15 TAX & INVESTMENT MISTAKES *for* SMSF DIRECT SHARE INVESTORS

to avoid

Before you get started

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Letter from Wealth Today

Dear Reader

WELCOME TO WEALTH TODAY

Wealth Today was built specifically to facilitate the integration of financial planning into existing appropriate businesses and to provide sound individual financial advice to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of Members who share our vision and commitment to providing tailored financial advice and building a new foundation of financial understanding and security for everyone.

With a national network of like minded experts, we have the potential to provide the financial building blocks for future generations.

KNOWLEDGE GIVES YOU A HUGE ADVANTAGE

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of eBooks that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this eBook and find it informative and professionally presented. Of course your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

TAKE THE NEXT STEP

We invite you to meet with one of our authorised representative to discuss what it was you were hoping to achieve when you downloaded this eBook and to establish if they can help you achieve your goals and objectives.

At the rear of this book you will find the details on how to book an appointment with one of our experts.

We look forward to meeting you soon.

Wealth Today

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Introduction

More Australians are realising that directing their retirement funds towards a Self-Managed Super Fund (SMSF) can be an efficient and potentially beneficial way to maximise their retirement assets. The SMSF sector is, therefore, the fastest growing part of the Australian Superannuation environment. An SMSF can invest in a wide range of assets as long as the 'sole purpose test' is met (i.e. fund activities must be for the sole purpose of providing a retirement benefit).

Including a mix of asset classes in a fund will not only lead to the protection offered by a diversified investment portfolio but can also yield significant investment returns if such assets are chosen wisely.

One such area of diversified investment is, of course, direct shares. Investing in shares is often perceived as complicated and risky. This need not be the case.

The purpose of this eBook is to discuss some of the mistakes that are commonly made by SMSF trustees when they invest in shares directly. By reading this eBook you will hopefully get a better idea of what is involved with this type of investment and of some mistakes to avoid if you do decide to go down this particular investment route with your SMSF.

Mistake #1 – Not updating your SMSF investment strategy

It is an absolute requirement (laid down by the ATO) that every SMSF should have a formal investment strategy. This document (and it has to be in writing) sets out the investment objectives of the fund and stipulates the kind of investments that the fund can make. Your strategy has to be reviewed regularly. Best practise is to review your strategy at least annually.

If you make new types of investments without this being specified in the investment strategy you could run into audit difficulties. Drawing up, or amending, an investment strategy needs to be done with care and it is recommended that you engage the services of a professional adviser to assist you in this area.

The purpose of an investment strategy is to outline the plan that will be followed to achieve the investment objectives.

Trustees must consider:

- Risk and return
- Liquidity
- Diversification
- Liabilities
- Insurance

Mistake #2 - Not understanding the '45 Day Rule' for franking credits

Australia operates a 'Dividend Imputation System' where some of the tax already paid by companies (in the form of company tax) can be 'imputed' (attributed) to shareholders in the form of a tax credit (known as 'franking credits') when a dividend is paid. In practice this means that if you receive any franked dividends on Australian shares, the 30% prepaid tax on the dividends can be offset against tax payable by your SMSF.

Making use of franking credits is a very sensible way of avoiding 'double taxation' and of lowering the cost to the investor of investing in shares. There is, however, a significant limitation that will always have to be borne in mind when considering share investments in your SMSF. If you are very active in trading the shares in your SMSF's portfolio you could easily fall foul of the '45 Day Rule' (also known as the 'Holding Period Rule').

The '45 Day Rule' (90 days for certain preference shares) simply states that you have to own the shares for a continuous periods of 45 days (excluding the purchase and sale days) before a franking credit will be issued. Shares have to be 'at risk' during this period. 'At risk' means that the shares should have exposure to the open market (this is interpreted by ATO as not having more than 70% of total exposure protected by hedging). Defining 'at risk' positions can obviously be quite complex and you would do well to consult a professional if you are in doubt in this area but the bottom line is that it can be quite risky to buy and sell shares too quickly. In terms of this rule a very quick sale could, in fact, land you with a significant tax bill (as you may lose out on franking credits). The easiest way to avoid this is to make absolutely sure that all shares held within your SMSF are held in compliance with the Holding Period Rule.

