CASE STUDY

Session 2: Wealth Building Strategies

Disclaimer

Disclaimer: These notes are intended to be a guide only. You should not act solely on the basis of the information contained in these notes, because many aspects of the material have been generalised and the superannuation and taxation laws apply differently to different people and circumstances. Further, taxation laws change frequently and there may have been changes since the notes were written.

Therefore, TAG Financial Services Pty Ltd expressly disclaim any and all liability to any person, whether a purchaser or not, for the consequences of anything done or omitted to be done by any such person relying on part or the whole of the contents of this publication.

None of the comments contained in these seminar notes are intended to be advice, whether legal or professional. Do not act on the information contained in the seminar notes without first obtaining specific advice regarding you and/or your client's particular circumstances from a suitably qualified legal, taxation or superannuation professional.

While all endeavours have been made to ensure the accuracy of the content at the time of preparation, TAG Financial Services Pty Ltd accepts no responsibility for any inaccuracies contained herein.

These materials represent the author's interpretation of the law as it stands at September 2020.

Background

Sam and Kerrie Snow are aged 54 and 51 respectively. They have two adult sons, Max and Billie, who are aged 19 and 23 respectively.

For 27 years, Sam has run a self-storage franchise across 3 separate locations in the eastern suburbs of Melbourne.

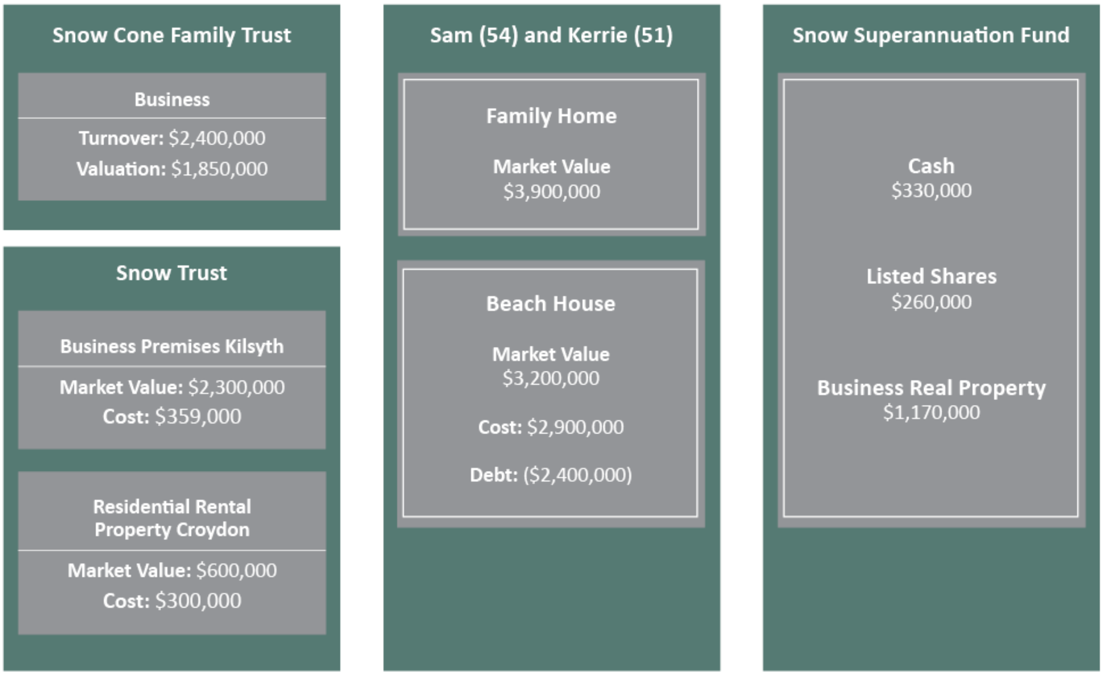
The family business is run via the Snow Cone Family Trust, which is a discretionary trust. The business has developed its own internet-based database/software programming for the booking and maintenance of the storage lockers. Recent valuations on this business suggest it is worth $1,850,000.

