SMSFS INVESTING IN RELATED VEHICLES

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#NC2020

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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 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 SMSF Association, the Television Education Network, Legalwise and various accounting bodies.

Outline

- Why invest in structures?
- In-house asset rules
- Other SIS Act considerations
- Tax issues
- What structures can an SMSF invest in?

Why invest in structures?

- Ability to bring in co-investors (related or unrelated)
- Ability to borrow
- Allowing the SMSF to acquire interests from related parties in a more efficient manner (including landholder duty savings)
- Asset protection - participating in riskier activities
- "Hiding" the SMSF from contracting parties
- "Avoiding" the application of the restrictions in the SIS Act
- Land tax savings

The in-house asset rules

The prohibitions

- The in-house asset rules are the main issue to consider when an SMSF invests in a structure
- The in-house asset rules have 3 prohibitions:
  - SMSF trustees cannot acquire an in-house asset if the value of the in-house asset is valued at 5% or more of the assets of the SMSF (auto breach) – section 83(3)
  - SMSF trustees cannot acquire an in-house asset if they have already exceeded the 5% limit (auto breach) – section 83(2)
  - If at the end of the financial year, an SMSF's in-house assets exceed the 5% limit, it must by the end of the next financial year (section 82):
    - Prepare a written plan that states what steps it will take to dispose of in-house assets to the value that exceeds the 5% limit; and
    - Implement that plan

    (only a breach if plan not prepared and implemented)

The in-house asset rules

So what is an in-house asset?

- Relevantly, in-house assets include (section 71(1)):
  - An investment in a **related party** (company)
  - An investment in a **related trust**

The in-house asset rules

What is a related party and a related trust?

- A **related party** of an SMSF includes (section 10(1)):
  - A member of the SMSF
  - A standard employer sponsor of the SMSF
  - A Part 8 associate of the member or standard employer sponsor
- A **related trust** means a trust that a member or a standard employer sponsor of the SMSF controls within the meaning of section 70E(2) (section 10(1))
- Both tests rely on:
  - Relationships to members and standard employer sponsors via Part 8 associates
- This raises the questions of:
  - What is a **standard employer sponsor**?
  - What is a **Part 8 associate**?

The in-house asset rules

What is a standard employer sponsor?

- A **standard employer sponsor** of an SMSF is an employer who contributes because of an arrangement between the employer and the SMSF trustee (section 16(2))
  - It does not apply if the arrangement is between the member and the SMSF
- Most modern SMSFs will not have a standard employer sponsor
- But could apply to:
  - Old employer SMSFs that still have the employer as a party to the SMSF deed
  - Where, for whatever reason, there is an agreement between the SMSF and the employer to contribute to the SMSF

The in-house asset rules

What is a Part 8 associate?

- There are 3 types of Part 8 associates:
  - Of individuals
  - Of companies
  - Of partnerships

The in-house asset rules

What is a Part 8 associate of an individual (members)?

- The following persons are Part 8 associates of individuals (members) (section 70B)
  - Relatives:
    - Which includes:
      - Spouses, parents, grandparents, siblings, uncles and aunties, nephews and nieces, lineal descendants and adopted children
      - Plus spouses of each of the above
    - Spouses is defined as:
      - Married persons, persons in a registered relationship and persons who live together on a genuine domestic basis in a relationship as a couple
    - Does not include:
      - Cousins, ex spouses, divorced spouses, step children
  - Other members of the SMSF
  - For single member SMSFs – co trustees or co directors of corporate trustees

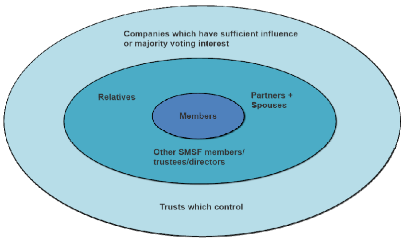
The in-house asset rules

What is a Part 8 associate of an individual (members)?

- The following persons are Part 8 associates of individuals (members) (section 70B):
  - Where the individual is in a partnership:
    - The partnership
    - The partners
    - The spouse and children of the partners
  - The trustee of a trust where the individual controls the trust (per section 70E)
  - A company which is sufficiently influenced or in which a majority voting interest is held by:
    - The individual
    - Part 8 associates of the individual
    - 2 or more of the individual and/or their Part 8 associates

The in-house asset rules

Part 8 associates of members (group)



The in-house asset rules

What is a Part 8 associate of a company?

