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Understanding SMSF Expenses

SMSFs inevitably incur expenses during their operating life. It is important to understand that of the expenses incurred, not all are able to be claimed as a deduction in the annual tax return. Some expenses may be incurred as a capital outlay or may not be fully deductible under the Income Tax Assessment Act 1997. Others may be determined by the Superannuation Industry (Supervision) Act 1993 and Superannuation Industry (Supervision) Regulations 1994 and need special attention to determine where they should be paid from, such as administration penalties.

It is in the best interest of members and trustees alike that an SMSF only incur expenses that relate to the operations of the fund. This fact sheet will highlight some of the general requirements for expenses, the common deductible expenses, capital expenditure, non-deductible expenses and other issues that may arise in relation to expenses in an SMSF.

General requirements for expenses

To determine the appropriateness for an SMSF to pay for an expense it's important to consider the expense in light of the fund's investment strategy, whether the expense is allowable under the trust deed plus the relevant tax and super laws as noted above.

SMSFs must comply with the sole purpose test i.e. that a fund is established and run solely to provide benefits to the members upon retirement or attaining age 65, or to pay benefits to the member's beneficiaries should they pass away prior to these events. There are of course other conditions upon which a benefit can be paid, these conditions are considered ancillary to the primary purpose. Therefore, all decisions made regarding an SMSF must be made in contemplation of the sole purpose test. Where an expense is not in line with the objectives of the sole purpose test, it is not likely to be deductible for tax purposes.

Given that it is a requirement under superannuation law that trustees keep personal assets separate from fund assets, it is important that expenses be in the name of the fund and paid from the SMSF bank account. Any invoices or receipts should be addressed to the fund and paid by the fund; and retained as required for record keeping purposes for at least 5 years from lodgement. Failure to comply with the general requirements may see the fund miss out on important tax deductions.

Expenses that do not relate to the operations of the fund should not be paid by the SMSF, including personal and business expenses or donations. If an expense has any element of personal use it should not be paid from the SMSF and any pro-rata expenses, based on the SMSF's share of an investment, should clearly indicate the proportion payable by the fund.

Reimbursement of expenses

All SMSF expenses should be paid from the fund's bank account. However, situations arise where expenses can be incurred by the fund that are subsequently paid by the members personally, or an employer. When fund expenses are paid in this manner, the trustees should seek to reimburse the payer immediately, alternatively they may be able to treat these payments as contributions, subject to the contribution caps. Once reimbursed, these expenses are still tax deductible where allowed under the Income Tax Assessment Act 1997. It should be noted that paying expenses personally, or not making provisions for expenses could result in an SMSF paying tax at the highest marginal rate under the non-arm's length income rules.

Tax deductible SMSF expenses

Where an expense is incurred in the operations of the SMSF, invoiced to the SMSF and paid appropriately, it is necessary to next determine whether it is a deductible expense. Generally, expenses are claimed in the financial year in which they are incurred except for deductions for the decline in certain depreciating assets which are deducted over the effective life of the asset.

The deductibility of an expense is determined under section 8-1 of the Income Tax Assessment Act 1997 unless there is a more specific deduction provision in the law that is relevant. Expenses are normally deductible under the general deduction provision where they are incurred in gaining or producing assessable income for the SMSF.

Where an SMSF has retirement phase (pension) accounts and accumulation accounts there may be a need to apportion expenses to determine the deductible component. For more information about apportionment see our fact sheet 'Apportioning SMSF expenses'.

An SMSF cannot deduct a loss or outgoing incurred where it is:

- Of a capital nature
- Of a private or domestic nature
- Incurred in relation to gaining or producing non-assessable income (such as exempt current pension income)
- Prevented from being claimed under income tax laws

The most common categories of deductible SMSF expenditure are as follows:

- Operating expenses
    - Management and administration fees
    - Audit fees
    - ASIC annual fees

- Investment related expenses
    - Interest expense
    - Investment adviser fees for ongoing management (not for new financial plans)
    - Rental property expenses – including but not limited to agent fees, repairs and maintenance, depreciation. It should be noted that travel expenses to inspect residential property are no longer deductible since 1 July 2018
    - Other investment related expenses such as subscriptions/seminars/newsletters – these expenses are deductible to the extent that they relate to the running of the fund. For example, investment subscriptions, superannuation trustee seminars, or superannuation and investment newsletters. However, tax advice should be requested with these types of expenses and the expense may not be in the best interest of the fund as there may be a personal benefit to these subscriptions etc.