Mistake #3 - Not understanding how CGT works in an SMSF

Investors should realise that SMSFs are not somehow exempt from Capital Gains Tax (CGT). SMSF trustees should therefore carefully investigate the possible effects of this tax on transactions.

A major consideration in this regard will be whether the fund is in the 'pension phase' or if it is not paying out any pension entitlements (i.e. the accumulation phase). The following tax rules apply in the different phases:

		Accumulation Phase	Pension Phase
Earning Tax		15%	0%
Tax on Capital Gains	Asset held less than 12 months before sale	15%	0%
	Asset held 12 months or more before sale	10%	0%

It should be clear from the above that waiting (either for 12 months to elapse or for the commencement of the pension phase) can sometimes make a significant difference in terms of tax payable.

Mistake #4 – Attempting to 'wash' losses

'Wash sales' refer to the selling of badly performing shares to create a tax loss and then buying them again soon after. This practice is seen as tax avoidance by the ATO (since the loss can be used to reduce tax payable) and it is therefore the subject of strict punitive measures to discourage it.

ATO monitors the share markets and also share sales near to the end of the financial year. If they believe that 'wash sales' occurred the investors in question can be hit with penalty fines. The best way to avoid even the hint of suspicion in this regard is to carefully record the rationale behind all investment decisions and to steer clear of any re-purchase decision that could be interpreted as 'washing'.

Mistake #5 - Not taking advantage of carried forward losses

A tax loss can occur inside an SMSF when the total deductions for a financial year exceed the fund's assessable income and net exempt current pension for that year. Such tax losses can be carried over to the next financial year to offset future tax liabilities.

It is important to distinguish between capital losses and tax losses. A capital loss can only be offset against capital gains in the same income year or carried forward to be offset against future capital gains. It cannot be offset against income.

While taking advantage of the provisions regarding the carrying forward of losses (to be offset against future tax liabilities) can make a significant difference to the bottom line of your fund it is important that this is done correctly as mistakes can lead to corrective measures being imposed by ATO.

Mistake #6 – Not understanding that 'in specie transfers' can be Capital Gains Tax events

It is possible to transfer shares held in the names of fund members into an SMSF. This can be done directly without having to first sell the shares and then buying them back. The transfer can take place 'off market' and this is known as an 'in-specie transfer'. Making such transfers is a good way to strengthen the fund and to include investments already held in the favourable tax regime provided by the superannuation environment.

A word of caution is in order however. SMSF trustees should realise that in specie transfers are a Capital Gains Tax event. This means that you could be liable to pay CGT under your own name after transferring assets into you super fund. Advice on whether an in specie transfer is advisable in your case is recommended.

It is important to remember that in-specie transfers will count towards your contribution cap (whether concessional or non-concessional).

Mistake #7 – Trading too often

Many SMSF trustees make the mistakes of trading far too often (i.e. buying and selling shares on a very regular basis). There are at least two reasons why this is not recommended. The first is the fact that frequent trading creates Capital Gains Tax events. It is, secondly, the case that research has shown time and time again that overzealous trading by amateur investors (who often get too easily spooked or excited by market movements) can do serious harm to the long term health of an investment portfolio. In the long run a solid 'buy and hold' strategy, with some pruning, will in many cases deliver a better result.

Mistake #8 - Not having a Trading Plan

One of the most important disciplines practised by experienced and successful share investors is to conduct their trading activities in line with carefully thought-out trading plans. By methodically following a written plan such investors protect themselves against rash decisions based on panic or hype. A trading plan is different from the broad SMSF investment strategy discussed above as it is designed to particularly govern the share trading part of your portfolio. A trading plan sets out the trading approach that you will be following, the kinds of investments you would like to see in your portfolio (and those you would like to avoid) and the risks you are comfortable with. Many people also stipulate intervals at which they will formally evaluate the performance of their portfolios within their plans. Having such a trading plan is not a guarantee of success but it will certainly place you in a different category from other investors who often fly blind and invest on the basis of spur-of-the-moment decisions.

