Complicated SMSF investment structures and avoiding the NALI minefield: Key learnings from ATO determinations

***UPDATE:** 28th July 2021, ATO releases LCR 2021/2: Non arm's length income – expenditure incurred under a non arm's length arrangement*

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Complicated SMSF investment structures and avoiding the NALI minefield: Key learnings from ATO determinations

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Key learnings from ATO Determinations

The non-arm's income rules, or NALI, have been around for decades. Despite that, historically, they have been rarely invoked by the ATO and largely ignored by many advisors and trustees.

However, in the last 10 years, NALI has become an increasing focus for both the ATO and the Government. This has culminated in the non-arm's length expenses (NALE) law and the ATO's views of those laws as set out in LCR 2019/D3.

In this paper, I will cover:

- The NALI and NALE rules and their application to property development and unrelated trust arrangements
- Case studies which have resulted in an ATO determination of NALI
- Key ATO focus areas when considering the application of NALI
- How to correctly structure an investment arrangement to avoid NALE and NALI

Legislative references in this paper are to the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**), *Superannuation Industry (Supervision) Regulations 1994* (**SIS Regs**), the *Income Tax Assessment Act 1997* (**ITAA97**) and the *Income Tax Assessment Act 1936* (**ITAA36**), unless otherwise stated.

ATO material

The ATO material discussed in this paper can be found in the links below:

SMSFRB 2020/1

LCR 2019/D3

Case studies

TD 2016/16

1. WHAT IS NALI AND NALE?

One of the benefits of using superannuation to save for one's retirement is that income from the fund's investments are typically taxed at the fund level at a concessionary rate of 15% (for assets in accumulation phase) or 0% (for assets in pension phase). However, where the taxable income of a complying superannuation fund contains a non-arm's length component, that non-arm's length component will be taxed at 45%. This non-arm's length component is the fund's non-arm's length income less any deductions to the extent they are reasonably attributable to that income.

These are known as the 'NALI' rules and they were introduced initially as 'special income' under section 273 of the ITAA36, to 'prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers'. [1] That is, the special income provisions were an anti-avoidance provision designed to prevent the diversion of income to the concessionally taxed superannuation environment.

'Special income' is now known as 'non-arm's length income' or NALI. The NALI rules are now contained in section 295-550 of the ITAA97.

Section 295-550(1) of the ITAA97, as extracted below, sets out when an amount of income will be treated as NALI of a superannuation fund:

(1) An amount of *ordinary income or *statutory income is ***non-arm's length income*** of a *complying superannuation entity if, as a result of a *scheme the parties to which were not dealing with each other at *arm's length in relation to the scheme, one or more of the following applies:

(a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;

[1] Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999, para 2.13

(b) in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;

(c) in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.

This subsection does not apply to an amount to which subsection (2) applies or an amount *derived by the entity in the capacity of beneficiary of a trust.

There are also specific provisions relating to trust distributions to super funds in section 295-550(4) and 295-550(5).

Generally, the NALI rules will catch:

- income derived as a result of non-arm's length dealings;
- private company dividends that are derived as a result of non-arm's length dealings;
- distributions from non-fixed trusts (eg discretionary trusts); and
- distributions from fixed trusts where the fixed trust's income was derived from non-arm's length dealings.

In a complicated investment (such as a property development context), the non-arm's length rules will generally be avoided if all the dealings with related parties are undertaken on an arm's length (commercial/market value) basis.

What does 'arm's length' mean in this context?

There are, therefore, two key elements to a finding of NALI:

1. There are non-arm's length dealings; and
2. The income derived under the scheme is more than would be expected if the parties are dealing with each other at arm's length.

Accordingly, to show there is NALI, it must first be shown that there are dealings which are not on arm's length terms.

'Arm's length' is defined under section 995-1 of the ITAA97 as 'in determining whether parties are at arm's length, consider any connection between them and any other relevant circumstance.'

That is, section 995-1 doesn't so much define 'arm's length' as direct the reader how to assess whether the parties are at arm's length.

In the absence of an express definition in the legislation, case law has provided some useful guidance:

- 'the expression 'dealing with each other at arm's length' involves an analysis of the manner in which the parties to a transaction conducted themselves in forming that transaction. What is asked is whether the parties behaved in the manner in which parties at arm's length would be expected to behave in conducting their affairs.'[2]
- 'What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining'[3]
- The expression 'at arm's length' plainly implies a dealing carried out on commercial terms. A useful test to apply is 'whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment.'[4]

The above extracts from the case law make clear that, for the purposes of the NALI provisions, the key consideration is not whether the parties are at arm's length, but whether or not they dealt with each other in the way that arm's length parties would do. This is an important distinction when looking at complicated SMSF investment structures where related parties of the SMSF are involved (as will be discussed further below).

NALE

In mid-2018, the definition of NALI under the ITAA97 was amended to include non-arm's length expenditure (**NALE**) (refer section 295-550(1)(b) and section 295-550(1)(c) above). The NALE provisions are designed to apply where, in gaining or producing the income, if there is any NALE that is less than what might have been expected if the parties were dealing at arm's length, that income is NALI. NALE includes not just an expenditure, but also a loss or outgoing that is lower than an arm's length amount, and also includes where there is a nil amount (ie, no expenditure).

A tension therefore exists between section 17A of the SIS Act and the NALE provisions. Section 17A provides that a trustee/director must not receive any remuneration for services performed by the trustee/director in relation to the SMSF (subject to limited exceptions set out in section 17B of the SIS Act). So what happens where a trustee/director performs work for a business conducted by the SMSF but doesn't charge for their work to avoid breaching s 17A – will they be caught by the NALE provisions?

The NALE provisions are discussed in more detail below under the LCR 2019/D3 heading.

[2] Lee J in *Granby Pty Ltd v FCT* 95 ATC 4240 at 4243
[3] Davies J in *Re Hains (deceased); Barnsdall v FCT* 88 ATC 4565 at 4568
[4] Weinberg J in *Australian Prudential Regulation Authority v Derstepanian* [2005] FCA 1121 at [18]

2. KEY ATO MATERIAL ON NALI and NALE IN RELATION TO PROPERTY DEVELOPMENT AND SMSF INVESTMENT ARRANGEMENTS

While acknowledging that property development and business ventures by SMSFs is not prohibited per se, the ATO has increasingly raised concerns with SMSFs conducting these types of activities and investments. This includes the following recent comments made by Kasey Macfarlane, Assistant Commissioner, Superannuation:

- "An SMSF can undertake a property development or other business venture. However, significant caution is required because the manner in which these activities are undertaken can give rise to breaches of regulatory rules."
- "In particular, the general prohibition on borrowing by SMSFs, the related-party rules and rules about non-arm's length transactions as well as the sole-purpose test."
- For JVs "extreme care" was needed to ensure the SMSF didn't breach the regulatory rules, "particularly if the other party to the joint venture is a related party".
- "The very small number of cases we have seen to date have raised concerns from a regulatory perspective, particularly the rules about related-party transactions and non-arm's length transactions. The cases have also commonly involved related-party joint ventures and trusts that have raised potential application of the NALI provisions in tax law."
- This was an area the ATO would continue to "monitor closely".
- "Our concern is that in some of these cases, involving SMSFs in related-business undertakings may be viewed as a mechanism for diverting members' business-related income into a more tax concessionary environment. If extreme caution is not exercised significant regulatory and income tax issues can arise which may risk members' retirement savings."

Therefore, it is important for SMSF trustees to appreciate that property development by SMSFs must be carefully undertaken (in a way that doesn't breach the super laws) and that they may be reviewed or audited by the ATO (and therefore should be ready for the time and expense associated with such reviews/audits).

The ATO has released a number of publications setting out their views and concerns on SMSFs undertaking property development or other business ventures, and how the NALI and NALE provisions might apply in these contexts. The main publications are discussed below.

