

Technically Speaking: COVID-19 and SMSFs with property – What do I need to think about?

The health, social and economic impacts of the global COVID-19 pandemic have been far and wide and the SMSF sector is no different. The high degree of volatility and large falls in the global financial markets have created various issues and concerns for SMSF trustees. The restrictions on businesses and implementation of social distancing have had a significant impact on jobs, incomes and commercial and residential property.

The SMSF Association has worked with the Government, ATO and ASIC to provide some relief and guidance for the SMSF industry. The next step is for the sector to apply these measures in a practical and appropriate way.

The SMSF landlord dilemma – Rent, loan relief and the National Cabinet Rent Code

Many SMSFs with property, particularly commercial, will be experiencing hardship due to COVID-19. SMSF trustees with a non-related loan or their small business premises will be experiencing further difficulties.

A key feature of superannuation legislation is that all transactions must be at arm's length market rates. During this pandemic, 'market rate' is a term that can have many meanings. The offer of concessions for loans, rentals and other expenses are now standard and arguably commercial.

The ATO released the following guidance relating to rentals:

Question: *My SMSF owns real property and wants to give my tenant – who is a related party – a reduction in rent because of the financial effects of COVID-19. Charging a related party a price that is less than market value is usually a contravention. Given the effects of COVID-19, will the ATO take action if I do this?*

Answer: *Some landlords are giving their tenants rent relief as a rent reduction, waiver or deferral because of the financial effects of COVID-19 and we understand that you may wish to do so as well. Our compliance approach for the 2019–20 and 2020–21 financial years is that we will not take action if an SMSF gives a tenant – even one who is also a related party – a temporary rent reduction, waiver or deferral during this period.*

If your SMSF holds an interest in an interposed entity such as a non-g geared company or unit trust and that interposed entity leases property to a tenant, we will not treat the investment in the interposed entity as an in-house asset for the current and future financial years as a result of a deferral of rent being provided to the tenant due to the financial effects of COVID-19.

If there are temporary changes to the terms of the lease agreement in response to COVID-19, it is important that the parties to the agreement document the changes and the reasons for the change. You can do this with a minute or a renewed lease agreement or other contemporaneous document.



So, how do we apply this?

The key is to be as commercial and arm's length as possible. While there are further considerations when related parties are involved (such as financial assistance to members), this basic principle is of most importance.

It is also worth noting that while the ATO will not be taking an action if an SMSF gives a tenant a temporary rent reduction, waiver or deferral during this period it does not give SMSF trustees free reign to do as they please. The superannuation laws are still binding and in force.

Therefore, relief must be commercial, reasonable and documented.

The first aspect to ensure relief is arm's length is to ensure that the tenant is facing financial difficulty because of COVID-19. Relief can not be provided because of downturns relating to the reasons such as bushfires, or prior to the COVID-19 pandemic. A reduction in turnover because of social distancing measures is a good and clear example.

SMSF trustees then also must ensure that any relief is temporary. Detailing strict time limits, or review dates guarantees that relief is restricted to the COVID-19 impacts.

The relief offered then must be reasonable and justified to ensure that it is appropriate for the tenant. The most common set of principles is the National Cabinet Rent Code which is discussed below. However, if there is reasonable evidence for why a certain amount of relief is provided this will justify why the SMSF has taken action.

For example, the JobKeeper payment requires the employer to substantiate the estimated reduction in turnover and retain evidence. The same principles would apply in the request from a tenant (related or otherwise) for a reduction in rent proportionate to the financial impact to the tenant.

Finally, all of this must be documented. The ATO have stated this can be undertaken by minute or a renewed lease agreement or other contemporaneous document. It may be best practice to ensure any agreement change is legally enforceable.

Providing the relief looks reasonable and the trustee is able to show evidence to their auditor that the relief was documented and offered as a result of the adverse financial impacts of COVID19 then auditors can use their professional judgment in forming an opinion on the commerciality of the arrangement.

Importantly, the ATO will not treat interests in interposed entities, such as non-geared unit trusts, as in-house asset for the current and future financial years. This may have been an issue when a Regulation 13.22C unit trust provided rental relief and would then be considered an in-house asset requiring the unwinding of the structure.

What evidence can we use to document commerciality?

