

Related Parties – what complex strategies are people putting in place to avoid related party transactions?

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Facilitator: Peter Hogan, Head of Education and Technical, SMSF Association





Leigh Mansell

Leigh is a Director, SMSF Technical & Education Services at Heffron SMSF Solutions, and she is intimately involved in developing the firm's range of products and services for clients (including technical and educational materials) and the provision of technical support to SMSF practitioners and their clients.

She regularly delivers presentations to SMSF practitioners around Australia and one of Leigh's greatest attributes is her ability to make complex concepts appear simple through the use of real life scenarios. Participants in previous training events have valued this practical approach highly.

She is a Chartered Accountant with over 25 years of superannuation experience and has specialised in SMSF technical support, advice and administration for almost 20 years. This gives her a unique ability to advise not only on the technical issues faced by SMSF practitioners but also the practical solutions she has developed and implemented.





Peter Hogan

Peter Hogan is the SMSF Association's Head of Education and Technical. He is one of Australia's foremost SMSF specialists, having worked in the sector over many years. A lawyer by training, he cut his teeth in the ATO before joining some of Australia's largest financial institutions to work in key superannuation, investment and taxation roles. His enormous industry experience and knowledge, especially as they pertain to tax issues, means he is in constant demand on the SMSF speaking circuit. Away from the world of SMSFs, he is a keen weekend golfer when he is not providing a taxi service to junior sporting events. Peter is an SMSF Association Specialist Adviser and former Chair and National Board member of the Association.






Why do we care about related parties?

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<p>Fund can't acquire assets from related party (or member)</p> <ul style="list-style-type: none"> Unless an exception applies Exceptions include <ul style="list-style-type: none"> Listed securities Business real property (SMSF / SAF only) Units in widely held trusts In-house assets Assets that would be in-house assets but for an exclusion (eg 13.22C assets) 	<p>5% limit applied to investments "in" / loans to / assets of fund leased to related parties</p>	<p>Collectables</p> <ul style="list-style-type: none"> Can't be <ul style="list-style-type: none"> leased to stored in private residence of used by related party If sold to related party must be sold at MV determined by qualified independent valuer
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Investment in a "controlled" entity vs "non-controlled" entity

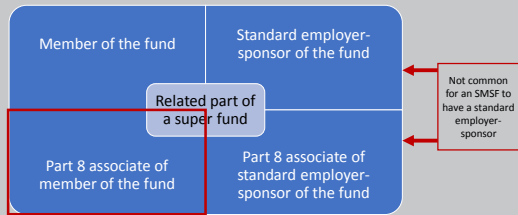
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<p>Controlled entity</p> 	<p>SMSF <u>can</u> acquire from members / RPs</p> <p>Will be an <u>in house asset</u> (5% limit) <u>unless</u> ...</p> <p>Unit trust / company meets Division <u>13.3A</u> SISR</p>
<p>Non-controlled entity</p> <p>This is commonly misunderstood</p>	<p>SMSF <u>cannot</u> acquire from members / RPs <u>unless</u> ...</p> <p>Asset is listed securities, units in widely held trusts</p> <p><u>Even if < 5%</u> of SMSF assets</p>

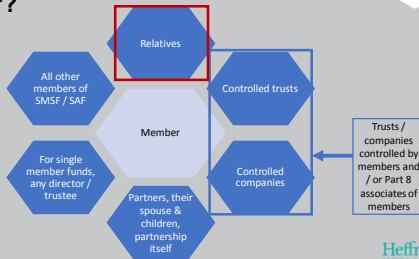
When do we care about related parties?



What is a related party of a super fund?




Part 8 associates of a member?



Relatives of a member

Who are they?



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Former spouse

?

An SMSF wants to acquire residential property directly from the former spouse of an SMSF member. Is the former spouse a related party of the SMSF?

A Yes, the former spouse is a Part 8 associate and therefore a related party

B No, the former spouse is not a related party

C Unsure

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Relative?

