2014 National SMSF Conference

Self-Managed Future

*The strategies you need **today**, to make the most of **tomorrow**.*

F4 Property inside an SMSF

Daniel Butler

Director

DBA Lawyers

Chartered Accountants Australia and New Zealand is a trading name for the Institute of Chartered Accountants in Australia (ABN 50 084 642 571) and the New Zealand Institute of Chartered Accountants – see charteredaccountantsanz.com for further information.

CHARTERED ACCOUNTANTS

CONTENTS

1 Introduction: SMSFs: Property and Investment Structures 5

2 Legal and regulatory hurdles of SMSFs undertaking property development 6

2.1 Carrying on a business 6

2.1.1 When will real estate development not constitute a business? 6

2.1.2 Case law 6

2.1.3 The ATO position 7

2.1.4 Practical implications 7

2.2 SISA compliance hurdles 8

2.2.1 Trust Deed 8

2.3 Services provided to an SMSF 8

2.3.1 The problem 8

2.3.2 A possible contribution 8

2.3.3 Non-arm's length income 9

2.3.4 Is it permissible to remunerate? 9

2.4 Investment strategy (SISA and SISR) 10

2.4.1 Sole purpose test (s 62 of the SISA) 11

2.4.2 No financial assistance to members (s 65 of the SISA) 11

2.4.3 No related party acquisitions (s 66 of the SISA) 12

2.4.4 Borrowing prohibition (s 67 of the SISA) 12

2.4.5 Arm's length (s 109 of the SISA) 12

2.4.6 No charges over assets (reg 13.14 of the SISR) 12

3 Investing in related parties — tips and traps for the IHA rules 13

3.1 In-house asset rules 13

3.2 Non-geared unit trusts ('NGUT') 14

Example 14

4 Property development via unit trusts 15

© DBA Lawyers 2014

4.1 Three allowable unit trusts 15

4.1.1 Pre-99 unit trusts 15

4.1.2 Unrelated unit trust 15

4.1.3 NGUT 15

4.2 Pre-99 unit trust grandfathering rules 16

4.3 Conversion of pre-99 unit trusts to NGUTs 16

4.4 Other issues for unit trusts 17

4.4.1 Fixed entitlement, non-arm's length income 17

4.4.2 Public trading trusts 18

5 Structures for SMSFs undertaking property acquisitions and development 19

5.1 SMSF undertakes development solely 19

Example — sole investment 19

5.2 SMSF buys property as tenants in common ('TIC') 19

Example — TIC 20

5.3 Joint ventures (JV) 20

Example — JVs 20

5.4 Unrelated unit trusts 20

Example — unrelated unit trust 20

5.5 NGUT 21

Example — NGUT 21

6 Tips and traps on BRP 22

6.1 Vacant land 22

6.1.1 Examples from SMSF 2009/1 22

6.2 Plant and equipment 22

7 SMSFs buying overseas property – tips & traps 23

7.1 Introduction 23

7.2 Investment with no borrowings 23

7.3 Investment with borrowings 24

7.4 Increased costs 25

1 Introduction: SMSFs: Property and Investment Structures

This session will cover:

- Moving business real property into an SMSF
- Non-geared unit trusts – tips and traps
- Geared unit trusts – 50/50 arrangements
- Other structures including the use of companies' related party remuneration.

While some SMSF trustees seek more passive forms of investment, some have sought to engage in real estate development in order to improve properties and hopefully make a short term substantial gain. This paper will broadly explore possible structures, legal and regulatory hurdles and other tips and traps associated with SMSFs investing in property. Specifically, the following will be covered:

- The main legal and regulatory hurdles if an SMSF undertakes property development.
- The tips and traps of the in house asset ('IHA') rules, including investing in related parties.
- An overview of how SMSFs can structure their investment via unit trusts.
- A summary of structures that SMSFs can utilise when undertaking property development.
- Tips and traps regarding business real property ('BRP').

References to SISA and SISR should be taken to be references to the *Superannuation Industry (Supervision) Act 1993* (Cth) and the *Superannuation Industry (Supervision) Regulations 1994 (Cth)* respectively.

2 Legal and regulatory hurdles of SMSFs undertaking property development

2.1 Carrying on a business

Real estate development activities may border on or cross over into carrying on a business. The important question is then whether an SMSF can run a property development business. The ATO, as well as many advisers, have previously considered that an SMSF running a business may have contravened the sole purpose test. However, the ATO has recently confirmed this is not necessarily the case.

2.1.1 When will real estate development not constitute a business?

The question being explored is only relevant if a business is in fact being carried on. There is no 'hard and fast' test for when real estate development will constitute a business, however, there are a list of salient features that are relevant. These features include (*Ferguson v FCT* (1979) 26 ALR 307, 311):

- whether there is repetition and regularity of the activities;
- whether the activities are of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business; and
- the size, scale and permanency of the activity.

2.1.2 Case law

If a business is being carried on, the question is whether a trustee (including an SMSF trustee) is allowed to run a business. Broadly, the answer is no, but the trust deed can allow it. In *Kirkman v Booth* (1848) 11 Beav 273, 280 it was stated:

> a rule without exception, that, to authorise [trustees] to carry on a trade there ought to the most distinct and positive authority and direction given by the [trust deed] itself for that purpose.

