The ins and outs of in-house assets

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Why do we care about in-house assets?

SIS contains a number of rules that govern the investment activities of superannuation funds. Collectively, these rules are designed to limit the risks associated with superannuation fund investments and to ensure that superannuation savings are preserved for retirement purposes.

One of these rules imposes a limit on the amount of a fund's assets that can be held in the form of "in-house assets".

The limit is 5% and it is imposed at:

- the time an in-house asset is acquired [SIS s.83], and thereafter
- each 30 June [SIS s.82].

SIS imposes various penalties in cases where the in-house assets rules are contravened and such penalties could include administrative (ie monetary) penalties issued to the trustee(s) of the fund, disqualification of trustees, and loss of complying status for the fund.

What is an in-house asset?

An in-house asset of an SMSF is an "asset of the fund" that is [SIS s.71(1)]:

- 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.

Asset of the fund?

An asset of the fund is considered [SIS s.10(1)] **any form of property** (including money, whether Australian or foreign currency).

The term "property" is not defined in SIS and therefore takes its ordinary meaning [SMSFR 2009/1 PARA 7]. The Commissioner has taken the view that the phrase "any form of property" has a very wide meaning and includes [SMSFR 2009/1 PARA 8] every type of right, interest or thing of value that is legally capable of ownership and encompasses both [SMSFR 2009/1 PARA 9]:

- real property (ie land and interests in land), and
- personal property – ie all forms of property *other than* real property. Personal property includes *tangible* personal property such as gold bullion and *intangible* personal property that can be enforced by legal or equitable action, for example:
    - a debt,
    - an interest in a trust fund,
    - rights arising under a contract, and
    - an option to acquire something, for example, a boat, machinery, shares in a company, units in a unit trust, a mining exploration licence, a mining lease, patents, trademarks, copyright.

Meaning of "loan"?

SIS expands upon the normal meaning of "loan" (ie a payment and repayment of money) to include [SIS s.10(1)]:

- the provision of credit, or
- any other form of financial accommodation

whether or not enforceable, or intended to be enforceable, by legal proceedings. Note that the formality and the legal enforceability of an arrangement do not affect whether it is a "loan" [SMSFR 2009/1 PARA 12].

Under this expanded meaning, arrangements that are in substance financing arrangements where the payment of an amount is *deferred* such as:

- the lending of money,
- the sale of goods or land on credit,
- instalment payment arrangements, and
- arrangements for the deferral of payment of debts or entitlements

are considered a "loan" [SMSFR 2009/1 PARA 11]. Note also that the Commissioner has taken the view that an arrangement will be considered a loan even in cases where there is no purpose of gaining interest, income, profit or gain (eg an interest free "loan") [SMSFR 2009/1 PARA 12].

Not every situation where a payment is deferred necessarily amounts to a "loan" under the extended meaning.

The Commissioner accepts that payment for goods on **normal commercial terms** will not amount to a "loan", nor will late payments which were not agreed to by the trustee of the superannuation fund [SMSFR 2009/1 PARA 13].

Example 1

Shazza is a member of the On Just Terms SMSF. The other members of the SMSF are Das and Sal (her parents) and Con (her husband).

Rent payable to the On Just Terms SMSF from Shazza's nail and beauty business is due on the last day of each month.

Prior to COVID-19, the June 2019 rent payment was overlooked due to a clerical error. This was not discovered until the next payment was due in July 2019 and payment was received for both months at that time.

As the late payment was not part of an arrangement between the parties (ie the SMSF had not agreed/consented to Shazza's business making the payment after it was due), it is not financial accommodation or provision of credit. Therefore the outstanding amount was not a "loan" on 30 June 2019 and consequently was not required to be included in the in-house assets of the SMSF at that time.

[ADAPTED FROM SMSFR 2009/4 EXAMPLE 1]

Unpaid present entitlements

Where an SMSF is presently entitled to a distribution from a related or non-arm's length trust, and payment of this amount is not sought, the recording of an unpaid trust distribution as a loan in the financial statements of the SMSF will not of itself determine that the amount is a loan for the in-house asset rules [SMSFR 2009/3 PARA 6].

However, should the SMSF trustee and the trustee of the trust agree to bring a loan into existence (eg by executing a loan agreement) there will be a constructive receipt of the distribution by the SMSF trustee and a subsequent loan back of that amount to the trust. Such loan would be an in-house asset of the SMSF where the trust is a related trust.

In addition, in cases where the trust is a related trust and the circumstances indicate that consensual agreement for the provision of credit or other form of financial accommodation has been reached between the parties, the Commissioner has taken the view that the extended definition of "loan" [SIS S.10(1)] will be satisfied in relation to the non-payment of the trust distribution amount. Such amount would be an in-house asset of the SMSF [SMSFR 2009/3 PARA 8].

Meaning of "investment in"?

The term "investment" is not defined in SIS, however, "invest" is defined as [SIS S.10(1)]:

- apply assets in any way, or
- make a contract

for the purpose of gaining interest, income, profit or gain.

The Commissioner has determined the meaning of "investment' can be derived from the meaning of "invest" [IN ACCORDANCE WITH ACTS INTERPRETATION ACT 1901 S.18A] and in this context, an "investment" is the asset resulting from the application of the fund's assets or from entering into a contract for the purpose of gaining interest, income, profit or gain [SMSFR 2009/1 PARA 15].

Whether an investment is "in" a particular entity (ie a related party or related trust in the context of in-house assets) is then determined by reference to the legal rights acquired by the SMSF in return for its expenditure. The Commissioner has taken the view that where money or assets are provided by the fund for the benefit of a related party or related trust for the purpose of receiving income, interest, profit or gain, a sufficiently close connection will be established between the investment and that entity to enable it to be described as an investment "in" that entity [SMSFR 2009/1 PARA 18].

It is the fund's reliance on the related party or the related trust for payment on the investment which determines whether the fund has an "investment in" that related party or related trust [SMSFR 2009/1 PARA 18].

Meaning of "lease" and "lease arrangement"

The term "lease" is not defined in SIS and therefore is given its ordinary meaning.

In the case of real property, the Commissioner has taken the view that a lease will occur where the lessee is granted *exclusive possession* of the property, generally in exchange for a rent [SMSFR 2009/1 PARA 21].

In the case of any other property, the Commissioner has taken the view that the term "lease" means a legally enforceable hiring agreement involving the payment of consideration by the hirer in exchange for enforceable *temporary possession* of the asset.

The term "lease arrangement" is defined as [SIS S.10(1)] any agreement, arrangement or understanding in the nature of a lease (other than a lease) between a trustee of a superannuation fund and another person, under which the other person is to use, or control the use of, property owned by the fund, whether or not the agreement, arrangement or understanding is enforceable, or intended to be enforceable, by legal proceedings.

An arrangement "in the nature of" a lease will resemble a lease, ie it will have some, but not necessarily all, of the characteristics of a lease [SMSFR 2009/1 PARA 25].

The Commissioner has taken the view that the term "lease arrangement" expands the definition of in-house assets to include *informal* arrangements under which a person uses or controls the use of fund property. This includes arrangements where a related party gains possession of an asset of the superannuation fund, even where no rent is payable in exchange for that possession [SMSFR 2009/1 PARA 27].

Example 2

Gazza and Kath have an SMSF. The SMSF owns some machinery that used to be leased to an unrelated motor crash repair business.

Gazza's parents (Das and Sal) own a motor crash and radiator repair business.

While looking for a new lessee, the machinery owned by the SMSF is kept at the premises of Das and Sal's business (ie at a related party's business premises) and is used by that business. There is no formal arrangement for the lease of the asset and no rent is paid.

Several factors point to the machinery being subject to a lease arrangement between the SMSF and Das and Sal's business.

The machinery is physically located in Das and Sal's business premises, giving them the right to control access to it and they use it in their business. Das and Sal have *possession* of the asset rather than mere

custody of it. The nature of the arrangement is therefore similar to a lease despite there being no rent payments or formal lease agreement.

The machinery is therefore an asset of Gazza and Kath's SMSF that is subject to a lease arrangement while it is being used in Das and Sal's business, and therefore is an in-house asset of the SMSF.

