SMSFs and Property Development:

OPPORTUNITIES AND PITFALLS

A paper presented by Michael Bennett at the Television Education Network

FIRST ANNUAL PROPERTY TAXATION CONFERENCE

Thursday, 20 October 2016

Michael Bennett

E mbennett@wentworthchambers.com.au

W www.michaeljbennett.com.au

D 02 8915 5111 M 0408 029 416

1 General Overview ... 4

2 SMSFs Carrying on a Business ... 6

3 What interest does a beneficiary of a superannuation fund have in the assets held by the superannuation fund? ... 7

4 Bankruptcy ... 9

4.1 Overview of Bankruptcy ... 9
4.2 Contributions into superannuation funds ... 11
4.3 Post-28 July 2006 Contributions ... 13

5 The SIS Act, the SIS Regs & Commissioner's Pronouncements ... 15

5.1 Sole Purpose Test ... 15
5.2 Arm's Length Dealings ... 18
5.3 Prohibition on Acquiring Assets from Related Parties ... 20
5.4 The In-House Asset Provisions ... 22
5.4.1 Pre-11 August 1999 Investments and Loans ... 24
5.4.2 Reinvestments ... 24
5.4.3 Exemption for certain geared investments ... 25
5.5 The Prohibition Against Borrowing ... 25
5.6 Restrictions on Recognising or Sanctioning a Charge ... 26
5.7 The Prohibition of Providing Financial Assistance to Members ... 26
5.8 The SMSF's Investment Strategy ... 27
5.9 Keeping Fund Money Separate ... 28
5.10 Remuneration of the Trustee ... 28
5.11 Consequences of breaching the SIS Act or the SIS Regs ... 29
5.12 The Trustee's Right of Indemnity ... 29

6 Funding Developments ... 31

6.1 Contributions ... 31
6.1.1 Concessional contributions ... 31
6.1.2 Excess concessional contributions ... 32
6.1.3 Non-concessional contributions ... 33
6.2 Taxation of fund income ... 33
6.3 Non-arm's length income ... 34
6.3.1 What is a 'fixed entitlement'? ... 35
6.4 Segregated current pension assets ... 39
6.5 Borrowing By a SMSF ... 40
6.5.1 Diagrams of the Property Borrowing Structure ... 40
6.5.2 How Does the Borrowing Structure Work? ... 41
6.5.3 What Assets May be Acquired ... 43
6.5.4 Use of borrowed funds ... 45
6.5.5 Establishing the Correct Structure ... 45
6.5.6 What Happens at the End of a Borrowing Arrangement ... 47

7 Tax Issues ... 48

8 Structures for SMSF Developing ... 49

8.1 SMSFs ... 49
8.2 As a Tenant in Common ... 49
8.3 Pre-1999 Unit Trust ... 50
8.4 Reg 13.22C Unit Trusts ... 51
8.5 Unrelated Trusts ... 52
8.6 Joint Ventures ... 53

9 Use of Related Party Builders 54

10 Conclusion 55

1 General Overview

A regulated self-managed superannuation fund ('**SMSF**') is not an investment itself; it is a vehicle through which allowed investments can be undertaken in accordance with the governing rules. Those rules are the:

- *Superannuation Industry (Supervision) Act* 1993 (Cth) (the '**SIS Act**');
- *Superannuation Industry (Supervision) Regulations* 1994 (Cth) (the '**SIS Regs**'); and
- although not law themselves, pronouncements from the Commissioner of Taxation (the '**Commissioner**').[1]

This conference is the Property Taxation Conference and, to that end, this paper will focus on a SMSF's ability to undertake, and the attractiveness of if undertaking, property developments.

SMSFs have been carrying on property developments since they were first established. Despite the longevity of these activities there remains concern that by doing so the trustees of a SMSF will render the SMSF non-compliant or otherwise in breach of the SIS Act or the SIS Regs. Given that the penalties of ceasing to be a compliant fund or otherwise breaching the SIS Act and SIS Regs can be substantial this concern is understandable.

There is no express prohibition on SMSFs undertaking property development activities or a property development business. What is required is that in undertaking those activities or that business the trustees of a SMSF must ensure that they otherwise comply with the various rules of the SIS Act and SIS Regs and do not trigger any adverse tax consequences under the *Income Tax Assessment Act* 1997 (Cth) (the '**1997 Act**'), the *Income Tax Assessment Act* 1936 (Cth) (the '**1936 Act**') or, in relation to stamp duty consequences, the Duties Legislation of the various States and Territories.

This paper will consider:

1. Whether a SMSF can carry on a business.

[1] The Commissioner is responsible for regulating SMSFs whereas the Australian Prudential Regulation Authority ("APRA") is responsible for regulating other regulated superannuation funds.

2. A member's interest in a SMSF.

3. Asset Protection advantages of superannuation.

4. SIS Act and SIS Regs issues that apply.

5. Funding Developments, including the limited way in which a SMSF can borrow funds.

6. Tax issues that apply.

7. Structures that can be used to carry out a SMSF property development or property development business.

8. Issues regarding a SMSF's use of related party builders.

The paper will then conclude the topics.

2 SMSFs Carrying on a Business

As noted above, there is no express prohibition on an SMSF undertaking a property development or carrying on a property development business. There is a regulatory framework – largely comprised of the SIS Act and the SIS Regs – with which the SMSF must comply and an income tax regime that will create beneficial, or adverse, tax consequences depending on what is undertaken. These provisions are considered in more detail later in this paper.

A common question raised in relation to property developments is whether the trustee of an SMSF can carry on a property development business. It seems that a general misunderstanding pervade the general awareness of this issue: people seem to think a SMSF cannot carry on business generally and, in particular, carry on a property development business.

An obvious way to dispel this misunderstanding is to look at some of the operations of the public sector superannuation funds – such as CBus – which are governed by the same SIS Act and SIS Regs on this issue. They often conduct major development businesses, including the development of major office towers or other commercial properties.

There is no provision of the SIS Act, the SIS Regs, the 1936 Act or the 1997 Act that expressly prevents a SMSF from operating a business or deriving assessable income from a business in any way different from taxpayers. Nor does that legislation differentiate between such business income and “passive” investment income.

The Commissioner has confirmed his view a number of times, albeit in non-binding ways. At the National Tax Liaison Group – Superannuation Subcommittee meeting on 26 October 2005, and the associated publication “Carrying on a business in a self managed superannuation fund”, the Commissioner has confirmed that whilst running a business does not, of itself, cause the trustee of a SMSF to breach the SIS Act or SIS Regs, the activities conducted as part of that business operation may fall foul of a provision of that Act or those Regulations.

It is therefore convenient to consider those provisions in more detail in the next section. It should be here noted, however, that the Commissioner has given one inconsistent statement on the ability to run a business: see the Commissioner’s statement in *SMSF Sole Purpose Test (NAT2061)* set out at 5.1 below. For the reasons there stated – he is wrong.

3 What interest does a beneficiary of a superannuation fund have in the assets held by the superannuation fund?

Given the increase in the value held in superannuation funds in this country it is becoming more important, though it was never unimportant, to know exactly what interest a member of a superannuation fund has.

