Regulations* stipulate that the trustees of an SMSF must ensure that its *sole purpose* is to provide benefits to members (or, in some circumstances, their dependants) on events such as:

1. Retirement;
2. Death; and
3. Leaving employment.

The *SIS Act* and *Regulations* also set out a number of "covenants" which individuals are considered to have made when they agree to act as trustees of an SMSF. Those covenants may be summarised as follows:

1. To act honestly in all matters;
2. To exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide;
3. To act in the best interests of members and their beneficiaries;
4. To keep the SMSF's money and assets separate from their own (or those of any employer contributing to the SMSF);
5. Not to enter into any contract or do anything which would hinder them from properly carrying out their trustee functions;
6. To formulate and give effect to an appropriate investment strategy;
7. To formulate and give effect to an appropriate strategy for the management of the SMSF's reserves (if applicable); and
8. To allow members and other beneficiaries access to any information prescribed under the *SIS Act* and *Regulations*

Whenever a decision is made in relation to an SMSF (in particular, when decisions impacting upon its investments are made), the decision-maker should ask themself two questions:

1. whether the outcome is consistent with the sole purpose of the SMSF, or are they making the decision for some other reason; and
2. whether the decision will help or hinder them in abiding by their covenants.

In addition to the *SIS Act* and *Regulations*, an SMSF and any parties that contribute to it must comply with a range of other items of legislation – the *Income Tax Assessment Act 1936* (Cth), the *Income Tax Assessment Act 1997* (Cth), the *Superannuation Guarantee (Administration) Act 1992* (Cth), *Corporations Law*, etc.

It is also important to ensure that trustees act within the regulating Trust Deed.

**Membership**

SMSFs can have a maximum of six members. Generally (but not always), these are members of the same family and, typically, if there were more than six family members who wanted to manage their superannuation together, more than one SMSF would need to be established.

If persons wish to have more than six members in a single superannuation fund, then the fund will no longer be classified as an SMSF, whose ongoing management will be subject to a different regime.
You should also note that it is important that no member of an SMSF may be employed by another member, unless the two members are related.

**Trusteeship**

All members of an SMSF must also be its trustees, either directly (i.e. as an individual trustee) or in their role as a director of a company which acts as trustee of the SMSF.

The converse is also true – all trustees of an SMSF must generally be members. There are, however, special rules for SMSFs with only one member. Single-member SMSFs must have two individual trustees, or two directors of a trustee company. In this case, the two trustees/directors must *either* be related *or* ensure that neither is an employee of the other. Alternatively, a single-member SMSF can have a corporate trustee with only one director – the member (the company may have as many or as few shareholders as is desired).

Importantly, however, not every individual is permitted to act as the trustee of an SMSF. Examples of people who cannot be trustees of SMSFs are those who:

1. are bankrupt;
2. have been convicted of an offence related to dishonest conduct; or
3. who have previously been a trustee of a superannuation fund and a “civil penalty order” has been made against them.

It is vital, therefore, to ensure that as soon as a new person joins as a member of an SMSF, they are also appointed as a (direct or indirect) trustee.

This means that they must not only complete a membership application (along the lines of the applications you completed when you first established the SMSF), but that they should also:

1. sign a formal acknowledgement that they consent to act as a trustee;

2. confirm that they are not a disqualified person;

3. (in the case of individual trustees) have their name recorded as one of the owners of any investments, bank accounts, insurance;

4. policies, etc, held by the SMSF;

5. have both their membership and trusteeship noted in the minutes of a trustee meeting; and

6. advise the ATO (currently, the appropriate form for doing this is called “Superannuation Entities Change of Details” and it is available from the ATO’s website).