[ADAPTED FROM SMSFR 2009/4 EXAMPLE 5]

Example 3

The members of the On Just Terms SMSF are Das and his wife Sal, their daughter Shazza and her husband Con.

The SMSF is the proud owner of a set of jousting sticks.

The sticks are mounted on the wall of commercial premises owned by the SMSF. The commercial premises are leased to Das and Sal's business. There is no lease in place between the SMSF Trustee and the business in relation to the sticks.

Regardless of whether or not the business pays rent to the SMSF, Das and Sal's business has the right to control access to the sticks. As a result, a lease arrangement is considered to exist between the SMSF Trustee and the business.

The sticks are therefore an asset of the On Just Terms SMSF that is subject to a lease arrangement while it is being used in Das and Sal's business, and therefore is an in-house asset of that SMSF.

[ADAPTED FROM SMSFR 2009/4 EXAMPLE 5]

SMSF leases part of asset to a related party

Where an SMSF trustee enters into a lease or lease arrangement with respect to *part* of a property, the in-house asset is the part of the property that is leased to the related party.

Example 4

The members of the On Just Terms SMSF are Das and Sal (married), their daughter Shazza and her husband and Con.

Assume the On Just Terms SMSF owns residential property which is leased to an unrelated third party with the exception of a garage at the rear of the property with its own street access.

This garage is specifically excluded from the residential lease and the tenant has no access to it.

Instead, Das holds the keys and security alarm code to the garage and he uses it for the storage of his (personally owned) Holden car collection. No rent is paid to the SMSF by Das for the garage but he

personally pays for insurance and a monitored alarm. The part of the property comprised of the garage is subject to a lease arrangement with Das (a related party of the SMSF) and consequently is an in-house asset of the SMSF.

[ADAPTED FROM SMSFR 2009/4 EXAMPLE 6]

Related party?

A related party, of a superannuation fund, means any of the following [SIS S.10(1)]:

- a member of the fund,
- a standard employer-sponsor of the fund, or
- a Part 8 associate of an entity referred to above.

Standard employer-sponsor of the fund?

An employer is a "standard employer-sponsor" of a fund, and thereby a related party of a fund, if the employer makes contributions to the fund because of an arrangement between the employer and the trustee(s) – not an arrangement between the employer and the member(s) – of the fund [SIS S.16(2)].

While an employer is an "employer-sponsor" of a fund if it contributes to a fund for the benefit of an employee [SIS S.16(1)], importantly it would not be a "standard employer-sponsor" of a fund if it contributes to the fund only because of an arrangement with the employee /member [SMSFR 2009/4 PARA 137].

Note that it is not common for an SMSF to have a standard employer-sponsor.

Part 8 associates of a member?

The Part 8 associates of a member include [SIS S.70B]:

- the relatives [SIS S.10(1)] of the member,
- if the superannuation fund is an SMSF or a small APRA fund (SAF), the other member(s) of that SMSF/SAF,
- if the superannuation fund is a single member SMSF, all directors of the corporate trustee or all individual trustees,
- if a member is a partner in a partnership [SIS S.70E(4), ITAA 1997 S.995-1(1)], the member's partner (and their spouse or child if the partner is an individual) and the partnership itself,
- a trust, where the member(s) and/or their Part 8 associates "control" the trust [SIS 70E(2)]. A trust will be controlled by the member(s) and/or their Part 8 associates (collectively known as a "group") if:
    - the group has a fixed entitlement to more than 50% of the capital or income of the trust,

  - 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 the group, or
  - the group is able to remove or appoint the trustee, or a majority of the trustees, of the trust (note the trust deed of the trust would generally prescribe who has the power to remove or appoint the trustee (or a majority of the trustees). If the trust deed of the trust does not prescribe who has these powers, the powers would be prescribed by the trustee act of the relevant state).

  Trusts that are controlled by a member and their Part 8 associates are known as "related trusts" [SIS s.10(1)], and

- a company, where the member(s) and/or their Part 8 associates "control" the company [SIS 70E(1)]. A company will be controlled by a group if:
  - the group "sufficiently influences", or
  - "holds a majority voting interest in"

  the company. Note that:

  - a company is "sufficiently influenced" by the group if the company, or a majority of its directors, 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 the group, and
  - a group holds a majority voting interest in a company if the group is in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

Exceptions : what isn't an in-house asset?

While an in-house asset of an SMSF is an asset of the fund that is [SIS s.71(1)]:

- 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,

exceptions apply to certain assets. If an exception applies, the asset will not be an in-house asset of the SMSF.

Business real property

Real property subject to a lease, or to a lease arrangement enforceable by legal proceedings, between an SMSF trustee and a related party of the fund will not be an in-house asset of the SMSF if, throughout the term of the lease or lease arrangement, the property is business real property [SIS s.71(1)(g)].

Business real property is defined as [SIS s.66(5]:

(a) any freehold or leasehold interest of the entity in real property,

(b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer, or

(c) if another class of interest in relation to real property is prescribed by the regulations for the purposes of this paragraph—any interest belonging to that class that is held by the entity,

where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not), but does not include any interest held in the capacity of beneficiary of a trust estate.

The Commissioner has taken the view [SMSFR 2009/1] that:

- real property refers to land, which can generally be identified by reference to titles held over particular parcels of land,
- a "freehold interest" in real property entitles the interest holder to ownership of the property. Such an interest entitles the entity holding it to exclusive possession of the property for an indefinite period of time. Note that a freehold interest can be co-owned with other entities (ie each co-owner holds a freehold interest in the real property) and an entity can hold a freehold interest in strata titled property,

- a “leasehold interest” in real property conveys a right on the part of the entity holding the interest to exclusively possess the property for a period of time that is either pre-determined or capable of being determined. A leasehold interest may apply to all of the land that is subject to a particular title, or only a defined part of such land,
- other more limited rights of possession, occupation or use over real property may be granted to an entity. These rights are not a freehold or leasehold interest in the property and therefore cannot give rise to business real property for the entity unless they satisfy ”b” or “c” above,
- any building or other thing that is a fixture attached to the land for the betterment of the freehold / leasehold interest by more than its own weight would generally form part of that real property (in accordance with property law) – unless it was only affixed temporarily. A demountable building, for example, would generally not form part of the real property – rather it would be a separate asset – unless, say, it was no longer practically demountable as a result of attachment to permanent foundations and connections to utility services (such as water and electricity).

  Further, some crops that form part of land (eg fruiting trees) would generally be considered to form part of the real property. In contrast, most annual crops would not be considered part of the real property – rather these would be considered a separate asset.
- Crown land is land which is vested in the Commonwealth, a State or a Territory of Australia that is subject to the provisions on administration and dealings set out in the relevant statute in each jurisdiction.

  In order for Crown land to be an eligible interest for the purposes of the business real property definition, it must be capable of being assigned or transferred, ie all rights and liabilities that exist under the interest must be capable of being transferred to another party. In order to determine this capability, it is necessary to examine the instrument that gives rise to the interest as this will specify the nature and extent of the interest. Examples of interests in Crown land that may be capable of assignment or transfer, depending on the relevant legislation, include pastoral, agricultural and mining leases.

  Note that whilst a leasehold interest in Crown land is excluded from “b”, it would be an eligible interest in real property under “a”.

Lease/ lease arrangement enforceable by legal proceedings?

The ATO recently expressed concern about SMSFs entering into related party lease arrangements without following a formal *written* process [SMSFRB 2020/1 PARA 30].

In the absence of a *written* lease document:

- the Commissioner may consider that the arrangement is not legally binding (which will mean the property is an in-house asset of the fund), and also

- it can be difficult to determine the terms and conditions on which the arrangement is based (which can make it difficult to determine if the arrangement is conducted on "arm's length" terms).

The Commissioner has taken the view [SMSFRB 2020/1 PARAS 31-37] that if:

- the term of a lease expires,
- the agreement is not renewed, and
- the original lease agreement did not include a "continuation clause" or other provision to deal with the period of time after the end of the original term

the lease arrangement has ceased to be legally binding.