Justice Gzell referred to (amongst others) the decision of *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53 in *CSR v The Chief Commissioner of State Revenue* [2006] NSWSC 1380 in finding that no members of a superannuation fund '... *had any beneficial ownership of any of the underlying investments* ...' held within the superannuation fund. Gzell J observed that:

> The trust deed was amended on a number of occasions in the period from 30 June 2002 to 30 June 2004. Key provisions, however, remained constant. The assets of the Fund were held by the trustee upon trust to be applied in accordance with provisions of the deed pursuant to cl 4.2. Clause 6.3 provided that no person should have any claim, right, or interest to or in respect of the fund, or any contributions thereto, or any interest therein, or any claim upon or against the trustee or an employer, except under and in accordance with the provisions of the deed. Members had to elect between a pension and a lump sum. The pension was calculated as a percentage of the final three years' average salary, the percentage increasing with the number of years of service. Likewise, the lump sum was calculated as a multiple of the final three years' average salary, the multiple increasing with the number of years of service. Upon termination of the Fund, cl 13, and later cl 13A, provided that any surplus should be applied by the trustee in any manner reasonably consistent with any of the objects of the Fund. Clause 7.4 provided that if the trustee should determinate at any time, on the advice of the actuary, that the value of the assets of the Fund exceeded 120% of the amount required to meet actuarial liabilities, the trustee might agree with CSR to apply all or part of the excess to CSR, to augment benefits payable to members, or as they might otherwise agree.
>
> Clause 13 and cl 13A of the deed vary the usual situation in which an ultimate surplus in a superannuation fund is prima facie held on a resulting trust for those who contributed to it (*Air Jamaica Ltd v Charlton* [1999] UKPC 20; [1999] 1 WLR 1399 at 1411, *Wrightson Ltd v Fletcher Challenge Nominees Ltd* [2002] 2 NZLR 1 at [23]).
>
> None of the members of the Fund had any beneficial ownership of any of the underlying investments including, in particular, the top-up contributions (*CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53; (2005) 79 ALJR 1724 at [25], *Halloran v Minister Administering National Parks and Wildlife Act 1974* [2006] HCA 3; (2006) 80 ALJR 519 at [75]).
>
> Until the happening of a prescribed event that crystallizes a member's right into an actual entitlement, a member of a superannuation fund is neither the legal nor the beneficial owner of any amount that stands to the credit of the member's account from time to time (*Re Coram; Ex parte Official Trustee in Bankruptcy v Inglis* (1992) 36 FCR 250 at 253, Wrightson at [28]).

Similarly, Heerey J in *Re John Sloane Kirkland; Ex Parte: Official Trustee in Bankruptcy* [1997] FCA 684 held that the rule in 'Saunders v Vautier' does not apply in the context of a superannuation fund. The Court observed that:

> The Official Trustee in Bankruptcy, as trustee of the bankrupt estate of John Sloane Kirkland (the bankrupt), seeks payment of a benefit to which the bankrupt is entitled under the TNT Group Retirement Fund (the Fund). In essence the Official Trustee contends that the amount in question, although payable at a future date, has unconditionally vested in the bankrupt and that he can call for immediate payment under the Rule in Saunders v Vautier (1841) Cr & Ph 240, 49 ER 282.

Justice Heerey found that:

> I conclude that at the date of the bankrupt's resignation, the date of sequestration, and the present time, the bankrupt was and is not entitled to payment of the Preserved Withdrawal Benefit. The rule in Saunders v Vautier does not apply. Because superannuation funds in Australia enjoy substantial tax benefits there is a complex statutory regime which restricts the access members may have to benefits. Speaking very generally, the object of superannuation is to make provision for death, disablement or retirement at normal retiring age, or earlier if there are exceptional circumstances. It would conflict with that objective if members of funds could treat their entitlements as though they were funds on deposit, available at call.
>
> The bankrupt could not on resignation or at the date of sequestration, and cannot at the present time, obtain payment of those benefits. The applicant can be in no better position than the bankrupt.

That is, a member of a superannuation fund does not have an interest in the assets held subject to a superannuation fund. Rather, the member's interest is the interest in the superannuation fund.

4 Bankruptcy

Given that superannuation has significant asset protection advantages, which have been extended by the simplified superannuation reforms because that protection is no longer limited by the 'reasonable benefits limit' which was removed as part of the reforms, bankruptcy in general, and how it ties in with the regulation of superannuation funds, will be considered in some detail.

4.1 Overview of Bankruptcy

Subsection 5(1) of the *Bankruptcy Act* 1966 (Cth) (the **'Bankruptcy Act'**) defines the term 'bankrupt'. There are two ways in which a person can become bankrupt, being:

> ***Involuntarily*** – the right of a creditor to enforce the status of 'bankrupt' on a debtor if a debt remains unpaid. This method involves a sequestration order being made by the Court as a result of an application being made by a creditor, which results in the debtor becoming 'bankrupt'; and
>
> ***Voluntarily*** – this occurs where a debtor presents a debtors petition, which is presented to the Official receiver. If there are no pending applications by creditors to bankrupt the debtor, and if the petition is accepted, then the debtor will become bankrupt.

With respect to involuntary bankruptcies, a creditor (who must be owed by the debtor at least $2,000) wishing to initiate bankruptcy proceedings must show that the debtor has committed an 'act of bankruptcy'.[2] This is typically shown via a non-compliance with a 'bankruptcy notice' served on a debtor. The creditor must present to the Court, within six months of the commission of an 'act of bankruptcy' a creditor's petition. The Court must then decide whether a sequestration order should be made.

With respect to involuntary bankruptcies, they can only be initiated by a debtor if the debtor is insolvent.

Unlike in the context of a company in liquidation, there is no separation of ownership and control with respect to assets of an individual. As a result, upon insolvency occurring for an individual, a separate 'bankrupt estate' is established, with the 'trustee in bankruptcy' appointed to that estate.

Only assets specifically exempted from vesting in the bankrupt estate do not pass to that estate. The trustee in bankruptcy must:

- determine the property of the bankrupt;

[2] Section 40 of the Bankruptcy Act sets out what constitutes an 'act of bankruptcy'.

- recover property improperly disposed of by the bankrupt;
- realize the property recovered by the trustee in bankruptcy; and
- pay the proceeds of the realized property to creditors of the bankrupt who have 'provable debts'.

A bankrupt may obtain automatic discharge from bankruptcy three years from the date of bankruptcy under a debtor's petition or if a bankruptcy has arisen out of a sequestration order, three years from the date of filing of the statement of affairs. However, bankruptcy may be extended for up to eight years.

A bankruptcy may be annulled if all of the debts of a bankrupt are paid, or if the Court considers that a sequestration order should not have been made due to certain irregularities.

As mentioned above, determining the actual date of commencement of bankruptcy is crucial, as the trustee in bankruptcy can claim the property belonging to the bankrupt at the commencement date and all property acquired by the bankrupt between the commencement date and the date of bankruptcy. Paragraph 116(1)(a) of the Bankruptcy Act provides that:

> Subject to this Act … all property that belonged to, or was vested in, a bankrupt at the commencement of the bankruptcy, or has been acquired or is acquired by him or her, or has devolved or devolves on him or her, after the commencement of the bankruptcy and before his or her discharge … is property divisible amongst the creditors of the bankrupt.

Generally speaking, bankruptcy proceedings are commenced by the creditor presenting a 'creditor's petition' to the Court (see section 44 of the Bankruptcy Act). The petition seeks the 'sequestration' of the debtor's estate, which causes bankruptcy to commence if a sequestration order is obtained.

