DBA Lawyers

NEWS Nov 2010

SMSFs investing in unit trusts

This news outlines some of practical tips and traps related to investing in both related and unrelated unit trusts.

Can further units be acquired in a pre-1999 unit trust?

If the trust is related (eg, greater than 50% owned) then the 5% in-house asset ('IHA') limit applies. We generally recommend that SMSFs should keep this 5% limit as a safety buffer just in case of an oversight. Further, the Cooper review has recommended the 5% IHA limit be phased out for SMSFs.

However, if the trust is not related there is no limit on the amount of investment. This is because the IHA limit applies to an investment in a related trust. Three independent SMSFs holding one-third of a geared unit trust each does not invoke the IHA rules.

What documents should have been in place for the 30 June 2009 deadline?

It is crucial that the relevant steps and documents were completed prior to 30 June 2009 to ensure the investment satisfied the 30 June 2009 reinvestment deadline. Broadly, an SMSF could previously reinvest distributions back into a pre-1999 related geared unit trust up to 30 June 2009.

In particular, the unit trust deed usually prescribes how to issue units. This generally requires a number of discrete steps including a valuation of each unit, an application for units, directors' approval, updating the unit register and the issue of the new unit certificates. Thus, no investment is typically made until each step has been completed.

Further, only amounts received before 30 June 2009 could have been reinvested into the unit trust and these had to have been reinvested prior to 30 June 2009 to ensure that they were exempt from being IHAs under the 30 June 2009 IHA transitional rules.

Must distributions be paid by 30 June?

Broadly, the ATO considers that an unpaid present entitlement ('UPE') is a 'loan' by the SMSF to a unit trust if it is not paid within 12 months of the end of the relevant financial year. Otherwise, the ATO state that a UPE could result in a breach of the IHA rules, the arm's length rules and the sole purpose test.

In particular, SMSFR 2009/3 states that a UPE will be an IHA to a related trust if a consensual agreement for the provision of financial accommodation has been reached or can be inferred between the parties.

Accordingly, SMSFs should ensure that any UPE from a related trust is paid to them in a timely manner; otherwise it will be considered a loan by the ATO.

Conversion of a geared unit trust to a non-geared unit trust

Many SMSFs that had acquired units under the transitional rules for pre-1999 unit trust investments now have the problem of how to acquire or invest in further units in the related unit trust without it breaching the IHA rules.

One option appeared to be for the unit trust to be converted to a non-geared unit trust ('NGUT') provided each and every requirement in SIS reg 13.22C was satisfied (eg, no borrowings or charges, no business nor could the unit trust have any investment in another entity such as BHP shares). This option was generally considered as a viable strategy after the unit trust paid off its borrowings. The proposal was for the SMSF to then buy units in a unit trust that subsequently qualified as a NGUT at market value without any IHA limit.

However, the ATO has recently stated that a unit trust is precluded from relying on the NGUT exception if the trust has breached a requirement in reg 13.22C after its introduction in mid 2000. In particular, the ATO stated that a new borrowing by a unit trust in 2001 would preclude the previously geared unit trust converting to a NGUT. This ATO view has only recently been released and is causing considerable concern.

While DBA Lawyers does not agree with this ATO view, the ATO are willing to test its view in the courts. This ATO view provides little flexibility for pre-1999 unit trusts seeking further SMSF equity injection after the 30 June 2009 deadline.

A pre-1999 unit trust may however still be capable of satisfying the NGUT exception if all the requirements in reg 13.22C have been complied with since mid 2000. This may still be possible if the unit trust still maintained borrowings provided these had not been increased after mid 2000.

Should the unit trust be a fixed trust?

Unless the unit trust deed qualifies as a fixed trust, any trust distributions received by an SMSF may be treated as non-arm's length income taxed at 45% (this 45% tax applies even if the SMSF is in pension mode).

Note that a unit trust does not automatically qualify as a fixed trust. We are aware of numerous definitions of fixed trust including for trust loss and franking credit purposes, for distribution purposes, for land tax purposes (eg, NSW and Victoria have special land tax provisions) and for general trust law purposes.

Broadly, a trust is a fixed trust for superannuation purposes if all the entitlements to income and capital are fixed and cannot be taken away from the unitholders. Many (non-DBA) unit trust deeds provide non-fixed entitlements and some provide discretionary or hybrid units with variable distributions. Further, under many deeds a majority of unitholders may be able to take away the income or capital rights of the minority. Naturally, these unit trust deeds are not appropriate for SMSFs.

Will the unit trust be taxed as a company?

A unit trust can be taxed as a company (ie, a public trading trust 'PTT') if both of the following tests are met:

- SMSFs hold at least 20% of the units in the trust; and
- the unit trust carries on activities beyond mere land ownership for the purpose of deriving rent and other passive investments such as investment in shares, units, loans, certain other financial instruments, etc.

Note, there is a safe harbour provided at least 75% of the trust's gross revenue is derived from rent as long as the remaining gross revenue is not derived from carrying on a business that is not 'incidental and relevant' to renting land.

If a unit trust is a PTT, it is broadly taxed as a company rather than a trust, ie, it is taxed at the company tax rate and distributions are taxed like franked dividends. For example, a unit trust that develops a property and sells it (rather than holding it for long-term rental) and where SMSFs own more than a 20% unitholding, would be taxed as a company at a 30% tax rate on any net income.

What are the current trust issues under ATO scrutiny?

The ATO has recently released Taxpayer Alert 2010/5, which strikes at SMSFs seeking to invest in an unrelated unit trust to avoid the usual SMSF investment restrictions (particularly lending to members and related parties).

The scheme the ATO attack in TA 2010/5 involves SMSFs investing in an unrelated unit trust that then on-lends a similar amount to a member or related party. The ATO see this as a blatant indirect breach of the super fund investment rules.

We should all consider the wider issues of this ATO alert. Similar concerns may be raised where an SMSF has invested in a related unit trust that provides a loan (eg, an extended UPE) or other investment that would not be permitted if undertaken directly by the SMSF — for example, the unit trust lending to a member, relative or related party. This is because the ATO generally looks through unit trusts to apply the usual super fund investment rules.

SMSF & Unit Trust Kit

DBA offers a kit for SMSFs investing in unit trusts. The cost for this kit is $440. The kit covers SMSFs investing in non-geared unit trusts, converting a pre-1999 geared unit trust into a non-geared unit trust and the rules on pre-1999 geared unit trusts. It includes sample SMSF and unit trust resolutions, various unit trust forms, a detailed memo with practical planning tips and traps and more.

Unit Trust (fixed trust)

DBA's unit trust qualifies as a fixed trust for tax purposes. This results in less onerous tax burdens when dealing with trust losses, franking credits and qualifying for certain other tax concessions. In addition, the DBA unit trust comes with a comprehensive range of documentation including an explanatory memo, trustee minutes, unit certificates, unit register and relevant ATO documents. The cost of a DBA unit trust is $400 and $50 extra for hardcopy.

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