SMSFRB 2020/1

SMSF Regulator's Bulletin SMSFRB 2020/1 (the **Bulletin**) sets out the ATO's view on SMSFs undertaking property development. There is no express prohibition on SMSFs undertaking property development activities or a property development business. Rather, the question is whether such activities cause the SMSF to breach the provisions of the SIS Act, the SIS Regs, or cause adverse tax consequences under the ITAA97 or ITAA1936.

While the ATO acknowledge in the Bulletin that an SMSF can carry on a property development either directly or through an entity or joint venture, the ATO has used the Bulletin to raise their concerns about SMSFs being involved in such arrangements.

The ATO outline their concerns in the Bulletin as follows:

- We have seen an increase in the number of self-managed superannuation funds (SMSFs) entering into arrangements, with related or unrelated parties, involving the purchase and development of real property for subsequent disposal or leasing.
- In particular, we are seeing a number of arrangements in which the investment activity is undertaken utilising joint venture arrangements, partnerships or investments through an ungeared related unit trust or company.
- Property development can be a legitimate investment for SMSFs, and the Commissioner does not have any concern with SMSFs investing in property development where it complies with the *Superannuation Industry (Supervision) Act 1993* (SISA) and *Superannuation Industry (Supervision) Regulations 1994* (SISR).
- However, these types of investments can cause concerns where they are used to inappropriately divert income into the superannuation environment, or if SMSF assets are used to fund property development ventures in a manner that is inappropriate for and sometimes detrimental to retirement purposes.
- Property development ventures may also involve complex structures and the manner in which they are implemented can lead to inadvertent but serious contraventions of the regulatory rules.

The ATO specifically notes at paragraph 9 of the Bulletin that SMSFs need to be conscious of income tax matters such as the NALI provisions and the general anti-avoidance rules, particularly where the arrangement involves other related parties.

LCR 2019/D3

Following the introduction of the NALE provisions to the ITAA97 as discussed above, the ATO issued Draft Law Companion Ruling 2019/D3 (**Draft Ruling**) indicating how they intend to apply the NALE provisions. While the Draft Ruling remains in draft form, it has caused widespread concern in the industry. It appears from the Draft Ruling that the ATO is proposing to administer the law such that a wide range of activities would be caught by the NALE provisions. Most concerningly, the Draft Ruling suggests that 'in some instances, the non-arm's length expenditure will have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund.' If this approach is followed, it could result in a potential tax outcome whereby all the SMSF's income is characterised as NALI.

In response to feedback from industry bodies, the ATO have sought advice from an independent advice panel on their interpretation of the NALE provisions as set out in the Draft Ruling, and it is hoped that the Draft Ruling, particularly as it relates to NALE of a general nature, will be amended prior to being finalised.

ATO case studies

In addition to the Bulletin, the ATO has recently released further property development case studies on its website (**Case Studies**) which further highlight their concerns. I have extracted the Case Studies to the annexure of this paper.

The case studies appear to be aimed at raising SMSF trustees' awareness of property development 'schemes' that have caught the ATO's attention. The case studies will be discussed further in the context of specific SMSF investment structures.

3. ATO MATERIAL ON NALI and NALE AND ITS APPLICATION TO PROPERTY DEVELOPMENT AND SMSF INVESTMENT ARRANGEMENTS

What does the Bulletin say about NALI and NALE?

Ensure arrangements are on arm's length terms

As set out above, the first limb of the NALI test is that the parties are not dealing on arm's length terms. The Bulletin highlights the importance of ensuring the parties are dealing at arm's length at paragraph 10 as follows:

Where an SMSF, or entities that the SMSF invests in, conducts a property development, care needs to be taken that the parties are dealing with each other at arm's length, including (but not limited to):

- the purchase of land or other assets
- the value of services provided
- the terms (including the use of personal or related party guarantees) of any borrowing arrangements of the SMSF or other entities involved in the development, and
- the return on investment and income or capital entitlements.

The question therefore arises – how do you ensure that parties are dealing with each other at arm's length when investing in complicated arrangements (including conducting property development)?

The best defence against the ATO here is the sourcing of benchmark material. That is, the parties should obtain material which shows the terms on which truly arm's length parties would enter into such an arrangement, and then benchmark their own arrangement to those terms. For example, if as part of the investment the SMSF is entering into a lease with a related party of the SMSF, the terms of the lease should be benchmarked against a similar lease arrangement entered into by arm's length parties, and documentary evidence of this benchmarking be retained and kept with the SMSF records. The rent should also be based on a rental valuation.

Further, while certain agreements do not need to be in writing to be enforceable (such as a lease or loan), SMSFs should ensure that all agreements as part of the investment are in writing. The written agreement will act as documentary evidence of the arm's length terms of the agreement, as well as reflecting the standard commercial practice of formalising agreements in writing.

Acquisition of assets

Similarly, where the SMSF (or an entity it is investing in) is to purchase land or other assets, the SMSF should ensure the asset is acquired for market value.

Market value is defined at section 10 of the SIS Act as follows:

market value, in relation to an asset, means 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:

(a) that the buyer and the seller dealt with each other at arm's length in relation to the sale;

(b) that the sale occurred after proper marketing of the asset;

(c) that the buyer and the seller acted knowledgeably and prudentially in relation to the sale.

Although not a legal requirement, is it prudent to have a qualified independent valuer determine the market value before such an acquisition, particularly if the acquisition is from a related party of the SMSF. Such a valuation provides evidence of compliance with certain SIS rules (eg, the acquisition of business real property exception under section 66(2)(b) of the SIS Act) as well as proof that the parties are dealing with each other at arm's length terms (important for both section 109 of the SIS Act, as well as the NALI/NALE provisions of the ITAA97).

The ATO further notes at paragraph 64 of the Bulletin that 'SMSF trustees in property development investments need to have regard to ensuring that both the overall structure, as well as the specific transactions that make up the property development, are conducted on arm's length terms.' SMSF trustees should therefore look at each specific transaction which makes up the overall structure (including the purchase of land or other assets, the terms of any leases or service agreements, particularly those involving related parties) and ensure they are on arm's length terms and can be proven to be on arm's length terms in the event of ATO scrutiny.

LRBAs and NALI

At paragraph 59 of the Bulletin, the ATO note that where LRBAs are used as part of an SMSF investment arrangement (including property development), that may give rise to NALI concerns.

Paragraph 59 and 60 of the Bulletin provide as follows:

59. Additionally, if the SMSF trustee has an LRBA that is not on arm's length terms, the SMSF trustee needs to consider if the income from the arrangement is greater than the income from a 'hypothetical borrowing arrangement' that was at arm's length terms.

60. The factors to be taken into account when considering if an LRBA is an arm's length dealing will depend on the structure of the development arrangement. The following aspects of the LRBA should be considered by trustees when determining whether the LRBA is an arm's-length dealing:

- repayments and ability to repay
- arrangements to provide security to a lender, and
- related party fees, particularly where these would be considered to be outside the ordinary course of normal commercial arrangements.