While many in the SMSF industry and legal commentators do not necessarily agree with the ATO's view, we recommend trustees are mindful of the ATO view and are prepared to defend their position should lease agreements not be renewed (in writing) upon expiry.

Example 5

The members of the On Just Terms SMSF are Das and Sal (married), their daughter Shazza and her husband and Con.

The most significant assets of the SMSF include beauty salon premises which are leased to Shazza's nail and beauty business and commercial premises leased to Das and Sal's motor crash and radiator repair business.

There is a written lease in place between the SMSF Trustee and Shazza (in relation to the beauty salon premises), and also between the SMSF Trustee and Das and Sal (in relation to the motor crash and radiator repair business premises).

Neither lease includes a continuation clause.

Should the term of a lease expire, and the lease not be renewed, the leased asset may become an in-house asset of the SMSF at that time.

Should business real property held directly by an SMSF be considered an in-house because of the lack of a legally enforceable lease arrangement, the situation may be relatively easy to rectify by altering the arrangement to ensure it is legally binding.

Investment in a "13.22C entity"

An SMSF's investment in a company or trust that is a related party / related trust of the SMSF will not be an in-house of the SMSF if [SIS S.71(1)(J)]:

- certain requirements are met [SIS REG 13.22C], **and**
- certain events have *not* occurred since the SMSF acquired its shares or units [SIS REG 13.22D].

Requirements of SIS Reg 13.22C

The rules are very restrictive. The company / trust (and the SMSF) must meet all of the following rules while the SMSF holds an investment in the company / trust in order for the in-house asset exception to apply:

- the fund must have fewer than five members.

  Note that this means the in-house asset exception is available to both SMSFs and SAFs.

  Note also that should legislation ultimately pass to increase the maximum number of SMSF / SAF members from 4 to 6, this restriction would be amended to "fewer than seven members",

- the company / trust cannot lease any of its assets to a related party unless the asset in question is business real property and the arrangement is legally binding (and there are additional rules to prevent other entities being interposed here to circumvent the requirement),
- the company / trust cannot borrow money. This prohibition on borrowing would even include a bank overdraft (whether intentional or not).

  Note, however, that the rules do not preclude an investor in the trust (the SMSF itself or other investors in the same vehicle) using borrowed funds to acquire their units,

- the company / trust cannot own an interest in another entity. This precludes the ownership of (say) shares, managed funds, units in other trusts etc – note that this would even preclude the company / trust from using a cash management trust as its cash account,
- the company / trust cannot lend money.

  Note that an amount held on deposit in a bank account in the name of the company / trust is deemed to be a loan from the company / trust to the bank that holds the deposit! Deposits held with an "authorised deposit-taking institution" (ADI), however, are specifically excluded,

- there must not be a charge over any of the company / trust's assets. For example, if parties other than the superannuation fund had acquired shares / units in the company / trust and had borrowed to do so, the underlying assets held by the company / trust could not be used as security for their borrowings, and

- except for business real property acquired at market value, the company / trust cannot have acquired an asset from a related party after 11 August 1999. There are additional rules to ensure that an asset cannot be acquired indirectly – eg passing from a related party, to another (unrelated) entity and then to the company / trust – if it was owned by a related party at any time in the three years before the fund made its first investment in the company / trust.

Given the restrictions imposed, these entities are really only suitable for owning property (commercial or residential) and other "real" assets such as collectables, machinery, furniture, fittings etc.

Events that will cause the SIS Reg 13.22C exception to cease to apply

In the event that the number of members of the fund increases to five or more, *any* investment in a company or trust that is a related party / related trust of the SMSF at that time will cease to be excluded from being an in-house of the SMSF (unless another exception applies) [SIS REG 13.22D(1)(A)].

Example 6

The Acme SMSF has four members and holds the following investments:

- 100% of the shares in Acme Pty Limited – a company controlled by the members of the Acme SMSF, and
- 100% of the units in Acme Trust - a unit trust controlled by the members of the Acme SMSF.

To date, both Acme Pty Limited and Acme Trust have complied with all the requirements of SIS Reg 13.22C and all of the Acme SMSF's investments in these entities are excluded from being an in-house asset.

An additional member was admitted to the Acme SMSF, increasing the number of members to five. Shortly afterwards, one of the members terminated their membership reducing the number of members of the fund to four.

As the membership of the SMSF increased to five or more for a period of time, an event has occurred that has caused the fund's investments in both Acme Pty Limited and Acme Trust to no longer be excluded from being an in-house asset.

This means the fund's investments in these entities will be treated as an in-house asset from that date.

In addition, any investment in those entities can **never again** be excluded from being an in-house asset [SIS REG 13.22D, SMSFD 2008/1]. This is the case even if the event which caused the entity to breach the rules no longer exists (ie membership of the fund decreases below 5 in this case) [SIS REG 13.22D, SMSFD 2008/1].

In addition, if [SIS REG 13.22D(1)(B) – (N)]:

- the related party / related trust operates a business,
- any transactions within the related party / related trust are carried out other than on an arm's length basis (regardless of whether the parties to the transaction are related parties or not), or
- the related party / related trust breaks one of the remaining rules outlined above (ie the SIS Reg 13.22C requirements)

an SMSF's investment in that particular related party / related trust will cease to be excluded from being an in-house of the SMSF (unless another exception applies).

Example 7

The Bizzee SMSF holds the following investments:

- 100% of the shares in Bizzee Pty Limited – a company controlled by the members of the Bizzee SMSF, and
- 100% of the units in Bizzee Trust - a unit trust controlled by the members of the Bizzee SMSF.

To date, both Bizzee Pty Limited and Bizzee Trust have complied with all the requirements of SIS Reg 13.22C and all of the Bizzee SMSF's investments in these entities are excluded from being an in-house asset.

Bizzee Pty Limited acquires a small number of listed shares.

As a result, an event has occurred that has caused the fund's investment in Bizzee Pty Limited (but not Bizzee Trust) to cease to be excluded from being an in-house asset from that time.

This means the fund's investment in Bizzee Pty Limited (but not Bizzee Trust) will be treated as an in-house asset from that date. In addition, any investment in Bizzee Pty Limited can **never again** be excluded from being an in-house asset [SIS REG 13.22D, SMSFD 2008/1]. This is the case even if the event which caused the entity to breach the rules no longer exists (ie the small number of listed shares are disposed of) [SIS REG 13.22D, SMSFD 2008/1].

The fund's investment in Bizzee Trust is unaffected and it remains excluded from being an in-house asset.

COVID-19 rent relief: deferred rent

As you may be aware, many landlords provided rent relief to commercial tenants under the COVID-19 rent relief provisions. Under these provisions, a rent deferral means the amount due is still owed and must be paid by the tenant over the longer of:

- the remaining term of the lease, or
- 24 months.

Under the extended definition of a "loan" in SIS, a rent deferral is considered the "provision of financial accommodation" and therefore the landlord would be taken to "acquire" a loan [SIS S.10(1) DEFINITION OF "LOAN", SMSFR 2009/4 PARAS 10, 11 & 66 TO 72].

Ordinarily, the creation of this loan would be [SIS S.71(1)]:

- considered an in-house asset of the SMSF if the tenant was a related party, and
- considered an event [SIS REG 13.22D] that causes an SMSF's investment in a "13.22 entity" [IE AN ENTITY THAT COMPLIED WITH SIS REG 13.22B OR C] to no longer be excluded from being an in-house asset.

The ATO have issued a legislative instrument [SELF MANAGED SUPERANNUATION FUNDS (COVID 19 RENTAL INCOME DEFERRALS – IN HOUSE ASSET EXCLUSION) DETERMINATION 2020] that excludes such asset (whether acquired or held) from being an in-house asset of the SMSF in 2019/20, 2020/21 or future years where rent relief is provided during 2019/20 and/or 2010/21 to ease the financial impact of COVID-19.

Importantly, note that the exclusion would only apply to situations where the SMSF trustee or "13.22 entity" acts in good faith and, as a result of the financial impacts of COVID-19, has offered the tenant a rent deferral under a lease (on arm's length terms) during 2019/20 and 2020/21 in order to ease the financial hardship caused by COVID-19 (evidenced by contemporaneous documentation drafted to reflect the revised rental terms agreed to by the SMSF trustee or "13.22 entity" and the tenant to ensure the parties continue to deal with each other at arm's length and the lease remains enforceable).