Turnover for the business last year was $2,400,000. Business profits each year filter their way through to Sam and Kerrie to the tune of approximately $120,000 each per annum.

The business leases one location from an unrelated party. The remaining two properties are owned within the Snow family group.

The first location is in Kilsyth and is owned by the Snow Trust. The property was acquired in 1998 for $359,000. It is currently worth $2,300,000 and has no debt attached. The business currently pays $160,000 per annum in rent to the Trust.

The family trust also holds assets in managed funds and listed shares to the value of $400,000, as well as a property in Croydon valued at $600,000 (cost base of $300,000). The SMSF holds business real property (being the other property used in the business), valued at $1,170,000 (debt free), cash of $330,000 and listed shares of $260,000.



Sam and Kerrie's member balances are as follows:

Member (age)	Taxable	Tax-free	Total
Sam (54)	$360,000	$540,000	$900,000
Kerrie (51)	$320,000	$540,000	$860,000

They own their own home, valued at $3,900,000 and this house has been debt free for a number of years.

Seven years ago, they bought a holiday house in Sorrento for $2,900,000 (current value: $3,200,000), and the debt on this house is currently $2,400,000. During the peak holiday periods they make the house available for rent, to cover some annual costs.

With both children now out of school, Sam and Kerrie approach you as their adviser with the explicit request to find avenues to help them grow their retirement wealth.

Small Business CGT

Sam and Kerrie come to your office for a meeting. They start the meeting by asking for clarity over how much they can contribute to their fund, as from talking to friends, they believed that they are able to make non-concessional contributions.

After confirming with them their SMSF member balances, and after making enquiries with the ATO, you ask them to hold that thought for a moment, and explain to them the concept of the small business retirement concessions and how the concessions, if available, would enable them to maximise their superannuation contributions. You explain to them the two tests for application – being the asset test and turnover test.

You confirm with them that they will not qualify under the turnover test, as their previous years turnover was $2,400,000, which is above the $2 million threshold.

For the asset test, the net asset values must be less than $6 million. You list their net asset position as follows:

Asset	Market Value	Cost
Business Value	$1,850,000	$150,000
Family Trust - Property	$2,300,000	$359,000
Property – unrelated tenant	$600,000	$300,000
Other Trust Assets	$400,000	$270,000
Sorrento property	$3,200,000	$2,900,000
Less Loan	($2,400,000)	
Net Assets	**$6,350,000**	

The net assets are currently above the $6 million threshold. While proud of their asset accumulation, Sam and Kerrie are a little disappointed, however you interject – these tests only apply immediately before your "sale". Sam and Kerrie reiterate to you that they are not looking to sell any assets, rather just to focus now on growing their superannuation.

You explain to Sam and Kerrie the notion of an in specie transfer, and how you could look to move the Kilsyth property (currently held by the Family Trust) into the Superannuation Fund by a series of in-specie transactions. The Small Business Concessions would still apply to this sort of transaction, however we first must determine whether the Snow Family Group is eligible.

Based on your initial assessment, the Family will not qualify for the concessions. However, as we are in the position where we can control the timing of the asset movement, this provides us with the opportunity to re-deploy assets in the areas where they are free from counting towards the asset test.

You explain that this essentially lies in two spots – the Family home, or superannuation. The net asset values of these assets are excluded from the $6 million test.

Sam and Kerrie are more than happy with their house – or at least comfortable enough that a large-scale renovation is not needed. Accordingly they ask about the superannuation angle – given after all that is why they are here!!

You explain to them that their assets are $350,000 above the threshold and accordingly this is the amount that we need to move into super. However, to save on stamp duty costs on the transfer, it will need Sam and Kerrie to make a contribution on behalf of the children. In fact, you explain, we will need to make additional contributions for the children with respect to the property in order to get as much into the Fund as possible. You draw up a contribution of $95,000 for each child, which together with a $100,000 contribution for Sam and Kerrie, moves $380,000 out of their asset base and qualifies them for the small business concessions.