It should be noted that as well as all property belonging to a bankrupt at the 'commencement of bankruptcy' and property that has been acquired by a bankrupt between the commencement of bankruptcy and the date of bankruptcy, subsection 116(1) of the Bankruptcy Act provides that the following (additional) categories of property may be divisible amongst the creditors of a bankrupt:

> (1) Subject to this Act:
>
> …

(e) money that is paid to the trustee of the bankrupt's estate under an order under paragraph 128K(1)(b); and

(f) money that is paid to the trustee of the bankrupt's estate under a section 139ZQ notice that relates to a transaction that is void against the trustee under section 128C; and

(g) money that is paid to the trustee of the bankrupt's estate under an order under section 139ZU; …

That is, in the superannuation context, the following is property which is divisible amongst the creditors of a bankrupt:

- money which is forfeited because of a breach (or proposed breach) of a superannuation account-freezing notice under section 128K of the Bankruptcy Act;
- money that represents a void transaction as against a trustee in bankruptcy under sections 128B or 128C of the Bankruptcy Act as provided for in a section 139ZQ notice; or
- money that represents a void transaction as against a trustee in bankruptcy under sections 128B or 128C of the Bankruptcy Act, where the amounts have been rolled-over into another superannuation fund and a section 139ZU order obtained.

4.2 ***Contributions into superannuation funds***

The primary concern of a trustee administering an estate is determining the property owned by a bankrupt. This is so the trustee can realize those assets, with the proceeds obtained from realization being distributable to the creditors. Indeed, unlike most other transfers that may be made to bankrupts (e.g. to a spouse or a related trust), a transfer made by a bankrupt which causes a bankrupt to obtain an interest in a superannuation fund is prima facie not divisible among the bankrupt's creditors.

The starting point in determining what property is available to creditors is contained in subsection 58(1) of the Bankruptcy Act. That is:

- paragraph 58(1)(a) of the Bankruptcy Act vests property of a bankrupt in the trustee in bankruptcy on the date of bankruptcy (see also *Anscor Pty Ltd v Clout (2004) 135 FCR 469); and*
- paragraph 58(1)(b) of the Bankruptcy Act vests property acquired by the bankrupt after bankruptcy in the trustee in bankruptcy as soon as the acquisition occurs.

Subsection 5(1) of the Bankruptcy Act defines the term 'the property of the bankrupt' for the purposes of section 58 of the Bankruptcy Act as:

> 'the property of the bankrupt', in relation to a bankrupt, means:
>
> (a) except in subsections 58(3) and (4):
>
> (i) the property divisible among the bankrupt's creditors; and
>
> (ii) any rights and powers in relation to that property that would have been exercisable by the bankrupt if he or she had not become a bankrupt …

That is, 'the property of the bankrupt' includes property, and rights and powers exercisable by the bankrupt had it not become bankrupt, that is divisible amongst the bankrupt's creditors.

The term 'property' is defined in subsection 5(1) of the Bankruptcy Act as:

> 'property' means real or personal property of every description, whether situate in Australia or elsewhere, and includes any estate, interest or profit, whether present or future, vested or contingent, arising out of or incident to any such real or personal property.

Whilst subsection 58(1) of the Bankruptcy Act contains the 'starting point' in determining what property is available to creditors, the property which is divisible amongst creditors is provided for in subsection 116(1) of the Bankruptcy Act. But in a superannuation context it is s 116(2), which excludes amounts from being available for creditors. Relevantly, paragraph 116(2)(d) of the Bankruptcy Act provides:

> (2) Subsection (1) does not extend to the following property:
>
> …
>
> (d) subject to sections 128B, 128C and 139ZU:
>
> (i) policies of life assurance or endowment assurance in respect of the life of the bankrupt or the spouse or de facto partner of the bankrupt;
>
> (ii) the proceeds of such policies received on or after the date of the bankruptcy;
>
> (iii) the interest of the bankrupt in:
>
> (A) a regulated superannuation fund (within the meaning of the Superannuation Industry (Supervision) Act 1993); or
>
> (B) an approved deposit fund (within the meaning of that Act); or
>
> (C) an exempt public sector superannuation scheme (within the meaning of that Act) … [emphasis added]

Paragraph 116(2)(d) of the Bankruptcy Act is subject to sections 128B and 128C of the Bankruptcy Act. In effect, the section provides that notwithstanding that a bankrupt's interest in a superannuation fund is protected, the protection does not extend to contributions which are void.

The policy objective behind paragraph 116(2)(d) of the Bankruptcy Act was explained in *Official Trustee in Bankruptcy v Trevor Newton Small Superannuation Fund Pty Ltd* (2001) 114 FCR 160 (***'Small's case'***):

> … the protection offered by s 116(2)(d)(iii)(A) is part of a broad legislative policy, manifest in a number of statutes touching superannuation, actively encouraging individuals to provide for their own future and retirement rather than to rely on government assistance. In order to achieve this goal, the legislature has provided for a person's interest in a regulated superannuation fund to be protected in the event that he or she should become bankrupt: the legislative policy seems to be that a person should not lose what he or she has bona fide managed to provide for retirement merely because that person becomes insolvent.

This is a legislatively sanctioned asset protection policy and should be used wherever possible. It should be noted, however, in the event that funds within a superannuation fund are accessed before bankruptcy, then those funds will not be protected.

Further, a payment made to a bankrupt from a superannuation fund made on or after bankruptcy will also <u>not</u> be divisible amongst the creditors of a bankrupt, provided that the payment is not a pension. Specifically, after bankruptcy, a pension will be income for the purposes of the contribution from income to creditors for the duration of the bankrupt[3]. Paragraph 116(2)(d)(iv) of the Bankruptcy Act provides that:

> Subsection (1) does not extend to the following property … subject to sections 128B, 128C and 139ZU … a payment to the bankrupt from such a fund received on or after the date of the bankruptcy, if the payment is not a pension within the meaning of the Superannuation Industry (Supervision) Act 1993 …

As a result, in the context of bankruptcy, it will be important to determine what the asset of the bankrupt is – that is, whether it is an 'interest' in a superannuation fund or otherwise.

4.3 ***Post-28 July 2006 Contributions***

Partly as a result of the High Court's decision in *Cook v Benson (*2003) 114 CLR 370, the law regarding claw-backs of contributions made into superannuation funds has been changed by the *Bankruptcy Legislation Amendment (Superannuation Contributions) Act 2007* (Cth), which

[3] Subparagraph 116(2)(d)(iv) and section 139L *Bankruptcy Act* 1966

inserted Subdivision B into Division 3 of Part VI of the Bankruptcy Act. Indeed, the accompanying Explanatory Memorandum provided that:

> … the principal purpose of the amendments to be made by this Bill is to allow bankruptcy trustees to recover superannuation contributions made prior to bankruptcy with the intention to defeat creditors. These amendments will address problems highlighted following the High Court's decision in Cook v Benson…

The Subdivision provides for the situations in which a contribution made into a superannuation fund will be void as against a trustee in bankruptcy, and broadly, provides for two types of recoverable contributions, being:

- contributions made by persons who later become bankrupt (section 128B of the Bankruptcy Act); and
- contributions made by a third party for the benefit of a person who later becomes a bankrupt (section 128C of the Bankruptcy Act).

5 The SIS Act, the SIS Regs & Commissioner's Pronouncements

There are numerous provisions in the SIS Act, the SIS Regs and the respective income tax acts. However, from a property development purpose there are certain provisions of more significant relevance. They will be considered in this paper. They should not be taken as an exhaustive list of all issues arising for a SMSF under the legislative instruments.

5.1 Sole Purpose Test

The trustee of a regulated superannuation fund, including an SMSF, must comply with the sole purpose test set out in s 62 of the SIS Act. Essentially, the test requires the trustee to ensure the fund is maintained solely for one or more of the "core purposes", or for one or more of the core purposes and for one or more of the "ancillary purposes". The test does not imply that the trustee is required to maintain the fund so that the same kind of benefits will be provided to each member of the SMSF: s 62(1A) of the SIS Act.