An investment in a widely held trust

An SMSF's investment in a widely held trust will not be an in-house of the SMSF [SIS REG 71(1)(H)].

A widely held trust is defined as [SIS S.71(1A)]:

- a unit trust in which entities have fixed entitlements to all of the income and capital of the trust, and
- it is not a trust in which fewer than 20 entities between them have:
  - fixed entitlements to 75% or more of the income of the trust, or
  - fixed entitlements to 75% or more of the capital of the trust.

In other words, a unit trust where the top 20 unitholders – grouping all related parties together - own less than 75% of the units.

A typical example of a widely held trust is an institutionally owned managed fund.

Note that there is no equivalent concept for companies that are widely held.

Limited recourse borrowing arrangement ("LRBA")

Under an LRBA, an SMSF trustee may borrow money to acquire an asset provided the lender only has recourse in the event of default to the asset acquired using the borrowed money. While the borrowing remains outstanding, the asset is to be held on trust (generally known as a "holding trust") so that the trustee of the SMSF acquires a beneficial interest in that asset.

In many cases, the holding trust will be a "related trust" of the SMSF [AS DEFINED IN SIS S.10(1)]. As outlined earlier, an investment in a related trust of the SMSF is an "in-house asset" of the SMSF [SIS S.71(1)], unless a relevant exception applies.

An exception applies [SIS S.71(8), SMSFR 2009/4 PARAS 171 - 172] to ensure the SMSF's interest in the holding trust under an LRBA arrangement [SIS S.67A(1) OR FORMER S.67(4A)] is not an in-house asset of the SMSF at a time provided that :

- the only property of the holding trust at that time is the asset acquired under the LRBA, and
- that asset would not be an in-house asset if held directly in the fund at that time.

Pre-11 August 1999 arrangements

The in-house asset rules were substantially extended in August 1999 [SUPERANNUATION LEGISLATION AMENDMENT ACT (NO. 4) 1999]. As a result, many investments held by superannuation funds which were not considered in-house assets prior to these amendments were now caught under the revised rules. As a consequence, transitional rules were inserted into the superannuation law [SIS PART 8 DIVISION 1 SUBDIVISION D] for certain assets held prior to the end of 11 August 1999.

The transitional rules allow fund investments or leases that were in place at the end of 11 August 1999 (and which were not in-house assets under the old rules) to continue without being subject to the amended in-house asset rules that apply from 23 December 1999 (ie the time the amending legislation received Royal Assent). The transitional rules also allow for certain additional investments after 11 August 1999 but before 30 June 2009 to be excluded from being considered as in-house assets.

11 August 1999 investments and loans [SIS S.71A, SMSFR 2009/4 PARAS 175 - 176]

Investments in, or loans to, related parties of an SMSF are permanently excluded from being an in-house asset if they were in place at the end of 11 August 1999 and were not an in-house asset under the previous rules. These include fund investments or loans under a contract entered into by the end of 11 August 1999, but where the investment or loan actually occurred after that date.

This exclusion from the in-house asset rules also applies to partly paid shares and units purchased prior to the end of 11 August 1999 provided that no payments are made after 30 June 2009. Payments made after 30 June 2009 on these shares or units will result in their becoming in-house assets of the fund, however, the value of the shares or units included in the calculation of the value of in-house assets will be reduced to reflect the amounts paid after 30 June 2009 [SIS S.71A(3)].

Reinvested earnings [SIS S.71D, SMSFR 2009/4 PARAS 185 - 187]

If a fund had an investment in a related entity on or before 11 August 1999 which was not an in-house asset under the old rules, the trustee could have, after that time but no later than 30 June 2009, reinvested earnings from that entity back into that same entity and have the "new" investment excluded from being an in-house asset.

The mechanics of this exception specifically excluded an amount of new investments made on or before 30 June 2009 from being an in-house asset where the amount was calculated as:

- any distributions / dividends made on the fund's "pre-99" unitholding / shareholding, plus
- any distributions/dividends paid on new investments in the same trust or company where those new investments themselves satisfied this rule.

Example 8

An SMSF held 100,000 units in the Castle Property Trust before 11 August 1999.

In 1999/20, the trust distributed $5,000 which was enough to buy 500 more units. Under this particular exemption, the fund could have bought those 500 units and they would not be an in-house asset. Further distributions on both the original 100,000 units and the new 500 units could also have been reinvested (on or before to 30 June 2009) without being classified as in-house assets.

If, however, the fund purchased 600 units in July 2000, the additional 100 units are in-house assets. Distributions on those units in the future would also fall outside the transitional rules and, if reinvested, are in-house assets.

An important point that is often missed is that the calculation above simply defines the dollar amount that the trustee could have invested in the related trust/company at some point before 1 July 2009 without those new investments being considered an in-house asset. It was not necessary for the money to actually have come from distributions. It could have come from (say) new contributions received that the fund chose to invest in the Caste Property Trust.

All that was important was that the dollar amount invested between 11 August 1999 and 30 June 2009 (inclusive) did not exceed the total dollar value of all distributions made in that time.

Geared investments [SIS S.71E, SMSFR 2009/4 PARAS 188 - 190]

Like the "reinvested earnings" exception outlined above, if a fund had an investment in a related entity on or before 11 August 1999 which was not an in-house asset under the old rules, the trustee could have, after that time but no later than 30 June 2009, made additional investments in a related entity (ie bought more units or shares) and have the "new" investment excluded from being an in-house asset.

Note that the SMSF trustee was required to make a written election (and retain it for 10 years) if it wished for this exception to apply [SIS S.71E(1)(E)].

Note also that if such election was made, the SMSF trustee could not have changed their minds and instead used the "reinvested earnings" option.

The mechanics of this exception specifically excluded an amount of new investments made on or before 30 June 2009 from being an in-house asset where the maximum dollar amount of the new investments was the amount of debt the related entity had outstanding at 11 August 1999. Note that once again, this was simply a way of describing the dollar limit on new investments:

- it did not mean that any new investments must have been used to repay debt,
- nor did it mean that the original debt had to have been in place at the time the new investment was made (the debt at the time of the new investment could have been entirely different, from a different source with different terms and conditions. In fact, there may not have even been any debt remaining at that time),
- it included debt to any party other than the superannuation fund itself (ie even loans from the fund's members or other related parties),
- it did not depend on the terms and conditions of the debt – ie even if the loan agreement did not provide for interest at particular times, there was no fixed date on which the money had to be repaid etc,
- it did not matter whether or not there were other unitholders / shareholders in the trust / company at the time. Even if the superannuation fund only owned 1 unit out of 100,000 on issue, it was able to invest enough additional funds to cover the entire debt outstanding within the trust / company at 11 August 1999, and

- it did not preclude the new investments being made by way of reinvesting distributions / dividends (ie the source of the funds was not important).

11 August 1999 leases and lease arrangements [SIS S.71B, SMSFR 2009/4 PARAS 177 - 180]

SMSF assets which have been subject to a continuous lease or an uninterrupted series of leases between the SMSF trustee and a related party will be excluded from being an in-house asset in cases where the lease was in place prior to the end of 11 August 1999 and has remained in place since.

Where a legally enforceable lease or lease agreement first came into force after 11 August 1999, the asset is deemed to have been subject to the lease or lease arrangement prior to the end of 11 August 1999 if the agreement was entered into prior to the end of 11 August 1999 [SIS S.71B(2)].

Note that the exception does not require that the terms covered by each lease in a series of leases be on identical terms, but does require that there are no gaps in the periods of the leases [SIS S.71B].

If the renewed lease or lease arrangement is in relation to a new asset or there is a gap between lease renewals then the market value of the asset that is subject to the lease or lease arrangement will be considered an in-house asset.

This transitional provision allowed the continued leasing of assets which would otherwise have been caught as in-house assets (eg non-real property assets such as machinery or equipment) provided the lease arrangement was in existence pre 11 August 1999 and subject to an uninterrupted series of leases post that date.