SMSF landlords must now also be aware of the National Cabinet Rent Code which impose a set of good faith leasing principles for application to commercial tenancies (including retail, office and industrial) between owners/operators/other landlords and tenants.



It is important to note that these principles only apply to commercial tenancies that are suffering financial stress or hardship as a result of the COVID-19 pandemic as defined by their eligibility for the Commonwealth Government's JobKeeper programme (30% fall in turnover), with an annual turnover of up to \$50 million (herein referred to as "SME tenants"). There is, however, no doubt this will be used as a reference point as to what will be considered arm's length for all these types of transactions.

We encourage you to read the Code in full. We will focus on the key principle of the Code which explains a proportionate response for rental relief.

Key Principles of the National Cabinet Rental Code

The key principle of the Code is landlords must offer commercial tenants **proportionate** reductions in rent payable **in the form of waivers and deferrals** of up to 100% of the amount ordinarily payable, on a case-by-case basis, based on the reduction in the tenant's trade during the COVID-19 pandemic period and a subsequent reasonable recovery period.

Rental waivers must constitute no less than 50% of the total reduction in rent payable over the COVID-19 pandemic period. They should be greater than 50% in cases where failure to do so would compromise the tenant's capacity to fulfil their ongoing obligations under the lease agreement. Regard must also be had to the landlord's financial ability to provide such additional waivers.

Tenants may waive the requirement for a 50% minimum waiver by agreement.

So, if the tenant's revenue has fallen by 100%, then at least 50% of total cash flow relief is rent free/rent waiver and the remainder is a rent deferral. If the qualifying tenant's revenue has fallen by 30%, then at least 15% of total cash flow relief is rent free/rent waiver and the remainder is rent deferral.

In addition, payment of rental deferrals by the tenant must be amortised over the balance of the lease term and for a period of no less than 24 months, whichever is the greater, unless otherwise agreed by the parties. For example, if a tenant only has 3 months left on lease they would still be entitled to pay off the deferred rent over a 24 month period.

Let's look at a real example.

An SMSF property tenant is currently paying rent of \$4,800 per month. However, due to COVID-19 turnover has fallen by 60%.

Therefore, the SMSF trustees are required to provide a 60% cash flow relief to the tenant. This equates to \$2,880 of relief (\$4,800 x 60%).

Half of these relief, \$1,440, is to be provided as a waiver/rent free.

The remainder is to be deferred, spread over the term of the lease, or at least 24 months.

The new rent is \$1,920, which is due and payable.



Remember parties are also free to make alternative commercial arrangement to this formula if that is their wish but care must be taken to ensure that repayment of the deferred rent does not affect the ability of the tenant to recover.

You should also consider the impact on some SMSFs funding pensions where unrelated tenants get a 24 month deferment & no new lease can be secured.

This provides a clear framework for SMSFs which are providing rent relief for their commercial tenants. The same framework should apply if the tenant is a related party.

Relevance to residential property?

While residential protocols will apply on a state by state basis, in the absence of any state legislation at this point in time, this is a potential starting point for assessing the relief SMSF trustees may also offer to residential tenants.

State legislation

Links to announcements made by State Governments are provided here. These will be useful for information regarding residential property and potentially further binding application of State law over the National Code Principles.

VIC - <https://www.premier.vic.gov.au/supporting-tenants-and-landlords-through-coronavirus/>

SA - <https://www.premier.sa.gov.au/news/media-releases/news/state-government-provides-rent-relief-for-businesses>

NSW - <https://www.nsw.gov.au/news/land-tax-break-to-support-tenants-and-landlords>

QLD (Res) - https://www.covid19.qld.gov.au/_data/assets/pdf_file/0016/126313/residential-tenancies-practice-guide-april-2020.pdf

ACT - <https://www.revenue.act.gov.au/covid-19-assistance>

TAS – Strong eviction bans but there is no financial relief available yet.

WA - <https://www.wa.gov.au/organisation/department-of-treasury/western-australian-fact-sheets-economic-response-coronavirus>

What about LRBA's?

Banks are now offering concessions for their loans including deferral of scheduled loan repayments, waiving fees, and temporary interest-only periods. The same principles should therefore apply to related party LRBA's.