The sole purpose test is a civil penalty provision, and the trustees of the SMSF may be liable to civil and criminal proceedings if they provision is breached.

The core purposes specified in s 62(1)(a) of the SIS Act are the provision of benefits:

- for each member of the fund on or after the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged (whether the member's retirement occurred before or after the member joined the fund);

- for each member of the fund on or after the member attaining age 65;

- for each member of the fund on or after the member's death if: (a) the death occurred before the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged; and (b) the benefits are provided to the member's legal personal representative, to any or all of the member's dependants, or to both; or

- in respect of each member of the fund on or after the member's death if: (a) the death occurred before the member attained the age of 65; and (b) the benefits are provided to the member's legal personal representative, to any or all of the member's dependants, or to both: r 13.18 of the SIS Regs.

The term "dependent" for taxation purposes is defined in section 302-195 of the 1997 Act. Subsection 302-195(1) of the 1997 Act provides for a more limited definition than that of "dependent" in the SIS Act. That is, a "death benefit dependant" with respect to a deceased includes:

- the deceased's spouse;
- the deceased's former spouse;
- the deceased's child, provided that at the time of death the child is under the age of 18;
- a person with whom the deceased had an 'interdependency relationship' just before the deceased died;
- any other person who was a 'dependant' of the deceased just before the death of the deceased; and
- under section 302-195 of the 1997 Act, a death benefits dependant also includes a person who receives a superannuation pension or annuity if the annuity or pension commenced before 1 July 2007 as a result of the death of another person.

The ancillary purposes specified in s 62(1)(b) of the SIS Act are the provision of benefits:

- for each member of the fund on or after the termination of the member's employment with an employer who had, or any of whose associates had, at any time contributed to the fund in relation to the member;
- for each member of the fund on or after the member's cessation of work, if the work was for gain or reward in any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged and the cessation is on account of ill-health;
- in respect of each member of the fund on or after the member's death if: (a) the death occurred before the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged (whether the member's retirement occurred before or after the member joined the fund); and (b) the benefits are provided to the member's legal personal representative, to any or all of the member's dependants, or to both;
- in respect of each member of the fund on or after the member's death if: (a) the death occurred before the member attained the age of 65; and (b) the benefits are provided to

the member's legal personal representative, to any or all of the member's dependants, or to both; or

- the provision of such other benefits as are approved by the Regulator.[4]

The Commissioner has issued extensive guidelines in *Self Managed Superannuation Fund Ruling* SMSFR 2008/2 on the application of the sole purpose test to SMSFs. In particular the ruling states that while the purpose test requires trustees to ensure that the fund is maintained solely for purposes specified in s 62 of the SIS Act, there are some circumstances where the fund may be maintained solely for these purposes while providing benefits (particularly to members or to related parties of the fund or its members) other than those specified without breaching s 62.

A common misconception of the sole purpose test is that a risky, or unusual investment, will cause a superannuation fund to breach the test. This is not the test's focus. The test is about whether a fund's activities result in the members, or related parties of the fund or its members, receiving pre-retirement benefits. That is, whether an inappropriate access to the assets of the fund has occurred. The Commissioner has confirmed this approach in SMSFR 2008/2. The Courts have confirmed this approach in a number of cases. Two prominent ones will be considered.

Before considering the authorities on the point, however, the Commissioner's statement in *SMSF Sole Purpose Test (NAT2061)*, which is not binding like the SMSFR 2008/2, is worth noting:

> Another indication of a possible contravention of the sole purpose test is where a fund is 'running a business' as part of its investment strategy. Our experience is that where a large portion of fund assets are used to conduct a business within a self managed superannuation fund, the fund will almost inevitably contravene the sole purpose test (and/or other SISA provisions). This is because generally the purpose for which the investment is made is not to generate retirement benefits but rather to enable the trustees to operate the business.

With respect to the Commissioner, he is wrong and this pronouncement does not stand up to any level of rigour.

- First, the degree to which the SMSF's assets are used in a business is immaterial; either there is a sole purpose or not and operating a business in an otherwise small fund or wealthy fund does not affect this test.

[4] From 12 December 2007 (and for regulated funds that are not SMSFs, from 27 November 2007), the ancillary purposes approved pursuant to s 62(1)(b)(v) are the provision of benefits for or in respect of each member of the fund which Part 6 of the SIS Regs permits to be paid (by being cashed, rolled over or transferred) or requires to be paid when, to the extent that, and to the persons to whom, the fund is permitted or required under that Part to pay them.

- Second, and as occurs with industry funds such as Cbus, the operation of a business to derive profit can be part of a plan to provide retirement benefits to members.

- Third, when a SMSF invests in listed shares in the ASX it is a bit owner in the business(es) that company operates. The Commissioner's reasoning would also apply to passive investment in listed companies, which is universally accepted as an approach SMSF strategy.

In the *Swiss Chalet Case* 95 ATC 374, the most oft cited case on the sole purpose test,[5] the relevant fund had purchased shares which enabled access to a golf club for Mr A, the managing director of the employer-sponsor of the fund; invested in a Swiss Chalet which also provided a source f funding for Mr for his family trust; and operated in a manner that denied funds members information about their entitlements in the fund. It was held the ancillary benefits were not for the sole purpose permitted by the relevant legislation.

Another oft cited case is *Case 23/96* 96 ATC 23/96, where the trustees of two superannuation funds ("B1" and "B2") were a husband and wife. They were members of the B1 fund with twelve others and were the only members of the B2 fund. The husband and wife withdrew approximately $53,000 from the B2 fund and paid it into the B1 fund, which then used the money to pay its tax liability ($21,000) and pay the trustee of the B Family Trust ($32,000). The Administrative Appeals Tribunal held that using the money held on trust for the members of the B2 fund to pay the B1 fund's tax liability was contrary to the purposes of the sole purpose test.

It can be seen, therefore, that undertaking property developments or operating a property development business will not, of itself, breach the sole purpose test. But if, in doing so, the members of the fund are inappropriately benefiting from the SMSF's assets or activities there is likely to be such a breach.

If there is any doubt, and due to the dire consequences of breaching the sole purpose test, a private binding ruling may need to be obtained before a development occurs.

5.2 Arm's Length Dealings

Section 109 of the SIS Act provides that a trustee of a SMSF must ensure that its investments are made and maintained on an arm's length basis. The rule does not prevent trustees or investment managers from dealing with a related party or associated parties, but are intended to ensure that investments are made or maintained on a commercial basis or on such terms (e.g. the sale and

[5] Although the sole purpose test considered in this case was contained in the *Occupational Superannuation Standards Act* 1987 (Cth), the same result would be expected under s 62 of the SIS Act.

purchase price of an investment should be a full market value and returns on the investment reflect a true market rate of return).

The arm's length rule has two limbs. Under the first limb:

a. the trustee of an SMSF (or the investment manager of the SMSF) must not invest money of the fund unless either the trustee or manager and the other party to the transaction are dealing with each other at arm's length in respect of the transaction (s 109(1)(a)); or

b. if they are not dealing with each other at arm's length in respect of the transaction, the terms and conditions of the transaction must be no more favourable to the other party than those that are reasonable to expect would apply if the parties were dealing at arm's length in the same circumstances (s 109(1)(b)).

That is, the SMSF investment must be made and maintained be on commercial and business-like terms. This affects all investment decisions made by the trustee, e.g. acquiring or disposing of an asset, investing in in-house assets, or entering into loan arrangements).