**Legislative Breaches**

Trustees of SMSFs are responsible for ensuring that the fund complies with all of the relevant laws and are personally liable for breaches. The penalties for non-compliance depend on the nature of the breach and can range from:

1. having the SMSF declared “non-complying” – in this case, there would be a 47% tax levied on all the SMSF’s assets except for any “undeducted” or “non-concessional” contributions (these are essentially contributions paid by an individual for which no tax deduction has been claimed);

2. fines being levied for minor offences, such as the late lodgement of returns; and

3. gaol terms.

Although the regulators have hitherto only penalised those trustees who (in their view) have deliberately broken the law, you should note that the *SIS Act* and *Regulations* permit fines to be levied, even where breaches are accidental or minor. Of course, goal terms can only be imposed where criminal action has occurred.

**Investments**

All superannuation funds must have a documented “Investment Strategy”.

The Investment Strategy should set out what the trustees are trying to achieve, how they intend to achieve it, and what factors they have considered in
making these decisions (such as cash-flow, risk, return, diversification, and liquidity).

Trustees should then ensure that all investment decisions are made in accordance with this documented strategy. Further, in some circumstances, the regulator may impose extra reporting requirements on SMSFs which use particular investments – e.g. funds that invest in particular types of derivatives are required to have a “Risk Management Statement”.

Certain investments are *prohibited* in the SMSF environment. In particular, SMSFs:

1. cannot borrow, except in a few limited and very particular circumstances, or where carefully executed bare trust and limited recourse arrangements are entered into Trustees should, therefore, ensure that they do not overdraw the SMSF's bank account, as this is a common cause of unintended borrowing;

2. cannot lend money or provide any other form of financial support to members or their relatives;

3. cannot, generally, buy assets from members, their relatives, or their associates. There are, however, some exceptions to this rule, e.g. SMSFs ***can*** purchase the following from members, their relatives or their associates:

    a. securities listed on a recognised exchange (e.g. the ASX);

    b. units in widely held unit trusts (e.g. managed fund units);

    c. "business real property"; and

    d. certain in-house assets within the restrictions applying to those assets (see below).

Naturally, any transaction between the SMSF and a member, their relative or their associate must be at market-value.

Other investments are *restricted*, in that they must constitute no more than 5% of the market-value as an SMSF's assets (known as "in-house assets"). In-house assets are essentially any assets which are:

1. loans to and/or investments in "related parties";

2. investments in related trusts (e.g. a family unit trust); or

3. assets which are subject to a lease between the trustee and a "related party" of the SMSF.

In this regard, "related party" is defined extremely broadly, and can include family members, employers who contribute to the fund, business partners, etc.

Once again, there are exceptions to these rules, e.g. business real property can be leased-back to related parties of the SMSF), and there are transitional arrangements for SMSFs which had arrangements in place before 11 August 1999. Nevertheless, trustees should always be mindful of the sole purpose of the SMSF and their covenants as trustees, whenever they are considering any financial arrangements which involve dealing with a "related party."

Within these restrictions, a Trust Deed establishing an SMSF provided by Macquarie Group Services gives trustees very broad powers in relation to the SMSF's investments. In particular, the trustees can:

1. have different investment strategies for different members;

2. allow members to choose their own investment strategy;

3. specifically allocate certain investments to particular members; and

4. establish reserves to "smooth" investment earnings credited to members' accounts.

**Contributions**

Under a Trust Deed establishing an SMSF provided by Macquarie Group Services, anyone can contribute to the SMSF, provided that they are permitted to do so by the *SIS Act* and *Regulations*. Currently, this includes:

1. members who make contributions in their own names;

2. individuals who contribute for their spouse who is a member (whether or not the individual is also a member of the SMSF); and

3. employers of members.

Contributions may be in cash or by the "in-specie" transfer of assets. As an example of an "in-specie" contribution, trustees could transfer personal shareholdings into the SMSF, by transferring ownership from their own name to that of the SMSF.

Note, however, that there are Capital Gains Tax and other consequences associated with doing so, and advice should be sought where parties wish to execute this type of transaction.

