

## Draft Sole Purpose Test Ruling

The dignity of the sole purpose test set out in section 62(1) of SIS has been strained - severely. The Tax Office has set out its thoughts in *Draft Self Managed Superannuation Funds Ruling SMSFR 2007/D1* which recognises that while a self-managed fund may be maintained solely for the purposes set out in section 62(1), a fund may (incidentally) provide members or other entities with benefits other than those specified in the section.

Life would be sweet if it were simple - this Draft Ruling is not simple and is in its present form, contradictory. As basic propositions, the Tax Office in the Draft Ruling states:

"Factors that would weigh in favour of a conclusion that an SMSF is not being maintained in accordance with section 62 because of the provision of benefits not specified in section 62 are:

- ❖ The trustee negotiated for, or sought out, the benefit (whether or not the trustee does so in the course of undertaking other activities that are consistent with section 62:
- ❖ The benefit has influenced the decision-making of the trustee to favour one course of action over another.
- ❖ The benefit is provided by the SMSF to a member or another party at a cost or financial detriment to the SMSF.
- ❖ There is a pattern or preponderance of events that, when viewed in their entirety, amount to a material benefit being provided that is not specified under subsection 62.

Factors that would weigh in favour of a conclusion that an SMSF is being maintained in accordance with section 62 despite the provision of benefits not specified in section 62 are:

- ❖ The benefit is an inherent or unavoidable part of other activities undertaken by the trustee that are consistent with the provision of benefits specified by subsection 62(1).
- ❖ The benefit is remote or isolated, or is insignificant (whether it is provided once only or considered cumulatively with other like benefits) when assessed in light of other activities undertaken by the trustee that are consistent with the provision of benefits specified by subsection 62(1).
- ❖ The benefit is provided by the SMSF on normal commercial terms consistently with the financial interests of the SMSF and at no cost or financial detriment to the SMSF.
- ❖ All of the activities of the trustee are in accordance with the covenants set out in section 52.
- ❖ All of the SMSF's investments and activities are undertaken as part of or are consistent with a properly considered and formulated investment strategy."

Sound enough one might say but on close analysis, the examples provided in the Appendix to the Draft Ruling seem to contradict the soundness of the basic propositions and to an extent, defy certain previous decisions of the Tax Office. To illustrate the point, we have attached excerpts from the examples as an Appendix to this Newsletter.

## More amendments to Simplified Super

*Tax Laws Amendment (2007 Measures No 4) Bill 2007* received Royal Assent on 24 September 2007. The new Act:

- ❖ Deems that allocated, market linked and account based pensions are not "segregated current pension assets" if the market value of the assets used to fund a retirement income stream, exceeds the account balance of the income stream itself;

- ❖ Extends the small business Capital Gains Tax relief applying to superannuation contributions, to a period after 1 July 2007 where payment was received after that date but, in respect of a transaction which attracted CGT prior to that date; and
- ❖ enables employer deductions for superannuation contributions in respect of employees who strictly speaking, are not engaged in producing assessable income on behalf of an employer. The most common example of such an employee is a non-executive director of a trading company or directors of trustee companies.

### New Retirement Income Stream (Pensions) Service

A "pension" is no longer a pension. It is now (officially) a Retirement Income Stream. "Pension" is a lot shorter and saves many more trees! As a result of the Simplified Super Regime, we have created new Retirement Income Stream packages catering for:

- ❖ Account Based Pensions;
- ❖ Transition to Retirement Income Streams; and
- ❖ Market Linked Income Streams (also known as Term Allocated Pensions).

Strictly speaking these are now the only types of new retirement income streams that may be commenced by members of self-managed superannuation funds. Allocated pensions and TRIP allocated pensions which were established prior to 20 September 2007 can continue to be paid by self-managed funds from 20 September 2007.

We have streamlined the paperwork and instruction process making it much easier for accounting and other financial advisers to order complete Retirement Income Stream packages from us. Quotations for the packages are available from Andrew Gray.

### Draft Ruling - financial assistance to members or relatives

Section 65 (1)(b) of the SIS Act prohibits a fund from providing any form of financial assistance to fund members or relatives of fund members using any resources of a fund. The term "financial assistance" must be viewed in a broader context than the mere payment of or loan of money.