2.1.3 The ATO position

The ATO has released material that indicates they implicitly accept there is no inherent contravention of the SISA merely because an SMSF runs a business (TR 93/17 [13]). Further material directly on point can be found at: http://www.ato.govau/content/00241937.htm. The ATO has stated in this material that (emphasis added):

> [w]hen determining compliance with the regulatory provisions it is the activities of the trustee that are examined rather than whether a business is being carried on by the SMSF.
>
> *The fact that activities undertaken by an SMSF trustee are considered business activities for income tax purposes does not necessarily mean that the trustee contravenes the regulatory provisions*.

2.1.4 Practical implications

There is nothing in the superannuation legislation to prevent an SMSF trustee from running a business. However, there are a number of provisions that trustees must be aware of. In particular:

- the fund should ensure its deed, investment strategy and related documents are carefully reviewed to ensure they authorise the activity;
- in many cases property development exposes a fund to commercial risks, for example, cost overruns, illiquidity of a builder/contractor/tenant;
- building contracts have to be checked and any charge in favour of the builder for their payments should be excluded; and
- joint venture development activities give rise to a range of other issues that are outside the scope of this article.

These will be discussed in greater detail below. However, if these provisos are met, carrying on a business may still entail an element of risk. In light of the above risks, an SMSF trustee might well consider engaging another entity to carry out the development 'leg work' so that any vacant land that forms part of the SMSF assets would still be developed but the SMSF trustee is merely realising an asset rather than carrying on a business. Moreover, the arrangement with the developer should be benchmarked with competitive quotes and otherwise reflect arm's-length terms.

2.2 SISA compliance hurdles

2.2.1 Trust Deed

Kirkman v Booth articulated that SMSF trust deeds must expressly empower the trustee of the fund to carry on a business and also provide powers which are broadly in relation to a certain investment activity. There is a risk that many older SMSF deeds will not have this power. As a matter of vigilance, an SMSF's trust deed should be reviewed before the trustee of the SMSF undertakes any property development activities.

In particular, the deed should have a positive power to deal with real estate, including improving, sub-dividing, leasing or otherwise exploiting real estate.

2.3 Services provided to an SMSF

SMSF trustees invest in real property for a variety of reasons. When these ventures are planned to include property development and improvements, this presents a number of possible pitfalls. Where a related party builder or other service provider is used, trustees and advisers must be even more cautious to not fall foul of compliance rules and taxation traps. This segment discusses the problem of related party remuneration and the definition of an SMSF. It must be noted however that there are many other 'live' issues in this area that are outside the scope of this paper.

2.3.1 The problem

If the trustees of an SMSF want to engage a related party, the question is whether to charge the SMSF for the value of the services provided. The relevant questions are:

- If no (or less than a market rate) remuneration is provided, is the value of the services a contribution?
- If no (or less than a market rate) remuneration is provided, does this give rise to non-arm's length income?

2.3.2 A possible contribution

The ATO view of what constitutes a contribution is set out in TR 2010/1:

> a contribution is anything of value that increases the capital of a superannuation fund provided by a person whose purpose is to benefit one or more particular members of the fund or all of the members in general

Initially, it appeared in TR 2010/1 that the ATO applied this in practice by drawing a distinction that where the SMSF is saved from ever incurring a liability, no contribution arose. In contrast, where a liability is forgiven or erased, this

gives rise to a contribution in the ATO's view. The distinction was also stated to have been based on 'whether the capital of the fund has been increased'.

Despite the above, a different view has been expressed in the March 2013 NTLG meeting, where the ATO stated that, where a related party improves an SMSF asset at no cost to the SMSF, for the purpose of benefitting the fund, this will constitute a contribution reflective of the increase in market value of the fund's assets. Accordingly, unless related party builders and service providers are remunerated, their services can give rise to a contribution. Naturally, any remuneration should be permitted under the SMSF deed and under the SISA and should also be at arm's length, with evidence retained to be able to show this.

2.3.3 Non-arm's length income

Section 295-550(1) of the ITAA 1997 provides that an amount of income is non-arm's length income if:

(a) it is derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme; and

(b) that amount is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme.

In light of the above, where the fund's asset has been improved at no cost by a related party (or at a cost being less than market value), and as a result, the trustee of the fund is able to derive a larger amount of income. In addition, a failure to remunerate the related party will mean a lower cost base for the asset than otherwise would have been the case. This in turn would give rise to a higher capital gain on realisation. Arguably, these situations give rise to non-arm's length income.

Considering the above, this is another reason to ensure related party service providers are remunerated.

2.3.4 Is it permissible to remunerate?

Following on from the above discussion on whether it is beneficial to remunerate a related party service provider, the question must be posed: is this allowable in the first instance?

Case law provides that, as a general proposition, trustees are expected to act for free (*Robinson v Pett* (1734) 3 PWms 249). If a trustee is to be remunerated, this requires express provision in a trust instrument (*Re Queensland Coal and Oil Shale Mining Industry (Superannuation) Ltd* [1999] 2 Qd R 524 and *Cuesuper Pty Ltd* [2009] NSWSC 981).