How to ensure NALI does not arise in related party LRBAs

Based on the ATO view as set out in TD 2016/16 and LCR 2019/D3, SMSFs can ensure income from related party LRBAs is not classed as NALI by:

- using the safe harbour loan terms as set out in PCG 2016/5 (however these only apply where the assets being acquired are listed shares/units or real estate); or

- benchmarking the loan terms to an offer from a commercial lender (to demonstrate that the LRBA terms are consistent with an arm’s length dealing in the same factual circumstances). Noting it can be difficult to obtain benchmarking evidence, especially for less common assets such as shares in a private company or units in an unlisted unit trust

Example of NALI from the Bulletin

The ATO give an example of where NALI may arise in a property development context at paragraph 66 of the Bulletin:

66. *John and Vanessa are unrelated individuals who come together to enter into a property development venture. John is the sole member of the J SMSF and Vanessa is the sole member of the v. SMSF. John and Vanessa incorporate a company, JV Co, to conduct the property development activities. J SMSF and v. SMSF each acquire 200,000 shares in JV Co at $1 per share.*

67. *JV Co uses the $400,000 invested to acquire vacant land. It then borrows $4 million from an unrelated bank. The bank will not lend this amount without additional security, and John and Vanessa need to provide personal guarantees and assurances, taking on the full financial and commercial risk of the development. JV Co also borrows a further $3 million from related parties for additional working capital.*

68. *After two years of development JV Co realises a profit and pays tax. JV Co distributes its profits as fully franked dividends to J SMSF and v. SMSF, funding these distributions by taking further loans from related parties. As the SMSFs are fully in retirement phase, they do not pay tax on these dividends and receive a substantial refund of franking credits.*

69. *Although the documented arrangements on face value appear to be at arm's length, when viewed holistically it is clear that these dividends are not consistent with an arm's*

length dealing.[49] *An unrelated SMSF would not have been able to access these dividends by investing in JV Co for the same value as the J SMSF and v. SMSF, (as) the risk was born by John and Vanessa personally. It is also unlikely that unrelated lenders would be willing to lend to JV Co for additional working capital and to fund dividends, which would prevent JV Co from realising its profit and distributing to the SMSFs.*

70. *As such, the dividends from JV Co may be NALI for the two SMSFs.*[50] *Consideration may also be given to whether the arrangement is a scheme to which Part IVA of the ITAA 1936 applies.*

The ATO finds that NALI is triggered because members of each SMSF provide personal guarantees to the borrowing undertaken by the unrelated company. This seems to be particularly based on the proposition that a new incoming SMSF would not have received the same valued investment due to the personal guarantees. With respect, I believe the ATO is wrong for a number of reasons:

- personal guarantees are an arm's length dealing that are required in almost all borrowing arrangements;
- the personal guarantees are likely to have been given by directors of the company in that role (not as representatives of the shareholders);
- it is likely that an incoming SMSF would likewise have its members provide a personal guarantee if that member became a director of the company;
- it is common, and arm's length, for some shareholders to provide guarantees and others to not.

This example also highlights that:

- in the ATO view, even where completely unrelated lenders are involved in funding the project, NALI may still arise;
- the ATO will examine both the specific transactions as well as the arrangement overall when assessing for NALI;
- related party loans should be benchmarked to arm's length terms and documentary evidence of that benchmarking should be sought and retained.

What does LCR 2019/D3 say about NALI and NALE?

As noted above, LCR 2019/D3 was released following the amendments which were made to the NALI provisions to specifically capture NALE.

Paragraph 1 of LCR 2019/D3 provides that 'this draft ruling clarifies how the amendments to section 295-550 of the Income Tax Assessment Act 1997 operate in a scheme where the parties do not deal with each other at arm's length and the trustee of a complying superannuation entity incurs non-arm's length expenditure (or where expenditure is not incurred) in gaining or producing ordinary or statutory income.'

The section of LCR 2019/D3 which has caused the most concern is contained at paragraphs 18 as follows (paragraph 17 included for context):

17. Non-arm's length expenditure incurred to acquire an asset (including associated financing costs) will have a sufficient nexus to all ordinary or statutory income derived by the complying superannuation fund in respect of that asset. This includes any capital gain derived on the disposal of the asset (see Example 1 of this Ruling).

18. In some instances, the non-arm's length expenditure will have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund (see Example 2 of this Ruling).

Example 2 of LCR 2019/D3 gives the example of Mikasa who, as trustee of her SMSF, engages an accounting firm, where she is a partner, to provide accounting services for her SMSF. The accounting firm does not charge the SMSF for those services. The ATO say that the SMSF acquired the accounting services under a non-arm's length arrangement and the NALE (being the nil amount incurred for the services) has a sufficient nexus to all of the ordinary and statutory income derived by the SMSF for that income year. As such, all of the SMSF's income for that income year is NALI.

This example will hopefully be removed as part of the current review of LCR 2019/D3, due to its completely draconian and disproportionate application of the NALE provisions.

There are other sections of LCR 2019/D3 which are more relevant to the topic of this paper, and it is possible they will be included in the finalised ruling as they are more consistent with the ATO approach more broadly.

Examples from LCR 2019/D3 giving rise to NALI

Similarly to the Bulletin, in LCR 2019/D3, the ATO identify specific transactions which make up larger investment arrangements as giving rise to NALI or NALE.

These include:

- where an asset is purchased under a non-arm's length arrangement[5]:

[5] Paragraphs 23-29 of LCR 2019/D3

- where a fund purchases an asset at less than market value under a scheme where the parties were not dealing at arm's length, the fund incurs NALE (in applying these provisions, the loss, outgoing or expenditure under the non-arm's length arrangement may be of a revenue or capital nature);
- a consequence of the NALE provisions applying to the purchase is that all of the income derived from that asset will be NALI, including any capital gains from the disposal of the asset;

- where an asset is purchased and the purchase is financed through an LRBA on non-arm's length terms[6]:
  - the ATO give the rather extreme example of Kellie, an individual trustee entering into an LRBA with herself to purchase a commercial property, with the SMSF borrowing 100% of the purchase price;
  - the terms of the loan include interest being charged at a rate of 1.5% per annum and repayments only being made on an annual basis over a 25 year period;
  - Kellie's SMSF received a commercial rate of rent from the property of $12,000 per month;
  - the ATO note that if Kellie's SMSF had entered an LRBA on arm's length terms, it would be expected that repayments of principal and interest would have occurred on a monthly basis and interest would be charged on the LRBA at a commercial rate. Further, the loan to market value ration would have also not exceeded commercial levels;
  - the terms of the LRBA constitute a non-arm's length dealing between the SMSF and Kellie, which resulted int eh SMSF incurring expenditure in gaining or producing rental income that was less than would otherwise be expected if the parties were dealing with each other at arm's length in relation to the scheme. The rental income derived from the property is therefore NALI (together with any capital gain that might arise on, eg, the disposal of the property).

These examples from LCR 2019/D3 illustrate how NALE can arise in the context of SMSF investment arrangements, particularly those involving related parties.

To ensure NALE is not triggered, SMSF trustees should ensure that all assets and materials are acquired (either by the SMSF or an entity the SMSF invests in) at market value, and commercial rates are charged for all services. This includes:

- all assets, including commercial property, should be acquired at market value;

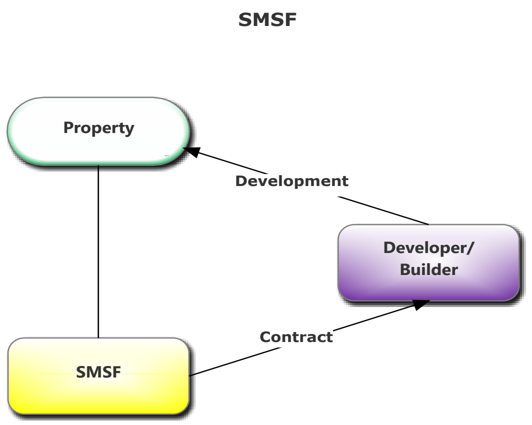
[6] Paragraphs 30-33 of LCR 2019/D3

- all building materials should be acquired at market value;
- all services (whether acquired from related or unrelated parties) including building and project management services, should be on arm's length terms and paid for on commercial rates;
- rent should be paid at a commercial rate;
- all related party LRBAs should either fall under the safe harbour loan terms in PCG 2016/5, or be benchmarked to a loan offer from a commercial lender

4. INVESTMENT STRUCTURES

In the following section of this paper, I have examined various structures under which an SMSF can undertake property development or invest in an entity which undertakes property development activities.

SMSFs



Property development activities can be undertaken directly by the SMSF trustee provided the SIS Act and SIS Regs are not breached.