Relative in direct line of descent (eg child, grandchild, great-grandchild)

Definition 1

- parent, child, grandparent, grandchild, sibling, aunt, uncle, great-aunt, great-uncle, niece, nephew, first cousin or second cousin of the individual or of his or her spouse or former spouse, or
- spouse or former spouse of the individual, or of an individual referred to above

This definition only relevant for s. 17A of SISA (definition of an SMSF)

Definition 2

- parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the individual or of his or her spouse, or
- spouse of the individual or of any other individual referred to above

This definition relevant for Part 8 associates (and also other parts of the SISA)

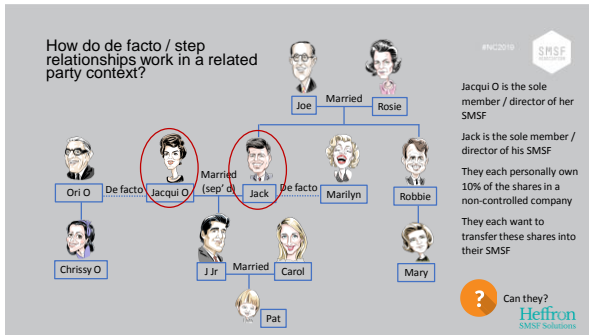
Member's former spouse is not

- a relative of the member,
- therefore not a Part 8 associate (unless caught by another limb)
- therefore not a related party of the SMSF

Any asset can be acquired from them

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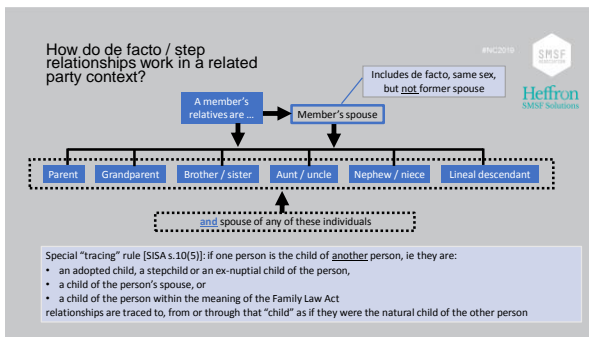


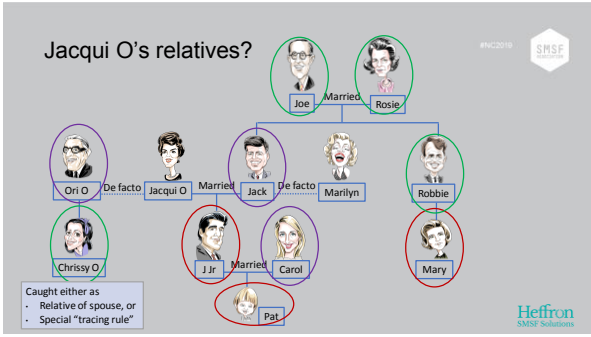
How do de facto / step relationships work in a related party context?

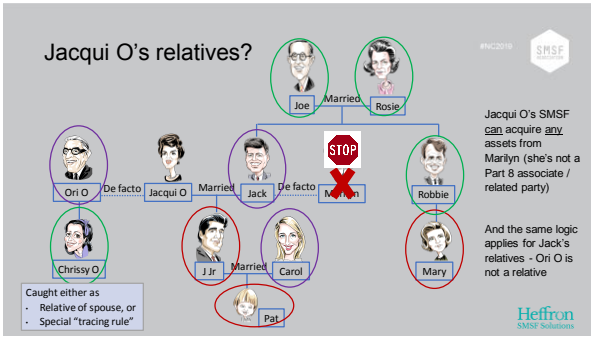
- Jack's SMSF **can't** buy his own nor Jacqui O's shares
 - It would be an acquisition from a member or a related party
- Likewise, Jacqui O's SMSF **can't** buy her own nor Jack's shares

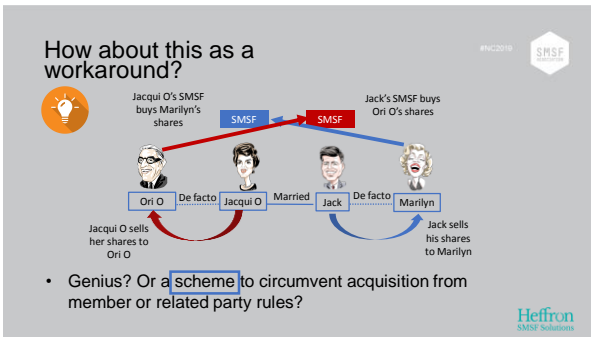
But ... could their SMSFs buy shares off someone else in their "family" ...