The next issue is the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA'). If the fund is to remain an SMSF, an SMSF trustee is prohibited from receiving remuneration for duties or services performed in relation to the fund. However, legislative change has introduced s 17B, which broadly provides that the element of s 17A just discussed will not apply where:

- the trustee performs the duties or services other than in the capacity of trustee;
- the trustee is appropriately qualified, and holds all necessary licences, to perform the duties or services;

- the trustee performs the duties or services in the ordinary course of a business, carried on by the trustee, of performing similar duties or services for the public; and
- the remuneration is no more favourable to the trustee than that which it is reasonable to expect would apply if the trustee were dealing with the relevant other party at arm's length in the same circumstances.

Accordingly, where a person who is a trustee or director of a corporate trustee personally (as opposed to, eg, via a company) provides services under any real estate development, the above should be complied with. Where the above cannot be complied with (assume for example that the related party builder does not carry out these services for the public, but only works on his or her own projects), then an alternative solution is necessary. An alternative structure might include:

- The trustee of the SMSF engaging the services of a different company (not the trustee of the SMSF) of which the related party service provider is a director. Once the trustee or director operates via a company to provide services, the concerns raised by s 17A no longer apply.

The trustee/director executing an enduring power of attorney in favour of their spouse, and then resigning as a trustee (the would still be SMSF (SISA s 17A(3)(b)(ii))).

2.4 Investment strategy (SISA and SISR)

Under the SISA and SISR, trustees of regulated superannuation funds are required to formulate, review regularly and give effect to an investment strategy that has regard to the whole of the circumstances of the fund including, but not limited to, the following:

- the risk involved in making, holding and realising, and the likely return from, the fund's investments having regard to its objectives and its expected cash flow requirements;
- the composition of the fund's investments as a whole including the extent to which the investments are diverse or expose the fund to risk from inadequate diversification;
- the liquidity of the fund's investments having regard to its expected cash flow requirements;
- the ability of the fund to discharge its existing and prospective liabilities; and
- whether the trustees of the fund should hold a contract of insurance that provides cover for one or more members of the fund.

Accordingly, the fund must have an investment strategy, as well as review it regularly. Furthermore, any development should be pursuant to a properly considered investment strategy.

2.4.1 Sole purpose test (s 62 of the SISA)

Each trustee of a regulated superannuation fund must ensure that the fund is maintained for certain core and ancillary purposes (eg, provision of benefits for each member of the fund upon retirement). This is referred to as the sole purpose test (s 62(1) of the SISA).

Case law suggests that having investments at arm's length makes it more likely the sole purpose test will not be contravened. This is consistent with the Commissioner of Taxation's comments in SMSFR 2008/2 ([12]–[13]).

The SMSF must therefore make prudential investments associated with providing retirement benefits. The SMSF should not be undertaking activities that merely enhance the members' or related parties' present-day interests, such that the SMSF becomes merely an extension of a property developer's business activities.

2.4.2 No financial assistance to members (s 65 of the SISA)

An SMSF trustee is prohibited from giving financial assistance to members pursuant to s 65 of the SISA. This raises the question of what constitutes financial assistance. The following judicial comments provide insight (*Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [1986] BCLC 1, 10):

> There is no definition of giving financial assistance ... The words have no technical meaning and their frame of reference is in my judgment the language of ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance ...

If an SMSF sells part of a development to a member, or a member's relative, for less than the market value of the asset, then this could be seen as financial assistance. As such, care should be taken when pricing the value of property to be sold to members and their relatives.

The AAT decision of *Trustee for the R Ali Superannuation Fund and Commissioner of Taxation* [2012] AATA 44 also suggests financial assistance can be provided indirectly.

The Commissioner is likely to agree with this view and provides insights as to how he believes the law operates in SMSFR 2008/1. In particular, he states that financial assistance can be provided indirectly if there is a 'sufficient connection' (SMSFR 2008/1 [192]).

Accordingly, financial assistance should not be given to an entity that then passes it on to a member or relative of a member.

By ensuring each transaction is at arm's length, this is likely to ensure there is no financial assistance. The proviso would of course be that the transaction is not a loan to a member of the fund or a relative of a member. Even an arm's length loan to a member or a relative of a member would still be a contravention (despite being arm's length) due to s 65(1)(a) of the SISA.

2.4.3 No related party acquisitions (s 66 of the SISA)

Prima facie, an SMSF trustee is prohibited from acquiring assets from related parties. There are a number of exceptions to this general rule, however, which will be discussed later.

The ATO has confirmed its view expressed in SMSFR 2010/1. Broadly, where an SMSF engages with a related party to construct a building on land owned by the SMSF, the related party must only provide building services. If the related party provides building materials (in addition to services), this would be a contravention of s 66 of the SISA (see NTLG meeting minutes on 8 December 2010).

A practical strategy to combat this is to establish an agency or re-imbursement agreement between the SMSF and the builder, whereby the builder purchases materials on the SMSF's behalf. Naturally, care should be taken to ensure that such an agreement does not contravene other provisions of the SISA (eg, arm's length requirements).

