The Do's and Don'ts of SMSF Property Development

Phil Broderick CTA
Principal, Sladen Legal

#NC2019

Phil Broderick

Phil is a principal of Sladen Legal and heads its superannuation team. He is member of a number of superannuation related committees. This includes being the co-chair of The Tax Institute's superannuation committee and the chair of SISFA's technical committee.

He is also a member of number of the ATO's superannuation liaison groups including the Superannuation Industry Relationship Network (SIRN) and the Superannuation Industry Stewardship Group (SISG). Phil is also heavily involved in liaising with Treasury and ATO in relation to the implementation of new super laws and administrative practices.

Phil's areas of practice include superannuation, estate planning and succession, duties and state taxes, trusts, federal tax and business structuring.

He is regular author and presenter. His articles have featured in The Tax Institute's Taxation in Australia Journal and CCH's Super News. He has presented at seminars and conferences conducted by The Tax Institute, the Television Education Network, Legalwise and various accounting bodies.

Outline

#NC2019

1. Can an SMSF carry on property development?
2. Can an SMSF carry on a business?
3. SIS Act considerations
4. Tax considerations
5. SMSF property development structures
6. Use of related builders

Can an SMSF carry on property development?

1. No express prohibition
2. Have to consider whether such activities:
3. Breach the SIS Act & Regulations
4. Cause adverse tax consequences
5. Also have to consider how it will be funded
6. Cash (consider contribution caps)
7. Borrowings (consider borrowing rules)
8. Structures (consider structure rules)
9. By non SMSFs (how are they included)

Can an SMSF carry on property development?

- SMSFs and property development on the ATO's radar - Kasey Macfarlane, Assistant Commissioner, Superannuation
  - "An SMSF can undertake a property development or other business venture. However, significant caution is required because the manner in which these activities are undertaken can give rise to breaches of regulatory rules."
  - "In particular, the general prohibition on borrowing by SMSFs, the related-party rules and rules about non-arm's length transactions as well as the sole-purpose test."

Can an SMSF carry on property development?

- Cont..
  - For JVs "extreme care" was needed to ensure the SMSF didn't breach the regulatory rules, "particularly if the other party to the joint venture is a related party".
  - "The very small number of cases we have seen to date have raised concerns from a regulatory perspective, particularly the rules about related-party transactions and non-arm's length transactions. The cases have also commonly involved related-party joint ventures and trusts that have raised potential application of the NALI provisions in tax law."

Can an SMSF carry on property development?

Cont..

- this was an area the ATO would continue to “monitor closely”.
- “Our concern is that in some of these cases, involving SMSFs in related-business undertakings may be viewed as a mechanism for diverting members’ business-related income into a more tax concessionary environment. If extreme caution is not exercised significant regulatory and income tax issues can arise which may risk members’ retirement savings.”

Can an SMSF carry on a business?

- Again, no express prohibition
- Old case law which suggests a super fund carrying on a property development business is not a superannuation fund
- Need to consider whether breach of SIS Act or Regulations or whether there are adverse tax consequences

SIS Act considerations – the sole purpose test

- Test – is the SMSF being maintained for the purpose of providing retirement benefits?
- Mischief trying to prevent:
  - Members and related parties extracting benefits or advantages out of the SMSF
  - i.e. outward focussed

The sole purpose test cont.

- Examples
  - Using fund assets
  - Members receiving collateral benefits
  - Dealings with related parties for greater than market value consideration
- In property development context – is this related property developer / builder being remunerated / rewarded on commercial terms?
- Does property development in itself cause a breach of the sole purpose test
  - Aussiegolfa v FTC suggests not

Arm's length dealings

Section 109 of the SIS Act

- Dealings with assets must be either:
  - On arm's length basis
  - If not – must not favour the non-SMSF party
- Like the sole purpose test it is an outward focussed test

Prohibition against accepting assets from related parties

S66 of the SIS Act

- One exception is business real property (BPR)
  - BPR must be used wholly and exclusively in one or more businesses
  - Special rule for farm land – can have a residence on land provided the non-business use is less than 2 hectares and not the predominant use of the land
  - Exclusive test is strict - although carve out for 'de minimis' non-business uses

Prohibition against accepting assets from related parties cont.

- Residential land generally can't be contributed / purchased from related parties unless
  - It's used in a property rental business
  - It's used commercially (e.g. doctor's surgery)
  - Its held as trading stock by a property developer
- Vacant land generally can't be contributed / purchased from related parties unless
  - It's used in a business (e.g. car park)
  - It's held as trading stock by a property developer

Prohibition against accepting assets from related parties cont.