Advantages of using this structure include:

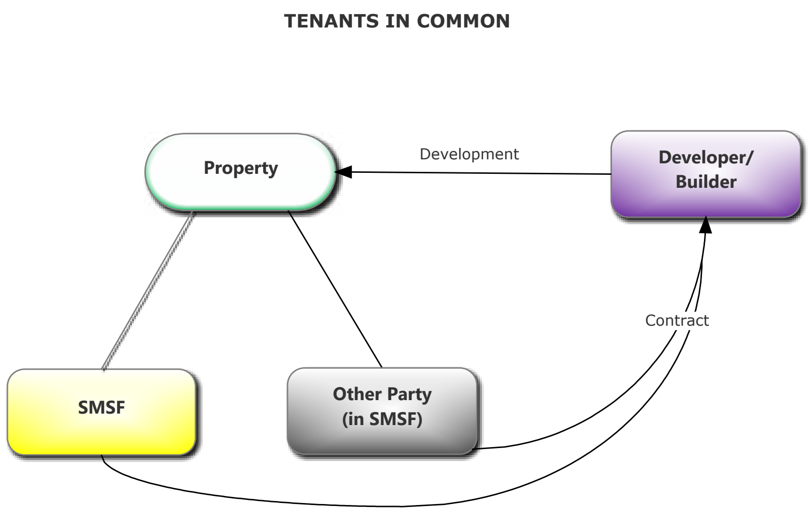
- there is no need for other entities and therefore there can be less cost and administration;
- the SMSF’s cash can be used directly in the development;
- existing SMSF assets can be developed (although not with borrowing);
- income and capital are taxed at SMSF rates;
- the SMSF can undertake a property development business.

Disadvantages of using this structure include:

- SIS Act and SIS Regs restrictions can make development difficult;
- there is no asset protection – SMSF assets are subject to claims from the development;
- it is difficult to use borrowing where making improvements;
- SMSFs cannot use borrowing to improve existing assets;

- it is difficult to bring other parties into the development (ie they would have to become members of the SMSF);
- the difficulties of using related party developers/builders.

Tenants in common



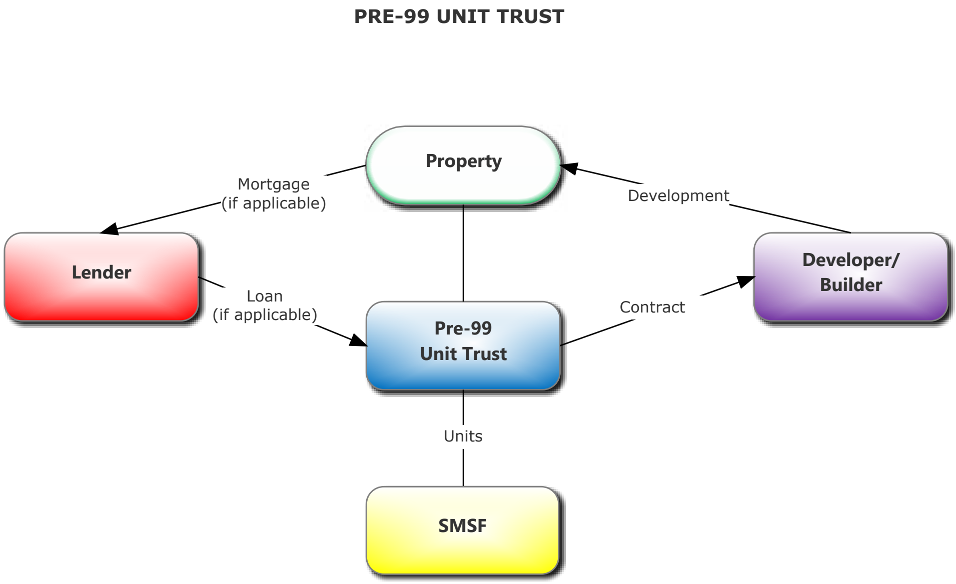
It is possible for an SMSF to hold assets as tenants in common with another party. That other party could be a related party or an unrelated party (including another SMSF).

As the SMSF holds an interest directly in property the tenants in common structure has the same advantages and disadvantages as the SMSF structure. In addition, it has the following disadvantages:

- if the asset is non-business real property and the other tenant in common is a related party, the SMSF will be unable to buy the other party's interest in the property;[7]
- interactions with the co-owner could cause a breach of the SIS Act, for example an inadvertent borrowing by the SMSF or the provisions of financial accommodation to the related party co-owner;
- the tenants in common will be treated as a tax law partnership;
- duty may apply if the co-owner's interest is acquired by the SMSF.

[7] as that would breach s66 of the SIS Act

Pre-99 unit trusts



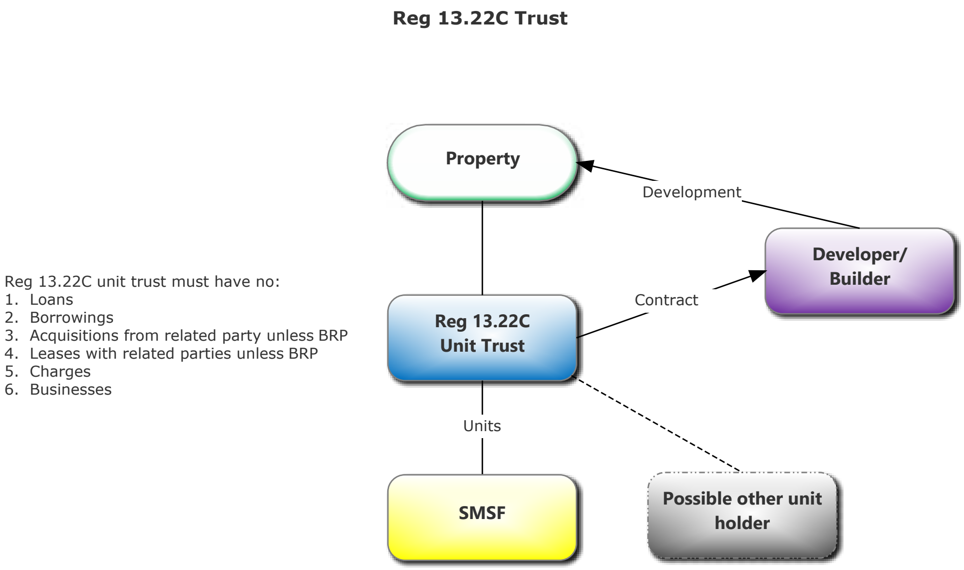
Where an SMSF acquired units in a unit trust (or company) prior to 12 August 1999, or under the transitional period operating from that date to 30 June 2009, such units will never be in-house assets. Any units acquired from 12 August 1999 (other than those acquired under the transitional rules) will be in-house assets.

This means that such unit trusts (commonly known as pre-99 unit trusts) can undertake activities that an SMSF cannot do directly without causing the SMSF to breach the in-house asset rules. Such activities can include borrowing and dealing with related parties. This can make a pre-99 unit trust valuable in a property development sense.

It is important to note that although the units in a pre-99 unit trust may not be in-house assets that the other SIS Act and SIS Regs rules and the tax acts will continue to apply to the holding of the units. This includes the sole purpose test, section 109 of the SIS Act, the non-arm's length income rules and the public trading trust provisions. Therefore, it is particularly important that the activities of the pre-99 unit trust be undertaken on an arm's length basis.

In addition, as any further units will be in-house assets and the distributions cannot be left unpaid without, in the ATO's view becoming an in-house asset (as financial accommodation), there can be cash flow issues. This is especially so where the pre-99 unit trust has low levels of cash, a principal and interest loan and the obligation to pay distributions. This issue can often be fixed (in the short to medium term) by interest only loans (and possibly with the capitalisation of interest).