2.4.4 Borrowing prohibition (s 67 of the SISA)

Section 67(1) of the SISA prohibits an SMSF from borrowing. There are a number of exceptions to this prohibition, the most popular being s 67A of the SISA.

A practical thing to note for SMSFs undertaking property development is that the SMSF is unable to borrow to cover small expenses like cash flow shortages, even through an overdraft facility. This puts SMSFs at a disadvantage to other business structures. Similarly, the issue of borrowing may arise where money is needed for repairs and improvements to the property.

2.4.5 Arm's length (s 109 of the SISA)

An SMSF must broadly deal with other parties on arm's length terms.

When related parties are dealing with an SMSF, this rule is easily overlooked, eg, intra-group transactions may arise that contravene this rule.

Thus, SMSFs must avoid any contraventions and document transactions with related parties that evidence arm's length terms, eg, obtain quotes from third parties and gather suitable evidence.

Failure to keep related party transactions at arm's length can give rise not just to superannuation legislation compliance issues, but also to tax issues (eg, excess contributions tax and non-arm's length income).

2.4.6 No charges over assets (reg 13.14 of the SISR)

An SMSF must generally not give a charge over a fund asset. Many building contracts however provide a charge or builders' lien over the land and property being worked on. SMSFs must therefore carefully inspect each relevant document, especially standard building contracts, and exclude any mortgage, lien or other encumbrance.

3 Investing in related parties — tips and traps for the IHA rules

3.1 In-house asset rules

Broadly, an in-house ('IHA') asset is an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund (s 71(1) SISA).

'Related party' is very broadly defined, and includes a member of the fund, a standard employer-sponsor of the fund, or a 'Part 8 Associate' of either of these. The full list of who is a 'Part 8 Associate' is very complex and expert advice should be sought when there is doubt.

'Related trust' is also broadly defined and generally, a trust is a related trust of an SMSF if it is 'controlled' by a member, standard employer-sponsor or their Part 8 Associates of the SMSF.

These entities are taken to 'control' a trust such as a unit trust if they meet any of the following three tests, as defined by s 70E(2) of the SISA:

- that person or their 'group' has a fixed entitlement to more than 50% of the capital or income of the trust; or
- the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of that person or their 'group' (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); or
- that person or their 'group' is able to remove or appoint the trustee, or a majority of the trustees, of the trust.

A 'group' in relation to an entity means (s 70E(3)):

(a) the entity acting alone (eg, the member);

(b) a Part 8 associate of the entity acting alone (eg, a related trust of the member);

(c) the entity and one or more associates of the entity acting together (eg, the member, his/her family trust and a relative of the member; and

(d) 2 or more Part 8 associates of the entity acting together (eg, the member's relative, family trust and family company acting together).

Given the broad definitions mentioned above, advice should be obtained if there is any doubt. In the event that the investment in the unit trust is an IHA then care must be taken to ensure that it meets the 5% IHA test limits which are imposed.

Technically, two unrelated SMSFs could each have an investment of 50% in a unit trust and this would not be an investment in a related trust. However, the ATO may nevertheless deem this to be an in-house asset, and accordingly, it is safer to have, for example, three unrelated SMSFs undertaking such an investment with, for example, 33.3% units each. In addition to the percentage of ownership held by each SMSF, care must be taken that a certain member or group does not 'control' the unit trust (eg, by having a casting vote). Otherwise the investment will be an IHA.

Note that the ATO has a broad discretion to deem an SMSF trustee's investment to be an IHA even if it does not constitute an IHA under the usual rules (ss 70A, 71(2) and 71(4) SISA). In our view this is more likely to be exercised where the ATO considers that there has been some attempt to avoid the normal application of the IHA rules, or that it is only for 'technical' reasons that an investment does not fall within the rules (ie, if, in substance, it is an investment that gives rise to a situation that the IHA rules were designed to prevent).

3.2 Non-geared unit trusts ('NGUT')

Another exception to the IHA rules is where an SMSF makes an investment in an asset which is excluded by the regulations (see s 71(1)(j) SISA). The regulations provide an exemption in relation to a NGUT. For example, reg 13.22B SISR applies to assets acquired before 28 June 2000 and reg 13.22C SISR applies to assets acquired on or after 28 June 2000 (we will focus on reg 13.22C). Assuming all of the conditions are met on acquisition of the asset and moving forward, reg 13.22C exempts an SMSF's investment in a related unit trust from being an IHA.

To come within this exemption, certain conditions must be met. These are outlined in reg 13.22C of the SISR.

If a condition is breached (other than the number of members increasing to 5 or more), then all the investments in the particular related unit trust that were acquired under the exception in regs 13.22B and 13.22C SISR become IHAs. Even if the event is then rectified, any existing and future investments in the particular unit trust that were acquired under the regs 13.22B and 13.22C exemption can never again be excluded from being an IHA. Hence, the SMSF can no longer invest in the unit trust and such investments will always be considered an IHA (see SMSFD 2008/1).

Example

An SMSF has an interest in a NGUT that holds business real property. The NGUT then invests in shares (it now fails to meet the requirements under reg 13.22C of the SISR for the unit trust to remain a NGUT). The ATO requires the SMSF to dispose of the units. The effect is that the business real property has to be sold. Fortunately, in this case a new NGUT could be established to buy the BRP from the old NGUT which has since 'blown up'.