*Draft Self Managed Superannuation Funds Ruling SMSFR 2007/D2* was released by the Tax Office on 27 September 2007 and sets out the Commissioner's view as to a range of other transactions by which a self-managed fund can provide financial assistance and thereby, be in breach of section 65 (1)(b). The Draft Ruling whilst instructive, is lengthy. In the Commissioner's view, the following circumstances constitute the giving of financial assistance by a fund:

- ❖ giving a gift using the resources of the SMSF to a member or a relative of a member;
- ❖ selling an SMSF asset to a member or relative of a member for less than its market value;
- ❖ purchasing an asset from a member or relative of a member for greater than its market value;
- ❖ acquiring services from a member or a relative of a member on non-arm's length terms - for example, paying for unnecessary services or paying an amount for services in excess of an arm's length amount;
- ❖ providing security or a charge over SMSF assets or giving a guarantee for the benefit of a member or a relative of a member;
- ❖ forgiving a debt of a member or a relative of a member, or releasing a member or a relative of a member from an obligation to the SMSF, including where the amount is not yet due and payable; and
- ❖ taking on a financial obligation of a member or a relative of a member.

The Commissioner has set out his view of exhaustive criteria which will apply in many situations we are all familiar with by reference to a volume of legislation and case law. The Draft Ruling should be carefully understood as in all likelihood, it will represent the final position of the Commissioner on the subject

## Reliance on financial advice

In *AAT Case [2007] AATA 1732, Re Kerr and FCT*, the Administrative Appeals Tribunal accepted that a taxpayer had relied on incorrect advice as to whether he qualified for a higher pension RBL. Whilst accepting that the Taxpayer had relied on incorrect advice from a financial planner, the Tribunal held that the Commissioner of Taxation was within his rights to find that special circumstances did not exist in order to allow the Commissioner to exercise a discretion in the matter.

## Retirement Income Stream beneficiaries turning 60 during a financial year

The Commissioner of Taxation has recognised that existing withholding scales fail to deal with a retirement income stream beneficiary who turns age 60 in a year in which an income stream benefit commences to be paid. Payment from a taxed source made to a superannuation beneficiary who has turned 60 years of age are, from 1 July 2007, treated as non-assessable, non-exempt income (tax free). The current withholding tables fail to recognise the change. In recognition of the shortcoming, the Commissioner has released *Taxation Administration Act - Variation to the rate of withholding of certain superannuation income stream beneficiaries who turn 60 during the financial year - No 2* as a Legislative Instrument. The new Instrument deals specifically with withholding rates for income stream beneficiaries who turn age 60 in a financial year.

## Transitional Termination Payments & workplace agreements

ETPs made as a consequence of workplace agreements entered into prior to 10 May 2006 are subject to the Transitional ETP regime which grants the same concessions (until 2012) as ETPs paid prior to 1 July 2007. However, employers and employees not infrequently amend old workplace agreements or, enter into new agreements. If the old and a new workplace agreement made after 10 May 2006 are identical in providing for the making of employer payments in lieu of notice, does the pre 1 July 2007 regime apply?

The Tax Office says "No". The pre 1 July 2007 regime does not apply. In *ATO Interpretative Decision ATO ID 2007/163*, the Tax Office says:

"Employment termination payments made under a workplace agreement, entered into after 10 May 2006, are not transitional termination payments, even if the terms under which the payments were made are the same as the terms under a workplace agreement in place just before 10 May 2006."

The Tax Office maintains that the legislation simply does not allow it a discretion despite the identity of provisions in pre and post 10 May 2006 workplace agreements. A harsh blow for those who entered into workplace agreements on or after 11 May 2006!

## SGC now a priority

For some years, employer superannuation contributions have been recognised as a priority in the winding up of an insolvent company. However, section 556 of the *Corporations Act 2001* has curiously excluded the Superannuation Guarantee Charge - the default provision where employers fail to make contributions for employees.

In *Corporations Amendment (Insolvency) Act 2007*, equivalent treatment of SGC has finally received recognition. Section 556 has been amended to ensure that SGC attracts the same priority in winding up of an insolvent company as employer contributions. About time!

## Care with contributions from reserves

Reserves in superannuation funds have been wonderful things since the days of section 23JA of the 1936 Tax Act (for those who can remember it), allowing flexibility and control in many different situations. However, with the advent of concessional and non-concessional contributions, reserves now constitute a trap for the unwary.

The *Income Tax Assessment Amendment Regulations 2007 (No 3)* now prescribe when an allocation from a fund reserve is to be treated as a concessional contribution. The Regulations are complex and should be clearly understood before anyone contemplates allocating contributions from fund reserves.

