

PLANNING AN EXTENDED OVERSEAS STAY? ... IS YOUR FUND STILL A RESIDENT?

The question of whether a fund is a resident superannuation fund is an important one, particularly as it is one of the requirements of being a complying superannuation fund.

A fund which ceases to be a resident/Australian fund will be subject to tax of 45% on the value of the fund's assets (less undeducted or non-concessional contributions). As the Australian Taxation Office (ATO) has no discretion to overlook even minor breaches of the residency test, particular care should always be exercised in this area.

As part of the re-write of the tax legislation governing superannuation there have been some subtle changes to the definition of a resident superannuation fund.

PRIOR TO 1 JULY 2007

Prior to 1 July 2007, to remain a resident fund, a superannuation fund must have met all of the following conditions at all times throughout the year:

- the fund must have either been established in Australia or any asset of the fund was situated in Australia; and
- the central management and control of the fund must have been in Australia; and
- the fund must have passed an active member test.

CENTRAL MANAGEMENT AND CONTROL

As indicated above, one of the tests of residency is central management and control. Prior to 1 July 2007, the central management and control of a fund must have been in Australia for a fund to remain a resident fund.

There is no explanation of the term 'central management and control'. In general, the central management and control of a fund will be where its 'real business' is carried on. If the general day to day management and investment decisions of the fund occur within Australia, it will generally be held that the central management and control of the fund is in Australia. If the trustees (or a majority of the trustees) were physically located overseas, it would be difficult for this central management and control test to be met.

Previously a superannuation fund was exempted from the central management and control test, if the following conditions were met:

- the trustees were temporarily absent from Australia; and
- the central management and control of the fund would have been in Australia if the trustees were not temporarily absent; and
- the trustees had been outside Australia for a continuous period not exceeding two years.

While return visits to Australia could have restarted, the two year window (provided the visit to Australia was for a continuous period of at least 29 days), the trustee's absence from Australia must still have been considered to be of a *temporary* nature.

Trustees which would otherwise fail the central management and control test could adopt a strategy whereby they would resign and appoint as trustee another person who resides in Australia. Funds in this situation would still satisfy the self managed fund definition of SIS provided each member who was not a trustee had given the trustee an enduring power of attorney over their affairs.

ACTIVE MEMBER TEST

In addition to central management and control, funds must have also passed an active member test to remain a resident fund.

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The active member test required that, for funds which had at least one active member, the accumulated entitlements of the resident active members represented at least 50% or more of the total accumulated entitlements of all the active members.

An active member was someone who made contributions to the fund or for whom contributions were made. Note, for this purpose 'contribution' included rollovers into the fund.

A member was regarded as a resident member if they were a resident of Australia for tax purposes. One of the simplest methods of passing this test was to cease all contributions and rollovers to the fund whilst overseas.

POST 30 JUNE 2007

From 1 July 2007, a resident superannuation fund is now referred to as an 'Australian superannuation fund'.

A fund will qualify as being an Australian superannuation fund if it meets the criteria set down in income tax legislation.

While the new drafting is very similar to the previous legislation, there are some noteworthy changes, for example:

- The 'two year temporarily absent rule' has been interlinked with the central management and control test, rather than being an exception to this test. To meet the central management and control test, it is sufficient for the central management and control of the fund to be "ordinarily" in Australia. Legislation states 'to avoid doubt, the central management and control of a superannuation fund is ordinarily in Australia at a time even if that central management and control is *temporarily* outside Australia for a period of not more than 2 years'.
- The ability to restart the two year window with a visit to Australia for a continuous period of at least 29 days has been removed.
- Contributions have not been defined in the rewritten legislation. However, we would still expect rollovers or payments of superannuation guarantee shortfall to cause a member to be regarded as an active member.
- The reworded legislation confirms you do not have to satisfy the active member test if you do not have an active member (ie no contributions or rollovers are made).

If you are uncertain if these regulations could apply to your fund, please call your JR advisor to discuss the extent and nature of your overseas stay.

CALCULATE SUPER USING ORDINARY TIME EARNINGS

From 1 July 2008, you must use ordinary time earnings, as defined in the super guarantee law, to calculate super guarantee contributions for your employees. This ensures all employees are treated the same for super guarantee purposes.

Ordinary time earnings are generally what employees earn for their ordinary hours of work, including:

- over-award payments
- commissions
- shift allowances, and
- paid leave.

ORDINARY TIME EARNINGS DOES NOT INCLUDE OVERTIME

This means from 1 July 2008, you cannot use an earnings base to calculate your super guarantee contributions which is based on:

- an industrial award
- an existing employment agreement

- a fund's trust deed, or
- a law of the Commonwealth, States or Territories.

If an earnings base other than ordinary time earnings is currently being used to calculate superannuation contributions, ordinary time earnings must be used for all eligible employees from 1 July 2008.

Between now and 1 July 2008, employers will have time to adjust to these new employment arrangements and build the increased superannuation contributions into their workplace bargaining processes if they need to.

Until 30 June 2008, some employers can continue to use valid earnings bases contained in industrial awards, existing agreements with employees, fund trust deeds, or some laws. For example, many existing awards or other superannuation arrangements contain an earnings base that is founded on an employee's earnings and meets the requirements of the superannuation guarantee legislation. This new law comes into effect from 1 July 2008.