Other assets that are excluded from being an in-house asset

Various other assets are also excluded from being an in-house asset of an SMSF, ie:

- a life policy issued by a life insurance company [SIS S.71(1)(A)],
- a deposit with an authorised deposit-taking institution (ie a body corporate that is an authorised deposit-taking institution for the purposes of the Banking Act 1959 or a State bank) [SIS S.71(1)(B)],
- an investment in a pooled superannuation trust, where a trustee of the SMSF and the trustee of the pooled superannuation trust acted at arm's length in relation to the making of that investment [SIS S.71(1)(C)],
- an asset which the Regulator, by written notice given to a trustee of the SMSF, determines is not an in-house asset of the fund [SIS S.71(1)(E)],
- property owned by the SMSF and a related party as tenants in common, other than property subject to a lease or lease arrangement between a trustee of the fund and a related party [SIS S.71(1)(I)],

Regulator's powers to make determination

Notwithstanding that a related party of a superannuation is specifically defined [SIS s.10(1)] as outlined earlier, ie:

- a member of the fund,
- a standard employer-sponsor of the fund, or
- a Part 8 associate of an entity referred to above

the Regulator (ie the ATO in the case of SMSFs) has power to make a determination to treat an asset, ie:

- a loan to,
- an investment in, or
- an asset subject to a lease or lease arrangement with

a party that is *not* a related party of the fund (and therefore not an in-house asset by definition) as though it *is* an in-house asset [SIS s.71(4)]. This means the in-house asset limit (see next section) would apply, and effectively means the Regulator has power to treat a party that is not a related party as though it is a related party for the purpose of the in-house asset provisions.

The ATO recently applied this power to an SMSF [Aussiegolfa Pty Ltd as trustee for The Benson Family Superannuation Fund]. Ultimately, however, the Federal Court [Aussiegolfa Pty Ltd (Trustee) v Commissioner of Taxation [2017] FCA 1525] found that the asset was an in-house asset by definition and consequently the Regulator did not have the power to apply this provision [SIS s.71(4)] to the SMSF – the Regulator only has power to deem an asset to be an in-house asset in cases where the asset is *not* an in house asset by definition. The Court mentioned, however, that if the asset had not been an in-house asset by definition then the Regulator's determination to deem it an in-house asset would have stood.

Since the above case, the Regulator has issued a decision impact statement [Aussiegolfa Pty Ltd (Trustee) v Federal Commissioner of Taxation] which states it will continue to consider issuing a determination [under SIS s.71(4)] as appropriate in circumstances where an SMSF trustee enters into an arrangement to acquire an asset that would otherwise be an in-house asset [per SIS s.71] if directly held by the SMSF.

An SMSF can acquire an in-house asset from a member or related party

The acquisition of an asset from a member or related party is prohibited altogether [SIS s.66(1)] unless an exception applies to the asset.

Common exceptions to this prohibition on acquisition include where the asset is:

- a listed security (eg an asset listed on an approved stock exchange (within the meaning of the ITAA 1997) [SIS s.66(2)(a)],
- business real property of the related party but only in cases where the acquiring fund is an SMSF or a SAF (ie the acquiring fund has fewer than 5 members) [SIS s.66(2)(b)], or
- an investment in a widely held unit trust [SIS s.66(2A)(a)(iv), SIS s.71(1)(h)]

and the asset is acquired at market value.

Less common exceptions to this prohibition also exist where the asset is:

- transferred directly from another regulated superannuation fund because of reasons directly connected with the breakdown of a relationship between spouses (or former spouses) and the asset represents all or part of the member's own interests payable from the transferring fund or their entitlements to the interests of their spouse [SIS s.66(2B)], or
- the asset is of a kind which the Regulator, by legislative instrument, determines may be acquired from a related party [SIS s.66(2](d)]

and the asset is acquired at market value.

Exceptions also exist where the asset is:

- an **in-house asset** [within the meaning of SIS s.71(1)] of the fund [SIS s.66(2A)(a)(i)]. Note, however, that a limit applies (discussed in next section), or
- specifically excluded from being an in-house asset because the asset is an investment in a "13.22C entity" (ie a company or trust that satisfies the conditions in SIS Reg Division 13.3A [SIS s.66(2A)(a)(iv), SIS s.71(1)(j)]]

and the asset is acquired at market value.

5% limit

When is it measured?

SIS imposes a 5% limit on the total amount of in-house assets a superannuation fund can hold and this limit is applied at:

- the time the in-house asset is acquired [SIS S.83], and
- each 30 June [SIS S.82].

How do you calculate the "market value ratio" of an SMSF's in-house assets?

The 5% limit is known as the "market value ratio" and the general formula for calculating the market value ratio of an SMSF's in-house assets is as follows [SIS S.75(1)]:

$$\frac{\text{Number of whole dollars in value of in-house assets of the fund}}{\text{Number of whole dollars in value of all the assets of the fund}} \times 100$$

Note that:

- "value" means "market value" [SIS S.10(1), SMSFD 2008/2], and
- "market value", in relation to an asset, means [SIS S.10(1), SMSFD 2008/2] the amount that a willing buyer of the asset could reasonably be expected to pay to acquire the asset from a willing seller if the following assumptions were made:
    - the buyer and the seller dealt with each other at arm's length in relation to the sale,
    - the sale occurred after proper marketing of the asset, and
    - the buyer and the seller acted knowledgeably and prudentially in relation to the sale.

Note that an SMSF would be required to value **all** the fund's assets at market value when determining the SMSF's market value ratio of in-house assets [SMSFD 2008/2, PARA 9]. Not just some of the assets.

Also, note that any liabilities of the fund are *not* taken into account when determining the market value ratio of an SMSF's in-house assets – rather only the "gross" market value is considered.

Example 9

An SMSF holds the following assets at 30 June:

- $0.1m of units in a related trust (for which no in-house asset exception applies) acquired using an LRBA. The outstanding LRBA loan amount at that 30 June was $0.06m, and
- $0.9m of shares in listed companies.

The SMSF's market value ratio at that 30 June is calculated as:

$$\frac{\text{\$0.1m (ie Number of whole dollars in value of in-house assets of the fund)}}{\text{\$1m (ie Number of whole dollars in value of all the assets of the fund)}} \times 100 = 10\%$$

Not:

$$\frac{\text{\$0.04m (ie Number of \textit{net} whole dollars in value of in-house assets of the fund)}}{\text{\$0.94m (ie Number of \textit{net} whole dollars in value of all the assets of the fund)}} \times 100 = 4.25\%$$

Acquisition time : What if the 5% limit is exceeded?

An SMSF is prohibited from acquiring an asset if doing so would cause the fund's market value ratio to exceed 5% [SIS s.83(2)].

If an SMSF acquires an asset and the limit is exceeded at that time, the fund will have illegally acquired that asset (or such portion of the asset that exceeds the 5% limit) [SIS s.83].

The fund will be required to rectify this situation by disposing of the "excess" asset (or such portion of the asset that exceeds the 5% limit).

Note that "acquisition time" not only means the time an SMSF acquires legal or beneficial ownership of an asset, it also refers to an *existing* asset of an SMSF that is not currently an in-house asset that *becomes* an in-house asset due to a new lease or lease arrangement being entered into [SIS s.83(4)].

Example 10

An SMSF acquired a residential property from an unrelated party (at market value) many years ago.

To date, the residential property has been leased to an unrelated party at market value.

At the end of the lease, the SMSF trustee is considering leasing the property to a nephew of a fund member.

If it the SMSF trustee did so, the residential property would be considered to be "acquired" at the time the new lease between the SMSF trustee and the nephew was entered into for the purposes of the in-house asset provisions. This means that SMSF would need to calculate its market value ratio at that time the new lease was entered into using the market value of all of the fund's assets at that time.

30 June : What if the 5% limit is exceeded?

If this limit is exceeded at 30 June of a particular year (ie year 1) (eg because the value of an existing in-house asset grows in value relative to the overall fund value), the SMSF trustee will be required to prepare a written plan [SIS s.82(2)] which:

- specifies the "excess amount" at that time. The "excess amount" is calculated as [SIS s.82(3)]:

$$\left[\text{Market value ratio of the fund's in-house assets at that 30 June} - 5\% \right] \times \text{Value of fund's assets at that 30 June}$$

- and also sets out the proposed steps the SMSF trustee will take in order to ensure that one of more of the fund's in-house assets held at that 30 June is disposed of during the *following* financial year (ie year 2) and the value of the disposed assets is equal to or more than the excess amount [SIS s.82(4)].