- The following persons are Part 8 associates of companies (section 70C)
  - Where the company is in a partnership:
    - The partnership
    - The partners
    - The spouse and children of the partners (if they are individuals)
  - The following controlling entities of the company that sufficiently influence the company or have a majority voting influence in a company:
    - A single entity and/or
    - One or more Part 8 associates of that entity
    - (Entity means individual, company, partnership or trust)
  - Another company which is sufficiently influenced or in which a majority voting interest is held by:
    - The company and/or
    - One or more Part 8 associates of the company

The in-house asset rules

What is a Part 8 associate of a partnership?

- The following persons are Part 8 associates of partnerships (section 70D):
  - The partners
  - Part 8 associates of the partners
    - For individuals per section 70B
    - For companies per section 70C

The in-house asset rules

When will a company be a related party ?

- A **related party** of an SMSF includes (section 10(1)):
  - A **member** of the SMSF
  - A standard employer sponsor of the SMSF
  - A **Part 8 associate of the member** or standard employer sponsor
- A **company is a Part 8 associate** of a member if it is **sufficiently influenced** or in which a **majority voting** interest is held by (section 70B(f)):
  - The member
  - Part 8 associates of the member
  - 2 or more of the member and/or their Part 8 associates
- Ie must "group" the member and/or their Part 8 associates to see if they sufficiently influence or have a majority voting interest

The in-house asset rules

What is sufficient influence of a company?

- Sufficient influence (section 70E(1)(a))
  - Majority of company's directors
    - Accustomed to
    - Under an obligation (formal or informal) to
    - Might reasonably be expected to
  - Act in accordance with
    - Directions
    - Instructions
    - Wishes
  - Of an entity or entities
  - Where directions, instructions or wishes
    - Are
    - Or might reasonably be expected to be
  - Communicated
    - Directly
    - Through interposed companies, partnerships or trusts

The in-house asset rules

What is sufficient influence of a company?

- As a general rule sufficient influence will follow directorship or shareholding in a company
  - Eg if SMSF members hold more than 50% of the directorships or shares then company will be a related party
- But there are many corporations law cases on when an individual is found to be a "shadow director" – although difficult to prove.
  - *Guttridge v FCT* – father controlled a trust even though daughter was the sole director and shareholder of the trustee on the basis that the daughter just followed father's directions

The in-house asset rules

What is majority voting interest of a company ?

- Majority voting interest (section 70(1)(b))
  - Entity or entities
    - Position to cast
    - Control the casting of
  - More than 50% of the maximum number of votes that might be cast at the general meeting of the company
- Importantly
  - Only relates to voting not dividend or capital rights
  - Will only apply to shares with voting rights
  - Is **more** than 50%
- Therefore a company in which the member and his/her "group" hold 50% of the shares will generally not be a related company or a Part 8 associate

The in-house asset rules

What is a related trust?

- Section 10 – a related trust means a trust that a member of a standard employer sponsor controls under section 70E
- First we must consider a **group** (section 70(3)) which includes:
    - An entity
    - Part 8 associates of the entity
    - Combinations of the above

The in-house asset rules

What is a related trust?

- Section 70E(2) contains 3 control tests for a related trust, only one must be satisfied to be a related trust
- Test 1 – more than 50% income/capital test
    - Does the Group have a fixed entitlement to more than 50% of the capital or income of the trust?
    - Need to look to entitlements of income and capital
        - Is it more than 50%?
        - If holding 50% of the units in a unit trust you do not fail this test
    - Can include investments in sub-trusts
        - *Aussiegolfa v FTC*

The in-house asset rules

What is a related trust?

- Test 2 – control test
    - Trustee or majority of trustees
        - Accustomed
        - Under an obligation (formal or informal)
        - Might reasonably be expected to
    - Act in accordance with the Group's
        - Directions
        - Instructions
        - Wishes
    - Whether directions, instructions or wises
        - Are
        - Might reasonably be expected to be
    - Communicated
        - Directly or
        - Through interposed companies, partnerships or trusts

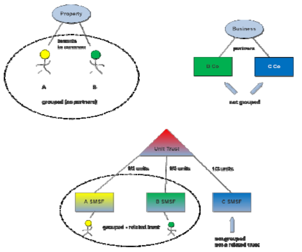
The in-house asset rules

What is a related trust?