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How do de facto / step relationships work in a related party context?

Robbie's SMSF wants to acquire unlisted shares in a company from an unrelated party - Chriissy O controls the company. Robbie is the sole member / director of his SMSF.

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How do de facto / step relationships work in a related party context?

?

Robbie's SMSF wants to acquire unlisted shares in a company from an unrelated party - Chriissy O controls the company. Would the asset be an investment in a related party?

A	Yes, Chriissy O is Robbie's niece (a relative), therefore a Part 8 associate, and therefore her company is a related party
B	No, Chriissy O is not a relative of Robbie's, therefore not a Part 8 associate, and therefore her company is not a related party
C	Unsure

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How do de facto / step relationships work in a related party context?

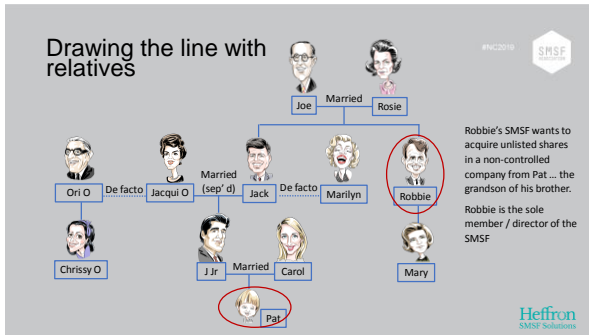
- Under the special "tracing" rules
 - Chriissy O is the child of Jacquie O's spouse and she's therefore considered Jacquie O's natural child
 - As Jacquie O is Robbie's sister-in-law, any child of hers is a nephew / niece of Robbie's

?

Bonus question : would the answer be different if Jacquie O and Jack were divorced

- Yes, Chriissy would no longer be Robbie's niece (a relative), and no longer a Part 8 associate of his

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Drawing the line with relatives

Robbie's SMSF wants to acquire unlisted shares from Pat ... the grandson of his brother. Is Pat a related party of Robbie's SMSF?

A Yes, Pat is the grandson of Robbie's brother (and a blood relative), therefore a Part 8 associate, and therefore a related party

B No, Pat is not a relative of Robbie's in this context and, therefore not a Part 8 associate, and therefore he is not a related party

C Unsure

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Drawing the line with relatives

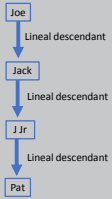
From the perspective of Robbie's SMSF, Pat is not

- a parent, grandparent, brother / sister, aunt / uncle or lineal descendant of the member, nor
- a nephew / niece of the member
 - rather Pat's father (J Jr) is a nephew of the member

Pat is therefore not a related party of Robbie's SMSF

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Drawing the line with relatives



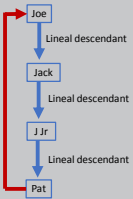
Joe's SMSF wants to lease an asset (not BRP) to a company Pat controls. Is Pat's company a related party of Joe's SMSF?

- Yes, because Pat is a lineal descendant of Joe's
 - Therefore a Part 8 associate, and therefore a related party

But what if we flipped things around ...



Drawing the line with relatives

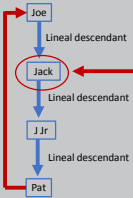


Pat's SMSF (sole member / director) wants to acquire residential property from a family trust controlled by Joe. Would the acquisition constitute an acquisition from a related party?