Care should be taken to ensure that all of the conditions continue to be met if this exemption is to be relied on.

An advantage with a NGUT is that additional unit holdings can be purchased by the SMSF without breaching the IHA rules. Additionally, significant stamp duty savings can also be accessed in a number of states and territories where the land value falls below the land rich or landholder threshold (eg, $2m in New South Wales and $1m in Victoria).

4 Property development via unit trusts

4.1 Three allowable unit trusts

Broadly, there are three types of unit trusts which can be used as SMSF investment vehicles (including for the purposes of property development), these are as follows:

- A pre-99 unit trust;
- An unrelated unit trust; and
- A NGUT.

The features and regulatory requirements of these trusts are outlined below.

4.1.1 Pre-99 unit trusts

Specific grandfathering provisions were provided to SMSFs so that any share or unit in a unit trust which was acquired prior to 12 August 1999, or a contract which was in place prior to 12 August 1999 in relation to the acquisition, could be exempt as an in-house asset (s 71(A)(1) SISA). The exemption applies indefinitely. There are grandfathering rules for reinvestments in pre-99 unit trusts were phased out in mid 2009.

4.1.2 Unrelated unit trust

An 'unrelated' unit trust is similar to a trust described above in the discussion of the IHA rules. It will not meet the definition of a 'related trust' for the purposes of the IHA definition in s 71(1) of the SISA. A typical example of this type of trust would be a unit trust where the units are held by three unrelated SMSFs in equal proportions (ie, 33.3% each).

4.1.3 NGUT

An NGUT has been discussed above. It is exempt from being an IHA by being a type of trust which is exempt under the regulations (see s 71(1)(j) SISA). Regulation 13.22C of the SISR outlines the requirements and features of a NGUT.

4.2 Pre-99 unit trust grandfathering rules

Broadly, in addition to the rules which exempt an investment in a pre-99 unit trust from the IHA rules, there are further exemptions regarding certain re-investments. Certain conditions must be met (for example, they must have taken place by 30 June 2009) for these re-investments to be excluded indefinitely from the IHA rules. This paper will highlight three exceptions in particular:

- Partly paid up units (s 71A of the SISA)
- Reinvestment of units (s 71D of the SISA)
- Reinvestment up to debt value (s 71E of the SISA)

4.3 Conversion of pre-99 unit trusts to NGUTs

An SMSF may choose to convert a pre-99 unit trust to an NGUT for a variety of reasons. For example, the SMSF may wish to make improvements to the property, or inject more equity into the unit trust to pay off a debt. Conversion allows SMSFs flexibility with respect to their pre-99 unit trusts.

Many SMSFs that had acquired units under the transitional rules for pre-99 unit trust grandfathering rules 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 NGUT provided each and every requirement in reg 13.22C was satisfied (eg, no borrowings or charges, no business nor could the unit trust have any investment in another entity, for example, 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 view (expressed in ATO ID 2012/52 and ATO ID 2012/53) is that a unit trust is precluded from relying on the NGUT exception if the trust has breached a requirement in reg 13.22D after its introduction in mid 2000. In particular, a new borrowing by a unit trust after 28 June 2000 would preclude the previously geared unit trust converting to a NGUT. The ATO argue that Division 13.3A applies alongside ss 71A – 71E. The ATO is also willing to test its view in the courts. Accordingly this view provides little flexibility for pre-99 unit trusts seeking further SMSF equity injection after the 30 June 2009 deadline. The takeaway points from this are that:

- Pre-99 unit trusts can be converted to a NGUT provided they have not invoked one of the criteria in 13.22D since 28 June 2000.
- Where a NGUT has had borrowings in place prior to 28 June 2000, provided these borrowings have not increased but have been paid off and the trust otherwise complies with reg 13.22C, further investments by SMSFs into that NGUT do not count as IHAs.

- A pre-99 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 and an event in reg 13.22D has not occurred. This may still be possible if the unit trust still maintained borrowings provided these had not been increased after mid 2000 and all borrowings can be extinguished before the SMSF invests in the unit trust and there other criteria in reg 13.22C are fully complied with, eg, no charges, etc.

4.4 Other issues for unit trusts

4.4.1 Fixed entitlement, non-arm's length income

Unless an SMSF derives income as a beneficiary of a trust as a result of a fixed entitlement, any trust distributions received by an SMSF may be treated as non-arm's length income taxed at 47% (this 47% tax applies even if the SMSF is in pension mode).

Note that the provisions of a unit trust deed do not always mean there will be a fixed entitlement. We are aware of numerous definitions of 'fixed entitlement', 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, there will be a 'fixed entitlement' if all the entitlements to income and capital are fixed entitlements and cannot be taken away from the unitholders. Many 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.

The concept of fixed entitlements was also considered in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16. There, a special resolution (ie, 75% of unitholders) was able to vary the terms of the trust. Accordingly, it was held that 'members could vote to terminate the present right to a share of income and capital' ([106]) and thus there were no fixed entitlements as defined in the ITAA 1936.