Reg 13.22C unit trusts



Reg 13.22C unit trusts are sometimes referred to as non-geared unit trusts due to the specific prohibition against the trustee of such trusts from borrowing. However, the restrictions are much wider than that. For an SMSF to invest in such a unit trust that trust must satisfy the requirements of regulation 13.22C (or 13.22B) of the SIS Regs and not breach regulation 13.22D of the SIS Regs. These requirements include:

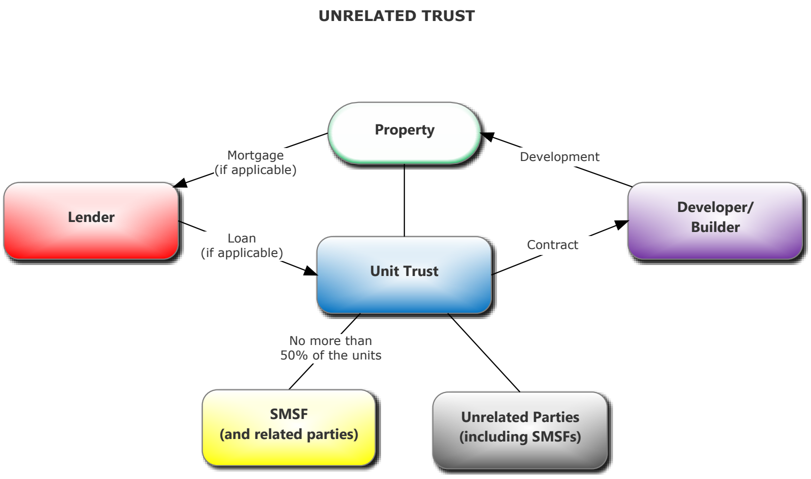
- the trustee of the unit trust, is not a party to a lease with a related party of the superannuation fund, unless the lease relates to business real property; and
- the trustee of the unit trust, is not a party to a lease arrangement with a related party of the superannuation fund, unless the lease arrangement:
    - is legally binding; and
    - relates to business real property; and
- the trustee of the unit trust, is not a party to a lease, or lease arrangement, with another party in relation to an asset that is the subject of another lease or lease arrangement between any party and a related party of the superannuation fund (unless the asset is business real property); and
- the trustee of the unit trust, does not have outstanding borrowings; and
- the assets of the unit trust do not include:
    - an interest in another entity; or
    - a loan to another entity, unless the loan is a deposit with an authorised deposit-taking institution within the meaning of the Banking Act 1959; or
    - an asset over, or in relation to, which there is a charge; or

  - an asset that was acquired from a related party of the superannuation fund after 11 August 1999, unless the asset was business real property acquired at market value; or
  - an asset that had been, at any time (unless it was business real property acquired by the trustee of the unit trust, at market value) in the period from the end of 11 August 1999 to the commencement of this Division, an asset of a related party of the superannuation fund;
- the trustee of the unit trust does not conduct a business.

Although restrictive, the reg 13.22C unit trust has the significant advantages that units in such a trust held by an SMSF will not be an in-house asset and the SMSF can acquire units in such a trust from related parties[8]. A reg 13.22C unit trust also has the advantage that related parties can hold units in such a unit trust, even where the Group controls the unit trust.

In a property development context, the trustee of a reg 13.22C unit trust can acquire property and develop it but it must do so without borrowing money, charging the asset, acquiring assets from a related party (including materials from a related party builder) or operating a business. Therefore, any property development would need to be fully funded from capital contributions by the unit holders.

Unrelated trusts



An unrelated trust is a unit trust which does not fall within the definition of a “related trust” under section 10(1) of the SIS Act. Determining whether a trust is a related trust is a complicated task. However, as a simple rule of thumb, if the SMSF and its Group hold no more than 50% of the units in the trust, hold no more than 50% of the shares in the corporate trustee, hold no more than 50% of the director roles in the corporate trustee and do not have the unilateral power to remove the unit trust’s trustee, then the unit trust will not be a related trust.

[8] section 66(2A)(a)(iv) of the SIS Act

An example of an unrelated trust is where two unrelated SMSFs each hold 50% of the units in the unit trust and their respective related parties hold no more than 50% of the shares in the corporate trustee and 50% of the director roles in the corporate trustee.

Unrelated trusts have significant advantages, as, like pre-99 unit trusts, the units held by the SMSF will not be treated as in-house assets regardless of what activities the unrelated trust does. Therefore, the unrelated trust can borrow, charge its assets, deal with related parties and carry on a business without causing the units held by the SMSF to be in-house assets. As noted above for the pre-99 unit trusts, units in an unrelated trust can still cause an SMSF to breach the SIS Act (for example the sole purpose test or section 109) or trigger adverse tax consequences under the non-arm's length income rules. Therefore, it is important that an unrelated trust deals on an arm's length basis to avoid the potential application of these rules.

Leveraging using an unrelated trust has a particular advantage over LRBAs as the loan can be full recourse and neither the single acquirable asset rule nor the replacement rules apply.

As a result of the advantages noted above, the unrelated trust is the best structure for SMSFs to have an interest in property development. The biggest downside however is that an SMSF and its Group can only have a 50% interest in the unit trust. Therefore, this structure will not be appropriate where the SMSF and its Group want to control more than 50% of a unit trust or other investors cannot be found.

What does the ATO material say?

The ATO has recently published material on their website setting out a number of case studies which are aimed at helping SMSF trustees to identify and avoid retirement planning schemes. This material is extracted in full at the end of this paper.

In the first case study, Eddy and his business partner Michael establish a unit trust with Eddy's friend Paul, who owns Best Building Company (**BBC**). The unit holders in the unit trust are their respective SMSFs. They have existing SMSFs but they each establish a new one for the purposes of investing in the development unit trust (the **EMP Trust**). Their existing SMSFs hold the majority of their other retirement savings.

The three new SMSFs subscribe 100 units at $1 each in the EMP Trust, with each of the SMSFs holding one-third of the EMP Trust. None of the SMSFs control the EMP Trust in their own right, however, Paul is an expert in property development and so Eddy and Michael rely entirely on Paul's knowledge and connection in the industry to manage and make decisions on this property development project.

Paul, Eddy and Michael each borrow $4 million from a bank, using their personal assets as security. They then each on-lend the $4 million to the EMP Trust at the same interest rate as the bank, however the EMP Trust does not have sufficient assets to provide security for the loan from Paul, Eddy and Michael. That is, if the EMP Trust defaults on the loan, Paul, Eddy and Michael will carry the financial burden individually. The EMP Trust now has capital of $12 million and purchases land for $4 million.

The EMP Trust then signs a contract with Paul's company, BBC, to build a 10-storey apartment building. In order to minimise costs:

- BBC (whose sole shareholder is Paul) will supply any materials and building and construction services at cost
- Eddy and Michael will manage all the paperwork and accounts free of charge
- BBC will be responsible for acquiring all materials and subcontracting.

The apartments are completed in 18 months and sold off giving a profit of $10 million, which the EMP Trust distributes down to the three SMSFs. The SMSFs then pay 15% tax on that distribution. All three SMSFs receive a significant return on their initial investment of $300.

What happens as a result?

In their case study, the ATO flag the following issues:

- Upon the SMSFs lodging their tax returns, the ATO note the SMSFs' assets grew significantly over a very short period of time, which raises alarm bells;
- When audited, the SMSFs have no other assets apart from the units in the unit trust and the trust distribution arising from the property development;
- Certain aspects of the arrangement indicate the parties did not deal with each other at arm's length, including with respect to the supply of materials and services by related parties to the arrangement;
- Therefore, the EMP trust distributions are found to be NALI;
- The arrangement may also attract the application of the general anti-avoidance provision of Part IVA.

In addition to these issues, the ATO state that, in their view, the SMSFs have breached the following SIS provisions:

- Sole purpose test, as the SMSFs were specifically set up to facilitate an arrangement that is designed to inappropriately seek tax concessions, rather than for retirement purposes;
- Section 85, for entering into a scheme that was artificially designed to circumvent the in-house asset rules;
- Section 109 (requirement to deal on an arm's length basis).