- | | |
|---|--|
| A | Yes of course, because Pat is a lineal descendant of Joe's. The same Part 8 associate relationship applies as before |
| B | No, Joe is not a relative of Pat's in this context, therefore not a Part 8 associate, and therefore the family trust Joe controls is not a related party |
| C | Unsure |



Drawing the line with relatives



From the perspective of Pat's SMSF, the member's relatives do not extend above grandparents

- Joe is therefore not a Part 8 associate of Pat's and therefore not a related party of Pat's SMSF
- Pat's SMSF can acquire the residential property from Joe's trust



Drawing the line with relatives

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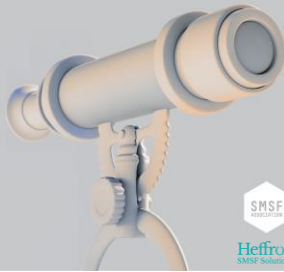
Critical issues

- Knowing which perspective you're coming from
- Knowing when to stop
 - Only relatives of a member are Part 8 associates of the member and therefore related parties of the SMSF
 - Not relatives of the member's relatives, relatives of non-member trustees / directors of corporate trustees
 - And unfortunately, relatives will change from time to time as relationships evolve, so we need to keep reviewing arrangements



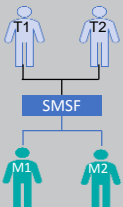
"Other" trustees / directors

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"Other" trustees / directors

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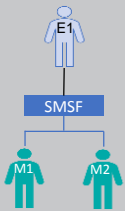


- SMSF has more than 1 member. M1 and M2 each
- granted an EPoA to E1 (who is their trusted friend and with whom they have no family or other relationship)
 - resigned as an individual trustee
 - were replaced by E1



“Other” trustees / directors

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Is E1 a related party of the SMSF?

- A Yes of course, because he's a trustee of the SMSF
- B No. E1 doesn't meet the definition of a Part 8 associate, and therefore is not a related party
- C Unsure

E1 is not a

- relative of a member
- member themselves, or
- partner of a member

so is not a Part 8 associate of the members



“Other” trustees / directors

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- What does this mean?
- The SMSF could
 - Acquire assets from E1
 - Lend to / invest in / lease an asset of the SMSF to E1 or any entity he controls
- Naturally, E1 would be bound by fiduciary duties bestowed upon him by the relevant trustee act and the SIS covenants
 - But it's something to be mindful of



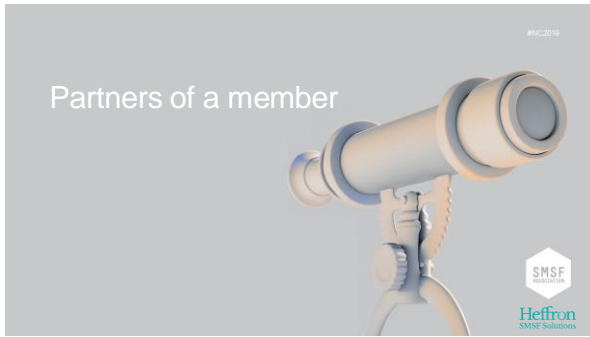
“Other” trustees / directors

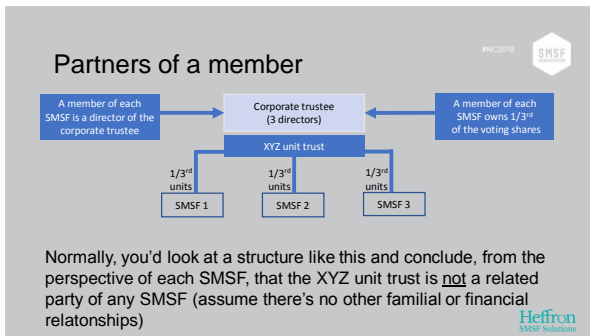
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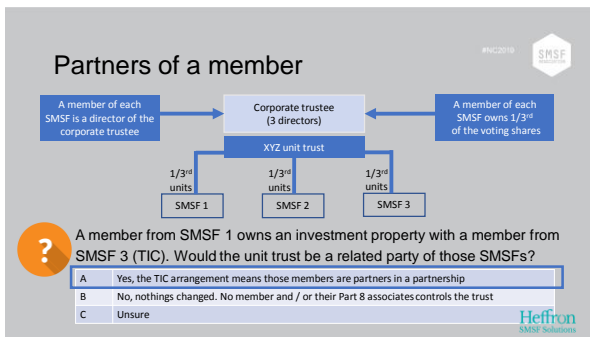