Broadly, the ATO generally accept a unit trust is fixed if all income and capital entitlements are distributed proportionately to units held and do not take a strict legal or tax view of the meaning of fixed trust in ITAA 1997 s 295-550(4): TR 2006/7 paras [205-209].

Despite the above, recent and upcoming develops may change significantly the understanding of 'fixed entitlement'.

The AAT decision of The Trustee for MH Ghali Superannuation Fund and Commissioner of Taxation [2012] AATA 527 examined whether a distribution was from a fixed trust. The Tribunal held that s 272-5 of the ITAA 1936 sets out the meaning of the expression fixed entitlement to a share of income or capital of a trust. The SMSF was held to have a fixed entitlement despite some flexibility in its distribution clauses but the SMSF ended up with a greater proportion of income distributions than its proportionate unit holding entitlement.

The outcome in the Ghali decision is not binding on a court and there are court decisions where fixed entitlements have been given a strict application. Thus, expert advice should be sought if there is any doubt as to whether there is a fixed entitlement.

Further, even if there is a 'fixed entitlement', income can still be non-arm's length income if the income was derived under a scheme, the parties to which were not dealing with each other at arm's length, and the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length. Accordingly, all dealings should be at arm's length to avoid a non-arm's length income problem.

4.4.2 Public trading trusts

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.

Broadly, there is a safe harbour provided if at least 75% of the trust's gross revenue is derived from rent.

If a unit trust is a PTT, it is broadly taxed as a company rather than as a trust, ie, it is taxed at the company tax rate and distributions are taxed like franked dividends. For example, where a unit trust develops a property and sells it (rather than holding it for long-term rental) and SMSFs own more than a 20% unitholding in that unit trust, it would be taxed as a company at a 30% tax rate on any net income and make franked distributions to unitholders. There is a special way the CGT provisions apply to public trading trusts (which is beyond the scope of this paper).

5 Structures for SMSFs undertaking property acquisitions and development

SMSFs can utilise a number of different structures to undertake property development, including the following:

- SMSF undertakes the development by itself
- SMSF buys property as tenants in common ('TIC') with another entity
- Joint venture
- Purchase property through an unrelated unit trust
- NGUT

This seminar paper will briefly outline each of the structures above, as well as the pros and cons of each.

5.1 SMSF undertakes development solely

This refers to a structure where the SMSF has a direct investment in the property. The advantages of this structure are that it is relatively straightforward and it allows the SMSF to make additional contributions to top up moneys required for the project. On the other hand, this structure also carries with it a host of regulatory compliance hurdles contained in the SISA, including an exclusion on borrowing for shortfalls.

Example — sole investment

Husband and Wife are both members of HW Super Fund. The fund buys an inner city apartment for $800,000 and spends $200,000 on improvements to the property. Where cash flows are low, Husband and Wife can use future contributions to top up any shortfall.

5.2 SMSF buys property as tenants in common ('TIC')

This structure is where an SMSF buys property as TIC with another party (or parties). It allows an SMSF to acquire an asset jointly which it may not be able to afford alone. The related party can use other property they own as security to finance their interest in the property to be subject to TIC with the SMSF.

The negative features of this structure are that the SMSF cannot purchase a greater interest in the property from related parties if the property is residential, due to the prohibition in s 66 of the SISA. Furthermore, the nature of a TIC means that transfers of title, etc may be delayed.

Example — TIC

HW Super Fund jointly buys the inner city apartment as TIC with the HW Family Trust, each entity contributes $400,000 (ie, total purchase price of $800,000). The HW Super Fund gets the advantage of investing in a property worth $800,000.

5.3 Joint ventures (JV)

JV arrangements refer to a situation where an SMSF contributes land and a friendly builder contributes labour and materials. The output would be shared. Note that JV does not have a fixed meaning and the specifics of the JV will ultimately depend on what the parties agree on.

The main advantage of JVs is that the SMSF will have access to expertise and other resources that it wouldn't otherwise have.

Many JVs readily fall into becoming a partnership for tax purposes as soon as there is any sharing of revenue. Because of the nature of JV arrangements, contraventions of SISA are likely. There is a risk that the debit/credit relation between the parties (ie, payments of expenses, etc) could result in a loan (which could contravene s 67 of the SISA). Further, all aspects of the contract must be at arm's length.

Properly drafted documentation can limit the risk of these contraventions, and is essential.

Example — JVs

HW Super Fund buys a vacant block of land and then enters into a JV arrangement with a friendly builder to build 10 apartments. Upon completion, the fund and builder will split the output 50/50.

5.4 Unrelated unit trusts

An unrelated unit trust should be structured as three unrelated SMSFs investing in a unit trust. An advantage here is that the unit trust itself can borrow and secure its assets. Risk is also quarantined at the unit trust level, which is important as many developments provide exposure to risk.

SMSFs should be careful so as not to contravene the in house asset rules in relation to a 'related trust' in SISA. There may also be an issue as to whether the trust will be considered as a public trading trust if the investment in land is not for the purpose of rental.