You highlight to Sam and Kerrie that while they could contribute up to $300,000 each, by not triggering the bring forward provisions, it provides additional room for the contribution of the property.

Now, assuming you have made that contribution, you tell them, the small business concessions can mean the following:

Market Value	$2,300,000
Less Cost base	$ 359,000
Gain	$ 1,941,000
50% general discount	$ 970,500
50% active asset discount	$ 485,250

After the above discounts, we are left with a capital gain of $485,250. This gain can be ignored in full if a contribution to superannuation is made by the recipient, meaning that we have moved the entire asset without incurring capital gains tax.

Sam and Kerrie are extremely enthused by this idea. You explain to them some of the caveats that come with this, however.

Items to Consider if Transferring the Property into the Fund

- As the transfer that triggers the gain is between the Family Trust and individuals, they are able to make this $485,250 contribution by the in-specie transfer of this much of the property into the SMSF (i.e. it does not need to be a contribution of cash or a different asset). Doing so means there will still be $1,814,750 of the property to contribute to the Fund.

- The triggering of a capital gain due to the sale of the property, and the making of the contribution cannot occur as part of the same transaction but can be part of the same property. For example, you could sell part of the property, and trigger the capital gain, and then contribute a different part of the property to make the contribution that would provide the concession.

- As the asset is held by a Family Trust, it is the family trust which is selling the asset and realising a gain. Accordingly, only the Trust can obtain the retirement concession and so a maximum of $500,000 is allowed for the concession – i.e. we cannot use $500,000 each for Sam and Kerrie, as would have been the case if they held the asset personally.

- There are GST implications that need to be considered on the transfer of the property. The ATO takes the view that an in-specie distribution of property from a trust that is registered for GST to a beneficiary for no consideration, can be a taxable supply. However, if Sam and Kerrie were registered for GST in their own right and rented out the property for a period of time before transferring the property into the Fund, then this issue would be overcome.

You advise they can get the property into the Fund by utilising their remaining non-concessional contribution caps. You propose that they wait until after 30 June to make their initial $100,000 contributions, so as to ensure that Sam and Kerrie's Total Superannuation Balance stays at their current levels. This is because, should either members balance move above $1,400,000, then their non-concessional maximum is reduced to $200,000, as opposed to their current $300,000 levels.

Sam, Kerrie, Billie and Max could all make a $300,000 non-concessional contribution, together with the in-specie contribution of their annual concessional contributions (although stamp duty would apply if they did make concessional contributions). This would total $1,300,000, leaving the final $514,750 in the family trust.

What do we do with that, Sam asks?

Well, the SMSF could consider the following options:

Option 1: Purchase this directly from the family trust
Option 2: Leave the remaining portion of the property in the trust
Option 3: Borrowing (LRBA) for the final component

Retaining the asset in the Trust would mean that, of the annual $160,000 in rent, $35,808 would stay in the Trust accounts. At Sam and Kerrie's marginal tax rates, they would pay tax of approximately $13,250 (37%).

Purchasing the property off the Fund would mean that this income would be taxed at 15% within the Fund, and so the extra tax payable overall is really $7,878.

Having the Fund buy the remaining parcel from the Trust would however incur stamp duty. At the stamp duty rates this would be approximately $28,311. As a result, it would take approximately 4.3 years to recoup the stamp duty costs, if they purchased the remaining parcel.

Sam and Kerrie contemplate the costs. They are keen to maximise their super now while they can, but are a little uncomfortable with the costs.

You explain to them about their Total Superannuation Balances, and that once these reach $1,600,000, then they will be prohibited from making any further non-concessional contributions, unless it is a small business contribution.

Keen to get a jump now, Sam and Kerrie take the plunge. They decide to add Max and Billie to the fund and make the contributions to assist in getting below the $6 million net asset threshold. They then proceed to make the in-specie transfer of property, before having their Fund purchase the remaining portion of the property.

As a result of all of the contributions, Sam and Kerrie are now both over $1,600,000. Accordingly, by the time the Fund reports their year-end balance, and by the time their three year bring forward period expires, they will be unable to contribute non-concessional contributions again.