Mistake #9 – Not being careful of “gunna” shares

A ‘gunna company’ refers to those that are forever ‘gunna’ be successful but that never quite make it. Such companies are often quite adept at telling their stories and claiming that success is really just around the corner. Throwing money in their direction can be a dangerous move. Especially so in the case of inexperienced investors who may not be able to interpret the data that claims of future success is based on.

If you are just starting out with share investing through your SMSF we would, therefore, recommend that you stick with companies that can show a proven track record of success and solid investment returns.

Mistake #10 – Simply ‘Following the Crowd’

Herd instinct may be a wonderful asset in the animal kingdom but it can be disastrous in the world of investment. Many investors over the years have been burned through rushing to buy the next ‘hot stock’ that turned out to be something of a damp squib.

Be careful, therefore, of simply doing what everyone around you is doing because there is no guarantee that the crowd is, in fact, right. One of the most important safeguards that you can put in place to avoid being swept along by groupthink is the trading plan that we discussed above. By sticking to your predetermined principles and strategy you will be able to rest assured that you are steering your own course.

Mistake #11 – Buying shares in a business that you don't understand

Trading in shares can be quite a complex undertaking and it is important that you make decisions based on the best possible information. This can be difficult in some cases where the business models being spruiked by companies looking for investors are so opaque and difficult to understand that most investors are left scratching their heads. You are essentially left with a 'Trust me it will work' promise if you do not fully understand how exactly a business plans to generate returns for its investors.

This is, needless to say, a rather dangerous scenario. The smart investor will essentially be left with two alternatives. Walk away and direct your investments towards more mainstream shares or to do the hard yards by carefully acquainting yourself with the company, its business model and the environment in which it operates.

Mistake #12 - Blindly following experts

There are, of course, many people out there who know quite a bit about the share market and can help you to make good investment decisions. This section is, therefore, not about advising you to simply do your own thing without ever gathering advice. We would, in fact, suggest that gathering as much information as possible is an indispensable part of any successful investment strategy. We would, instead, caution against viewing anybody as a kind of 'guru' whose advice should be uncritically followed in all circumstances.

Read, learn, gain advice as widely as possible but always keep your eyes open.

Mistake #13 – Adopting a risky and overly speculative strategy

It can be great fun to 'play the market' and to chase after the next big thing. You should, however, be very careful to avoid using your retirement funds (in the form of SMSF share investments) to do this.

Risky shares my sometimes provide good returns but they can, by their very nature, leave investors exposed to significant losses. Being too speculative is, therefore, akin to gambling with your retirement funds.

The problem isn't necessarily some speculation but the amount of allocated capital to it. Consider your speculative trading in the contest or your broader asset allocation.

Mistake #14 – Not adequately diversifying

One of the most important principles undergirding long term wealth building strategies is diversification. Applied to shares in an SMSF this means that you should avoid having most of the assets of the fund in shares and that the shares that you do select are not primarily speculative.

Make sure that you include some 'blue chips' to provide solid growth and stability. This is especially important as you approach retirement as a volatile investment portfolio is probably the last thing that most people would want as they contemplate life after work.

Mistake #15 – Not being careful around thinly traded stocks

Thinly traded stocks are those that are exchanged in low numbers, often due to a limited number of interested buyers and sellers. While many stocks within this category may represent good value it is a simple fact that this part of the investment world is subject to high levels of volatility. This is because of the significant impact that even a low volume of new transactions can have on the price. Investors are therefore advised to proceed with caution by making sure they do as much research as possible before investing in thinly traded companies. All of the comments made above about avoiding overzealous speculation and making sure that you have a diverse portfolio are particularly relevant here.

Conclusion

It should be clear from the above that investing in shares through an SMSF may have its ups and downs. It can be a wise step under certain circumstances. We would, in light of this strongly recommend that you take the time to weigh up all the pros and cons and get professional legal, tax and financial planning advisers involved.

We trust that this guide was useful in helping you to think through some of the issues associated with SMSFs and that it also sets you thinking about some wider financial planning issues.

It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this. We urge you to continue your explorations by making use of some of the other resources and eBooks from the Wealth Adviser stable.

We also stand ready to serve you with professional advice, so please do not hesitate to contact us if we can be of further assistance.

Readers Notes

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Take the next step

We trust you enjoyed this eBook and found it informative and professionally presented. Of course your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

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