- ATO view is that provision of materials by a related party builder or developer is in breach of section 66
- Therefore need to ensure
  - The materials are directly acquired by the SMSF
  - Any acquisitions by related parties done as agent for the SMSF

In-house asset rules

- For property development the important considerations are:
  - Any loans from the SMSF to related party developers
  - Investments in development entities (unit trusts or companies)
- Consider what is in Part 8 Associate "Group" –
  - Includes Parents and Siblings
  - Can include business partners if in partnership
  - Includes "standard employer-sponsors

In-house asset rules cont

For investments in unit trusts not to be in-house assets, the unit trust must be:
- A reg 13.22C unit trust
- A pre-99 unit trust
- An unrelated unit trust

Prohibition against borrowing

S67 of SIS Act
- Exception – LRBAs (old law and new law)

Prohibition against providing financial assistance to members and their relatives

S65 of the SIS Act

In property development context this prohibition has fairly limited impact unless the builder is a member / relative in their personal capacity

Investment strategy

S52B of the SIS Act

- Again, fairly limited application for property development
- Most significant aspect is that if property development is contained in the investment strategy that members cannot seek compensation from the trustee for poor performance

Prohibition against charging SMSF assets

Regulation 13.14 of the SIS Regulations

- Charge defined widely to include a mortgage, lien or other encumbrances
- Importance for property developments:
  - Charges can exist if related to an LRBA
  - Beware development contracts as can involve the SMSF granting a charge over the assets to the developer
  - Developers often want to mortgage the land to help finance the development

Trustee Remuneration

- Generally trustee / director cannot be remunerated under S17A of the SIS Act
- Consequence of breach: automatic non-compliance (ATO has no discretion)
- S17B allows remuneration if:
  - Trustee / director is qualified and has necessary licences
  - Trustee / director performs such services in a business to the public
  - Remuneration is no more favourable than arm's length remuneration

Consequences of breach of SIS Act and Regulations

- “Old” penalty regime
  - Making SMSF non-compliant (value of assets less non-concessional contributions taxed at 47%)
  - Disqualifying trustees / directors
  - Civil or penalty orders in the Federal Court
  - 12 month imprisonment (for breach of s66)
- “New” penalty regime (from 1 July 2014)
  - Fines between $1,050 - $12,600 per offence
  - Directing trustees to rectify breaches
  - Directing trustees / directors to attend education course

Tax Considerations

- All SMSF CGT assets held on capital account (s295-85)
- SMSF development property will never be on income account
- Rule does not apply to entities an SMSF invests in
  - E.g. if SMSF invests in a reg 13.22C unit trust that holds land on income account then proceeds derived by SMSF will be on income account
- Need to consider:
  - Non-arm’s length income rules

Non-arm’s length income rules

- Need to be considered for:
  - Non-arm’s length dealings resulting in higher than arm’s length income (e.g. a development agreement under which development charges no fee or a low fee)
  - Private company dividends
  - Distributions from a non-fixed trust (discretionary trust)
  - Distributions from a fixed trust that derives income on a non-arm’s length basis
- NALI rules will generally be avoided if all dealings are done on an arm’s length basis
- Expansion of NALI to undervalue expenses

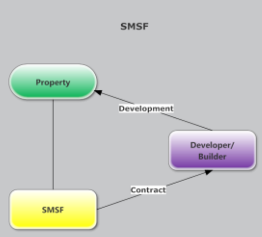
Risks

- Increased ATO scrutiny
  - Need to be prepared for an ATO review and audit
  - Need to make sure everything is done 100% - eg
    - proper paperwork
    - Arm's length terms
    - Correct payments
- Investment risk
  - Property development is inherently risky
  - Protect with separate entities
  - Winding up SMSFs post development

Risks

- Funding and liquidity risks
  - Especially in light of tightening of contribution caps
- Investment risk
  - Property development is inherently risky
  - Protect with separate entities
  - Winding up SMSFs post development
  - Use of intermediate developers

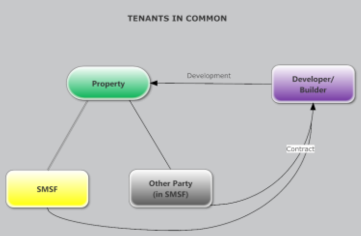
Structures - SMSF



SMSF cont.

- Advantages
  - No other entities
  - SMSF can use its cash directly
  - Can develop existing asset (without borrowing)
  - Taxed at SMSF rate
- Disadvantages
  - SIS Act and Regulation restrictions
  - No asset protection
  - Difficulties with LRBAs

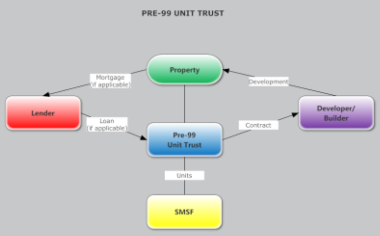
Tenant in Common



Tenants in common cont.