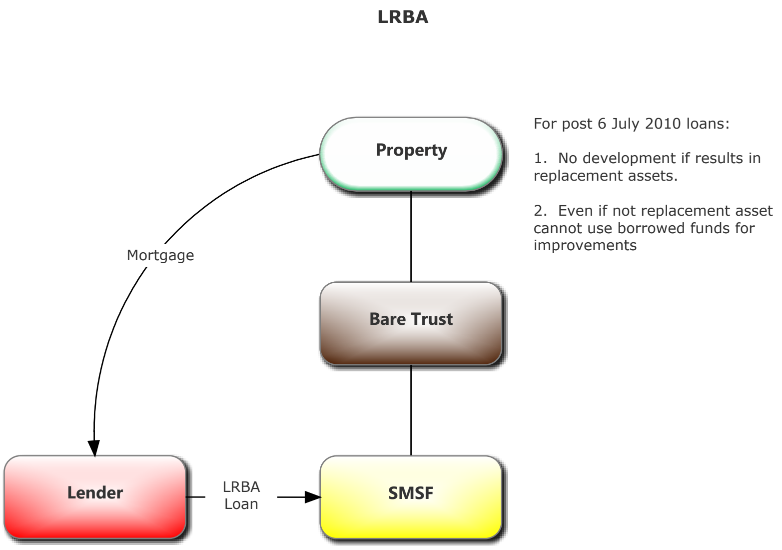
As a result, the ATO apply the following penalties:

- Make the SMSFs non-complying; and
- Disqualify Paul, Eddy and Michael as SMSF trustees.

These are two of the most severe penalties available to the ATO in respect of breaches of the SIS provisions, and reflect how the ATO view these types of investments.

The consequence of these penalties is that the new SMSFs will be subject to tax at the highest marginal rate, and Paul, Eddy and Michael will have to roll their member balances out of both the new SMSFs and their other SMSFs, given they are now disqualified as trustees.

LRBAs



The examination of the LRBA (limited recourse borrowing arrangement) rules is a topic in itself. Therefore, in this paper I have confined the issues of using LRBAs to those relating to property development.[9]

New law LRBAs

LRBAs put in place after 7 July 2010 (**New Law LRBAs**) are governed by sections 67A and 67B of SIS Act. In a property development context, these New Law LRBAs are very restrictive for the following reasons:

- they can only be used to acquire single acquirable assets;

[9] For a detailed explanation of the LRBA rules, as they apply to New Law LRBAs, see my paper "An A to Z of limited recourse borrowing arrangements" - http://sladen.com.au/news/2014/3/31/an-a-to-z-of-limited-recourse-borrowing-arrangements

- borrowed funds cannot be used to improve assets under a New Law LRBA;
- assets under an LRBA cannot be improved to the extent that it results in a "new asset".

Despite these restrictions, the development of a property held under a New Law LRBA can occur where that improvement is funded from the SMSFs own funds (not borrowed funds) and the nature of the property does not change. The ATO gives the following examples of permitted improvements:

- Each (or all) of the following changes to a residential property would be treated as improvements but would not result in a different asset:
    - an extension to add two bedrooms;
    - the addition of a swimming pool;
    - an extension consisting of an outdoor entertainment area;
    - the addition of a garage shed and driveway;
    - the addition of a garden shed.[10]
- The trustees of an SMSF enter into an LRBA where the single acquirable asset is a property which has a car washing facility on it. The property is leased to a tenant who operates a car washing business.
- The trustees decide to expand the facility by extending the back of the building to double the number of wash bays. The extension, which involves concreting, roofing and plumbing work, will be funded from accumulated funds held by the SMSF and will result in higher rent being received from the tenant. Although there is an improvement to the asset, that improvement does not result in the commercial property becoming a different asset. The fundamental character of the property remains a car wash facility.[11]

Old law LRBAs

Any LRBAs put in place between 24 September 2007 and 7 July 2010 (**Old Law LRBAs**) have the following significant advantages over New Law LRBAs:

- they could be used over multiple assets;
- property could be improved and subdivided under Old Law LRBAs;
- the borrowed funds could be used to make improvements.

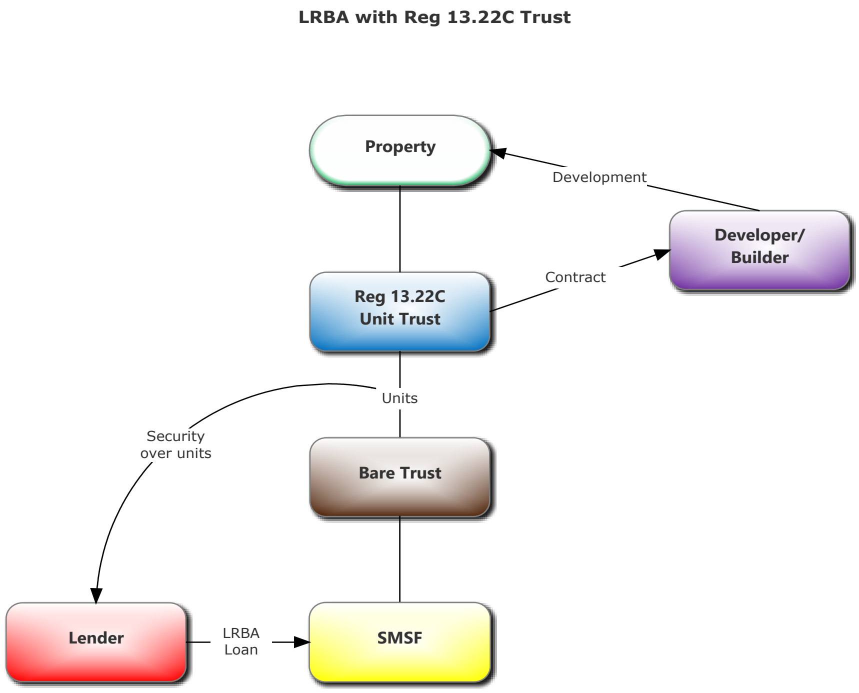
This gave a lot more flexibility to do property development under Old Law LRBAs. Old Law LRBAs retain this flexibility post 7 July 2010 provided the terms of the arrangement permit such activities. If they don't then, in the ATO's view, changes to the arrangement may result in it being deemed to be refinanced into a New Law LRBA.

[10] item 7 of paragraph 35 of SMSFR 2012/1
[11] paragraph 83 of SMSFR 2012/1

What does the ATO material say?

As set out above, both the Bulletin and LCR 2019/D3 discuss non-arm's length LRBAs and the application of NALI/NALE in detail, suggesting this is a key focus area for the ATO.

New Law LRBAs and the reg 13.22C unit trust combination



Due to the difficulties of undertaking property development activities under a New Law LRBA, one alternative structure is for the property to be held by a reg 13.22C unit trust and for the SMSF to acquire the units in the unit trust using a New Law LRBA. In that way the unit trust trustee can undertake development of the property and not be restricted by the LRBA rules. The units held by the SMSF in the reg 13.22C unit trust under the LRBA structure will not be affected by such activities and therefore there will be no breach of the LRBA rules.

The major downside of this structure is that the activities of the reg 13.22C unit trust will be highly restricted (as discussed above). In particular the property held by the reg 13.22C unit trust cannot be used as security for the LRBA loan. Therefore, any security given to the lender will have to be restricted to the units in the reg 13.22C trust or other assets provided by guarantors.

What does the ATO material say?

As outlined above, the Bulletin specifically mentions the LRBA reg 13.22C structure, the difficulty in obtaining benchmarking and the application of NALI.

Companies

From an in-house asset perspective companies are effectively treated the same way as unit trusts. That is, SMSFs can invest in pre-99 companies, reg 13.22C companies and unrelated companies.