As a general rule, personal contributions can only be made by a person who is under age 67, or by their spouse (if the member is under age 67). Where a person is age 67 or older, but has not yet reached age 75, they may still make personal contributions, but only if they:

1. have been "gainfully employed on at least a part-time basis" during the relevant financial year, i.e. they have worked at least 40 hours in a period of not more than 30 consecutive days in the year; or

2. the contributions are being made by their spouse, they are age 67 or older but have not yet reached age 75 and they have been "gainfully employed on at least a part-time basis" during the relevant financial year.

However, SMSFs cannot accept personal contributions from persons who have not quoted their Tax File Number to the SMSF, or where the person has reached age 75.

Importantly, there are essentially two types of superannuation contribution that can be made:

1. "non-concessional contributions" for which no tax deduction is claimed by the contributor. As a general rule, unless a person is self-employed, any contributions they make to an SMSF from their personal savings or from their after-tax income will not entitle them to a deduction; and

2. "concessional contributions", which are contributions that have been claimed as a tax deduction by whoever made them. Unless a person is self-employed, only their employer's contributions will be deductible. If a person has a "salary sacrifice" arrangement with their employer, they are effectively exchanging higher employer superannuation contributions for a lower cash salary. These extra employer contributions are classified as "concessional contributions", as the employer will still be entitled to a deduction for the full amount of the employee's remuneration "package." If a person is self-employed, however, they are able to claim all of the contributions they make as a tax deduction, provided that the deduction cannot be greater than the amount that reduces the individual's taxable income to nil, i.e. the deduction cannot create a loss.

Although there is no limit on the tax deduction employers and self-employed people who make deductible contributions can claim, there are limits on the amounts of "concessional" contributions that can be made before the relevant member becomes liable to excess contributions tax.

Currently, the limits are as follows:

Maximum Concessional Superannuation Contributions

| 2022/23 | 2023/24 |
|---|---|
| $27,500 | $27,500 |

If you exceed your concessional contributions cap, the excess concessional contributions (ECC) are included in your assessable income. ECC are taxed at your marginal tax rate less a 15% tax offset to account for the contributions tax already paid by your super fund.

There are also currently limits on the amount of "non-concessional" contributions that can be made before a liability to Excess Contributions Tax arises. Those limits are as follows:

Maximum Non-Concessional Superannuation Contributions

| 2022/23 | 2023/24 |
|---|---|
| $110,000 | $110,000 |

When a member exceeds the non-concessional contributions (NCC) cap in a financial year, they have two options available as to how their excess NCCs will be taxed.

Option 1: The member can elect to withdraw excess NCC plus 85% of the associated earnings on the excess contributions, and tax is payable on the associated earnings, or

Option 2: The member is liable to pay excess contributions tax on the excess contributions. The tax rate is 47%.

Notably, persons who are aged under 65 in a year can bring-forward the next two years' entitlements to make non-concessional contributions, i.e. they can make total non-concessional contributions of $330,000 at any time over three financial years without exceeding their non-concessional contributions cap.

**Benefits**

Generally, the benefits received by a person upon their retirement, death, becoming disabled or leave an SMSF for any other reason, will be the amount held in their account balance at that time. Under some circumstances (e.g. death or disablement), a person may have arranged for insurance to supplement their benefit and, if this is the case, the proceeds of the insurance policy will be paid in addition to their account balance. A person's benefit can be paid to them either in the form of a pension or lump-sum, or as a combination of the two.

The Trust Deed establishing an SMSF provided by MGS gives trustees very broad powers to pay benefits in a number of forms – essentially anything permitted by the *SIS Act* and *Regulations* can be accommodated.

Most superannuation benefits are "preserved", which means that they generally cannot be paid to the member until they "retire" or reach their preservation age. To "retire", a person must either:

1. have worked at some point in the past, reached a particular age and decided that they never intend to work again for more than ten hours per week. A person's "preservation age" depends on when they were born – for people born before 1 July 1960 it is 55, and for people born after 30 June 1964 it is 60. For people born in between, it is between 55 and 60; *or*

2. reach 60 and leave their current job (even if they fully intend to work again in the future).