- Advantages
  - Same as SMSF
- Disadvantages
  - SMSF cannot acquire residential property interest from related co-owner
  - Co-owner’s actions can cause breach (e.g. inadvertent charging or financial accommodation)
  - Will generally be treated as a tax-law partnership
  - Duty if acquire co-owner interest

Pre-99 unit trusts



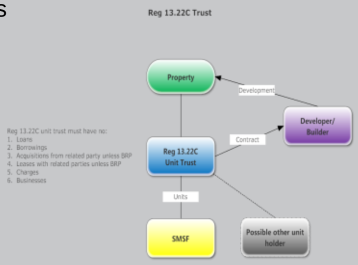
Pre-99 unit trusts

- Advantages
  - Units pre-12 August 1999 and under the transitional rule will never be in-house assets
  - Can borrow and deal with related parties
  - Flow through from tax perspective unless a public trading trust (unit trust advantage)
  - Asset protection (unit trust advantage)
  - Note: need to undertake activities on an arm's length basis

Pre-99 unit trusts

- Disadvantages
  - Reinvested units can be in-house units
  - Cash flow issues with principal and interest loans
  - Must pay out distributions - as unpaid present entitlements can become in-house assets - as financial accommodation (unit trust issue)
  - Assets can be held on income account (unit trust issue)

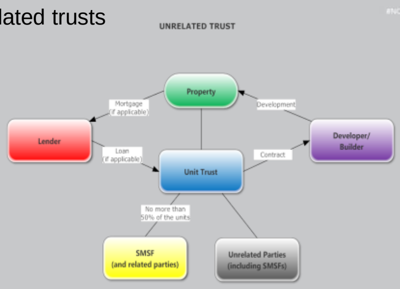
Regulation 13.22C unit trusts



Regulation 13.22C unit trusts cont.

- Advantages
  - Units are not in-house assets
  - Can have co-investors as unit holders
  - Can acquire units from related parties
  - Depending on number of units acquired, duty may not apply for acquisition of units
- Disadvantages
  - Activities of trust very restricted
  - Cannot operate as a business
  - Once 13.22D is breached, can never rectify

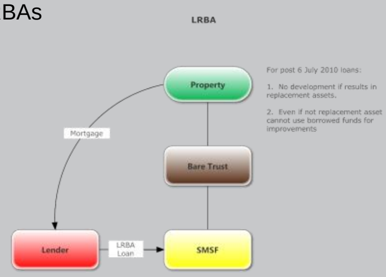
Unrelated trusts



Unrelated trusts cont.

- Advantages
  - Units are not in-house assets
  - Can borrow, charge its assets and deal with related parties
  - Can operate a business
- Disadvantages
  - Unrelated parties must hold at least 50% of the units
  - Cannot acquire units from related parties

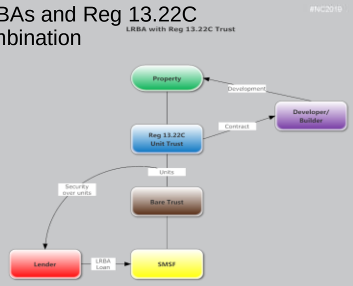
LRBAs



LRBAs cont.

- Advantages
  - SMSF can borrow directly without requiring unrelated investors
- Disadvantages
  - Single acquirable asset rule
  - Replacement asset rule for improvements
  - For related party loans need to follow the safe harbours or benchmark

New Law LRBAs and Reg 13.22C Unit trust combination



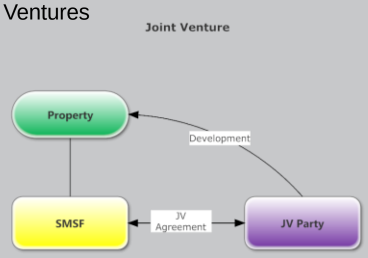
New Law LRBAs and Reg 13.22C Unit trust combination cont.

- Advantages
  - SMSF holds units and therefore won't breach the single acquirable asset rule or cause there to be a replacement asset
  - Reg 13.22C unit trust can hold multiple assets and develop the property
- Disadvantages
  - Cannot give security over the unit trust's assets
  - Bank unlikely to lend - as want security over real property
  - Difficult to benchmark

Companies

- Advantages
  - Can retain income and therefore don't have problems with associated unpaid present entitlements
  - Easier to administer than a public trading trust
- Disadvantages
  - Loss of flow through taxation

Joint Ventures



Joint Ventures

- Advantages
  - SMSF can participate in development of property
  - Not a tax law partnership
  - Generally no duty as no transfer of property
  - Taxed at SMSF rates
- Disadvantages
  - Can be complicated to structure correctly and easy to get wrong
  - Joint venture party could cause SMSF to breach SIS Act and Regs

Joint Ventures

- What about a “reverse joint venture”
  - Related party has the property
  - SMSF contributes the cash
- Still possible but
  - If the land owner is a related party - the ATO is likely to consider it to be a loan to, or investment in the related party
  - Higher risk to the super fund?
  - If the super fund is to receive a parcel of property is section 66 breached?

Use of related builders

- ATO take the view that supply of materials from a related party builder breaches s66
- Therefore if a SMSF, or Reg 13.22C unit trust, uses a related party builder / developer must be for services only
- Options for acquisitions of materials include:
  - SMSF buys them directly
  - SMSF appoints builder / developer as agent to acquire materials for SMSF
  - Consider separate bank account for acquiring materials
  - SMSF engaging sub-contractors – building licence issues?

Questions?

Phil Broderick

Principal, Sladen Legal