PERSONAL FINANCIAL
STRATEGIES
YOUR PERSONAL GUIDE TO WEALTH CREATION

SMSF borrowing - 1 year on

For many years superannuation funds have been precluded from borrowing to acquire investments. Recent legislative changes allow Self Managed Superannuation Funds (SMSF) to borrow for funding certain investment assets.

In recent years instalment warrants have been limited to financial institutions to allow superannuation funds to effectively "gear" into equities. To provide an element of certainty for SMSF in respect of this "instalment warrant" issue, legislation was passed in September 2007 making it acceptable provided certain strict conditions were met.

Now that the dust has settled, there are a number of issues of concern to the ATO. Some of these are highlighted in Taxpayer Alert 2008/5. The ATO will shortly release a draft ruling clarifying the Commissioner's view on a range of SMSF borrowing issues.

ATO Concerns

The tax office concerns largely relate to SMS entering into non-commercial or transactions that are not considered to be at arm's length, potentially raising other issues for SMSF trustees.

Excess Contributions Tax

Monies advanced by a member or related party to an SMSF at zero or less than a commercial rate of interest could be characterised as a contribution to the SMSF. Accordingly, this may result in the trustee/member being required to pay excess non-concessional contributions tax.

Sole Purpose Test

Monies advanced by a member or related party at greater than a commercial interest rate of interest may be considered a breach of the sole purpose test. In simple terms, the sole purpose test requires that a SMSF is maintained solely for the purpose of providing superannuation benefits. Where an unrelated benefit is derived, a SMSF may fail this requirement.

Financial Assistance

Monies advanced by a member or related party at greater than a commercial interest rate of interest may result in a the trustee breaching the Superannuation Industry (Supervision) Act 1993. The SIS Act prohibits a trustee from giving financial assistance or benefit to a member of the SMSF or to a relative of such a member using the resources of the SMSF.

Continue to page 2

PRT
Chartered Accountants

SUITE 3
46 ALBERT STREET
BUSSELTON WA, 6280

•

TEL (08) 9752 3222
FAX (08) 9752 2374

•

E-MAIL
prt@prtonline.com.au

•

WEBSITE
www.prtonline.com.au

•

Business Management,
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ISSUE NUMBER 6

- SMSF borrowing - 1 year on
- Investment vs trading warrants
- Beware the watchful eye of the tax office
- CGT confusion over trust cloning resolved
- Fuel tax credits for developers

Continue to from page 1

Benchmarking

With related party SMSF borrowing arrangements, superannuation and income tax law make it critical to document the loan agreement between the fund and the related party lender on arm's length (commercial) terms.

The key terms of the loan (e.g. interest rate, lending ratio, length of loan) should be 'benchmarked' by gathering independent evidence of similar arrangements provided by two or more external lenders in the market.

Where the related party lender is a private company or a family trust that has a corporate beneficiary, it is also important to ensure that the loan is compliant with Division 7A of the Income Tax Act, including the minimum statutory benchmark interest rate.

Summary

Alongside SMSF compliance, taxation issues are also critical. If there is a contravention of the SMSF, there could be significant tax consequences for the fund if it is found to be 'non-complying'.

In addition, taxes such as stamp duty, land tax, income tax, capital gains tax and GST can all have a significant impact and need to be considered on acquisition of the asset, during the ownership period, and finally on transfer of the asset to the fund's trustee.

There is a potential for increased liability for certain taxes if the arrangement is not properly documented.

SMSF borrowing is complex and in many cases requires input from a range of advisors so trustees need to be aware of the full range of issues.

Investment vs trading warrants

A warrant is a financial instrument that gives an investor exposure to an underlying asset, such as a share or currency. Under such an instrument, an initial part-payment is made, and the remaining instalments plus interest and the cost of setting up the loan to fund the asset, are paid at a later date. Warrants allow investors to leverage an asset - so they increase risk - but they also provide the potential for higher returns.

