

THE PAINFUL TRUTH ABOUT THE SUPERFUND RESIDENCY RULES

This article outlines the three (3) elements that are required to satisfy the superfund residency test.

To enjoy the significant tax concessions available to complying superannuation funds, a self managed super fund (SMSF) must, amongst other things, satisfy the definition of Australian superannuation fund in subsection 295-95(2) of the Income Tax Assessment Act 1997 (Cth) (ITAA97). Late last year, the Australian Taxation Office published Taxation Ruling TR 2008/9, a 57 page document setting out its interpretation of that definition.

In this article, experienced superannuation lawyer, Ian Waters examines the three elements of the residency test that must be satisfied for a fund to be an Australian superannuation fund and the potentially draconian tax consequences of failing to satisfy any one of them.

The residency test

Subsection 295-95(2) of the ITAA97 provides that a fund is an Australian superannuation fund at a particular time, and for the income year in which that time occurs, if:

1. it was established in Australia, or any asset of the fund is situated in Australia; and
2. the central management and control of the fund is ordinarily in Australia; and
3. the fund satisfies the active members test.

For a fund to satisfy the definition, it must satisfy all three elements of the residency test at the same time.

While the ATO has acknowledged that, if a fund satisfies all three elements of the test simultaneously at any time during an income year, it will be an Australian superannuation fund for the entire income year, note well that it is of the view that to enjoy the significant tax concessions available to complying super funds in a particular income year, a fund must satisfy all of the elements of the residency test at all times throughout that year. (Refer TR 2008/9, paras 11 & 88-92)

First element – fund established or asset situated in Australia

Fund established in Australia

The ATO has indicated that a super fund is established in Australia if the initial contribution made to establish the fund is paid to and accepted by the trustee of the fund in Australia and that it is not necessary for the trust deed to be executed in Australia.

This requirement is a once and for all requirement, ie once it has been satisfied, the first element of the residency test will be satisfied at all times, irrespective of whether or not any asset of the fund is situated in Australia. (TR 2008/9, paras 13 & 14)

Asset situated in Australia

If a super fund was not established in Australia, it will still satisfy the first element of the residency test at

a particular time if at least one asset of the fund is situated in Australia at that time.

The location of an asset is determined by reference to the type of asset and the common law rules established by the courts for determining the location of assets of that kind, eg land is situated in the place where the land lies, shares are likely to be situated at the place where the share register is kept and bank accounts are deemed to be situated where the bank resides.

In a nutshell: If a fund that was not established in Australia does not have an asset in Australia at a particular time, it will not satisfy the first element of the residency test and the fund will not be an Australian superannuation fund at that time. (TR 2008/9, paras 15-17 & 105)

Second element – central management and control

According to the ATO, the central management and control (CM&C) of a super fund involves a focus on the who, when and where of the strategic and high level decision-making processes and activities of the fund, including formulating, reviewing, updating and varying the investment strategy for the fund and monitoring and reviewing the performance of the fund's investments.

The areas of operation of a super fund that form part of the day-to-day or operational side of the fund's activities, including the acceptance

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of regular contributions, the actual investment of the fund's assets (eg by an investment manager), administrative duties and the preservation, payment and portability of benefits, do not constitute CM&C, because they are of a more formalistic or administrative rather than strategic or high level nature. (TR 2008/9, paras 20 & 21)

Who exercises the CM&C?

While the trustee of a fund has the legal responsibility to exercise the CM&C, the mere duty to exercise CM&C does not, of itself, constitute CM&C. The trustee will only be exercising the CM&C of a fund if it, in fact, performs the high level duties and activities of the fund in practice and there may be situations where a person other than the trustee exercises the CM&C, eg where the trustee has delegated its duties and powers to a person who, independently and without any influence from the trustee, performs the duties and activities that constitute the CM&C of the fund. (TR 2008/9, paras 22-24)

Where is the CM&C exercised?

The ATO accepts that the CM&C of a fund is ordinarily in Australia if the fund's strategic decisions are regularly made, and high level duties and activities are performed, in Australia (regardless of where the persons exercising the CM&C of the fund reside). (TR 2008/9, para 27)

When is the CM&C ordinarily in Australia?

According to the ATO, whether the CM&C of a fund is ordinarily in Australia at a particular time involves determining whether the CM&C of the fund is regularly,

usually or customarily exercised in Australia and there must be some element of continuity or permanence.