The plan must be prepared by the end of the *following* 30 June (ie year 2) [SIS s.82(5)] and must be carried out by that following 30 June [SIS s.82(6).

Example 11

Revisiting a previous example above, an SMSF holds the following assets at 30 June (ie year 1):

- $0.1m of units in a related trust (for which no in-house asset exception applies) acquired using an LRBA. The outstanding LRBA loan amount at that 30 June was $0.06m, and
- $0.9m of shares in listed companies.

The SMSF's purchase of units in the trust did not cause the fund to exceed the in-house asset market value ratio at the time of acquisition of the units.

The SMSF's market value ratio at that 30 June is calculated as:

$$\frac{\$0.1\text{m (ie value of in-house assets of the fund)}}{\$1\text{m (ie value of all the assets of the fund)}} \times 100 = 10\%$$

By the following 30 June (ie year 2), the SMSF trustee must prepare a written plan that specifies the excess amount, ie:

[10% market value ratio – 5%] x $1m value of fund's assets at that time (ie $50,000)

and which also sets out the proposed steps the SMSF trustee will take in order to ensure that at least $50,000 of the fund's in-house assets are disposed of during the *following* financial year (ie year 2).

The SMSF trustee must ensure that both the plan to remove the excess in-house assets is prepared, and implemented, by that following 30 June.

What if the excess in-house asset was something indivisible – for example property?

Generally, property directly held (either legally or beneficially) by an SMSF would be an in-house asset if it was:

- residential property leased to a member or related party, or
- business real property that was leased to a member or related party where a legally binding lease arrangement is not in place [SMSFRB 2020/1].

Would it be acceptable if the proposed steps to remove the excess were to:

- in the case of residential property : terminate the lease with the member or related party by the following 30 June, or
- in the case of business real property : put a legally binding lease arrangement in place by the following 30 June

rather than disposing of the excess in-house assets by the following 30 June?

Unfortunately, no. SIS requires the excess in-house assets to be **disposed of** [SIS S.82(4)] and the lease / lease arrangement is *not* the in-house asset, rather the underlying property is [NATIONAL TAX LIAISON GROUP, SUPERANNUATION TECHNICAL MINUTES, JUNE 2012].

Whilst SIS requires the excess in-house assets to be disposed of, depending on the circumstances, the Regulator may be willing to excess its discretion and allow a fund to retain the asset/s if the steps proposed above were taken.

COVID-19 relief

The ATO has advised [COVID-19 FAQ] that it will not undertake compliance activity if an SMSF exceeded the 5% limit as at 30 June 2020, if a written rectification plan was prepared by 30 June 2021 but was unable to be executed by 30 June 2021 because the market has not recovered by that time, or it was unnecessary to implement the plan as the market had recovered by that time.

This compliance approach also applies where the SMSF exceeded the 5% limit as at 30 June 2019 but was been unable to execute the written rectification plan by 30 June 2020.

Note in each case, the relief only applies in cases where the written rectification place was prepared by the relevant 30 June.

Preventing breaches of 5% limit

Prevent an SMSF's asset from becoming an in-house asset at 30 June

Members of the SMSF's "group" could change over time

As previously outlined, unless an exception applies, an in-house asset of an SMSF includes an asset of the fund that is [SIS s.71(1)]:

- a loan to or an investment in a *related party* of the fund which includes a company where the SMSF member(s) and/or their Part 8 associates "control" the company [SIS 70E(1)], or
- an investment in a *related trust* of the fund which is a trust "controlled" by the SMSF member(s) and/or their Part 8 associates [SIS 70E(2)].

In each case, a company or trust will be controlled if *more than 50%* of the voting shares / units are held by the "group" comprised of the SMSF member(s) and/or their Part 8 associates.

Over time, familial, investment and business relationships may change and consequently members within the relevant "group" may change.

It is important to keep on top of these evolving relationships in order to ensure that "control" of a unit trust / company in which an SMSF has invested, or to whom the SMSF has lent money, does not shift to the group.

If it does, remember that the market value ratio (ie 5% limit) is only measured at the time the SMSF acquires an in-house asset / makes a loan to a related party, and thereafter each 30 June when the fund holds in-house assets.

If circumstances change and an asset of the fund becomes an in-house asset some time *after* it was acquired, it is possible that steps could be taken to ensure that the group does not control the unit trust / company on the following 30 June. If the group does not control the asset at the following 30 June, then the loan to / investment in that unit trust / company will not be an in-house asset, and will therefore not be assessed against the 5% limit.

Example 12

Das is a member of the On Just Terms SMSF, together with Sal (his wife), Shazza (his daughter) and Con (Shazza's husband).

The SMSF holds 20% of the shares in Dreaming Pty Limited.

Das has just bought a residential investment property with his old friend Denis. Prior to this investment, Das had no familial, investment or business relationship whatsoever with Denis.

Das and Denis own the residential investment property as tenants in common. This means that Denis is now a "partner" of Das, and is therefore a Part 8 associate of Das [SIS s.70B(c)].

Denis owns 40% of the shares in Dreaming Pty Limited.

The SMSF's "group" for the purposes of determining the Part 8 associates of the SMSF includes:

- the On Just Terms SMSF (ie a trust controlled by the members of the SMSF), and
- Denis (a partner of a member)

and collectively the group owns 60% of the shares in Dreaming Pty Limited.

This means the group controls Dreaming Pty Limited and it has become an in-house asset of the SMSF.

If nothing changes, the SMSF would need to calculate its market value ratio on the next 30 June, and if it exceeded 5% the SMSF would be required to prepare and implement a written plan to dispose of the excess in-house assets (ie dispose of shares in Dreaming Pty Limited) by the subsequent 30 June.

This disposal may be undesirable.

If Das and Denis were to cease being "partners" by the next 30 June (ie the 30 June immediately they acquired the residential investment property as tenants in common), however, the SMSF's group would no longer control Dreaming Pty Limited and it would no longer be an in-house asset of the SMSF.

Das and Denis could cease being partners by disposing of the property altogether, or by one of them disposing of their interest in the property.

Ownership interests could change over time

In addition to the potential changes in the members of an SMSF's "group", ownership interests in an entity may change.

Care should be taken to ensure that control of the entity does not inadvertently move to the SMSF's group if it will create an in-house asset that exceeds the 5% limit.

The On Just Terms SMSF owns 50% of the shares in the Your Honour Unit Trust.

The remaining shares are held by Das' old friend Kenneth Huxtable.

Example 13

The SMSF's group does not have the ability to direct the decision making of the trustee of the trust, nor does it have the power to remove or appoint the trustee of the trust.

Currently, the SMSF's investment in the trust is *not* an in-house asset as the SMSF's group does not control the trust.

The trust is about to pay a distribution and does not have enough cash to pay all the distributions payable in the form of cash.

Das has a brainwave and suggests to the trustee of the unit trust that the SMSF be paid its distribution in the form of additional units (acquired at market value), leaving the unit trust sufficient cash to pay Kenneth's distribution in cash.

The fund receives its distribution in the form of additional units, and Kenneth receives his in cash. The SMSF now owns more than 50% of the units in the trust and the SMSF's units in the trust have become an in-house asset.

If nothing changes, the SMSF would need to calculate its market value ratio next 30 June, and if it exceeds 5% the SMSF will be required to prepare and implement a written plan to dispose of the excess in-house assets (ie dispose of units in the Your Honour Unit Trust) by the subsequent 30 June.

This disposal may be undesirable.

If Kenneth had also been paid his distribution in the form of additional units – ie the 50%/50% unitholdings had been maintained - the SMSF's investment in the trust would not have become an in-house asset.

Size of fund assets

In cases an SMSF holds an in-house asset, no action is required to dispose of any part of that asset in cases where the asset was within the 5% limit at the time of acquisition, and also at each subsequent 30 June - action to dispose of any "excess" is only required if the value of the in-house asset exceeds the 5% limit at the relevant time.