The second limb in s 109(1A) provides that, where an SMSF trustee or investment manager deals with a party who is not at arm's length in respect of an investment, that dealing must be undertaken in the same manner as it would if the other party was at arm's length.

The term "invest" in the SIS Act "applying assets in any way, or making a contract, for the purposes of gaining interest, income, profit or gain": s 10(1) of the SIS Act.

There is no definition of "arm's length" in the SIS Act. It is the dealing itself, not whether the parties are in fact at arms length or not, that is relevant. Justice Hill said in *Trustee for the Estate of the Late A W Furse No 5 Will Trust v FCT* (1990) 21 ATR 1123 at 1132:

> 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.

Although it cannot be put as highly as a presumption in favour of an arm's length dealing, the starting point is that parties at arm's length usually deal at arm's length. This point, and the qualification to it, was expressed by Lee J in *Granby Pty Ltd v FCT* (1995) 30 ATR 400 at 403-4:

> If the parties to the transaction are at arm's length it will follow, usually, that the parties will have dealt with each other at arm's length. That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.

> That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other.

In the context of a property development there is therefore a need for the trustee of the SMSF to be undertaking the development, or operating the business, on commercial terms and not overly benefiting (often to increase profit in a tax friendly environment) or suffering (considered an early access of super).

The Commissioner has issued various rulings dealing particular transactions – such as not calling for trust distributions – and how they relate to the non-arm's length rule.

5.3 Prohibition on Acquiring Assets from Related Parties

The trustee (or investment manager) of a regulated superannuation fund, including a SMSF, must not intentionally acquire an asset from a related party of the fund, except as otherwise permitted by the SIS Act: s 66(1) of the SIS Act.

A "related party" of a fund means a member or a standard employer-sponsor of the fund, and their "Part 8 Associates". These are discussed at 5.4 below.

The prohibition covers the intentional acquisition of an asset. Therefore, the prohibition will be breached only if the trustee knowingly acquires the asset from the related party; inadvertent acquisition will usually not offend s 66 unless an avoidance scheme is involved.

The term "acquire" is not defined in the SIS Act, and therefore takes its ordinary meaning. It is taken to mean the trustee becoming the legal or equitable owner through the purchase or transfer of any asset. The term "asset" means "any form or property" and it includes money (domestic or foreign): s 10(1) of the SIS Act.

There can, therefore, be no *in specie* contribution to a SMSF, or the purchase by the trustee of an SMSF, from a member or related party.

The Commissioner has provided extensive guidelines and examples on the application of s 66(1) of the SIS Act to contribution of assets (*in specie* contributions) by a related party to a SMSF: *Self Managed Superannuation Fund Ruling* SMSF 2010/1. This ruling discusses the provision of "services" to a SMSF (at [17] to [19]). For example, where the trustee of an SMSF engages a related party on commercial terms to do work on land owned by the fund, i.e. a contract for services using goods and materials supplied by the related party. Although the provision of "services" (the substance of the transaction) will not breach s 66(1) of the SIS Act, care must be

taken if the goods and materials are not insignificant in value and function as this may be taken to be an acquisition of assets (i.e. the goods and materials) from the related party.

Two issues regarding the application of s 66 of the SIS Act were raised in relation to builders who are related parties:

1. Will the trustees of an SMSF breach s 66 if the trustees appoint as their agent a related party to purchase the goods and materials on behalf of the trustee and those goods and materials are used in the construction of a building on land owned by the SMSF?

2. Will the trustees of an SMSF breach s 66 if the trustees executed a deed of bare trust and transfer funds from the SMSF to the bare trust to finance the purchaser of goods and materials used by a related party in the construction of a building on land owned by the SMSF?

As an initial response the Commissioner stated that whether the particular arrangements under which building materials are supplied do amount to a direct acquisition by the SMSF from the original suppliers, with the related party only acting as an agent, will be determined by the application of the normal laws of contract and agency to the facts of each case.

There are some exceptions to the prohibition in s 66(1):

- the asset is a listed security acquired at market value: s 66(2)(a);

- for a SMSF, the asset is business real property and is acquired at market value: s 66(2)(b);

- the asset is acquired under a merger between regulated superannuation funds: s 66(2)(c);

- the Regulator has determined in writing that the asset is of a kind that may be acquired by the fund, or a class of funds of which the fund is included: s 66(2)(d);

- the asset is an in-house asset that is acquired at market value and the acquisition does not result in the fund breaching the in-house asset threshold: s 66(2A); and

- the asset is acquired for the member of the acquiring fund because of reasons directly connected with a relationship breakdown of the member: s 66(2B).

The most significant exemption for this paper is the business real property exemption. "Business real property" is defined as certain interests in real property "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 an interest held in the capacity of beneficiary of a trust estate": s 66(4) of the SIS Act.

The motivation of this exemption is that it encourages small business owners – who otherwise tend to reinvest their savings in their business and, should it fail, will not have provided for their retirements – to build up an asset base outside of their business.

An important part of the definition is that the land must be used wholly and exclusively in one or more business. This would generally rule out residential property unless the owner of the land is carrying on a rental business or is a property developer and the land is held as trading stock. There is a legislative concession for farm land meeting the definition of business real property which allows farm land to still be classed as business real property even if up to two hectares of the land is used as a residence provided the predominant use of the property is not private or domestic: s 66(6) of the SIS Act.

The Commissioner's view on what constitutes "business real property" is set out in an extensive ruling, *Self Managed Superannuation Fund Ruling* SMSFR 2009/1. Examples therein of business real property include:

- your "classic" retail, commercial, industrial and farm land;
- a residential property used as a retail or commercial premises (e.g. a doctor's surgery);
- a residential property used by the owner in a rental business;
- leasehold interests in business real property;
- vacant land if it is used in a business (e.g. a car park);
- land held by a property developer for the property developer's business (including where the property was held as pre-development vacant land, in the part development stage, at the completed stage and as a showroom).

5.4 The In-House Asset Provisions

Subsection 10(1) of the SIS Act, which contains the definitions for that Act, provides that a "related party" of a superannuation fund means any of the following:

- a member of the fund;
- a standard employer-sponsor of the fund; and
- a Part 8 associate of a member or standard employer-sponsor the fund.

Sections 10(1) and 15B of the SIS Act, and regulation 1.03 of the SIS Regs, define the term "member".

A "Part 8 Associate" is defined in terms of an individual, partnership or company as the primary entity: sections 70B to 70E of the SIS Act. In broad terms, Part 8 associates are those entities that are relatives of the individual, partners, companies that are controlled or majority-owned, entities that control the primary entity. As

The decision of *Trevisan v FCT* (1991) 21 ATR 1649 made it clear that an investment in units of a unit trust, even where the trustee of the unit trust is a standard employer sponsor, is not an in-house asset. This decision was based on the fact that an investment in units is not an investment in the trustee of the unit trust. This interpretation led to the prevalent use of unit trusts as a way of a superannuation fund indirectly owning property that has been acquired using borrowings.

In response, and on 11 August 1999, major amendments were made to the superannuation investment rules. These amendments were introduced to overcome the decision in *Trevisan* that investments in related trusts were not in-house assets. The amendments led to the wording of s 71(1) of the SIS Act, which states:

> For the purposes of this Part, an in-house asset of a superannuation fund is an asset of the fund that is 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, but does not include [a number of specified exceptions].