Temporary absences: While the legislation provides that the temporary exercise of the CM&C of a fund outside Australia for a period of not more than two years will not prevent the CM&C being ordinarily in Australia at a particular time, the CM&C can be outside Australia for a period greater than two years if the period of absence is still temporary and conversely, if the CM&C of the fund is permanently outside Australia, it will not ordinarily be in Australia at a time even if the period of absence is two years or less.

The CM&C of a fund will be temporarily outside Australia if the person or persons who exercise the CM&C of the fund are outside Australia for a relatively short period of time and during that time they exercise the CM&C of the fund overseas. To satisfy the temporarily requirement, the duration of the absence must either be defined in advance or related (both in intention and fact) to the fulfilment of a specific, passing purpose.

Division of CM&C: Where there is an equal number of individual trustees or directors of a corporate trustee located in Australia and overseas and each of those trustees/directors substantially and actively participates in the exercise of the CM&C from those locations, the ATO accepts that the CM&C of the fund is ordinarily in Australia, despite the fact that the CM&C of the fund is also ordinarily being exercised overseas. (ITAA97, s 295-95(4) & TR 2008/9, paras 28-35)

Third element – active members

A fund will satisfy the active members element of the residency test at a particular time, and for the income year in which that time occurs, if either the fund has no active members or has active members who are Australian residents holding at least 50% of:

- the total market value of the fund's assets attributable to super interests held by active members; or
- the sum of the amounts that would be payable to or in respect of active members if they voluntarily ceased to be members.

A member will be an active member of a super fund at a particular time if they are a contributor to the fund or contributions to the fund have been made on their behalf.

However, a member will not be an active member at a particular time if contributions have been made on their behalf and:

- they are a foreign resident;
- they are not a contributor at that time; and
- the contributions made on their behalf after they became a foreign resident were made in respect of a time when they were an Australian resident. (ITAA97, s 295-95(3))

Contributors: According to the ATO, whether a member of a super fund is a contributor to the fund at a particular time is to be objectively determined having particular regard to the member's intention, established by reference to objective evidence, eg the member may intend to and actually make personal

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contributions on a regular or periodic basis. In such a situation, the member would be a contributor, not only at the actual point in time a contribution is made, but also for the period of time between the making of contributions.

If it is established on the facts that a member who had been making contributions to the fund over a period of time intends to and in fact ceases to make any further contributions, then the member would no longer be a contributor from the time they formed that intention. Conversely, if that member later intends to and actually makes further contributions, then their status as a contributor will be reinstated. (TR2008/9, paras 186-188)

In a nutshell: The active members element of the residency test should be monitored carefully to make sure that if there are any active members, the 50% accumulated entitlement requirement is met. Conversely, if the fund does not have an active member at a particular time, the 50% requirement is not applicable and the fund will be an Australian superannuation fund at that time if the first two elements of the residency test are met.

The painful truth

A fund that ceases to be a complying super fund in a particular year of income because it fails to satisfy the definition of Australian superannuation fund faces potentially draconian taxation consequences, ie in the income year that it becomes non-complying, the fund must include in its assessable income an amount equal to the total market value of its assets (as

calculated just before the start of the income year), less any contributions it has received that are not part of the taxable income of the fund. This amount will be taxed at the highest marginal rate.

Furthermore, the fund is not eligible for the tax concessions available to a complying superannuation fund, eg for every income year that the fund remains non-complying, its income will be taxed at the highest marginal rate. (TR2008/9, paras 199-200)

Finally, if a super fund that has lost its Australian superannuation fund status later regains it, it will take another hit in the year in which it regains its Australian superannuation fund status, because it must include in its assessable income in that year its net income in respect of previous years (ie asset values less member contributions).

Conclusion

To enjoy the significant tax concessions available to complying superannuation funds, an SMSF must, amongst other things, satisfy the three elements of the residency test.

While, if a fund satisfies all of the elements of the test simultaneously at any time during an income year, it will be an Australian superannuation fund for the entire year, the fact that all three elements of the test have to be satisfied at the same time and the potentially draconian tax consequences of failing to satisfy any element of the test at any time mean that if SMSF trustees/members are heading overseas, either temporarily (for an extended period of time) or permanently, it would seem prudent for them to seek professional advice

before they go to ensure that the Australian superannuation fund status of their fund will be maintained at all times while they are away and/or they give themselves the opportunity to restructure their superannuation arrangements before they go.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

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