Investment Warrants

Warrants with an investment purpose, such as instalments, are generally longer-dated, tend to be less frequently traded and have a lower risk/return profile.

Each warrant has a set of features that determines its characteristics. These features vary between warrant types, and are tailored to meet the needs of different types of investors. Some of the features offered by warrants are:

- Entitlement to the full dividends and franking credits paid on the underlying share.
- Ability to pay a portion of a share's value upfront without the obligation to repay the balance.
- Capital guarantees over the issue price of the warrant.

Until recently, because instalment warrants involve borrowing, super funds could not technically invest in them without breaching the law.

However, from 24 September 2007, changes to the law mean that super funds can now invest in some instalment warrants.

Some of the advantages that are achieved by investing in warrants include:

- Greater leveraged exposure to an underlying share;
- Diversification of exposure to the sharemarket;
- Generation of an income stream through dividends and franking credits;
- Protection of value of a share portfolio.

Trading Warrants

Trading warrants are similar to options contracts, except that they are typically issued by an banks (the issuer) and are traded on the Australian Stock Exchange, like shares. Unlike investment warrants, they are shorter dated. The issuer of the warrant determines the structure and terms of each particular warrant issue.

Trading warrants are often used as a means of speculating on the future direction of an underlying asset. Different types of warrants enable traders to benefit from either a rise or fall in the value of the underlying asset. Call warrants typically increase in price as the underlying asset appreciates, while a fall in the underlying asset price will generally cause an increase in the value of a put warrant.

The underlying assets over which trading warrants are available include:

- Equity Warrants – shares ranging from blue chip companies such as Telstra, BHP or Commonwealth Bank to the more speculative, smaller market cap stocks.
- Index Warrants – the ASX200 index covering the leading 200 shares on the ASX.
- Currency Warrants – the Australian/US Dollar exchange rate.

Beware the watchful eye of the tax office

The Tax Commissioner recently provided some insight into the scope of the tax office investigations of tax claims.

In 2007-2008 the tax office:

- Reviewed over 25,000 high risk refund returns, resulting in revenue adjustments of $38 million.
- Completed around 7,200 reviews or audits re rental expenses resulting in revenue adjustments of $9.2 million.
- Reviewed nearly 7,000 individual tax payers' capital gains tax (CGT), resulting in revenue adjustments totalling $51.5 million.

The CGT figures are even more interesting when one considers that a new phone service offered by the tax office to tax agents concerning CGT queries, showed that the top five most commonly asked CGT questions related to:

1. Share transactions
2. Rollovers
3. Primary residence exemptions
4. Small business concessions
5. Deceased estates

Not surprisingly, the CGT small business concessions rate highly on the tax office area of investigation. Whilst the concessions available are significant, they are nonetheless complex and in many cases not understood.

The tax office is also maintaining its review of rental property deductions claimed in income tax returns. The primary area of concern is rental deductions are being over-claimed, especially as the growth in rental expenses continues to outweigh rental income.

With rental deductions up 12 percent from the previous year, it is understandable that this is one area on the tax office's radar. Data matching will be used as one of the tools by the tax office to identify rental property owners. The tax office plans to write to property owners to remind those, that appear to fall well outside of the benchmarks, to report rental income correctly.

The tax office will also be playing close attention to excessive claims for interest deductions and building depreciation

Keep in mind that the tax office does verify claims. Whilst the tax law provides scope for claiming many deductions and concessions, there are consequences for getting it wrong.

CGT confusion over trust cloning resolved

The Federal Government has moved to abolish a capital gains tax (CGT) concession for the cloning of trusts.

Trust cloning involves the creation of a new trust based on the same terms and with the same beneficiaries as an original trust. Under existing rules capital assets could be transferred to the cloned trust free without triggering a capital gains tax event.