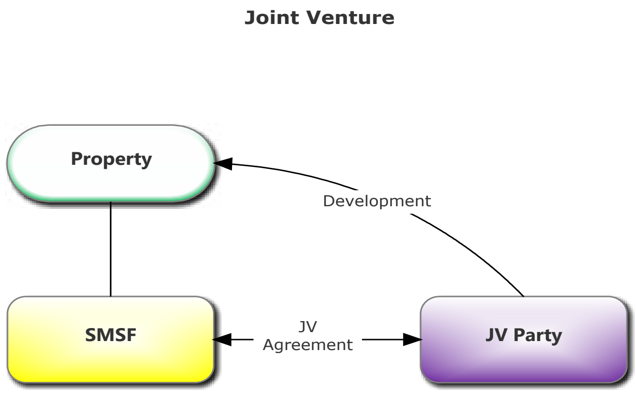
Unit trusts are generally favoured over companies due to their flow through nature from a tax and income perspective. That said, companies could still be used in certain circumstances, including:

- where a unit trust would be treated as a trading trust and taxed like a company in any event;
- accumulating income at the corporate entity was desirable;
- to avoid the complications arising out of the obligation to pay unit trust distributions in cash (or through reinvestments in units) rather than leaving them as unpaid present entitlements;
- the ability to use a corporate group structure.

What does the ATO material say?

The Bulletin does not deal with companies specifically but rather considers companies and unit trusts together.

Joint ventures



Typically, under a joint venture arrangement each party will contribute something to the venture and they will each share the profits in an agreed manner. For example, an SMSF could “contribute” its property and a builder could contribute its building services and at the end of the arrangement the developed property, or proceeds from the sale of the developed property, would be shared according to some type of agreement or formula.

There are no provisions in the SIS Act or SIS Regs which prevent an SMSF from entering into a joint venture. However, entering into and implementing a joint venture could cause an SMSF to breach the SIS Act or SIS Regs. One example where this could occur is where the SMSF charges its assets under the JV agreement or in support of the joint venture partner’s development activity.

What does the ATO material say?

The Bulletin

The Bulletin mentions the ATO’s concerns in relation to SMSFs participating in joint ventures a number of times, including devoting a whole section on it (paragraphs 71 to 76). The ATO has stated that related joint ventures may result in an investment in or loan to a related party. The investment in argument will generally be difficult to maintain given that investing would generally require the issue of shares or units and is practically impossible where the other party is a discretionary trust.

71. A joint venture[51] is defined in the Butterworths Concise Australian Legal Dictionary[52] as:

An association of persons for particular trading, commercial, mining, or other financial undertakings or endeavours with a view to mutual profit. It is not a technical legal term with a settled common law meaning: United Dominions Corp Limited v. Brian Pty Ltd (1985) 157 CLR 1; 60 ALR 741. The association is usually for the participation in a single project rather than a continuing business. A joint venture may be carried out by way of a partnership, company, trust, agency, joint ownership, or other arrangement. It may include an activity carried on by a body corporate which was formed to carry on the activity by means of joint control or ownership or shares in the body corporate: (Cth) *Trade Practices Act 1974* s4J(a).

72. This definition indicates that a joint venture may be carried out in the form of a partnership, company, trust or other arrangement. While there may be different tax outcomes depending on the chosen structure, for the purpose of the risks that this Bulletin is concerned with, the term joint venture is used under its general meaning.

73. Care must be taken by SMSF trustees undertaking property development via a joint venture to ensure the arrangement, particularly when undertaken with a related party, is a true joint venture. That is, the contribution (whether it be financial or time) made by the

SMSF and its members must be reflected in the proceeds received (whether it be rental income or sale proceeds).

74. If the SMSF's return from the arrangement is excessive when compared to their input into the arrangement, we would be concerned that the income derived from the joint venture is NALI.

75. In a joint venture with a related party, SMSF trustees also need to ensure that their stake in the joint venture does not amount to an investment in or loan to that related party and is therefore an in-house asset. We would expect the SMSF to hold a proprietary interest in the real property that is being developed, and to be comfortable that the SMSFs investment is 'in' that property and not an investment 'in' the related party.

76. However, where the SMSF has only provided a capital outlay for the arrangement, and has no rights other than a contractual right to a return on the final investment, we would be concerned that they may instead hold an investment in or loan to the other party, depending on the terms of the joint venture agreement.[53]

The Case Studies

One of the ATO case studies involves a joint venture property development.

Tom and Leanne are very experienced in developing small blocks of units and duplexes. Tom worked for many years as a bricklayer before getting into property development, and Leanne as an architect. They decide to involve their SMSF in their next development project in order to boost their superannuation balances (currently a little over $300,000 between them).

One of Tom and Leanne’s companies, TNL Pty Ltd (**TNL**), holds a large block of land with council approval to construct three townhouses.

Tom and Leanne set up a unit trust (the **TLP Trust**) and use $300,000 of the SMSF’s money to subscribe for all the units in the TLP Trust. The TLP Trust and TNL then enter into a joint venture (**JV**) to build townhouses on the land owned by TNL.

The TLP Trust’s contribution to the JV is $300,000 cash to finance the development. TNL’s contribution is the land, which is worth approximately $1 million at the time.

To reduce the costs associated with the development, Leanne is to draw up the plans for the development, and Tom is to undertake all the bricklaying work.

Tom and Leanne's family trust (**Family Trust**) is able to access building materials at significantly discounted rates as they have used the Family Trust in previous developments. Given this, the Family Trust will be engaged to supply, at cost, the necessary building materials for the development, and engages contractors to undertake the work Tom and Leanne can't do themselves.

It is suggested that the development profits be split 50/50 between the TLP Trust and TNL, even though the TLP Trust's contribution to the venture only represents about 23% of the total value contributed by the venture.

What happens as a result?

Tom and Leanne run ths proposal by their financial planner and tax agent, who have a number of concerns with the proposed arrangement. They contact the ATO to check.

The ATO advise that the income distributed to the SMSF by the TLP Trust will be NALI, on the following grounds:

- the proposed arrangement will constitute a scheme under which the SMSF derives income from the TLP Trust;
- there is no real bargaining between the parties (which is required to prove an arrangement is on arm's length);
- there is clear collusion between the parties with one controlling mind, and transactions artificially creating a taxing point within the SMSF;
- the TLP Trust will receive 50% of the JV profits despite only contributing 23% of the capital (and nothing else) to the venture;
- significant professional services will be provided by Tom and Leanne at no cost to the venturers; building materials and contract labour will be provided to the venturers at less than commercial rates; and
- due to the non-arm's length dealings, the distribution the SMSF receives from the TLP Trust will be significantly greater than it would have received had the parties to the scheme been dealing with each other at arm's length.

The ATO also take the view that:

- the SMSF's investment in the TLP Trust will be an in-house asset (it's not stated in the example but we assume this is due to the TLP Trust conducting transactions on a non-arm's length basis and therefore triggering reg 13.22D, meaning the units held by the SMSF in the TLP Trust are no longer exempt from being an in-house asset);
- the SMSF's investment in the TLP Trust may be a scheme to avoid the application of section 66(1) of the SIS Act;
- the SMSF may contravene the sole purpose test as it is being maintained for purposes other than those set out in section 62 of the SIS Act.

ANNEXURE – ATO WEBSITE CASE STUDIES – EXTRACTED JULY 2021

SMSFs and property development

Eddy and his business partner Michael have operated a successful strata management company for many years. In the past, they considered diversifying into property development, but they are cautious operators. With land prices at an all-time low and market indicators suggesting property prices are on the rise, they decide to take the plunge.

What is the arrangement?

Eddy's friend Paul, who owns Best Building Company (BBC) has made a small fortune through property development, so Eddy goes to him for advice. Paul suggests that Eddy and Michael go into business with him.

Paul explains that the three of them should establish a unit trust. The unit holders will be their respective self-managed super funds (SMSFs). Paul says he has seen his other friends in the building development industry do similar things. The advantage of having their SMSFs invest in the unit trust is that the profits from their property development project can then be distributed to their super fund. Not only will it boost their retirement income significantly within a short period of time without the need to worry about their contribution caps, it also has the added advantage of the income being taxed at 15%.