- Same result would arise if the multi member SMSF had a corporate trustee instead
 - Anyone acting in place of the member as trustee / director is not a Part 8 associate of the member
- What if the SMSF was a single member fund?
 - Any trustee / director would be a Part 8 associate of the member









Partners of a member

#MC2019 SMSF

A member of each SMSF is an individual trustee

Individual trustees (3)

XYZ unit trust

1/3rd units SMSF 1

1/3rd units SMSF 2

1/3rd units SMSF 3

Is the unit trust a related party of each SMSF?

A No, the trustee structure hasn't changed anything. No member and / or their Part 8 associates controls the trust

B Yes. The individual trustees are considered partners

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Partners of a member

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Partnership means ... an association of persons ...

- Carrying on a business as partners
- In receipt of ordinary and statutory **income jointly**

Including entities that own an income producing asset as **joint tenants or tenants in common**

Any **individual** trustee of a trust (in their capacity as a trustee of that trust) – the income of the trust would be received jointly by all trustees

A **corporate** trustee of a unit trust could be useful. A company is its own legal entity and is specifically excluded from being a partnership – the directors **don't** jointly receive income, definitely not partners

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Partnership or a joint venture?

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SMSF contributes property

Agreement between the parties

Other party contributes cash (pays for development of property)

Partnership : each party gets a proportion of the **income / profit**

Joint venture : each party gets a proportion of the **output** (eg, home units)

Devil will be in the detail of the agreement

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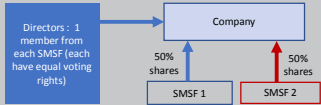
Controlled company



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Controlled company



Directors: 1 member from each SMSF (each have equal voting rights)

Company

SMSF 1 (50% shares)

SMSF 2 (50% shares)

Normally, you'd look at a structure like this and conclude, from the perspective of each SMSF, that the Company may not be a related party of either SMSF

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Controlled company

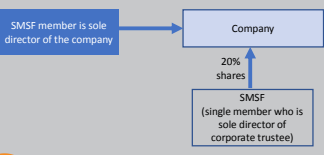
But what if Constitution says ...

- Chairman had a casting vote in the event of a deadlock
 - Control would fall to SMSF of which chairman was a member
 - In cases like this, it's common to not buy an "off the shelf" constitution
 - Rather, a constitution that doesn't allow an extra vote
- Directors have different voting powers

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Controlled company

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SMSF member is sole director of the company → Company


20% shares ↑
SMSF (single member who is sole director of corporate trustee)

Is the company a related party of the SMSF?

A Yes, SMSF member is the sole director of the company
B No, the SMSF only owns 20% of the shares
C Unsure



Controlled company


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But what if ... there was an agreement between the sole director and the shareholders


- Director's role was "execution only"
- Shareholders made all decisions
 - Member and Part 8 associates were not shareholders

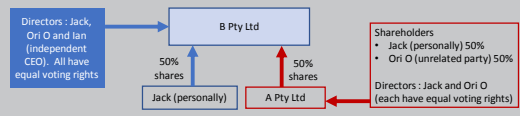
Is the company a related party of the SMSF?