INVESTMENT IN INSTALMENT WARRANTS BY SUPERANNUATION FUNDS

Recent legislation amendments now allow Superannuation Funds to invest in instalment warrants.

The amendment inserts an exception to the borrowing restriction contained in section 67 of the *Superannuation Industry (Supervision) Act 1993*. This will allow superannuation funds to invest in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly.

It also inserts a new provision in the in-house asset rules contained in section 71 of the *Superannuation Industry (Supervision) Act 1993*. This will provide that an investment in a related trust forming part of an instalment warrant arrangement which meets the requirements of the borrowing exception will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.

Over a number of years instalment warrants have been marketed to superannuation funds, particularly self-managed superannuation funds. Instalment warrants are a derivative-based investment product, in that they derive their value from the underlying asset. Traditionally, such arrangements provide the investor with the right, but not the obligation, to buy the underlying asset through the payment of instalments. Investors in instalment warrants have a beneficial interest in the underlying asset, subject to a security interest held by the issuer that secures the payment

of later instalments. Once the investor has made the first instalment they are likely to be entitled to income from the underlying asset (eg. dividends from shares or rental income from property).

Funds that invest in instalment warrants must continue to comply with other legislative requirements. Furthermore, fund trustees are still required to demonstrate the appropriateness of including instalment warrants in their investment strategy.

The exception of the prohibition on borrowing in section 67 of the *Superannuation Industry (Supervision) Act 1993* will allow a superannuation fund trustee to borrow money in accordance with an arrangement that has the following features:

- the borrowing is used to acquire an asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right to acquire the legal ownership of the asset (or any replacement) through the payment of instalments;
- the lender's recourse against the superannuation fund trustee in the event of default on the borrowing and related fees, or the exercise of rights by the fund trustee, is limited to rights relating to the asset; and
- the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly.

MORTGAGE VERSUS SUPER

Following the announcement of the changes to superannuation, debates began to arise over whether paying off the home mortgage before investing in other assets was still the best strategy. While many acknowledged the potential benefits of investing in super before paying off the home mortgage, the general consensus was that the strategy would only work for a certain group of people, and that it wasn't without its risks. The people most likely to benefit from this strategy are those in the higher tax brackets, who are very close to retirement. This minimises legislation risk, as well as the risk that the money will be locked in super if it is urgently needed. The rule of thumb is that the after-tax rate of return on the investment in super must be equal to or greater than the interest cost of

the debt in order to justify the investment. Meanwhile, paying off the mortgage offers a guaranteed return.

WHO WILL IT WORK FOR?

Because of the variability of many factors involved in making the salary sacrifice strategy work, it may be best used over shorter timeframes, where there may be reasonable certainty about the legislative and tax environment. Therefore it could be a suitable strategy for pre-retirees, particularly those on high or middle income tax brackets – and the higher the tax bracket, the greater the benefit.

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For those who still have 15 or 20 years to retirement, there may be too much uncertainty about continuing conditions to consider this strategy, and it may not be practical to tie up capital in super so early.

EXAMPLE: DR CAMERON TO CONTRIBUTE TO HOME MORTGAGE DEBT OR CONTRIBUTE TO SUPER

Assumptions

- Dr Cameron 56 years old
- Tax Rate: 46.5%
- Mortgage: \$300,000
- Interest rate: 7.5% pa
- Average Return Super: 7.3%

If Dr Cameron uses her pre-tax surplus savings of \$50,000 pa to contribute to her mortgage it will amount to a \$23,250 repayment (taking into account her marginal tax rate of 46.5%). At this rate of repayment, Dr Cameron will pay off an extra \$116,250 from her home mortgage over 5 years.

However, if Dr Cameron salary sacrificed the extra income into superannuation, it will amount to a \$42,500 contribution pa (taking into account the contributions tax rate of 15%). At this rate, over the same five year period, the super fund investment would be \$263,800.

The mortgage, at the end of this five year period (without extra repayments), would still have an amount of approx \$178,000 owing. Assuming Susan meets a superannuation condition of release, the mortgage could be repaid using the super balance, with a surplus of \$85,800.

WHEN DOES THE STRATEGY WORK BEST?

This strategy is at its best when the differential between personal income and superannuation tax rates are at their greatest. Hence an individual on the highest tax rate will reap the greatest benefit, yet it has application for others too.

One of the critical factors in making these strategies successful is the gap between the interest rate being paid on the mortgage and the net return from superannuation investments. For an individual on the highest marginal rate, this gap would almost need to be doubled before the advantages of such a strategy become negligible. However, if this differential is not sufficient, or cannot be sustained throughout the period the strategy is in place, further consideration is required before adopting such a strategy. Considerations include:

- Superannuation rate of return must exceed the interest on home mortgage. (A capital stable superannuation investment strategy or a period of negative returns may erode the benefit of this strategy).
- Cashflow Requirements – the contributions to super will be preserved and cannot be accessed until attaining age 55, retiring or attaining age 65.
- Legislative Risk – superannuation rules could change before you can access the benefits or personal tax rates maybe further reduced and the benefit of the strategy is diluted.

Please call your JR Accountant if you would like to determine if this strategy has relevance to your circumstances.

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