- Test 3 – power to replace the trustee test
  - The Group has the power to remove or appoint the trustee or a majority of trustees
  - Review the trust deed of the trust
    - Generally the power is with the unit holders of a unit trust
    - Some deeds give the power to an appointor type role

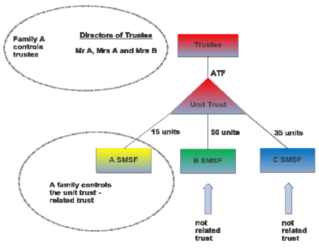
The in-house asset rules

Examples of related trust – partnership



The in-house asset rules

Examples of related trust – majority of directors



The in-house asset rules

Exceptions and anti avoidance rules

- Exceptions
  - Widely held unit trusts (sections 71(1)(h) and (1A))
  - Regulation 13.22C unit trusts and companies (section 71(1)(j) and regulation 13.22C)
  - Pre-99 unit trusts and companies (section 71A)
- Anti avoidance rules
  - Agreements which persons are aware that as a result an investment in or loan to an unrelated person that an investment will be made in a related party or related trust (section 71(2))
    - Applied in *Lock v FTC*
  - The Commissioner determines that an asset is an in-house asset (section 71(4))
    - Applied in *Aussiegolfa v FTC*
  - Schemes in which there is an intention to artificially reduce the value of in-house assets below the 5% limit (section 85)

Other SIS Act rules to consider

- Arm's length dealings requirement (section 109)
- Prohibition against acquiring assets from a related party (section 66)
  - Includes acquiring units or shares from related parties
  - Exception for acquiring units in regulation 13.22C unit trusts or shares in regulation 13.22C companies (section 66(2A)(a)(iv))
- Prohibition against providing financial assistance to members or their relatives (section 65)
  - In the ATO's view this can apply indirectly via investments in companies and trusts (SMSFR 2008/1)

Other SIS Act rules to consider

- Other applications of the in-house asset rules
  - Unpaid distributions - SMSFR 2009/3
  - Regulation 13.22C unit trusts that breach regulation 13.22D
  - Trusts converted into regulation 13.22C unit trusts in certain circumstances (SMSFD 2008/1)
- Investment strategy (section 52B)
  - This is an increasing focus of the ATO
- Sole purpose test (section 62)
  - In *Aussiegolfa v FTC* the Full Federal Court found an investment in a related trust did not breach the sole purpose test
- Indirect application of the SIS Act provisions – *Montgomery Wools v FTC*
  - Interest in a pre-99 unit trust found to breach sole purpose test by the actions of the unit trust trustee

Tax issues

"Normal" entity tax issues

- Assets can be held on income account
  - The rule that SMSF CGT assets are held on capital account (s295-85) does not apply to entities SMSFs invest 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
- Loss rules
  - For trusts
    - Trust loss rules
    - Is the unit trust a "fixed trust"
  - For companies
    - Continuity of ownership test
    - Similar business test
- Passing of franking credits for unit trusts

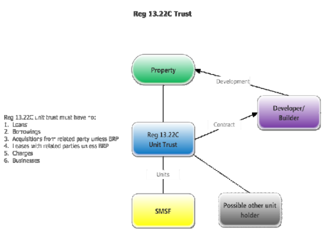
Tax issues

NALI

- Non-arm's length income (NALI) rules (section 295-550), in particular:
  - Is the SMSF's investment in a unit trust a fixed entitlement to income (section 295-550(4))?
    - ATO has sensible and pragmatic view of fixed entitlements for the NALI rules – TR 2006/7
    - But beware of hybrid trusts
  - Does the investment by the SMSF in a unit trust involve a scheme in which the income was derived on a non-arm's length dealing basis and the income is greater than it should be?
    - *Allen v FTC* – distribution from a discretionary trust to a fixed trust to an SMSF
  - Acquiring interests in companies and trusts for below market value
    - *Darrelen Pty Ltd v FTC* – acquiring shares for 10% of their value
    - *GYBW v FTC* – acquiring shares for "nominal value"

What structures can an SMSF invest in?

Regulation 13.22C unit trusts (and companies)



What structures can an SMSF invest in?

Regulation 13.22C unit trusts (and companies)

- Regulation 13.22C unit trusts and companies must meet very strict requirements
    - No leases of assets to related parties unless the asset is business real property and lease is legally binding
    - No lease of assets leased to another party which is in turn leased to a related party unless the asset is business real property and the lease is legally binding
    - No borrowings
    - No interests in another entity (eg units in another unit trust or shares in a company)
    - No loans
    - No assets acquired from a related party post 11 August 1999 unless its business real property acquired at market value
    - No assets that were formerly owned by a related party within 3 years of the SMSF acquiring its interest in the reg 13.22C unit trust or company unless its business real property acquired at market value
    - Not carrying on a business
    - Not carrying on activities on a non-arm's length dealing basis

What structures can an SMSF invest in?