Trust cloning has become increasingly attractive to private companies because of the CGT exemptions. However, the tax office has become increasingly concerned about how trust cloning concessions were being used. The amendments will resolve uncertainty surrounding the application of the exception, which has created significant compliance and administrative costs for taxpayers and the tax office.

The changes also eliminate the possibility of using the trust cloning exception to offset tax liabilities on accrued capital gains, ensuring greater equity and the integrity of the tax system.

Removing the trust cloning exception is consistent with the policy of taxing capital gains that arise where there is a change in ownership of an asset. This typically occurs on the creation of a trust over a CGT asset and on transferring a CGT asset to an existing trust.

A simple change of trustee of a single trust will continue not to trigger a CGT event. In addition, where the taxpayer is the sole beneficiary of the relevant trust, and the taxpayer is absolutely entitled to the asset as against the trustee, the CGT exemption will be retained.

Because of these changes, businesses that operate through trust structures and plan to move a capital asset from one trust to another will need to consider other options.

Fuel tax credits for developers

Recent expansion of the fuel tax credit system means that property developers and property managers can claim fuel tax credits for the first time. Eligibility is subject to a number of eligibility tests.

Following on the introduction of the Fuel Tax Act on 1 July 2006, several changes to the fuel tax credit system have come into effect. Generally, these changes have expanded the eligibility of the fuel tax credit system to a greater range of fuels and business activities than were previously eligible.

The fuel tax credit system

The Fuel Tax Act allows entities, in specifics circumstances, to claim credits for the fuel tax (i.e. excise and customs duty) included in the price of fuel used in their operations.

Where a property developer or property manager uses fuel for a purpose that entitles them to a fuel tax credit, the property developer or property manager may now be able to claim back from the Australian Tax Office an amount of tax paid on the fuel.

Registration is a must

Developers and property managers must be registered for both GST and fuel tax credits before any benefits under the Fuel Tax Act are claimed. Subject to certain exceptions, an entity is entitled to fuel tax credits for "taxable fuel" acquired, manufactured or imported into Australia. That is, provided that the taxable fuel is acquired, manufactured or imported for "use" in carrying on the entity's "enterprise".

Personal Super Contributions

Before a tax deduction for personal super contributions is claimed, individuals must notify with their super fund, retirement savings account or approved deposit fund.

A notice of an intention to claim a deduction must be provided before the day they lodge their income tax return for the year in which they made the contributions, or the end of the income year after the income year in which they made the contributions, which ever comes first.

Taxpayers are unable to cancel or withdraw a valid notice after it has been submitted, unless the variation is due to the full amount of the claim being disallowed. In this case an individual may vary the notice to reduce the amount being claimed as a personal deduction by the amount disallowed by the ATO.

If you have not lodged a return and plan to claim a deduction for personal contributions, please ensure that you have received written acknowledgement from the relevant fund or provider that they have received your notice prior to lodging your income tax return.

The Bookshelf

The Great Depression Ahead: How to Prosper in the Crash Following the Greatest Boom in History

Author: Harry Dent

Bestselling author and renowned economic forecaster Harry S. Dent, Jr., has delivered another classic. The year 2009 will be the beginning of the next long-term winter season and the initial end of prosperity in almost every market, ushering in a downturn unlike many of us have ever seen. Are you aware that we have seen long-term peaks in our stock market and economy very close to every 40 years due to generational spending trends: as in 1929, 1968, and next around 2009? Are you aware that oil and commodity prices have peaked nearly every 30 years, as in 1920, 1951, 1980 -- and next likely around late 2009 to mid-2010? The three massive bubbles that have been booming for the last few decades -- stocks, real estate, and commodities -- have all reached their peak and are deflating simultaneously.

Dent has observed these trends for decades. As he first demonstrated in his bestselling book, The Great Boom Ahead, he has developed analytical techniques that allow him to predict the impact they will have. The Great Depression Ahead explains "The Perfect Storm" as peak oil prices collide with peaking generational spending trends by 2010, leading to a more severe downtrend for the global economy and individual investors alike.

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