Example — unrelated unit trust

HW Super Fund buys units in a unit trust, which is held 1/3 by HW Super Fund and two unrelated super funds. There is no family or business relationships between the three families involved in the three different SMSFs. This is not a related trust for the purposes of s 71(1) of the SISA.

5.5 NGUT

A NGUT structure will typically involve an SMSF investing in a NGUT (which will meet the requirements of Reg 13.22C of the SISR) with another friendly entity. The related party can borrow and secure its borrowings on other assets outside the NGUT. The SMSF also has the advantage of purchasing units over time from the family trust due to exemption from IHA rules. However, strict requirements of 13.22C of SISR must be adhered to.

Example — NGUT

HW Super Fund invests in a 50/50 in an NGUT with the HW Family Trust (ie, the fund and trust each purchase 50% of the units of the NGUT). The NGUT purchases property. Further, equity by the way of issued units can be raised from the unit holders.

6 Tips and traps on BRP

SMSFs must ensure that all acquisitions of land and property from related parties satisfy the BRP test (or another exception) of s 66 of the SISA. Broadly the BRP test requires that property be wholly or exclusively used in one or more businesses.

6.1 Vacant land

Whether land qualifies as BRP or not is to be judged on normal legal analysis largely guided by tax cases.

An ATO ruling on BRP, SMSFR 2009/1, contains the ATO's view on whether vacant land will constitute BRP. Broadly, land purchased for development purposes typically requires entities to physically use land to realise development plans, and hence is considered to be purchased in the context of a business (see para 171 of SMSFR 2009/1).

However, land which is purchased primarily for the purposes of investment, would not meet the requirement of BRP (para 172 of SMSFR 2009/1).

It follows that SMSFs that are intending to purchase land from related parties must plan ahead when the related party makes the initial acquisition of the land.

6.1.1 Examples from SMSF 2009/1

Where vacant land is being used only temporarily for a business activity, the land will not be considered as BRP. For example, where 50 hectares of vacant land are used to graze cows for a limited period of time, this will not constitute BRP (see example 7, SMSF 2009/1).

Similarly, where members of an SMSF allow their son to park trucks and other machinery on their land as part of the son's business (but without any lease or agreement in place), the land is not considered BRP (see example 8, SMSF 2009/1).

6.2 Plant and equipment

Fixtures that are attached to BRP can be transferred to an SMSF without contravening s 66 of the SISA when BRP is transferred to the SMSF from a related party. However, there may be items of plant and equipment, which are not attached to the land, which will not be covered by the exception in s 66(2) SISA.

Tax efficiency generally encourages taxpayers to maximize the cost of plant and equipment being separate and detached from land and buildings due to potential Division 40 deductions.

A practical solution is that any plant and equipment should not be transferred to an SMSF from a related party.

7 SMSFs buying overseas property – tips & traps

7.1 Introduction

Overseas property investment may appear attractive to many; such as an investment in an apartment in Paris, a Balinese beachfront villa, or a ski chalet in Colorado. However, when an SMSF is the purchaser there are a number of compliance traps to navigate.

SMSF trustees can purchase property either by an outright purchase or borrow using a limited recourse borrowing arrangement ('LRBA'). To illustrate the potential risks involved, each of these types of investments will be considered in turn.

7.2 Investment with no borrowings

In short, an SMSF trustee can purchase a property overseas. However, there are many compliance hurdles. Some of these are listed below.

Sole purpose test — the acquisition meets the sole purpose test. In other words, is the SMSF being maintained solely for the prescribed purposes (eg, to provide retirement benefits). In the famous *Swiss Chalet Case* (*Case 43/95* [1995] ATC 374) a superannuation fund trustee invested in a unit trust, the assets of which included a Swiss chalet. The question in this matter was whether the fund met the then equivalent of the sole purpose test. The problem was not so much the investment itself, but that fund members and their friends stayed in the chalet without paying rent. The fund was held to have contravened the sole purpose test. Accordingly, it is important that an SMSF trustee only acquire real estate because it genuinely believes it is an appropriate way to achieve its core purpose of providing retirement benefits. Moreover, some SMSF members also mistakenly believe the ATO will never know that they are using the property overseas especially if it is in a far away destination. However, immigration, phone, credit card, GPS and other records can readily pin you to the 'scene of the crime' these days. We have had the opportunity to represent clients who were asked by the ATO to prove they did not use the overseas property owned by their SMSF or related structure.

In-house assets — this is a big issue if it is not the SMSF trustee acquiring the property itself but rather a company and the SMSF trustee acquires shares in the company. See below. Particularly, if an overseas bank account is required this may restrict the investment.

SMSF deed and Investment strategy — the acquisition must be authorized by the deed and consistent with the fund's investment strategy.

Perhaps the most prevalent risk that may restrict SMSF trustees from investing overseas is the in-house assets rule. This is because some overseas jurisdictions require that property be held by a company or similar vehicle in the foreign country. This type of restriction is usually designed to preclude too many non-residents acquiring local

property in the overseas country. Practically, this means that the SMSF member will often need to establish a company in the overseas jurisdiction and the SMSF trustee will invest in shares of that company. The company's share capital will be used to finance the acquisition of the overseas property. In some Asian countries I have come across SMSF trustees paying a local native to hold the title on their behalf and I have questioned how solid this arrangement was under the local native rules.