A Yes, SMSF member is the sole director of the company – he controls the company
B No, while the SMSF member is the sole director of the company he acts in accordance with the directions of the shareholders



Controlled company

#MC2019 



Directors: Jack, Ori O and Ian (independent CEO). All have equal voting rights → B Pty Ltd


50% shares ↑ Jack (personally) 50% shares ↑ A Pty Ltd

Shareholders
• Jack (personally) 50%
• Ori O (unrelated party) 50%


Directors: Jack and Ori O (each have equal voting rights)

Jack (and his Part 8 associates) is entitled to 75% of the capital and income of B Pty Ltd, ie

- 50% from personal direct shareholding
- 25% indirectly via ownership interest in A Pty Ltd




Controlled company


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? Is B Pty Ltd a Part 8 associate of Jack's (and therefore a related party of his SMSF)?

A	Yes, Jack and his Part 8 associates are entitled to more than 50% (ie 75%) of the capital and income of B Pty Ltd
B	No, Jack and / or his Part 8 associates only represent one director out of three
C	No, Jack and / or his Part 8 associates can only cast, or control casting of, 50% of the votes at a general meeting of B Pty Ltd



Controlled company

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What does control actually mean?

Majority voting interest

Members and / or Part 8 associates can cast, or control casting of, more than 50% of votes at general meeting


Sufficient influence

Company, or majority of its directors, are


- accustomed or under an obligation or might reasonably be expected to act
- in accordance with directions / instructions wishes of the "group"


↓

Combined, and considered a "group"



Controlled company

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- Sufficient influence? Who is actually making decisions?

Director(s) are actually making their own decisions

- Regardless of whether or not someone is attempting to influence them

No sufficient influence

Eg, director(s) refuse to follow directions / instructions that are improper

Director(s) aren't actually making decisions, rather they are merely

- mechanically implementing or rubberstamping decisions already made by others
- based on directions / instructions to do so

Sufficient influence

Eg, lack of knowledge of the business means decision makers unable to determine if following directions / instructions would be improper. More likely to be merely implementing or rubberstamping based on directions / instructions

Controlled company

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- Sufficient influence? Decisions?
 - Decisions made at the company / director level, eg
 - Setting investment and operational policy
 - Appointing officers or agents, and granting them power to carry on company's business
 - Overseeing and controlling those appointed to carry out day-to-day business of the company
 - Managing finances including determining how profits are to be used, and declaration of dividends
 - Doesn't include implementation, or rubberstamping, of decisions made by others, or administration tasks



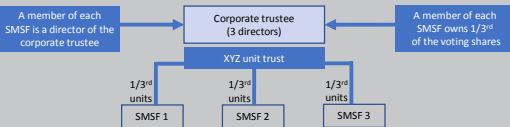
Controlled trust

#MC2018



Controlled trust

#MC2018



Revisiting this trust, you'd look at a structure like this and probably conclude, from the perspective of each SMSF, that the XYZ unit trust is not a related party of any SMSF



Controlled trust

#MC2018 SMSF

A member of each SMSF is a director of the corporate trustee

Corporate trustee (3 directors)

A member of each SMSF owns 1/3rd of the voting shares

XYZ unit trust

1/3rd units (SMSF 1, SMSF 2, SMSF 3)

? The trust deed of the unit trust states that the power to appoint / remove the trustee lies with the Settlor of the Trust (who is a member of SMSF 1). Would the unit trust be a related party SMSF 1?

A No, "control" of the trust is shared between the 3 "groups"

B Yes, as the member of SMSF 1's "group" has power to appoint / remove the trustee, the trust is controlled by that group and is therefore a related party

C Unsure

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Controlled trust

#MC2018 SMSF

What does control actually mean?

Members and / or Part 8 associates have a fixed entitlement to **more than 50%** of the capital or income of the trust

Combined, and considered a "group"

The Trustee, or majority of the trustees of the trust, are accustomed or under an obligation or might reasonably be expected to act in accordance with directions / instructions wishes of the "group"

The "group" is able to remove or appoint the trustee, or majority of the trustees of the trust

Need to examine trust deed of trust to identify who has appointment / removal powers

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Controlled trust

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Widely held trust

Sub-fund 1

Sub-fund 2

Sub-fund 3

Sub-fund x

SMSF + related parties own 100% of units

? Has the SMSF invested in:
• a related party (ie sub fund)?
• widely held trust?