Have you thought about? What other alternatives are there to assist in reducing the assets below the $6 million net asset test?

Have you thought about? What other alternatives are there to get the remaining portion of the property into the fund?

Barbeque Talk

Max has never been truly engaged with his superannuation. While he is working towards taking over the family business one day, as well as his desire to get involved in the property market, he has not seen the connection between his superannuation and his financial future.

Max is hanging out with mates at an Australia Day barbeque, and while discussing with one of his good friends, uncovers an investment opportunity which he believes could be quite fruitful. After discussing with his parents, Sam and Max come and visit you to discuss this opportunity.

Max is looking to “go in” as a 1/3rd equal investor in the purchase of a popular countryside pub. His mate will be a second investor. This friend has had a string of successful property developments over the years and his nous in the industry is highly regarded by Max and Sam.

The third investor is a business partner of Max’s friend. Max has met this person a few times before, and while connected on Facebook and the like, does not necessarily consider him a friend.

Sam and Kerrie advise you that they are keen for Max to get this exposure, and to build engagement with, his super balance. The contributions made and cash reserves in the Fund could be put towards this, Sam advises you.

Max tells you that the cash investment required will be around $250,000.

Curious, you ask what the pub purchase price was, to which Max answers “$1.5 million”. Max tells you that they will need to borrow to purchase the property. All three will have to “stump up” the same level of cash, so as to manage obligations equally.

You then discuss with Sam and Max the issues that firstly need to be navigated to determine whether the SMSF can be involved.

Given there is a borrowing needed, the Fund borrowing directly would need to be via a Limited Recourse Borrowing Arrangement. As all three parties will need to borrow, you suggest that it would be simpler for a central entity to borrow, rather than each individually source the finance. Further, from a practical standpoint, an SMSF loan direct with a bank appears harder to source these days, and so may limit the overall result Max is looking for or hamper the result the other investors are looking for.

You explain to them the notion of a “related party”, and work through the definitions with Max and Sam. You whittle the related party possibilities down to establish that no member of the SMSF is in a business relationship with the other two investors, and accordingly are satisfied that the other investors are not related parties. Accordingly, you say, this could be done via a structure such as a unit trust.

The units will provide a clear ownership entitlement, and the debt could sit within this trust. In doing so, the unit trust would have the repayment obligations to the bank. Looking further forward, you say, the trust structure would provide an avenue to add additional unit holders in time.

Further, you add, as we are now dealing with an unrelated trust, the unrelated trust can borrow, develop and potentially even run a business.

You caution Max, however, around the concept of property development, as you are aware of recent ATO concerns around these sorts of investments. You explain how the ATO have discussed (SMSFRB 2020/1) their concerns about shifting of wealth into super, circumventing contributions limits.

Additionally, you explain the ATO concerns around the suitability of the asset in light of the Fund’s investment strategy, and that all parties are consistent and are dealing at arm’s length. In laymen’s terms, no favours into this Trust just because you are investing in it.

Max is excited by the prospect of his investment plan coming to life. He tells you that part of the longer-term plan is for the development of accommodation on site for campers and back packers, and there was also talk between them of potentially taking over the business itself in time.

You explain to Max that, so long as the SMSF is involved, then we must continue to ensure that the trust is treated as an "unrelated" trust, and so there can be no other business partnerships which any SMSF member can have with the other investors. Control of a Trust is also a key factor. However, as Max will own only 1/3, and has a 1/3 say in the investment, then this is currently ok.

Essentially, maintain the status quo, he confirms back to you.

So, in terms of the investment, then yes, it is possible for the fund to be involved, you confirm.

However, have you given consideration to the following items?

• Managing disputes between the unit holders?

• Entry/exit of unit holders, including
  - Obligations – such as who has first rights, timeframes for disposal
  - Valuation methodology – setting clear expectations so there is no ambiguity about a value (whether you like the value or not)
  - Obligations for additional finance? What will they do if/when they choose to develop? Will the SMSF need to find more cash, or will they plan to use additional equity in the asset to finance it?

