Topic 1: Strategies for self managed super funds (SMSFs)

Instalments have special appeal for superannuation funds.

Under the Superannuation Industry Supervision Act 1993, trustees of super funds are not permitted to borrow to invest. This restriction means the possibilities for geared exposure of SMSFs are limited. However, instalments are eligible for use in SMSFs.

Since the final payment is generally optional, instalments are not usually seen to create a charge over a super fund's assets for the purpose of the act.

Another attraction is the possibility of enhanced after tax returns including franking credits. Since super funds are taxed at 15%, and the franking rate that applies to franked dividends is usually 30%, franking credits are especially valuable. They can be used to offset tax on the fund's additional income and tax payable on contributions to the fund.

You should always consult a licensed financial advisor, such as your accountant or taxation advisor, before making any superannuation investment decisions. Also, visit the ATO website.

Example

Assume you have a SMSF and are considering investing $20,000 in XYZ shares, currently trading at $25.00. For $20,000, you could buy 800 shares.

Alternatively, you could buy 800 XYZ instalments with the following specifications:

- Final payment: $10.00
- Instalment price: $16.45
- Funding cost: $1.45

XYZ is forecast to pay dividends of $1.60 over the next 12 months, fully franked at the company tax rate of 30%.

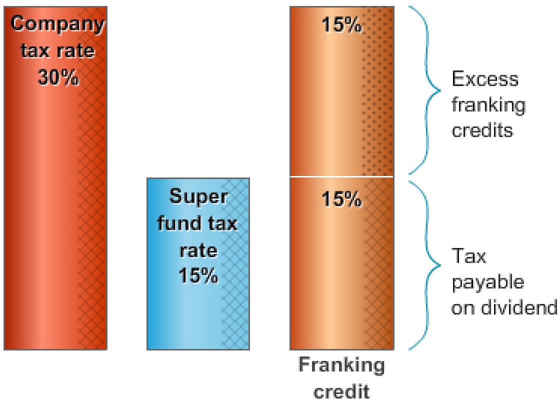
Your SMSF buys the instalments on 1 July, and holds them for a full financial year.

The table opposite compares the dividend yield from the instalments with the yield from the shares. While the dollar amount received is the same for the two investments, the instalments produce the higher yield, due to

The franking credit from a fully franked dividend...

may cover the tax payable on the dividend...

and leave excess franking credits to use against other income or contributions to the fund.



The net income, including franking credits, is the same for shares and instalments.

	XYZ Shares	XYZ Instalments
Number of shares / instalments	800	800
Unit price	$25	$16.45
Capital invested	$20,000	$13,160
Dividend	$1,280	$1,280
Dividend yield (%)	6.4%	9.7%
Franking credits	$548.57	$548.57
Net income (dividends + franking credits)	$1,828.57	$1,828.57

the lower outlay on 800 instalments compared to 800 shares.

Your SMSF may be able to claim a tax deduction for the interest/fee component up to an amount determined by the ATO.

This is an area of change, so advice from your licensed financial advisor or the ATO is recommended.

Continuing our example

Your SMSF has tax payable, but has franking credits of $548.57. Whether the fund has invested in shares or in instalments, there will be excess franking credits.

With instalments, after paying tax of $100.29, there are excess credits of $448.28.

These credits may be applied against tax on other income the fund earns, or against tax on contributions to the fund.

Excess credits have created an 'earnings offset'. The offset is the additional income that could be generated without needing to make additional tax payments, the additional income that, if taxed at 15%, would result in a tax liability of $448.28.

In this example, the excess franking credits of $448.28 create an earnings shelter of $2,988.53.

	XYZ Shares	XYZ Instalments
Tax payable @ 15%	$274.29	$100.29
Franking credits available	$548.57	$548.57
Excess franking credits	$274.28	$448.28
Earnings shelter	$1,828.53	$2,988.53

$2,988.53 of extra income could be earnt before the tax liability would exceed the available excess franking credits.

Summary

The difference between the 15% tax on earnings of super funds, and the company tax rate of 30%, makes fully franked income especially valuable to super funds.

Imputation credits attached to fully franked dividends will exceed the tax payable on those dividends.

These can be used to reduce tax on the fund's other income, or on contributions into the fund.

Deducting the funding cost component of the instalment reduces the net taxable income, further increasing the excess franking credits.

Taxation and superannuation rules are constantly under review, so you should consult your licensed financial advisor and the warrant issuer before implementing this strategy.

...which can be used to offset additional income or contributions to the fund.

	XYZ Shares	XYZ Instalments
Net income	$1,828.57	$1,828.57
Prepaid interest	–	($1,160)
Taxable net income	$1,828.57	$668.57
Tax payable @ 15%	$274.29	$100.29
Excess franking credits	$274.28	$448.28
Earnings offset	$1,828.53	$2,988.53

Methods of purchase

There are restrictions on the methods by which super funds can buy instalments.

Purchase by cash application or rollover application direct from the issuer is permitted, as is the purchase of instalments on ASX.

However, the acquisition by super funds of instalments by shareholder application (the 'cash extraction strategy') is not allowed, as it is deemed to create a charge over the fund's assets.