In cases where an SMSF is likely to exceed the 5% limit, the following could be considered:

- ensure **all** the assets of the SMSF are correctly valued at market value at the relevant time. If the value of the *other* assets of the SMSF are understated relative to the value of the in-house assets, the market value ratio will be higher than it should be. Conversely, if the value of the *in-house* assets of the SMSF are overstated relative to the value of the other assets, the market value ratio will be higher than it should be.

Example 14

The On Just Terms SMSF owns around 30 sets of jousting sticks that are mounted on the walls of commercial premises owned by the SMSF members.

The sticks are in-house assets of the SMSF and (collectively) are currently recorded at a value of $90,000 in the financial statements of the SMSF. This value was struck on the basis of the SMSF's most recent purchase of a set of "gold plated" sticks for $3,000.

Despite Das' wishful thinking, in reality, apart from the "gold plated" sticks, the other sets of sticks are only worth around $250 - $450 per set (ie around $7,000 - $13,000 combined).

If the sticks are valued at $90,000, the market value ratio of the SMSF's in-house assets will exceed 5%. In contrast, if the sticks are correctly valued at their real market value, the market value ratio of the SMSF's in-house assets will be around 1% – 2%.

- can additional contributions / rollovers from other funds be added to the SMSF prior to the relevant time? If they can be, the value of the *other* assets of the SMSF would increase thereby diluting the market value ratio of the fund's in-house assets.

Anti-avoidance

SIS contains various anti-avoidance provisions in relation to schemes designed to artificially reduce the value of a superannuation fund's in-house assets, ie:

- a loan to,
- an investment in, or
- an asset of the fund leased to

a related party of fund, in order to avoid the application of the 5% limit [SISA s.85]:

- at the time an in-house asset is acquired, or
- each 30 June thereafter.

Importantly, note that these provisions apply to any person involved in the scheme – which could include advisers, accountants etc – not just the trustee of the superannuation fund.

Non arm's length income : Non arm's length expenses

The taxable income of superannuation funds is generally taxed at the concessional rate of 15%. However, amounts regarded as "non-arm's length income" (NALI) are taxed at 45% [ITRA s.26]. This higher rate of tax is designed to act as a deterrent to taxpayers "injecting income" which may otherwise be taxable at company / individual rates, into concessionally taxed superannuation funds.

Types of NALI

There are broadly four types of NALI as detailed below. "Income" for the purpose of the NALI provisions includes both ordinary income and statutory income [ITAA 1997 s.295-550]. On this basis, both capital gains and franking credits (which are considered statutory income) have the potential to be NALI [ITAA 1997 s.10-5].

Dividends from private companies

All dividends from private companies paid to SMSFs are NALI, unless the amount paid to the fund is consistent with an arm's length dealing, having regard to a number of factors including [ITAA 1997 s.295-550(2), ITAA 1997 s.295-550(3)]:

- the value of the shares,
- the cost of the shares,
- the rate of dividend,
- the rate of dividend paid on other shares in the company,
- whether shares have been issued in satisfaction of dividends, and
- any other relevant matters.

A dividend paid to an SMSF by a private company would not ordinary be NALI if, for example:

- the SMSF pays market value for the shares,
- the price paid by the SMSF for the shares is the same as that paid by other investors,
- the rate of return to the fund reflects the price paid for the shares as well as the investment risk taken,
- the dividend paid to the fund is at the same rate as the dividend paid to other investors, and

- the dividend paid to the fund was not as a result of a scheme entered into by the trustee in order for the fund to derive non-commercial income.

However, as private company dividends are automatically included as NALI unless the amount is consistent with an arm's length dealing, the onus is on the fund trustee to establish that the amount received by the fund is indeed consistent with an arm's length dealing. We recommend accountants/fund administrators ensure sufficient records are maintained, on a timely basis, to evidence the fund's position.

The simple fact that an SMSF's investment in a private company is not an in-house asset (eg because the company is not "controlled" by the members of the SMSF and/or their Part 8 associates) does not prevent dividends from the company from being NALI. If the amount paid to the SMSF is not consistent with an arm's length dealing, the Commissioner may conclude that the income is NALI.

Example 15

The On Just Terms SMSF owns a small number of shares in a private company. Con, a member of the SMSF, is a director of the private company (there are three other directors).

The shares in the private company are not an in-house asset of the SMSF. However, the private company received excessive income (ie higher than market) via a rental arrangement it has with a related party tenant.

As a result, dividends paid by the private company to the SMSF could be taxed as NALI as the dividends ultimately received by the SMSF are greater than they would be if the private company and its related party were dealing with each other at arm's length.

Income from transactions where parties are not dealing at arm's length

Income derived by a superannuation fund is NALI if, as a result of a scheme whereby the parties are not dealing at arm's length [ITAA 1997 s.295-550(1)]:

- the amount of income derived by the fund is more than would be expected for an arm's length situation, or
- in gaining or producing the income, the fund incurs less expenditure (including no expenditure) than would otherwise have been expected if the parties had been dealing on an arm's length basis (note, this extension of the NALI provisions to take expenditure into account applies to income derived by the fund in the 2018/19 and later income years regardless of when the scheme was entered into).

Example 16

The On Just Terms SMSF leases commercial property to Das and Sal's motor crash and radiator repair business.

The market rate of rent payable to the SMSF in 2018/19 was $100,000, however the fund received $120,000.

In the absence of a reasonable explanation for the receipt of an additional $20,000 (eg a commercial rent in advance arrangement), **all** of the rent received of $120,000 will be NALI. This is because the parties are not dealing at arm's length and the amount of income derived by the fund is more than would be expected in an arm's length situation.

Example 17

The On Just Terms SMSF owns several Holden motor vehicles acquired from unrelated parties for no or minimal consideration.

In the absence of evidence that the motor vehicles were acquired on an arm's length basis, all income (including capital gains) will be NALI. This is because the parties are not dealing at arm's length and the amount of income derived by the fund is more than would be expected in an arm's length situation.

If income is NALI, it cannot be apportioned between:

- amounts that would have been derived if the parties were dealing at arm's length, and
- an "excess" portion.

The entire amount of income from the transaction is NALI, not just the excess.

In relation to the new NALI expenditure provisions, there must be a sufficient nexus between an expense and the income – in other words an expense must have been incurred "in" gaining or producing the relevant income – in order to trigger NALI [TREASURY LAWS AMENDMENT (2018 SUPERANNUATION MEASURES NO 1) ACT 2019, LCR 2019/D3 PARA 16].

Where a fund acquires an asset for less than market value through a non-arm's length dealing, not only will any revenue generated by that asset be NALI, but any statutory income (ie net capital gains) resulting

from the disposal of that asset would also be assessed as NALI [LCR 2019/D3 PARA 17].

Example 18

The On Just Terms SMSF acquired the commercial property from where Shazza runs her Beauty salon from a third party for market value on 1 July 2015.

The SMSF financed the purchase of the property using an LRBA. Shazza's father-in-law (Spiros) provided the LRBA loan from his private company.

The terms and conditions of the loan do not align with the ATO "safe harbour" provisions [PCG 2016/5], nor were the terms and conditions of the loan benchmarked to those that a commercial lender would have provided to the SMSF to acquire those business premises.

The terms and conditions of the related party LRBA loan include:

- no interest,
- no repayments until the end of the 25 year term, and
- 100% LVR.

The SMSF was in a financial position whereby it could have entered into an LRBA on commercial terms with an interest rate of approximately 5.8% pa.

The SMSF derives rental income of $1,500 pw from the property (ie $78,000 pa).

The SMSF has not incurred expenses that it might have been expected to incur in deriving the rental income under an arm's length dealing. Consequently, the income derived from the scheme is NALI, ie:

- rental income of $78,000, less
- deductions attributable to the income (however, note that there will be no deduction for interest).

In addition, the non-arm's length interest on borrowings to acquire the property will result in any eventual capital gain on disposal of the property also being treated as NALI.

