

## SMSFs and unit trusts

An SMSF trustee's investment in a unit trust ('UT') may be a prudent investment. There are still many pre-1999 grandfathered unit trusts and there is also a growing popularity for SMSFs to invest in non-g geared unit trusts. However, there are a number of key issues that may impact this type of investment. Most important is the quality of the UT deed. This newsletter examines these issues.

### Fixed trusts

It is important that SMSF trustees only invest in fixed UTs to ensure that any income is and will continue in the future to be concessional tax (or exempt if the fund is in pension mode). Note that non-arm's length income ('NALI') is also taxed at 45% even if a fund is in pension mode (see ss 295-385(2)(a), 295-390(2)(a) and 295-550 of the *Income Tax Assessment Act 1997* (Cth)).

Broadly, a UT is a fixed trust if all the entitlements to income and capital are fixed and cannot be taken away from the unitholders. Thus, a UT with non-fixed and discretionary style units gives rise to a NALI risk. The difficulty in practice is finding a UT that satisfies the strict 'fixed trust' test. The entire deed requires a careful review to determine whether it is satisfactory.

Many UT deeds that DBA Lawyers review fail to meet this test. A number actually provide discretionary or variable distributions. These UT deeds also give rise to complexity in ascertaining the market value for different unit entitlements. One surprise to many is that under many UT deeds a majority of unitholders can vary the deed and therefore take away the rights of a minority. This risk was highlighted in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 where Stone J stated 'It follows that the members could vote to terminate the present right to a share of income and capital.' In our view, UTs with such deeds are not appropriate for SMSFs to invest in.

Despite this technical analysis the ATO have applied a practical approach where, broadly, a proportionate distribution related to the number of units will not invoke NALI. This approach may not apply if the rights to units differ significantly. Further, the ATO could apply a different approach in the future.

Assuming an SMSF has invested in a UT that does not constitute a fixed trust, there may be a solution. In particular, in *CoT v Clark* [2011] FCAFC 5 the Full

Federal Court held that a trust deed can be varied, provided the variation power permits, without giving rise to a resettlement. The ATO then withdrew its statement of principles and issued TD 2012/21 confirming that no CGT event would occur if such a variation was made. Thus, an existing non-fixed UT could be varied to become fixed.

Therefore the main difficulty with varying a UT deed is generally how the local State or Territory stamp duty will apply. This is best resolved by getting expert duty advice before proceeding with any variation.

Naturally, this issue can be avoided altogether by obtaining a quality deed in the first place. The DBA Lawyers' UT qualifies as a fixed trust. The NSW Office of State Revenue ('OSR') has also recently confirmed this, despite having a very strict test of what is a fixed trust. By using a DBA Lawyers' UT there is potential to save around \$6,500 pa in land tax (for 2013-14) by accessing the NSW tax free threshold. This land tax saving will increase over time as the NSW land tax free threshold is indexed annually.

There are a number of other advantages of using a fixed UT deed including less onerous tax burdens when dealing with trust losses, franking credits and qualifying for certain other tax concessions. In addition, the DBA Lawyers UT deed comes with a comprehensive range of related documents.

### Allowable investments

Broadly, the in-house asset ('IHA') provisions contained in the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA') restrict SMSF trustees from investing in a related trust (eg, a related UT), unless an exception applies.

#### *Non-g geared unit trust ('NGUT') exception*

An SMSF trustee's investment in a related UT will not constitute an IHA if the trust is a NGUT.

A NGUT has a variety of characteristics. Among other things, the trustee must not have any borrowings or charges over its assets. Nor can a business be run by the trustee, nor can the trustee hold shares or an interest in another entity.

NGUTs can be an effective structure for holding real property. In particular there may be the ability to undertake further 'creeping acquisitions' of extra units at concessional or lower rates of duty, up to certain limits in the various jurisdictions across Australia.

An SMSF trustee can also invest in a NGUT by purchasing units from a related party under the SISA.

#### *Related unit trusts*

Broadly, an investment in a trust constitutes an IHA if a member and their associates 'control' that trust. A member's relatives, certain business associates and related entities are grouped for this control test.

Another common oversight that many do not appreciate is where a member and another otherwise non-related individual receive joint income (eg, rent) they are grouped due to this relationship constituting a tax law partnership.

#### *Non-related trusts*

An SMSF trustee can often invest in a UT that is not a related trust. A common structure is where say three non-related SMSFs invest one third each in a non-related UT. This structure is not an IHA and thus the UT trustee can borrow and undertake property development (ie, none of the NGUT restrictions discussed above apply).

The related trust test focuses on control of more than 50% of units, the ability to exert a controlling influence, or the ability to appoint and remove the trustee.

The ATO have provided recent qualified support for the view that a 50-50 unit holding, absent other influence or grouping, is a viable structure.

Even if there are two non-related SMSF trustees holding a 50-50 equity position in a UT, the other grouping rules need to be considered.

A non-related trust provides an effective structure for gearing and is simple to manage.

However, careful ongoing management is required to ensure gradual shifts in equity over time do not inadvertently trigger the IHA rules. Moreover, the land rich or landholder rules of the particular State or Territory also need to be considered for duty issues.

### **SMSFs and unpaid present entitlements ('UPEs')**

With 30 June now behind us, SMSFs with UPEs owing from related UTs should be mindful that the ATO's view is that an UPE that is not paid shortly after the UT financial statements are finalised is a loan.

The ATO consider such a (UPE) loan can result in a contravention of the IHA rules, the arm's length rules and the sole purpose test. Accordingly, SMSFs should ensure that any UPE from a related UT is collected in a timely manner. If not there is the risk that the (UPE) loan will constitute a borrowing and the NGUT will be considered an IHA. The bulk of the units acquired under the NGUT exception might need to be disposed of. Thus, all UPEs from related UTs must be carefully managed.

## **DBA LAWYERS' SMSF DEED 2013-14**

We have recently updated our SMSF trust deed to coincide with the new financial year. Some of the updates include updated rules in light of the new law implementing the extension of the pension exemption, enhanced power for the revised excess contributions tax regime, expanded rules in light of the changes to the law on insurance and SMSFs, specific insurance rules for cross-insurance and split-insurance, and much more. Now is the perfect time to take advantage of these updates.

Visit <http://www.dbalawyers.com.au> for ordering information, or contact our office on (03) 9092 9400.

## **SMSF KITS**

DBA Lawyers offers a range of kits, including a Unit Trust Compliance Kit, documentation to roll back and commence account-based pensions, transition to retirement income streams and other pensions, as well as related SMSF kits.

Visit <http://www.dbalawyers.com.au/Kit-Product-Summary.pdf> for further information.

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