

Special income and SMSFs: TR 2006/7

This ruling is a major step forward in clarifying an area of uncertainty. Clients can now self-assess whether an SMSF's income is 'special income'. This will give scope to SMSFs to hold shares in private companies without having to pay punitive tax rates!

In short, the ruling can provide valuable opportunities for those who plan properly and early.

The ruling: TR 2006/7

In its final ruling (previously issued as draft ruling TR 2006/D1), the Commissioner sets out his preliminary views on whether income of a complying superannuation fund is 'special income' which is taxed under income tax law at 45%, rather than the concessional rate of 15%.

What is 'special income'?

There are four different types of special income. These are:

- dividends paid by a private company, including income derived indirectly from a dividend and non-share dividends;
- income from a transaction where the parties are not dealing at arm's length;
- income received from a trust in the capacity of a beneficiary other than by virtue of holding a fixed entitlement; and
- non-arm's length income received from a trust in the capacity of a beneficiary holding a fixed entitlement.

The final ruling reaffirms the ATO view that 'income' is to be interpreted widely. It can include both income according to ordinary concepts and amounts included in assessable income under a statutory provision. This means that capital gains and franking credits can be special income.

Furthermore, once an amount of income has the character of special income, then the whole amount is special income. The amount cannot be divided between what is not special income and what is; ie, one in, all in.

Dividends paid by a private company

The ruling provides that dividends paid by a private company are special income unless the Commissioner is of the opinion that it would be reasonable not to treat the dividend as special income, having regard to the matters listed in the legislation.

No one matter is determinative.

Income that is derived indirectly from a dividend paid by a private company can also be a dividend paid to the entity by the company under s 273(2) of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA').

In other words, a private company dividend that is derived by a fund from an interposed entity is indirectly derived from a dividend and will be special income unless the Commissioner determines otherwise.

Self assessment

The trustee may self-assess whether to treat a private company dividend as special income or not having regard to the particular circumstances.

However, if the trustee is uncertain as to whether or not the Commissioner will exercise his discretion, ie, treating the dividends as not special income, the trustee should seek clarification by requesting a private ruling.

Dividends that are not special income

Broadly, the ruling confirms that private company dividends should not be treated as special income where the dividends are derived on an arm's length basis.

The ruling confirms that dividends are only derived on an arm's length basis where the shares are acquired, the investment is maintained, and the dividends are paid on an arm's length basis.

The emphasis is that parties must be arm's length to not be treated as special income even though they may be related.

This also means s 66 of SISA is not contravened where the shares in a company are owned by a complying super fund and the company leases the business real property owned by the super fund.

This, combined with self assessment, is a great opportunity for super funds to structure and take advantage of this flexibility.

This also means conversely, if the fund acquires shares in a company for less than market value, any dividends paid on those shares, *prima facie*, are considered to be special income.

Factors in determining whether dividends are special income

If the shares in the private company are paid-up to a different extent, and there are no other matters that the Commissioner considers to adequately explain the difference, the Commissioner will treat the dividend as special income.

It also means if the rate of dividends paid to the complying super fund is greater than other shareholders, and the difference does not reflect underlying commercial risks, it is likely the Commissioner would treat the dividend as special income.

Where the shares are of different classes, then differing rates of return may be more easily justified. Therefore, in general, the higher the rate of dividend paid as a return to shareholders, the more difficult it is to justify that the rate is at an arm's length and so the dividend will be held as special income.

In exercising his discretion, the Commissioner may also consider:

- the extent to which members who are at arm's length to the private company have an interest in the SMSF;
- the relationship between the SMSF and the private company;
- the relationship between the SMSF and any party with which the private company has dealings; and
- who the SMSF acquires the shares from and the circumstances of that acquisition.

A simple example from the ruling showing a favourable outcome is as follows:

Example

A private company ABC has 2 shareholders, X and Y SMSFs. X Super Fund has 2 members, Mr & Mrs Smith, who are also employees of ABC. The two SMSFs acquired all the shares (50% each) in ABC at \$1 per share. Y Super funds has two members, Mr & Mrs Jones, who are directors of ABC.

Both the Smiths and the Jones are paid market rate salary by ABC. X Super Fund owns the business real property which ABC runs its business, and the rent paid by ABC to X super fund is at market rate.

ABC makes large profits and pays the same amount of dividends to both SMSFs, reflecting the large profits made by ABC.

Analysis

Although the relationship between the super funds and ABC are not at arm's length, however, the rate of dividend generated is at arm's length.

The rental of the business real property is also at arm's length. Therefore, although the parties are related, the ATO therefore conclude, their dealings with each other are at arm's length.

It is reasonable to not treat the dividends paid by ABC as special income.

It is critical that any transaction carried out is commercial, and appropriately documented. By having proper documentation, you then have evidence to prove:

- the arm's length nature of the dealings conducted by the related parties;
- that the transactions, pricing and decision-making are properly recorded; and
- that the transactions carried out by related parties are commercial in nature and at arm's length.

DBA Butler is pleased to assist in advising on any restructuring or other queries related to this ruling.

For further information please contact:

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