## When dividends and distributions are received

Many will remember the impact of *Superannuation Legislation Amendment Act (No 4) 1999* which effectively ended the ability of funds to invest in many assets which are now deemed to be in-house assets. The Act excluded certain reinvestments in closely held companies and trusts prior to 30 June 2009 from being in-house assets. There has apparently been a practice developing of funds not actually receiving the amounts which are allegedly reinvested in these closely held entities.

The Tax Office has issued *Draft Self Managed Superannuation Funds Determination SMSFD 2007/D1* which proposes that a dividend or trust distribution is not actually received by a fund until it is paid to a fund. Sounds logical to us.

The contents of this Newsletter are not intended to constitute the provision or rendering of legal or other advice. Accordingly, we can accept no responsibility for loss or damage (howsoever arising) to persons who act solely on the basis of this Newsletter without first seeking our professional advice.

## Appendix

### Example 1 - benefit inherent in investment: no breach of section 62

16. As part of a portfolio of property investments and in line with the SMSF's investment strategy, the trustee invests in a number of holiday apartments through a property syndicate. All investors in the property syndicate pay normal market rates when staying at the apartments but, subject to availability on the day of arrival, may be able to upgrade their accommodation at no extra cost. The SMSF cannot dispose of this right to its financial advantage. Two members of the SMSF stay at the apartments and their accommodation is upgraded.

17. This benefit, being the upgrade right, is incidental to the SMSF's investment in the holiday apartments. The trustee does not contravene the sole purpose test in these circumstances.

18. The trustee did not seek to obtain this benefit for the members and there is nothing to suggest that it influenced the trustee's decision-making. Further, it is an inherent feature of investing in the apartments available to all investors and is a relatively insignificant benefit.

19. Even if the trustee makes a pattern of like property investments (for example, due to expertise the trustee has in making property investments in certain holiday destinations) that each provide a similar benefit, the facts as set out here do not suggest a purpose of maintaining the fund in contravention of the sole purpose test.

20. In contrast, Case 43 / 95 (the Swiss Chalet case) is an example where there was a pattern of investing in assets that provided significant pre-retirement benefits to the members of the fund. This was sufficient for the Administrative Appeals Tribunal to infer an ulterior purpose in relation to the maintenance of the fund. The following example broadly reflects similar facts to that case.

### Example 2 - separately negotiated benefit: breach of section 62

21. The trustee of an SMSF invests in a block of holiday apartments at a popular tourist destination. The members of the SMSF holiday in this area every year and prior to making the investment owned a separate holiday house nearby.

22. The trustee, when undertaking the investment, additionally negotiated for members of the SMSF to be able to stay at the apartments for free. This is not a standard feature of the investment. The members of the SMSF sell their holiday house immediately after the SMSF makes the holiday apartment investment.

23. The separate negotiation of the benefit, which also has the potential to materially affect the return on the SMSF's investment, demonstrates that the benefit is purposeful and not incidental. The facts given in this example reveal that the SMSF is being maintained for a purpose of providing benefits to members other than those specified by section 62. Therefore, the trustee contravenes the sole purpose test in these circumstances.

24. In some cases, trustees may be able to divest the SMSF and/or its members of benefits attaching to an investment that are outside of those specified by subsection 62(1) to ensure that the trustee does not breach the sole purpose test by making the investment.

### Example 3 - benefit assigned to unrelated party at market value: no breach of section 62

25. In line with the SMSF's investment strategy, the trustee invests in shares in the Solo Golf Club. Membership rights attach to the shares, which can be assigned by the owner of the shares on nomination of a person who may exercise the rights.

26. The SMSF arranges for the golf club to assign the membership rights independently from the SMSF. The golf club advertises widely and the membership rights are assigned to a person unknown to the trustees and members of the SMSF at market value. The SMSF is entitled to the proceeds of the assignment.

27. In these circumstances, the trustee does not contravene the sole purpose test even though the investment in the shares includes membership rights for an individual.

28. The circumstances show that the SMSF's purpose in investing in the shares was not to provide membership rights to members or any other entity other than at market value.

### Example 4 - benefit assigned to unrelated party at market value: breach of section 62

29. Lee and Andrew are keen golfers who regularly play golf together. Lee and Andrew are each a member and individual trustee of their respective and unrelated SMSFs.

30. Both SMSFs invest in shares in the Tango Golf Club. The trustees did not receive independent advice regarding the investment. Membership rights attach to the shares, which can be assigned by the owner of the shares on nomination of a person who may exercise the rights.

31. Lee and Andrew agree to assign the membership rights attaching to the golf club shares to each other at market value.

