SMSF Investment Rules

Summary

The Superannuation Industry (Supervision) Act (SIS Act) places a number of investment restrictions on the trustees of superannuation funds. Non-compliance with these rules is a breach of SIS law and may result in significant penalties to both the trustees and the fund. This flyer provides a brief summary of the 7 basic tests for investment by a self-managed superannuation fund (SMSF).

7 basic tests for investment

There are 7 basic investment rules that trustees of self-managed super funds must adhere to at all times. These are:

1. Sole purpose test
2. Investment strategy
3. Arm's length transactions
4. Loans and financial assistance
5. Acquisitions from related parties
6. In-house assets
7. Borrowing

1. Sole purpose test

Generally a member's superannuation benefits must be maintained for one or more core purposes or for at least one core purpose and one or more ancillary purposes. A superannuation fund cannot be maintained only for one or more ancillary purposes.

Core purposes

The core purposes are provision of benefits for:

- each fund member on retirement or upon reaching age 65; and
- the fund member's legal personal representative or dependants upon the death of a member, provided the death occurred before turning age 65.

Ancillary purposes

The ancillary purposes are provision of benefits for:

- each member on termination of employment
- each member on ceasing work due to permanent or temporary incapacity
- the fund member's legal personal representative or dependants upon the death of a member, where the death occurred after turning age 65.

The sole purpose test is broad enough to allow funds to develop features, which add value to their fund members in accordance with their individual needs.

The ATO have provided guidance on the sole purpose test in SMSF ruling SMSFR 2008/2. Accordingly, trustees should ensure:

- Dealings are in keeping with fund's investment strategy
- Dealings are in the SMSF's best interests
- Dealings are at arm's length
- No purposeful benefit to the members or related parties when undertaking SMSF activities

The more tenuous the link between a fund's activities and the core and ancillary purposes, the greater the chance of breaching the sole purpose test.

2. Investment strategy

Trustees of a SMSF must formulate an investment strategy for the fund. The investment strategy sets out the guidelines for all future investments by the fund.

When preparing an investment strategy the trustee must have regard to the whole circumstances of fund and consider the following:

- Risk & return
- Diversification
- Liquidity
- Ability of the fund to discharge liabilities
- Objectives of each member
- Separate strategy to manage fund reserves
- Include insurance coverage
- Review investment strategy

3. Arm's length transactions

All investment transactions must be made on an arm's length commercial basis. This does not mean that trustees of SMSFs cannot enter into transactions with related parties where permitted. It simply means that the terms of the transactions must be on an arm's length basis or no more favourable to the other party.

Considerations as to whether a transaction has been conducted on an arm's length basis may include:

- The purchase price is at market value
- The expected return is at market value (e.g. rental income)
- Professional valuations obtained
- Terms and conditions of contracts are consistent with commercial equivalents

Example

Jim wants to use his SMSF to purchase the commercial property that his brother owns and then lease the use of the premises to his brother's business. To ensure the transaction is completed on an arm's length basis, Jim obtains a professional valuation of the property and ensures that the rental income and terms and conditions of the lease agreement is consistent with that available on the open market.

4. Loans and financial assistance

An SMSF trustee cannot use the resources of the fund to loan money or provide financial assistance to a member or relative of a member.

Financial assistance includes:

- Non-arm's length dealings with a related party
- Loans
- Provision of a guarantee
- Forgiveness of a debt

5. Acquisition of assets from related parties

An SMSF trustee is prohibited from intentionally acquiring an asset from a related party of the fund. There are a number of exceptions to the general rule and these include the acquisition of:

- Business real property acquired at market value
- Listed securities acquired at market value
- In-house assets acquired at market value where the acquisition of the asset would not result in the level of in-house assets in the fund exceeding 5% of the fund's assets
- A life insurance policy (other than a policy acquired from a member or relative)
- Units in a widely held unit trust

6. In-house assets test

An in-house asset of a superannuation fund is:

- a loan to, or an investment in, a related party of the fund
- an investment in a related trust
- an asset of the fund subject to a lease or lease arrangement between the trustee of the fund and a related party

It does not include:

- a life insurance policy issued by a life insurance company (other than a policy acquired from a member of the fund or from a relative of a member)
- a deposit with a bank or building society
- an investment in a widely held unit trust

7. General prohibition on borrowing

A superannuation fund is generally prohibited from borrowing, other than:

- To make benefit payments or to pay a surcharge liability. It is limited to maximum value of 10% of fund assets and for a maximum period of 90 days
- To settle a securities transaction. It is limited to a maximum value of 10% of fund assets and for a maximum period of 7 days
- Limited recourse borrowing arrangements.