A superannuation fund must not acquire an in-house asset if the market value ratio of the fund's in-house assets exceeds 5%, or would exceed 5% if the asset was acquired, of the market value ration of all of the fund's assets: section 83 of SIS Act.

From 11 August 1999, investments in related trusts will be in-house assets. Shares in a related company or units in a related unit trust held by a fund are considered to be in-house assets of the fund if the company or trustee of the unit trust is a related party, unless an exception applies to exclude the shares or units from being in-house assets of the Fund: see for instance *Self Managed Superannuation Fund Determination* SMSFD 2008/2 at [5].

Transitional rules also came into effect at the time of the change of the definition of in-house asset and extended in-house asset rules to provide concessions which take into account the commencement date of the in-house asset rules from the end of 11 August 1999 (originally the commencement date was 12 May 1998) and the date when the rules became law (23 December 1999). Essentially, where an asset was not previously an in-house asset but would now be caught by the in-house asset definition, the transitional rules apply to prevent retrospective disadvantage and, in certain circumstances, allow additional investments in existing related party assets to be made until 30 June 2009.

The transitional arrangements (provided in the SIS Act in ss 71A to 71F) cover two main categories of transactions – those that took place before 11 August 1999 and those between 11 August 2009 and 23 December 1999. Broadly, they ensure that the changes to the in-house asset rules do not apply before 11 August 1999 (the "test time") and do not affect transactions during the "transition period" from the test time to 23 December 1999 by way of exemptions or partial exemptions for the following transactions:

- pre-11 August 1999 investments and loans;
- pre-11 August 1999 leases and lease arrangements;
- investments, loans, leases and lease arrangements in the transition period;
- reinvestments; and
- geared investments and additional investments.

5.4.1 Pre-11 August 1999 Investments and Loans

An asset of a superannuation fund is exempted from being an in-house asset of the fund at any time after 11 August 1999 (i.e. post-test time) if the asset consists of:

- a loan or an investment made before the test time, or made after the test time under a contract entered into before the test time, or
- a share or unit in a unit trust, if the share or the unit was acquired before the test time or under a contract entered into before the test time (this applies regardless of any payments on the share or unit made to the issuer of the share or unit post-test time and before 1 July 2009).

These exemptions only apply if the asset would not have been an in-house asset before the test time and, if not for the exemption, would have been an on-house asset at post-test time (s 71A of the SIS Act). If the exemption applies to partly paid shares and units, any payments made on these shares and units by 30 June 2009 are exempted as in-house assets. However, if payments are made after 30 June 2009, a proportion of the share or unit will be an in-house asset.

5.4.2 Reinvestments

Certain reinvestments of earnings are exempted as in-house assets: s 71D of the SIS Act. The exemption applies if a superannuation fund had originally invested in a company or trust (original entity) before 11 August 1999 (i.e. the test time) and the fund made further investments in the

original entity between the test time and 30 June 2009. The assets covered by the exemption continue to be excluded from being in-house assets after 30 June 2009.

For completeness I note that the exemption applies only if the post-test time investments would not have been in-house assets before the test time.

5.4.3 Exemption for certain geared investments

An alternative transitional arrangement applies for superannuation funds with fewer the five members (s 71E of the SIS Act), which is the case for a SMSF. Basically, any additional investments of the fund in a unit trust or company ("first entity") made between 11 August 1999 (the "test time") and 30 June 2009 are not treated as in-house assets if the total amount of the additional investments does not exceed the amount of the first entity's debt to entities other than the fund (the "principal") at the test time.

The transitional provision only applies if the fund makes a written election to apply the transitional provision by 23 December 2000. Where an election is made, the transitional provision applies to all of the post-test time investments made by the fund to the first entity (including those made before the election).

The transitional arrangement in s 71E is an alternative to the transitional arrangements for payments on partly paid shares and units or investments and loans under pre-test time contracts (under s 71A) and for reinvestment of earnings (under s 71D). Therefore, if there is an election for the s 71E alternative, the other transitional arrangements do not apply to investments in or loans made after the test time.

Where the additional investments made by the fund exceed the amount of the first entity's debt, the excess amount (as calculated using the formula in s 71E(4) of the SIS Act) is treated as an in-house asset.

5.5 The Prohibition Against Borrowing

Subject to certain exceptions the trustee of a regulated superannuation fund must not borrow money, or maintain an existing borrowing of money: s 67 of the SIS Act. The main exemption – a limited recourse borrowing arrangement – is considered in details at 6.5 below.

The term "borrow" is not defined in the SIS Act and therefore takes its ordinary meaning. *Self Managed Superannuation Fund Ruling* SMSFR 2009/2 states that, for the purposes of s 67(1) of the SIS Act, a borrowing is an arrangement under which there is a temporary transfer of money from one party (lender) to the fund (borrower) where there is an obligation or intention that the money (the principal amount) transferred will be returned or repaid (plus any interest payable as

stipulated under the arrangement between the parties, whether payable in advance or during the term of the borrowing). It is not strictly necessary that money is ultimately repaid for the arrangement to be a borrowing of money. For example, a fund providing money's worth to the lender (such as transferring an asset) to satisfy or fulfil the obligation or intention to repay the money borrowed.

Further, where an obligation to repay is forgiven or is otherwise waived, or if an intention to repay on the part of the fund changes and there is otherwise no obligation to repay, the arrangement is a borrowing up until the point where an obligation or intention to repay no longer exists.

While an obligation or intention to repay is a necessary feature of a borrowing, a limitation on the lender's capacity to recover the amount lent on default by the borrower does not mean an arrangement is not properly characterised as a borrowing. A limited recourse loan (discussed below at 6.5) is an example of a borrowing even though the lender's recourse on default is limited to assets whose value may be less than the principal amount outstanding at the time.

5.6 Restrictions on Recognising or Sanctioning a Charge

A trustee of a SMSF must not recognise, encourage or sanction an assignment of a member's superannuation interests or a charge over a member's benefits: regs 13.12 and 13.13 of the SIS Regs. Nor must the trustee give a charge over the assets of the fund: r 13.14 of the SIS Regs.[6]

Interestingly, a charge already existing over an asset acquired by the Fund will not breach r 13.14: *Interpretative Decision* ATO/ID 2011/81.

Whilst *Taxpayer Alert* TA 2008/5 talks of guarantees by related trusts being for the benefit of a Fund, and therefore something of concern to the Commissioner, it is clear that alert is considering the situation where the Fund is the borrower and where the Fund's assets are at risk because of that status.

It is important that a trustee of an SMSF does not inadvertently breach this provision in its contractual documentation. For example, the development agreement can contain a contractual term which is an encumbrance as it prevents the trustee of the SMSF from dealing with the land.

5.7 The Prohibition of Providing Financial Assistance to Members

Section 65 of the SIS Act prevents a trustee of an SMSF from providing financial assistance to members or relatives of members. The operation of the provision permits the loans, but they are

[6] The restrictions do not apply to the approved charges set out in regs 13.15 and 13.15A of the SIS Regs.

treated as in-house assets. There is therefore a limit to their value of no more than 5% of the fund's value.

The Commissioner has provided his guidance on this issue in *Self Managed Superannuation Fund Ruling* SMSFR 2008/1.

A "loan" includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings: s 10(1) of the SIS Act. "Giving financial assistance" is not defined, but the expression under its ordinary meaning would cover transactions such as providing guarantees for private loans to members, charging fund assets for the benefit of members, the release of an obligation and the forgiveness of a debt.