• If they decide to run the business:
  - Rent – ensuring this flows through to the unit trust
  - Compliance – i.e. Max cannot be an owner in the business itself, and so suddenly loses the full equality as while he (via the SMSF) is a 1/3 partner in the premises, he is not a partner in the business, which is the source of income for the landlord.

From the SMSF perspective, you advise the Trustees will need to update the investment strategy and take steps to help ensure that the investment is considered appropriate given this strategy, particularly when considering liquidity in the fund to cover its own obligations. While not in pension mode, you explain, what if there are needs for the properties the Fund already owns?

Sam and Max thank you for the discussion. They go away to consider all you have advised, and in time confirm that they will proceed with the investment. Unit holder agreements have been drafted and vetted by lawyers.

Max is happy to not be involved with any business should the other investors choose to take this path, and he advises that he has discussed this with them.

Have you thought about? What other alternatives are there to structure the purchase in a share of the pub?

Have you thought about? If a LRBA was used to purchase the 1/3 share of the pub, how do you ensure the LRBA is compliant?

Expansion plans

Sam calls you out of the blue on a Monday morning. This is out of the ordinary as you know Sam is not a morning person.

Sam has an idea that he believes can be extremely profitable within the storage business – portable storage units. He explains their concept and believes these can be made for approximately $1,000 per unit, split between materials ($600) and labour ($400).

Sam has clearly been thinking about this. He believes starting with 200 units and using the positive cash flow from the leasing of these to fund the construction of further units in time.

He asks you whether his SMSF can own these units, believing this is an excellent manner in which to grow his retirement wealth further.

You ask him what their sale value would likely be once built, and Sam believes they could sell for as high as $2,500 each, however more likely to be in the range of $2,000. He would prefer, however, to manufacture and lease the assets, rather than build to sell.

Sam has had his tenant move out of his other property within the Snow Trust and would like to use this site, if possible, to store these units.

Sam believes these units could be leased to other franchisees and estimates a return of $250 per unit per month.

Sam's existing business has the infrastructure to enable the delivery and collection of the units from the end user. The business would also be used for such items as taking phone calls, making bookings, organising delivery and pickup, etc, and it would charge an agent/management fee for these services. Sam has estimated an industry average service fee for such a provider as 10% (refer **Appendix A**)

The business would be capable of separately entering into service agreements (on behalf of the SMSF as legal owner of the units) with franchisees for the booking/supply of these units, enabling a greater footprint in the marketplace. These businesses would receive a booking fee of 20%.

Sam tells you that his Fund now has approximately $340,000 in cash available.

Given the estimated construction cost, the SMSF could conservatively construct (say) 200 units at a cost of $200,000 to begin with, using cash reserves.

Once constructed and operational, the cash flow from the units could then be used to build up a greater unit inventory over time.

For example

	$ per annum	Assumption
200 units leased at $250/month	$300,000	50% utilisation
Less service fee	$90,000	30% service fee*
Less rental costs – Snow UT	$30,000	Rental expense
Net Income	$180,000	
Less SMSF tax @ 15%	$27,000	
Net income year 1	**$153,000**	

*includes 20% booking fee and 10% service fee as discussed.

Based on the above assumptions, the SMSF would have sufficient cash to fund the construction of a further 100-150 units within 12 months.

So, you agree. The cash flow within the Fund makes this project feasible. You explain to Sam that the cash flow seems the easy part. Satisfying superannuation legislation and the Fund auditor is where the fun begins.

You explain to Sam some of the issues.

Business real property rules

You explain to Sam what these rules mean. He understands, having already two properties in the Fund leased to his business. You explain that care should be taken to ensure that any lease arrangement entered into with a related party is the lease of a freehold or leasehold interest in the property owned by the SMSF. Where the lease is NOT for the leasehold interests in land, such as in this example where the leasing is of property that is not land and buildings, then this lease arrangement would create an in-house asset issue for the Fund, and a contravention of the legislation.

In this situation, it is therefore imperative that the units are not leased by the SMSF to a related entity.