- Tax related expenses
    - Preparation and lodgement of the SMSF annual return and preparation of the financial statements
    - Actuarial costs

- Legal expenses – including trust deed amendment fees (if the amendments are required to ensure the fund remains compliant)

- Insurance premiums – A deduction is available in relation to premiums paid that provided for the following types of death/disability benefits:
    - Super death benefits
    - Terminal medical condition benefits
    - Disability super benefits
    - Temporary incapacity benefits

- Collectables and artworks
    - Insurance costs
    - Storage costs

- Statutory fees and levies – including the ATO supervisory levy

Capital expenditure

As stated previously, under the general deduction provision of section 8-1 of the Income Tax Assessment Act 1997, a deduction is not allowable for expenditure of a capital nature. A capital outlay is treated as an asset of the fund, and tax deductions may be allowable if the asset is a depreciable asset. For example, purchasing a new air conditioner for an investment property is a depreciable asset, and depreciation can be claimed over the effective life of the asset.

Conversely, legal fees incurred in setting up the initial trust deed are capital in nature but cannot be depreciated over time. These purchases differ from ongoing operating expenses as they are often for larger sums of money, and are for the purchase of a good, rather than a service.

Non-deductible and excluded expenses

Some expenses are not tax deductible for SMSFs, including fines for non-compliance or other breaches of the law. These fines are levied upon the trustees or directors and must not be paid or reimbursed from the SMSF assets.

Some expenses are specifically excluded by the law and cannot be paid by the SMSF such as, remuneration for trustees or directors for undertaking their role as trustee. Remuneration for trustees could be considered as providing financial assistance to members or relatives of the fund, which is prohibited. Engaging in such conduct may result in penalties being imposed on the fund, trustees and/or directors if there is a corporate trustee.

There may also be instances where you choose specifically not to claim a deduction where it may otherwise be allowable. This may be the case for life insurance premiums. Under s295-460 of the Income Tax Assessment Act 1997, the premiums are deductible as there is a link between the premiums and a contingent liability to pay a benefit. Where a tax deduction has been claimed (or will be) for premiums, and life insurance proceeds are received upon death, there is a requirement to calculate an untaxed element of the death benefit and there may be an additional tax liability where a lump sum death benefit is paid to a non-tax dependant. This effectively ensures tax is paid on the insurance proceeds component of the death benefit.

A further issue arises where a member holds accumulation and pension balances in the SMSF and is paying insurance premiums. It is important that the trustees are notified which member specific account to deduct insurance premiums from as this will impact the death benefit payment to beneficiaries. Where the member insurance premiums are deducted from is where any insurance proceeds will be allocated upon receipt.

Insurance proceeds received to a pension account may be included in reversionary pensions, without impacting the reversionary beneficiary's Transfer Balance Cap (TBC). This is because the credit to the transfer balance account is based on the balance of the pension at the date of death and is credited to the recipient's transfer balance account 12 months later. The insurance proceeds are normally paid after that balance is determined so it is included in the pension balance without impacting the recipient's TBC. However, if the insurance proceeds are paid into the accumulation account or a non-reversionary pension account, it may have TBC implications and need to be withdrawn from the superannuation system.

An estate planning lawyer should be engaged to confirm the best treatment for individual circumstances.

Excessive expenses

SMSF expenses should not be excessive in amount. If payments appear to be unusually excessive, then it will most likely be flagged by the auditors or the ATO. Ensure that expenses are incurred at a reasonable market value. If you would not pay a comparable amount for services received personally, then it is likely to be considered excessive.

Non-Arm's Length Expenses (NALE)

As alluded to above, from 1 July 2018, if an SMSF incurs less than commercial expenses (including nil expenses) and a nexus exists between the expenses and fund income; that income could be non-arm's length income (NALI) and taxed at the highest marginal tax rate.

An amount of ordinary or statutory income is NALI if the parties to a scheme are not dealing with each other at arm's length in relation to the scheme. This can be the case if the amount of income received is more than what would have been received if dealing at arm's length or it can relate to the expenditure involved. Where the loss, outgoing or expenditure is less than what would have been incurred OR there was no loss, outgoing or expenditure incurred compared to what you would expect when the parties were dealing at arm's length, NALE arises.

For NALE to be an issue there must be a connection between the expenditure and the ordinary or statutory income of the SMSF. The expenditure can be of a revenue or capital nature. Where expenditure can be linked to specific income, then that income will be taxed as NALI at the highest marginal tax rate. In contrast where the expenditure is of a general nature with a sufficient connection to ALL of the ordinary and statutory income of the SMSF, then all income of the fund will be taxed as NALI at the highest marginal tax rate. Refer to our fact sheet on 'Non-Arm's Length Expenditure (NALE)' for a more detailed explanation of how NALE can arise together with some examples.

As you can see there is a lot to consider in ensuring that an SMSF is paying for valid expenses, whether they are deductible or not, and ensuring they are reasonable and don't create any compliance issues for the fund. Where an expense appears to be personal in nature, excessive or less than commercial; then the auditors are more than likely to give it some attention.