Income derived from other assets held by the SMSF (eg dividends, distributions, interest etc) would not be NALI merely because the SMSF incurred a non-arm's length interest expense under the LRBA – this is because there is no nexus between the non-arm's length expense (ie interest expense on the LRBA) and the other income derived by the SMSF.

Income from trusts where fund does not have a fixed entitlement

Without exception, all income derived by a superannuation fund from a trust where the fund does not have a fixed entitlement to the income of the trust (eg a discretionary trust) is NALI [ITAA 1997 s.295-550(4)]. In addition, the income received will be deemed to be a contribution to the fund if the purpose of the trust is to benefit the member of the fund [TR 2010/1 PARA 167].

Income from fixed trusts where parties are not dealing at arm's length

Income derived by a superannuation fund as a beneficiary of a fixed trust is NALI if, as a result of a scheme whereby the parties are not dealing at arm's length [ITAA 1997 s.295-550(5)]:

- the amount of income derived by the fund is more than would be expected for an arm's length situation, or
- in acquiring the entitlement in the trust or in gaining or producing the income, the fund incurs less expenditure (including no expenditure) than would otherwise have been expected if the parties had been dealing on an arm's length basis (note, this extension of the NALI provisions to take expenditure into account applies to income derived by the fund in the 2018/19 and later income years regardless of when the scheme was entered into).

Example 19

An SMSF owns 100% of the units in a related pre-August 1999 unit trust. The trust owns commercial property which it would like to develop and then sell. The trust does not have sufficient monies to finance the development without borrowing (note, if the fund were to purchase further units in the trust these new units would be an in-house asset of the fund).

The trust borrows from a related entity on terms which are more favourable to the trust than an arm's length lender would have provided. In particular, the interest rate payable by the trust to the related entity is 2% lower than would have been payable to an arm's length lender.

As a result, the distributions payable to the SMSF by the trust are higher than would have been expected for an arm's length situation and consequently the distributions are NALI.

In addition, the non-arm's length nature of the trust's borrowings will result in any eventual capital gain on disposal of the SMSF's units also being treated as NALI.

Example 20

A retail superannuation fund acquires units in a unit trust but pays a lower amount for the units than stated in the promotional material for the unit trust due to a scheme the fund has entered into with the broker.

In acquiring the entitlement to a share of the unit trust's earnings, the fund trustee did not incur expenditure it might have been expected to incur if

it had been dealing at arm's length with the broker in purchasing the units.

The income derived from the units would have been the same whether or not they were acquired under an arm's length transaction.

The amount of income earned by the retail superannuation fund from the unit trust is NALI.

Non-arm's length expenditure (NALE)

As discussed earlier, amendments to the non-arm's length provisions mean that expenditure of the fund must now also be taken into account in determining if particular income of the fund is NALI [ITAA S. 295-550].

Draft LCR 2019/D3 details the ATO's view on how the amendments operate to a scheme where the parties do not deal with each other at arm's length and the trustee of the superannuation fund incurs non-arm's length expenditure (or where expenditure is not incurred) in gaining or producing ordinary or statutory income.

Nexus to income?

In relation to the new NALI expenditure provisions, in the ATO's view, there must be a sufficient nexus between an expense and the income – in other words an expense must have been incurred "in" gaining or producing the relevant income – in order to trigger NALI [TREASURY LAWS AMENDMENT (2018 SUPERANNUATION MEASURES NO 1) ACT 2019, LCR 2019/D3 PARA 16].

In the ATO's view, in some instances, a fund's non-arm's length expenditure will have a sufficient nexus to **all** of the ordinary and/or statutory income derived by the fund.

For example, in the ATO's view, certain "general" expenses (eg accounting fees, adviser fees etc) that don't relate to specific income have a sufficient nexus to all of the ordinary and/or statutory income derived by the SMSF [LCR 2019/D3 PARAS 21-22].

In cases where the costs of general expenses are less than an arm's length amount (say the service provider offers a discount), all income of the SMSF would be NALI.

Note that the view expressed by the ATO in the draft ruling is highly contentious and we understand many submissions were made to the ATO regarding this view. Submissions on the draft LCR closed in mid-November 2019 and we are hopeful that the final version aligns more closely to the explanatory statement.

Watch this space

As indicated above, the ATO has released LCR 2019/D3 which indicates how the ATO intends applying the restructured NALI provisions in light of non-arm's length expenditure.

As noted above, some parts of this draft ruling are highly contentious – eg the cost of "general" expenses that are less than an arm's length amount (because of, say, a discount) would cause all income of the SMSF to be NALI.

The ATO has also released PCG 2020/5 which outlines its intended compliance approach in relation to the NALI provisions in light of non-arm's length expenditure. It states that no compliance resources will be allocated to determine whether the NALI provisions apply to an SMSF in 2018/19, 2019/20 or 2020/21 where an SMSF incurs non-arm's length expenditure of a "general" nature that has a sufficient nexus to all ordinary and/or statutory income derived in those years.

Capacity in which activities are performed - what hat is the SMSF trustee wearing?

In some cases, an SMSF trustee may provide services or functions to the SMSF.

The question of whether the NALI provisions apply in respect of services or functions undertaken by the SMSF trustee depends on the capacity in which the trustee undertakes those activities, ie:

- if the services or functions performed are done so in the capacity of an SMSF Trustee, the NALI provisions are not intended to apply, however
- if the services or functions performed are done in a non-trustee capacity, the NALI provisions are intended to apply if the amount charged for any such services or function is less than that which would be expected to be charged between parties dealing at arm's length.

Draft LCR 2019/D3 outlines factors that, in the ATO's view, indicate when a person is not performing activities in their capacity as an SMSF trustee including [LCR 2019/D3 PARA 39]:

- the individual charges the SMSF for performing the services (however, the ATO have recognised that charging the SMSF, or not charging the SMSF, is not decisive),
- the individual uses the equipment and other assets of their business, or used in their profession or employment,
- the individual performs the activities pursuant to a licence and/or qualification relating to their business, or their profession or employment, or
- the activity is covered by an insurance policy relating to their business, or their profession or employment (eg indemnity insurance).

Draft LCR 2019/D3 also states that where an entity performs services in their capacity as an SMSF trustee and does not charge for those services, that is *not* a non-arm's length arrangement for the purposes of the NALI provisions.

In contrast, where an entity performs services in their *non-trustee capacity* and does not charge for those services (despite being able to do so) or charges a lower than arm's length amount it will be a non-arm's length arrangement for the purposes of the NALI provisions.

Range of transactions may be on arm's length terms

The explanatory statement to the Act which inserted the new expenditure provisions concedes it can be difficult to determine an exact price that is "non-arm's length" [TREASURY LAWS AMENDMENT (2018 SUPERANNUATION MEASURES NO 1) ACT 2019].

It contends that an "arm's length" price may be accepted to fall within a range of commercial prices. For example, loans may be available at different interest rates based on a range of factors. Accordingly, an SMSF may be able to apply an acceptable commercial rate of interest to a loan within a band of rates available to it on an arm's length basis.

In other circumstances, parties may enter into arrangements that result in discounted prices or favourable terms. This could occur where a party operates on simple cost-recovery basis for particular services but is able to justify doing so in commercial terms because of the economies of scale it achieves within its business by providing other services. For example, where services are provided to a large APRA fund either by the trustee acting in a separate capacity or by a related third party.

Example 21

Con is a qualified accountant, SMSF Approved Auditor and part-time financial adviser who works for a large accounting firm on the outskirts of Melbourne.

Con's firm holds an AFSL and provides accounting and audit services to over 500 SMSFs, including the On Just Terms SMSF (of which Con is a member and individual trustee). The On Just Terms SMSF receives a 50% discount on all fees charged by Con's firm.

In order for the NALI provisions to *not* apply, the SMSF will need to be able to demonstrate that the fees it pays to Con's firm are on an arm's length basis.

We are hopeful that the final version of LCR 2019/D3 will provide guidance / clarity on whether the NALI provisions would apply to situations like this.

Transactions that are on arm's length terms, for example, LRBAs financed by Authorised Deposit-taking Institutions and other commercial lenders or that meet the safe harbour terms [PER PCG 2016/5] would not be impacted by these amendments.