This prohibition will generally have limited application in a property development scenario but could be application if the trustee of an SMSF made a loan to a member or sold a development asset to the member on favourable terms. It could also apply if the member is employed by the SMSF as a builder and paid in an advantageous manner (e.g. paid for the full price upfront when the standard practice is to be paid in stages).

5.8 The SMSF's Investment Strategy

The trustee of an SMSF must prepare, and regularly review, an investment strategy: s 52B of the SIS Act. It must do so having regard to the whole of the circumstance of the fund, including, but not limited to, the following:

1. the risk involved in making, holding and realising, and the likely return from, the fund's investments, having regard to its objectives and its expected cash flow;

2. the composition of the fund's investments as a whole, including the extent to which the investments are diverse or involve the fund in being exposed to risks from inadequate diversification;

3. the liquidity of the fund's investments, having regard to its expected case flow requirements;

4. the ability of the fund to discharge its existing and prospective liabilities.

The requirements of s 52B(f) of the SIS Act are also prescribed as an operating standard for the SMSF under r 4.09 of the SIS Regs, with an additional requirement for the trustee to consider whether the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.

Although it would be prudent for the trustee of an SMSF undertaking property development to include this in its investment strategy, interestingly, the investment strategy requirements do not expressly require it to be accurate or for it to be followed. However, the investment strategy rules do provide a "safe harbour" for trustees of regulated funds that prevents members from taking actions against them for poor returns, provided the investment is undertaken in accordance with the fund's investment strategy: s 55A(5) of the SIS Act.

5.9 Keeping Fund Money Separate

Under s 52B(2)(d) of the SIS Act the trustee of an SMSF must keep money and other assets of the fund separate from their own personal assets and from the assets belonging to their employer-sponsor or associates, such as a business run by two partners who are members of the fund.

In the context of property development, the trustee of a SMSF should maintain accurate accounts and ensure no mixing occurs with member's / trustee's interests outside of the SMSF context.

5.10 Remuneration of the Trustee

Section 17A of the SIS Act provides that a fund will not be an SMSF if the trustee, or the director of the corporate trustee, receives any remuneration from the fund or from any person for any duties or services performed by the trustee or the director in relation to the fund. This is a draconian requirement as the breach of this provision will cause the SMSF to become non-compliant and the Commissioner has no discretion to treat it otherwise.

The rationale seems to be that in a SMSF each member is a director / trustee and each director / trustee is a member (other than single member funds when there can be an additional director / trustee). Therefore the members are the controllers and the controllers are the members.

This, however, raises whether the trustees / directors can be paid for performing some or all of the development services for the SMSF. Such activities will not be caught by s 17A of the SIS Act if the provisions of s 17B of that Act are satisfied. These provisions include:

- the trustee / director performs the duties or services other than in the capacity of trustee / director; and
- the trustee / director is appropriately qualified, and holds all necessary licences, to perform the duties or services; and
- the trustee / director performs the duties or services in the ordinary course of a business, carried on by the trustee / director, of performing similar duties or services for the public; and

- the remuneration is no more favourable to the trustee / director than that which it is reasonably to expect would apply if the trustee / director were dealing with the relevant other party at arm's length in the same circumstances.

5.11 Consequences of breaching the SIS Act or the SIS Regs

Up until recently the Commissioner's ability to punish the trustee of an SMSF for breaching the SIS Act or the SIS Regs comprised drastic measures. These included:

- making the SMSF non-compliant;
- disqualifying the trustee / directors of the corporate trustee of the SMSF;
- taking the trustee / directors of the corporate trustee of the SMSF to the Federal Court to seek civil or criminal penalties; and
- for breach of s 66 of the SIS Act, a penalty of up to twelve months imprisonment could also be sought.

Due to the drastic nature of these penalties the Commissioner was often reluctant to enforce them except in the most serious breaches. The penalty regime was consequentially amended from 1 July 2014. Under the new regime the Commissioner's options included:

- fining the trustee / directors of the corporate trustee of the SMSF for breaches of the SIS Act (the fines range from $850 to $10,200 per offence);
- directing the trustee / directors of the corporate trustee of the SMSF to rectify a breach; and
- directing that the trustee / directors of the corporate trustee of the SMSF attend an SMSF education course.

5.12 The Trustee's Right of Indemnity

As a SMSF is a trust it is relevant to consider the trustee's right of indemnity. The member's interest is subject to the trustee's right of indemnity out of trust assets (which applies unless excluded). If an indemnity applies the beneficiary's interest in the trust assets is qualified or deferred because the beneficiary cannot assert a right to compel the trustee to adhere to the terms of the trust to hold the property on the beneficiary's behalf without allowing for that indemnity. In *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367 the majority said (citations omitted) that a trustee:

> … is entitled to be indemnified against [liabilities incurred in discharge of the trust] from the trust assets held by him and for the purpose of enforcing the indemnity the trustee possesses a charge or right of lien over those assets … the charge is not capable of differential application to certain only of those assets. It applies to the whole range of trust assets in the trustee's possession except for those assets, if any, which under the terms of the trust deed the trustee is not authorised to use for the purposes of carrying on the business. …
>
> In such a case there are two classes of persons having a beneficial interest in the trust assets: first, the *cestuis que trust*, those for whose benefit the business was being carried on; and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust. The latter interest will be preferred to the former, so that the *cestuis que trust* are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied.

The High Court subsequently refined the nature of a trustee's right in indemnity, confirming the right is not in the nature of an encumbrance, in *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at 264, saying:

> [48] Until the right to reimbursement or exoneration has been satisfied, 'it is impossible to say what the trust fund is.' [*Dodds v Tuke* (1884) 25 Ch D 617 at 619] The entitlement of the beneficiaries in respect of the assets held by the trustee which constitutes the 'property' to which the beneficiaries are entitled in equity is to be distinguished from the assets themselves. The entitlement of the beneficiaries is confined to so much of those assets as is available after the liabilities in question have been discharged or provision has been made for them. [*Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Q)* [1984] 1 Qd R 576 at 587] To the extent that the assets held by the trustee are subject to their application to reimburse or exonerate the trustee, they are not 'trust assets' or 'trust property' in the sense that they are held solely upon trusts imposing fiduciary duties which bind the trustee in favour of the beneficiaries. [*Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 370].

It seems, therefore, that the trustee's right of indemnity is a right in the nature of a lien or charge, but that is only to enable a court of equitable jurisdiction to authorise the sale of conversation of those assets to satisfy the trustee's right or reimbursement or exoneration.

The right can be enforced even if there has been a change of trustee: *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd* [2008] NSWSC 1344. Though this has less relevance in the SMSF context.

6 Funding Developments

As with any property development or business, funding is a perennial issue if a SMSF is to undertake a development or conduct a property development business. How the development or business will be funded often falls into two categories: whether the SMSF funds it or an entity that the SMSF has invested in funds it.

Possible sources of funds include:

- existing cash from the SMSF;
- cash from the members of the SMSF by way of contributions (subject to the contributions caps applicable);
- borrowings; or
- non-SMSFs (provided they can invest and comply with the restrictions on any such investment).

It is convenient to discuss contributions and borrowings as these are likely to be the two main sources of development finance.

6.1 Contributions

Proposed changes to superannuation for 2016-17 were announced in the Federal Budget on 3 May 2016. It's important to note that the proposed changes to superannuation are yet to be legislated and are likely to come before the parliament before the end of the year. This paper will therefore consider the existing rules.

As there are a large number of legislative references, I will put them in foot notes for ease of reading.