On its face, the investment by an SMSF in an overseas company's shares is an investment that is an in-house asset; which itself is a serious contravention subject to considerable penalties. However if the investment meets the exceptions outlined in 13.22C of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') (ie, non-geared company or non-geared unit trust) then the investment will not contravene the in-house asset rule. One of the requirements of this exception is that the assets of the company being acquired must not include a loan to another entity, unless the loan is a deposit with an authorised deposit taking institution within the meaning of the *Banking Act 1959* (Cth). As such, if there is an overseas bank account established (or required to be established), the investment in that company by the SMSF trustee will be an in-house asset unless the overseas bank account complies with our banking legislation. As a result, the shares in the company would need to be disposed of by the SMSF trustee.

Unfortunately, many SMSF trustees are 'lambs to the slaughter' as smooth real estate agents tell them they are buying real estate but when the deal is done and the advisers get involved, the detailed requirements of the local jurisdictions law become apparent and a company or similar structure may be needed. This results in many falling into this compliance trap with great downside risk and substantial costs to unwind the transaction.

If the jurisdiction allowed the SMSF to invest in the property directly (without a local company intermediary) then the above risk would be extinguished. However, our experience has shown that numerous popular overseas jurisdictions require a company to be established.

7.3 Investment with borrowings

If the SMSF trustee were to borrow to acquire the property utilising a LRBA, this poses even further risks.

Firstly, if the property being acquired had to be held via a foreign company, we question whether a bank would be willing to lend to acquire overseas property. Practically, the bank would be lending money to acquire a piece of paper (being shares in the foreign company). Our experience is that banks will be very reluctant to lend on this basis where the security is shares in a company or units in a unit trust. Moreover, we have found few overseas banks that provide documents that are consistent with s 67A requirements and thus the LRBA may not be limited recourse or may otherwise contravene the law.

As an alternative or as supplemental to taking security over the shares of the foreign company, the bank may seek to take security over the overseas property itself. If it were to do so (and the property was held via a foreign company), this would contravene the requirements of reg 13.22C of the SISR. As such, the SMSF trustee's investment in the foreign company would be an in-house asset again with numerous potential penalties and downside risk.

If a related party were to lend instead of a bank, it is questionable whether that lending would be at arm's length unless evidence can be gathered that the friendly party LRBA terms and conditions are consistent with arm's length practices.

Our experience has also proven that dealings with different overseas jurisdictions can result in complicated legal analysis to ensure everything is properly bedded down. For example, many overseas countries do not recognise trusts and the legal system in some countries requires an examination of a lengthy chain of title and there is a need to ensure all legal matters are tied down adequately to satisfy Australian legal requirements as well as satisfying the overseas rules.

7.4 Increased costs

In addition to the compliance aspects outlined above, there are often inflated costs for the transaction that must be taken into account. These may include costs in sourcing the property (ie, buyer's agent or advocate in the foreign country), having repairs and maintenance undertaken and the costs for the lawyers and advisers overseas to complete the conveyance and provide ongoing advice. In addition to these costs, a structure such as a company may need to be established in that jurisdiction — ongoing maintenance costs are also likely to apply. Overseas tax compliance may arise and a range of other reporting and other obligations.

In addition to these costs, if an SMSF were to borrow to acquire the property using an LRBA there would be costs in obtaining documentation to allow the fund to borrow.

There may also be unexpected ongoing costs, such as overseas land and wealth taxes and costs associated with dealing with tenants (evicting a tenant may not be a straightforward process in overseas jurisdictions).

Such costs should be considered before embarking on overseas property investment.

* * *

Note: DBA Lawyers hold SMSF CPD training at venues all around Australia and online. For more details or to register, visit www.dbanetwork.com.au or call 03 9092 9400.

Daniel Butler

DBA Lawyers

19 August 2014

Disclaimer

This seminar paper is for general information only and should not be relied upon without first seeking advice from an appropriately qualified professional. The law is subject to constant change, and accordingly, expert advice should be obtained if the above information is not acted upon shortly after today's date or if there is any doubt in relation to this document. Unless specifically instructed by you in writing, and subject to you entering into an ongoing client agreement and payment of our required yearly fee, there is no obligation whatsoever on DBA Lawyers to notify you in respect of any changes to the law, ATO policies, etc and how any such changes might impact upon any advice previously given. Copyright belongs to DBA Lawyers and prior written consent should be obtained before releasing it to any person other than our client. DBA Lawyers are not licensed to provide financial product advice under the Corporations Act 2001 (Cth).

This presentation represents the opinion of the author(s) and not necessarily those of the Institute of Chartered Accountants in Australia (the Institute) or its members.

The contents are for general information only. They are not intended as professional advice – for that you should consult a Chartered Accountant or other suitably qualified professional.

The Institute expressly disclaims all liability for any loss or damage arising from reliance upon any information in these papers.

Chartered Accountants Australia and New Zealand is a trading name for the Institute of Chartered Accountants in Australia (ABN 50 084 642 571) and the New Zealand Institute of Chartered Accountants – see charteredaccountantsanz.com for further information.