There are also other circumstances when preserved benefits can be paid – e.g. upon death, disability, or hardship. Further, it is possible for a person to access their benefits when they have reached their preservation age, without having to "retire" from gainful employment, in the form of a Transition to Retirement Pension.

Such a pension is an account-based income stream with the total amount of payments in any year being limited to no greater than 10% of the account balance at the start of the year.

Notably, there are NO rules governing when a person's benefits *must* be paid. That is, a person is permitted to indefinitely leave their superannuation accumulating in an SMSF, irrespective of their age and/or whether or not they are gainfully employed.

**Taxation**

Superannuation is taxed at three different points:

- when contributions into the system are made;
- when investment income within the system is derived; and
- when benefits are paid out of the system.

## Contributions Tax

Because non-concessional contributions come from funds which have already been taxed (i.e. a person's personal savings or after-tax income), they are not taxed when they are paid into an SMSF.

Concessional contributions, however, are taxed at 15% on receipt by an SMSF.

## Investment Income Tax

Investment income in most SMSFs is taxed at 15%. This means that even if there is no direct tax concession involved in contributing money to the SMSF (e.g. There is no tax deduction available for non-concessional contributions), it is still may be worth doing, because the future investment earnings on that money will be concessionally taxed. As always, professional advice should be sought in these circumstances.

If an SMSF starts paying a pension, at least part of its income is completely tax-free. This is an extremely valuable tax benefit, as it effectively allows a person to invest their retirement savings in a completely tax-free environment.

## Resolutions

When undertaking any transactions, including the acquisition of assets, or making distributions from the Trust, the Trustee should evince its intention to do so by way of resolution. Resolutions should be filed in the Trust binder and maintained as a record of the decisions and agreements affecting the Trust Fund and/or its net income. As noted above, a resolution by the Trustee to distribute the net Trust income should be made on or before 30 June each year.

## Superannuation Benefits Tax

The way in which a superannuation benefit is taxed depends on whether it is taken as a "lump-sum" benefit or as a superannuation pension, the age of the recipient and whether the taxable component of the benefit includes an element "taxed in the fund" or an element "untaxed in the fund".

The taxation treatment of superannuation benefits is complex, but the key points are as follows:

1. "non-concessional contributions" are not taxed when they are drawn out as a benefit in any manner, as they were originally paid in from money on which the member had already paid income tax; and

2. the rest of a person's benefit (i.e. their "concessional contributions" and any income derived from the investment of their funds) is taxed.

The tax payable on benefits depends on your age, whether it is an income stream or lump sum and whether it is a taxable component or tax-free component.

Different rules apply if the benefit is paid as a result of death or disability.

## Tax on super death benefits

The tax on a super death benefit depends on whether:

- you were a dependant of the deceased
- it's paid as a lump sum or a super income stream benefit
- the income stream is an account-based income stream or a capped defined benefit income stream
- the super is taxable or tax-free, and whether the super fund has already paid tax on the taxable component
- your age and the age of the deceased person when they died.

If you are a dependant of the deceased, you don't need to pay tax on the taxable component of a death benefit if you receive it as a lump sum. If you receive the benefit as an income stream, different rates of tax may apply depending on the factors mentioned above.

If you're not a dependant of the deceased, you can only receive the benefit as a lump sum.

The taxable component of the payment will be entitled to a tax offset that ensures the rate of income tax is as follows:

**taxed element** – maximum of 15% plus Medicare levy

**untaxed element** – maximum of 30% plus Medicare levy.

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NOTE: The above information is meant as a general guide only, and the information applies to SMSF deeds provided by Macquarie Group Services Pty Limited.



Macquarie Group Services Pty Ltd
Level 7, 77 Castlereagh St, Sydney NSW 2000
(02) 9231 5111 contact@macquariegs.com.au www.macquariegs.com.au