The ATO have provided the following guidance:

Question: *My SMSF has a compliant limited recourse borrowing arrangement (LRBA) in place with a related party. Would the non-arm's length income (NALI) provisions apply if the related party offers repayment relief to the SMSF trustees because of COVID-19?*



Answer: *We understand that temporary repayment relief may be offered in relation to an existing LRBA between an SMSF and a related party due to the financial effects of COVID-19.*

If the repayment relief reflects similar terms to what commercial banks are currently offering for real estate investment loans as a result of COVID-19, we will accept the parties are dealing at arm's length and the NALI provisions do not apply. For example, these terms currently include temporary repayment deferrals for most businesses of up to 6 months, with unpaid interest being capitalised on the loan.

The parties to the arrangement must also document the change in terms to the loan agreement and the reasons why those terms have changed. It is also expected that there is evidence that interest continues to accrue on the loan and that the SMSF trustee will catch up any outstanding principal and interest repayments as soon as possible.

Any further repayment relief needed due to the continued effects of COVID-19 should be reviewed at the end of the agreed deferral period and remain in line with what the commercial banks are offering at that time.

See also:

- You can refer to the [Australian Banking Association's website](#) for current information on COVID-19 bank relief.

Yet again, the same principles will apply. Any **relief provided must be commercial, reasonable and documented.**

The ATO is clear that the relief provided under this FAQ does not extend to changes to interest rates or extension of loan terms. This relief is provided to ensure that a repayment deferral and capitalisation of interest will not trigger a non-arm's length income event. This is based on the relief that current commercial banks are offering.

However, SMSF trustees are still free to refinance their loans at anytime with reference to commercial principles and the existing superannuation laws.

Some related party loans will also have to deal with Div 7A requirements. The ATO is aware there may be a Div 7A problem and are reviewing the situation.

What does no compliance resources really mean?

As we have highlighted, just because the ATO is not allocating compliance resources does not mean that the superannuation laws no longer apply. Auditors will consider breaches as per the SIS Act.

However, the ATO will not impose penalties or look to disqualify the trustees for these types of breaches. In order to make it easier for auditors, the ATO are currently updating the Auditor/Actuary Contravention Report (ACR) instructions for the 2020 income year to state you will not need to report these breaches in the ACR. The SMSF independent auditor's report should nevertheless still be modified for material contraventions in accordance with the auditing standards.



Where auditors cannot be satisfied that the relief offered by the trustee is on commercial terms or whether it has been offered due to the adverse financial impacts of COVID19, they should report the contravention and provide an explanation in the ACR as to why they think there is a breach.

Therefore, it is important these further following rules, especially when related parties are involved, are considered:

The Sole Purpose test: This means your fund needs to be maintained for the sole purpose of providing retirement benefits to your members, or to their dependants if a member dies before retirement. Therefore, any relief that is provided should evidence how that relief is in the best interests of the members. For example, ensuring the sustainability of a tenant is in the best interests of members in the long run.

Financial assistance: Paragraph 65(1)(a) of SISA prohibits the lending of fund money to a member, or a relative of a member of the fund. Paragraph 65(1)(b) of SISA prohibits using fund resources to provide any other financial assistance to a member, or a relative of a member of the fund. It is important to document that any provision of relief to a related party is consistent with commercial, arm's length terms and therefore is not a prohibition of this section.

Arm's length rules: Section 109 of SISA provides that where an SMSF enters into an arrangement where the other party to the arrangement is advantaged to the detriment of the SMSF, then the transaction will be treated as being non-arm's length and so a breach of the section. Clear documentation of the changes to the arrangement between the parties is essential, comparing them to similar other arrangements being put in place generally to establish that while the SMSF may be disadvantaged, it is in line with commercial arrangements elsewhere.

In-house asset rules: Capitalisation of interest or rental deferral can be characterised as a new loan in circumstances involving a related party loan or lease arrangement and so fall within the definition of an in-house asset. In similar circumstances, where there is a wholly-owned interposed entity which owns the property and which relies on Division 13.3A of the SIS Regulations to avoid having the interest in the interposed entity being treated as an in-house asset, may lose that exemption if interest on a loan is capitalised or rental relief is provided to the tenant. In either instance, the ATO has made it clear that the in-house asset rules will not be applied provided the COVID19 guidelines discussed above are complied with. A breach of these requirements for any other reason will result in the application of the in-house asset provisions.

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