What do the governing rules / PDS of the trust say?

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... and don't forget the Regulator has special powers ... and will use them!




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Regulator has special powers!



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- Regulator (ie ATO for SMSFs) has power to treat an asset that is not an in-house asset by definition
 - ie an asset that is not an investment "in" / a loan to / an asset of the fund leased to a related party as being an in-house asset
- Recent Decision Impact Statement advises ATO will consider issuing determination where SMSF enters an arrangement to acquire an asset through an interposed entity if the asset would otherwise be an in-house asset if directly held by the SMSF

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Avoiding related party difficulties or resolving them if they arise



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At acquisition time ...



Critical to understand who the related parties of a fund are

- And to not acquire an asset when you shouldn't

Can an entity cease to be a related party prior to the acquisition?

- Be mindful of **avoidance schemes**
 - Was the motivation wanting to acquire an asset from the other party, or was that simply a by-product of a cessation for other purposes?
 - Was the cessation only temporary?

Can a prohibited asset be made allowable?

- Be mindful of **avoidance schemes**
 - Residential property becoming BRP
 - Acquiring asset from an interposed entity, which previously acquired asset from a related party



At other times ...



Relationships change and asset already held by SMSE becomes an in-house asset and 5% threshold exceeded at that time

Eg. asset becomes

- a loan to a related party, or
- an investment in a "controlled" entity that does not meet 13.22C rules

Could occur if "control" of other party / entity shifts to members and their Part 8 associates

Eg. asset becomes leased to a related party. Could occur if asset does not meet the BRP definition, ie asset is

- Residential property
- BRP where no lease / lease arrangement is in place
- Equipment

Sever related party relationship prior to 30 June (providing scheme not entered into)

Terminate or reduce loan / investment to 5% prior to 30 June

Terminate lease



if 5% threshold exceeded at 30 June, "excess" must be disposed of by following 30 June – ie in-house assets must be sold

Severing related party relationship, terminating lease may not be a solution



The paper trail

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Documentation

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Acquisition time

Documented evidence (eg minutes with supporting documents) that either the asset

- Not acquired from related party, or
- It was acquired from a related party, BUT the asset meets one of the "exceptions"
 - In the case of in-house assets or assets that comply with 13.22C rules, want evidence that the entity was controlled

30 June

Documented evidence (eg minutes with supporting documents) that either the asset

- Not an in-house asset, ie not
 - an investment,
 - loan to, or
 - asset of the fund (except BRP) leased to a related party
- Otherwise, satisfies the 13.22C rules

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Evidence?

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Other entity to a transaction is an individual

- Trustee declarations (including Statutory declarations if appropriate) that other entity to a transaction with the SMSF isn't (or is) a relative, partner, Part 8 associate of the member

Other entity to a transaction is a company (including corporate trustee of a trust)

- Examination of
 - Most recent ASIC annual statement plus check of ASIC website for subsequent 484 activity, or ASIC company search
 - Constitution
 - Most recent financial statements
- Trustee declarations (including Statutory declarations if appropriate) that director(s), shareholder(s) or other "controller" are (or aren't) Part 8 associates
- Examination of director / shareholder meeting minutes to ascertain how decisions were made
- Evidence the SMSF Trustee had an appropriate process to identify whether company is (or isn't) a Part 8 associate / 13.22C rules complied with, together with evidence that process was followed

Is the company being sufficiently influenced by the "group"?

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Evidence?

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Other entity to a transaction is a trust

- Examination of
 - Unitholder register
 - Trust deed of trust
 - Most recent financial statements (and tax return)
- Trustee declarations (including Statutory declarations if appropriate) that unitholder(s), trustee(s) or other "controller" are (or aren't) Part 8 associates
- Examination of trustee meeting minutes to ascertain how decisions were made
- Evidence the SMSF Trustee had an appropriate process to identify whether trust is (or isn't) a Part 8 associate / 13.22C rules complied with, together with evidence that process was followed

Is the trust acting in accordance with directions / instructions of the "group"?

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