Paul suggests that Eddy and Michael should also establish a new SMSF for this new business venture instead of using their existing super funds. He tells them it will ensure any risk associated with the business venture will only be limited to any assets in the new fund. Paul assures Eddy that the business venture is low risk, and this is all lawful and other people do it all the time.

Eddy, Michael and Paul establish the EMP Trust. They each establish a new SMSF, being the Paul SMSF, the Eddy SMSF and the Michael SMSF. The three SMSFs subscribe 100 units at $1 each in the EMP Trust. Each of the SMSFs holds one-third of the EMP Trust. None of the SMSFs control the EMP Trust in their own right, however, as Paul is the expert in property development, Eddy and Michael rely entirely on Paul's knowledge and connection in the industry to manage and make decisions on this property development project. Paul, Eddy and Michael each have their own existing SMSFs that hold the majority of their other retirement savings.

Paul, Eddy and Michael each borrow $4 million from a financial institution, using their personal assets as security. They then each on-lend the $4 million to the EMP Trust at the same interest rate as the financial institution. However, the EMP Trust does not have sufficient assets to provide security for the loan from Paul, Eddy and Michael. If EMP Trust defaults on the loan, the financial burden is ultimately carried by the three individuals. The EMP Trust now has capital of $12 million and it purchases the land for $4 million.

The next month, EMP Trust signs a contract with BBC to build a 10-storey apartment building, and to minimise costs:

- BBC (whose sole shareholder is Paul) will supply any materials and building and construction services at cost
- Eddy and Michael will manage all the paperwork and accounts free of charge
- BBC will be responsible for acquiring all materials and subcontracting.

The apartments are completed in 18 months and sold off giving a profit of $10 million, which the EMP Trust distributes to the Paul SMSF, the Eddy SMSF and the Michael SMSF. The SMSFs then pay 15% of tax on that distribution. All three SMSFs receive a significant return on their initial investment of $300.

What happens as a result?

The SMSFs lodge their tax returns with the ATO. We note the SMSFs' assets grew significantly over a very short period of time, which raises alarm bells. When audited, the SMSFs have no other assets apart from the units in the unit trust and the trust distribution arising from the property development.

Certain aspects of the arrangement indicate that the parties did not deal with each other at arm's length, including with respect to the supply of materials and services by related parties to the arrangement. Therefore, the EMP Trust distributions are found to be non-arm's length income under section 295-550 of the *Income Tax Assessment Act 1997*. We advise that the arrangement may also attract the application of the general anti-avoidance provision of Part IVA of the *Income Tax Assessment Act 1936*.

We also find that the SMSFs have breached one or more of the following provisions under the *Superannuation Industry (Supervision) Act 1993* (SISA):

- sole purpose test under section 62 as the SMSFs were specifically set up to facilitate an arrangement that is designed to inappropriately seek tax concessions, rather than for retirement purposes.
- Section 85 for entering into a scheme that was artificially designed to circumvent the in-house asset rules.
- Section 109 which requires dealings in relation to SMSF investments to be conducted on an arms' length basis.

We revoke the SMSFs' compliance status and disqualify the trustees, which means the:

- funds will be subject to tax at the highest marginal rate
- trustees' other SMSFs will be affected.

SMSF deriving income from related party property development entities

Tom and Leanne are very experienced in developing small blocks of units and duplexes, having completed numerous developments of this type over the past 10 years. Before getting into property development, Tom worked for many years as a bricklayer, and Leanne as an architect.

Recently a friend of Tom's tells him about some of the advantages (from a tax perspective) of holding assets in a super fund, particularly once you retire and start a super income stream (pension). Tom and Leanne have an SMSF, but their combined balances only amount to a little over $300,000. Given this and what Tom's friend tells him, Tom and Leanne discuss ways that they might be able to increase their superannuation balances.

Given their passion for property development and the success they have had in this field in recent years, they would like to use property as a means to increase their super.

One of Tom and Leanne's companies, TNL Pty Ltd (TNL), holds a large block of land in a leafy inner-city suburb. A number of years ago, TNL obtained council approval for the construction of three semi-detached townhouses but did not proceed with the development.

Given the contacts Tom and Leanne have in the building trade, they think that they could make a very good profit from developing the block. Tom wonders if there might be a way their SMSF could be involved in developing this land so it could benefit from the likely substantial profits.

While playing golf at the local club, Leanne's playing partner suggests that Tom and Leanne get in touch with a lawyer who he says is an expert in structuring and financing development projects involving SMSFs.

Tom and Leanne decide to obtain some advice from this lawyer.

What is the arrangement?

As part of the strategy the lawyer devises, Tom and Leanne are advised to set up a unit trust (the TLP Trust) and use $300,000 of their SMSF's money to subscribe for all of the units in that trust. The TLP Trust and TNL will then enter into a joint venture to build townhouses on the land owned by TNL. The TLP Trust's contribution to the joint venture will be $300,000 cash to finance the development. TNL's contribution will be the land, which is worth approximately $1 million at this time.

To reduce the costs associated with the development, it is suggested that Tom and Leanne do as much of the work on the development as possible, free of charge. Given her architectural qualifications, Leanne is to draw up the plans for the development. Tom, being a bricklayer by trade, is to undertake all of the bricklaying work.

Tom and Leanne's family trust (the Family Trust) are able to access building materials at significantly discounted rates as they have used the Family Trust in previous developments they have undertaken. Given this, the Family Trust is to be engaged to supply, at cost, the necessary building materials for the development, and engages contractors to undertake the work Tom and Leanne can't do themselves.

The lawyer suggests that the development profits be split 50/50 between the TLP Trust and TNL, even though the TLP Trust's contribution to the venture only represents about 23% of the total value contributed to the venture. He says that the disproportionate split of profits between the two venturers is good retirement planning as Tom and Leanne's super balances in the SMSF will be inflated as a result of the larger distribution.

What happens as a result?

Tom and Leanne think the arrangement sounds very complex and convoluted so they decide to discuss it with their tax agent and their financial planner who had helped them to establish their SMSF and create an investment strategy for the fund.

The financial planner and tax agent, on hearing the proposal, are concerned there may be a number of tax and regulatory issues that could arise under the arrangement. They decide to contact the ATO to check.

We provide advice that income distributed to the SMSF by the TLP Trust will be non-arm's length income (NALI), and therefore taxed at a significantly higher rate than would otherwise apply:

- The proposed arrangement will constitute a scheme under which the SMSF derives income from the TLP Trust.
- Our published position on non-arm's length income talks about real bargaining taking place between the parties, but in this case

    - there is clear collusion between the parties with one controlling mind, and transactions artificially creating a taxing point within the SMSF
    - the TLP trust will receive 50% of the joint venture profits despite only contributing 23% of the capital (and nothing else) to the venture
    - significant professional services will be provided by Tom and Leanne at no cost to the venturers; building materials and contract labour will be provided to the venturers at less than commercial rates.

- Due to the non-arm's length dealings, the distribution the SMSF receives from the TLP trust will be significantly greater than it would have received had the parties to the scheme been dealing with each other at arm's length.

We further advise that the:

- SMSF's investment in the TLP Trust will be an in-house asset.
- SMSF's investment in the TLP Trust may be a scheme to avoid the application of subsection 66 (1) of the *Superannuation Industry (Supervision) Act 1993* (SISA).
- SMSF may contravene the sole purpose test as it is being maintained for purposes other than those set out in section 62 of the SISA.

The tax agent and financial planner advise them not to proceed as it could result in the:

- distribution from the trust to the SMSF being taxed at the highest marginal rate
- fund being made non-complying and trustees being disqualified.

Tom and Leanne decide not to proceed with the arrangement. They are glad they sought further professional advice from their tax agent and financial planner prior to committing to the arrangement. This has ensured they avoided some serious tax consequences.