Related Party acquisition rules

The SIS Act essentially states that a superannuation fund must not acquire an asset from a related party. You explain that a common issue arising in builds of any kind, but more typically in a property build, surrounds the purchase of materials and the labour costs.

Sam tells you that he intends to use someone known to the business to provide this labour, and that this person/business is not a related party of the Fund.

So, with labour out of the way, what are the implication for purchase of materials, Sam asks.

You explain to him that the ATO has stated that goods or materials that are insignificant in value and function can be considered a service only. In the case of the units, the materials to construct the units would not be insignificant (as it represents 60% of the construction cost).

Therefore, in your proposed transaction Sam, this would require the SMSF to pay directly for all materials from the supplier. Under no circumstance should any of your existing business buy the materials and then have the Super Fund reimburse you, as this would be seen to be the Fund purchasing from a related party and therefore not allowed.

Arm's Length Transaction rules

It is a requirement of **SIS Act s.109** that all investments of a superannuation fund must be made on an arm's length basis. The investments must be entered into and maintained on a commercial basis.

In this instance, it would be necessary to consider the relationship between your SMSF and business, and to properly document the agreement between the entities with respect to the responsibility of provision of goods and services, agency agreement, remuneration and agreement length.

Running a business – SMSF Sole purpose test

You explain to Sam the SMSF must be deemed to meet the "sole purpose" test at all times. You go onto explain that an SMSF must be maintained for at least one core purpose **OR** at least one core purpose and one or more ancillary purposes.

For the core purposes, it is the provision of benefits the Fund's members on retirement, or the payment of a death benefit. For the ancillary purposes, it is the provision of benefits in other circumstances, such as termination of employment, cessation from work due to ill health, or death after retirement or attaining age 65, or at the Commissioners discretion.

While there is nothing in the SIS legislation that prevents an SMSF from running a business, the sole purpose test is the great litmus test for this notion.

You explain that an investment may cause the Fund to breach the sole purpose test where:

- It is selected with a non-retirement objective in mind.
- The purpose of the investment is not to build wealth towards retirement.

You continue and discuss with Sam what sort of factors would be favourable to a Fund satisfying the sole purpose test, and would include circumstances where 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.

Perhaps most importantly, you explain that all of the SMSF's investments and activities are undertaken as part of or are consistent with a properly considered and formulated investment strategy.

The units must be considered in light of the Fund's investment strategy to ensure the investment fits in with the overall investment objectives of the Fund. Any investment that steps outside the formulated investment strategy of the Fund may be subject to increased scrutiny from the ATO.

The investment strategy must take into consideration the best investment mix to ensure risk is minimised and the Fund has adequate diversity, liquidity and has the ability to discharge liabilities as they fall due. You explain further that the ATO has an increased focus on the thoroughness of a Trustee's investment strategy, and you recommend that all members give consideration to its effectiveness before proceeding.

Long term benefits

As Trustee and member of the SMSF, Sam is looking to select investments for the SMSF that will assist in growing their superannuation entitlements as they build towards retirement.

You run through all the numbers and based on the assumptions, factoring the cash flow for the construction of the units, you can forecast the anticipated benefits over the next decade. You determine that the units could generate $3,764,000, from a $1,000,000 total investment.

Given the tax effective environment of the SMSF, the adviser anticipates tax savings on this income of between $663,000 and $1,326,000 over the ten year period by undertaking the transaction in the SMSF as opposed to one of the Trusts (or a new entity). Furthermore, if Sam were to sell the units, you calculate that the anticipated capital gains tax savings would be approximately $210,000.

Investment strategy

You discuss with Sam the need to update the Fund’s investment strategy.