32. The facts given in this example indicate that both SMSFs are being maintained for a purpose other than that specified under subsection 62(1). Lee and Andrew negotiated with each other for a purposeful benefit outside of those specified in subsection 62(1). The failure of Lee and Andrew

to seek independent advice in relation to the investment reinforces this conclusion. In these circumstances, the trustees have contravened the sole purpose test in relation to their respective SMSFs.

33. In the case of collectables and boutique investments such as works of art, antiques, jewellery, classic cars and wine, trustees must take care to ensure that SMSF members are not granted pre-retirement use of or access to the assets in circumstances that suggest that the trustee is maintaining the fund for a purpose not specified in subsection 62(1).

Example 5 - use of work of art at no cost: breach of section 62

34. A trustee of an SMSF acquires a work of art and does not seek independent advice in relation to that investment. The investment strategy of the SMSF requires the fund to hold a certain percentage of its asset in a portfolio of listed securities. The trustee liquidates all of the listed securities that the SMSF has invested in to fund the acquisition of the work of art. Soon after the work of art is acquired, it is displayed in the home of a member at no cost to that member.

35. The trustee contravenes the sole purpose test in these circumstances.

36. Where the work of art is provided for the use of the member at no cost, or at less than market value, it indicates that a purpose of the investment is to provide a benefit otherwise than in accordance with subsection 62(1). The liquidation of a class of assets forming part of the SMSF's investment strategy reinforces the conclusion that the provision of the benefit outside of those stipulated in subsection 62(1) was purposeful.

Example 6 - lease of work of art to member at market value: no breach of section 62

37. An SMSF maintains an investment in a significant art collection as part of its investment strategy, and commonly leases works of art to unrelated third parties at market rates. The trustee has expertise in investing in works of art, but nevertheless receives independent advice in relation to each of its investments.

38. The SMSF acquires a work of art after it has received independent advice regarding the soundness of investing in it. The SMSF then enters into an arrangement with a member whereby the member leases the work of art from the SMSF at market rates and subject to normal commercial conditions and controls. The work of art is displayed in the home of the member.

39. There is no contravention of the sole purpose test in these circumstances.

40. The benefit to the member is the opportunity to use the SMSF assets by paying an arm's length amount. There is no cost or financial detriment to the fund as a consequence of the use of the work of art by the member.

41. Nevertheless, trustees need to ensure that they do not provide a purposeful benefit to the members when undertaking SMSF activities, even if there is no net cost to the SMSF in providing the benefit. Although the impact of an arrangement on the SMSF's resources is a relevant consideration, it is ultimately the objective purpose of providing the benefit rather than the net financial impact of the arrangement on the SMSF's resources that determines whether the sole purpose test is contravened.

Example 7 - loan of work of art to an unrelated party: no breach of section 62

42. Following on from Example 6, the SMSF provides, at no cost, the work of art to a local gallery, for display in a special exhibition that is to run for two months.

43. The work of art provides a benefit for the community at large. However the facts given in this example establish that there is not a contravention of the sole purpose test as the cost or financial detriment to the fund and the benefits provided by the SMSF outside of those specified by subsection 62(1) are remote and insignificant. The display of the work of art at the exhibition may in fact enhance its future value.

Example 8 - loan of work of art to a related party: breach of section 62

44. Following on from Example 6, a related party of the SMSF owns an art gallery. The related party charges the general public an admission fee for viewing the works of art at the gallery. It also sells picture cards and pens in the gallery gift store, promoting the paintings currently on display.

45. The SMSF regularly loans its works of art to the gallery at no cost. Its investment choices are also largely determined by the art gallery's desire to acquire certain paintings.

46. In this example there is a pattern of events that result, when viewed in their entirety, in a contravention of the sole purpose test.

Example 9 - choosing an option that provides a benefit to members: breach of section 62

47. A public company has issued Discount Card shares on the Australian Securities Exchange that are listed separately to the company's ordinary shares. From the date of listing, the purchase of a nominal number of Discount Card shares entitles a shareholder to participate in the Shareholder Discount Plan provided they agree to a debit on their dividend payments each six months. The only difference between the rights attaching to the shares relates to the Discount Card. The trustee of an SMSF invests in Discount Card shares and obtains a shareholder discount card, which allows its members to purchase discounted goods at particular stores.

48. The investment contravenes the sole purpose test in these circumstances.

49. By investing in the Discount Card shares rather than the ordinary shares, an objective assessment of the circumstances indicates that the trustee has purposefully sought to provide a benefit to the members otherwise than in accordance with subsection 62(1), particularly in view of the reduced dividend rights attaching to the shares. Such a purpose would not be evident had the SMSF invested in the company's ordinary shares.