Regulation 13.22C unit trusts (and companies)

- If those requirements are met then the units/shares will not be in-house assets (section 71(1)(j) and regulation 13.22C)
- A breach of any of these requirements will result in:
    - The units or shares becoming in-house assets (regulation 13.22D)
    - The breach cannot be rectified (regulation 13.22D(3))
    - The units/shares will have to be disposed of by the end of the next financial year to the extent they exceed the 5% test (section 82)

What structures can an SMSF invest in?

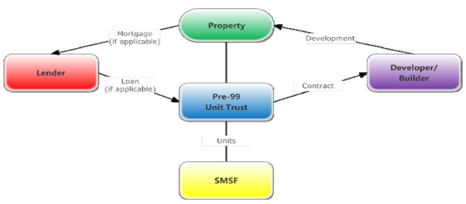
Regulation 13.22C unit trusts (and companies)

- Advantages
    - Units are not in-house assets
    - Can have co-investors as unit holders
    - Can acquire units from related parties (section 66(2A))
    - Depending on number of units acquired, duty may not apply for acquisition of units
    - Can have a controlling interest (even 100%) held by the SMSF
- Disadvantages
    - Activities of trust very restricted
    - Cannot operate as a business
    - Once 13.22D is breached, can never rectify

What structures can an SMSF invest in?

Pre-99 unit trusts (and companies)

PRE-99 UNIT TRUST



What structures can an SMSF invest in?

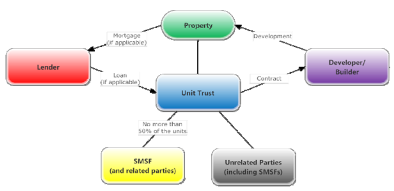
Pre-99 unit trusts (and companies)

- 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
- 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)

What structures can an SMSF invest in?

Unrelated trusts and companies

UNRELATED TRUST



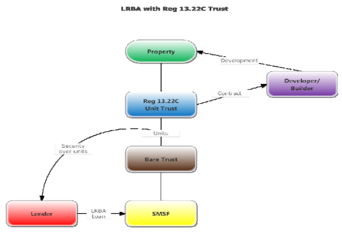
What structures can an SMSF invest in?

Unrelated trusts (and companies)

- 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
  - Lack of control
  - Cannot acquire units from related parties
  - Difficulty exiting

What structures can an SMSF invest in?

LRBAs and Reg 13.22C Unit trust combination



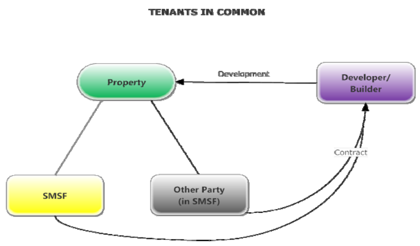
What structures can an SMSF invest in?

LRBAs and Reg 13.22C Unit trust combination

- 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

Other investment arrangements

Tenants in common / partnerships



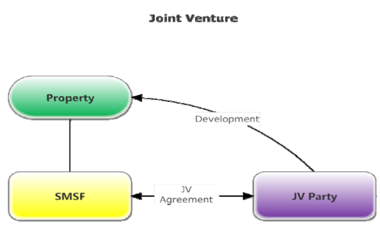
Other investment arrangements

Tenants in common / partnerships

- Advantages
  - Direct interest in the asset
  - SMSF can use its cash directly
  - Can develop existing asset (without borrowing)
  - Taxed at SMSF rate
- 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 which can have issues with tax, GST, duty and land tax
  - Duty if acquire co-owner interest

Other investment arrangements

Joint ventures



Other investment arrangements

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
  - On the ATO's radar – so expect scrutiny

Unit Trusts vs Companies

- Generally unit trusts are preferred - so why or why not consider a company
- Advantages of companies
  - Can retain income and therefore don't have problems with associated unpaid present entitlements
  - Franking credits refundable
  - Can time the derivation of income by the SMSF
  - General advantages of corporate structures (especially for unrelated companies)
- Disadvantages of companies
  - Loss of flow through taxation
  - Loss of the SMSF CGT discount
  - Risk of future changes to the law re refundable franking credits
  - Closer ATO attention? – TA 2015/1

Questions?

Thank you

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