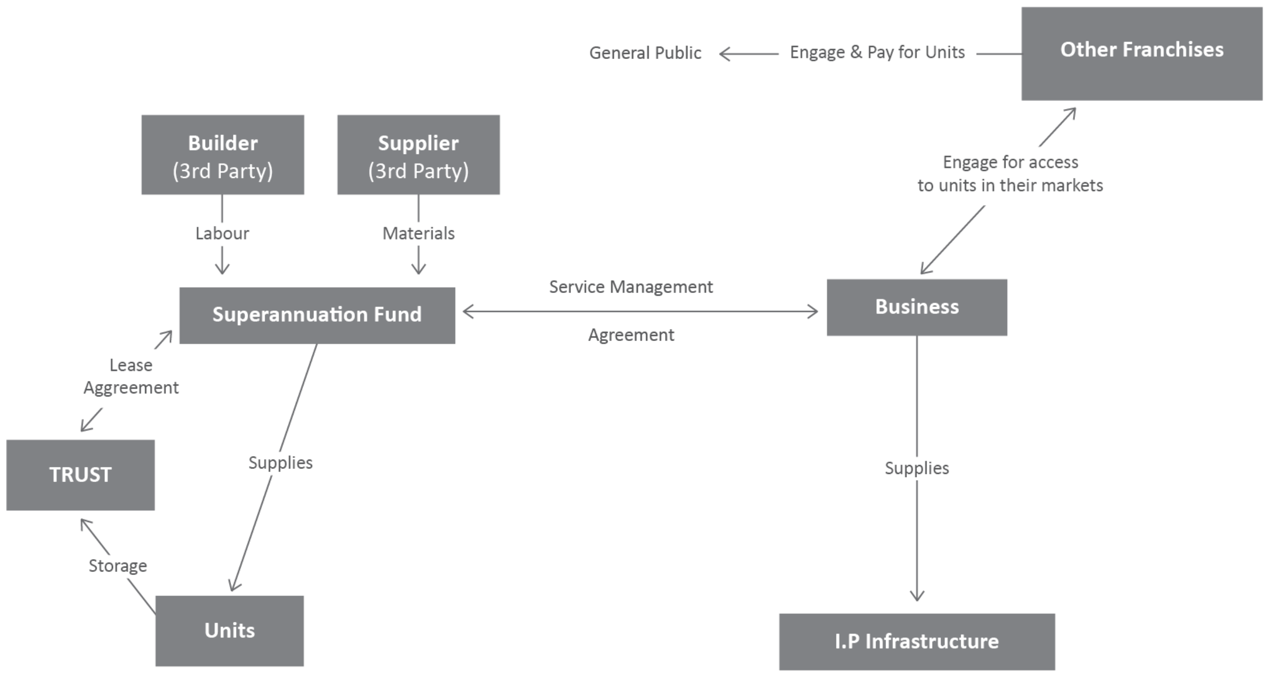
What’s that, Sam asks?

You explain how as Trustee, he must formulate and continually review and update the Funds investment strategy, which is how the Fund will invest to meet the needs of its members (and their beneficiaries).

You explain that the strategy should consider the risk of the investments, the diversity of investments, the liquidity of the investments, as well as the Funds ability to pay its members (or beneficiaries on death), and also consider the insurance needs of its members. With a significant asset addition, and with every investment decision, the trustees should document in writing the reasons, considering these factors.

You discuss with Sam that, particularly with investments like Max’s Trust and this investment, the Trustees should clearly write down why they believe the investment is suitable to the member’s needs, in light of the risks, diversity and liquidity the challenges that these investments pose.

APPENDIX A



Builder – provides the labour to construct the units (and is an unrelated party).

Supplier – will invoice the SMSF directly for materials.

Other Franchisees – may engage your business to provide the units to their customers. General Public – will lease the units from the legal owner (SMSF), however will liaise and engage via the agent – your business.

SFT– Snow Trust will enter into a lease agreement with the SMSF to lease part of its building to the SMSF (allowing storage of any unused units).

Business – enters into a service/management and agency agreement with the SMSF to provide the IP, IT infrastructure, inventory management, debt collection and delivery/collection from the general public (and may engage other agents on its behalf to do so).

Superannuation Fund – is the legal owner of the units. Engages Business to provide a service in an area of its expertise at market rates and with a legal agreement. Engages SFT to lease land to store unused units and also engages third parties to construct the units. Gets paid by the general public for lease of the units via its agent.