The taxation of superannuation contributions depends on whether the contributions are concessional[7] or non-concessional contributions.[8]

6.1.1 Concessional contributions

A *concessional contribution* is assessable to the fund at the 15% tax rate and generally deductible to the contributor, for example:

1. employer contributions (subject to certain conditions);[9]

[7] See sections 291-25 and 291-165 of the 1997 Act.
[8] See section 292-85 of the 1997 Act.

2. certain personal contributions where, amongst other things, the following conditions are satisfied:[10]

   (a) the recipient fund is a complying superannuation fund;

   (b) if you are:[11]

      (i) holding an office or appointment;

      (ii) performing functions or duties;

      (iii) engaging in work;

      (iv) doing acts or things, and

   the activities result in you being treated as an employee for the purposes of the *Superannuation Guarantee (Administration) Act* 1992 (assuming that subsection 12(11) of that Act had not been enacted); and

   (c) your assessable income from the above activities (if applicable) is less than 10% of the sum of:[12]

      (i) your assessable income for the income year (disregarding any excess concessional contributions you may have);

      (ii) your reportable fringe benefits for the income year;

      (iii) your reportable employer superannuation contributions for the income year.

Concessional contributions are subject to a contributions cap, which is currently:

1. $30,000 – for those individual under 50 years of age;[13] and

2. $35,000 – for those individuals 50 years of age and over.[14]

6.1.2 Excess concessional contributions

---

[9] Section 290-60 of the 1997 Act.
[10] Section 290-150 of the 1997 Act.
[11] Subsection 290-160(1) of the 1997 Act.
[12] Subsection 290-160(2) and (3) of the 1997 Act.
[13] Section 291-20 of the 1997 Act.
[14] Subsection 291-20(1) of the *Income Tax (Transitional Provisions) Act* 1997 ("**TPA**")

From 1 July 2013, excess concessional contributions are included in an individual's assessable income and taxed at their marginal tax rates together with an interest component.[15] Individuals may then elect to release up to 85% of the excess concessional contributions from their superannuation fund as a credit to cover their personal tax liability.[16]

In addition to the above, excess concessional contributions are also counted towards the non-concessional contributions cap (see below).[17]

6.1.3 Non-concessional contributions

A *non-concessional contribution* is not assessable to the fund.[18]

Non-concessional contributions are also subject to an annual cap, which is currently $180,000.[19] However, individuals under 65 years of age may take advantage of the 'bring forward rule' to contribute up to 3 years' worth of non-concessional contributions (or currently $540,000) at once without breaching the non-concessional contributions cap.[20]

The consequences of breaching the non-concessional contributions cap is that the individual is taxed at (currently) 49%.[21]

6.2 Taxation of fund income

The income of a complying superannuation fund[22] is split into two components:[23]

1. the non-arm's length component; and

2. the low-tax component.

The non-arm's length component is the fund's non-arm's length income less deductions attributable to that income (see below).[24]

The low-tax component is the fund's income other than the non-arm's length component (if any).[25] Note, however, that certain amounts are specifically excluded from the fund's income, such as non-concessional contributions as outlined above.

---

[15] Division 291 of the 1997 Act.
[16] Divisions 95, 96 and 97 of Schedule 1 to the *Taxation Administration Act* 1953 ("**TAA**")
[17] Paragraph 292-90(1)(b) of the 1997 Act.
[18] Subdivision 295-C of the 1997 Act.
[19] Section 292-85 of the 1997 Act.
[20] Subsections 292-85(3) and (4) of the 1997 Act.
[21] Section 5 of the *Superannuation Excess Non-concessional Contributions Tax) Act* 2007 and section 292-80 of the 1997 Act.
[22] See section 995-1 of the 1997 Act and section 45 of the SIS Act as to the definition of a 'complying superannuation fund'.
[23] Subsection 295-545 of the 1997 Act.
[24] Subsection 295-545(2) of the 1997 Act.

The low-tax component is taxed at 15%[26] (and capital gains may be entitled to a 33.33% discount reducing the effective tax rate to 10%).[27]

The non-arm's length component is taxed at 45%.[28]

6.3 Non-arm's length income

Broadly, an amount of income is non-arm's length income of a complying superannuation fund if:[29]

1. it is *both*:

   (a) derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme; and

   (b) the amount 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;

2. if it is *either*:[30]

   (a) a dividend paid to the entity by a private company; or

   (b) ordinary income or statutory income that is reasonably attributable to such a dividend,

   unless the amount is consistent with an arm's length dealing and relevant factors in this regard include:[31]

   (a) the value of shares in the company that are assets of the entity; and

   (b) the cost to the entity of the shares on which the dividend was paid; and

   (c) the rate of that dividend; and

   (d) whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend; and

---

[25] Subsection 295-545(3) of the 1997 Act.
[26] Paragraph 26(1)(a) of the *Income Tax Rates Act* 1986 ("**ITRA 1986**")
[27] See Subdivision 115-A of the 1997 Act.
[28] Paragraph 26(1)(b) of the ITRA 1986
[29] Subsection 295-550(1) of the 1997 Act.
[30] Subsection 295-550(2) of the 1997 Act.
[31] Subsection 295-550(3) of the 1997 Act.

(e) whether the company has issued any shares to the entity in satisfaction of a dividend paid by the company (or part of it) and, if so, the circumstances of the issue; and

(f) any other relevant matters;

3. income derived by the fund as a beneficiary of a trust other than by virtue of a *fixed entitlement* (see below);

4. income derived by the fund as a beneficiary holding a *fixed entitlement* if:

(a) the fund acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm's length; and

(b) 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.

The Commissioner's views on non-arm's length income are outlined in *Taxation Ruling* TR 2006/7. Although the ruling refers to the previous 'special income' regime, the Commissioner's views as to the operation of the relevant provisions have not changed,[32] although it is important to note that the current regime requires taxpayers to self-assess whether income is non-arm's length whereas previously certain amounts were deemed to be special income (and subject to high tax rates) unless the Commissioner exercised his discretion to treat it otherwise.[33]

6.3.1 What is a 'fixed entitlement'?

There has been much confusion surrounding the meaning of the phrase, 'fixed entitlement' in the context of the non-arm's length income rules.

The problem centres on the fact that the term, 'fixed entitlement' is defined in Schedule 2F of the 1936 Act but that definition appears to have a limited application to that particular Schedule.

The Commissioner accepts that the term, 'fixed entitlement' for present purposes was separate and distinct to that which applies for the purposes of Schedule 2F of the 1936 Act as follows:[34]

---

[32] See Explanatory Memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006 (Cth) at paragraph 3.14

[33] See *Darrelan Pty Ltd (trustee if the Henfam Superannuation Fund) v FCT* [2010] FCAFC 35 – no single factor decisive, rate of dividend
relevant.

[34] See TR 2006/7 at paragraphs 206-208

> The term 'fixed entitlement' is not defined for the purposes of section 273. The meaning to be ascribed to these terms must therefore be determined according to the ordinary meaning of the words having regard to the context in which they appear.
>
> When inserting subsections 273(6) to (8), Parliament sought to distinguish between investment returns on 'fixed entitlements' in 'unit trusts' and distributions made to persons as beneficiaries of 'discretionary trusts' resulting from the exercise of discretions. Parliament considered it appropriate that the latter should be treated as special income taxed at the non-concessional rate whereas the former should only be treated as special income if the acquisition of the fixed entitlement or the derivation of the income failed to satisfy an arm's length test.
>
> Having regard to the statutory context, it is considered that the composite expression 'income derived....by virtue of a fixed entitlement to the income' is designed to test whether an amount of trust income that had been included in the assessable income of a superannuation entity under subsection 97(1) was included because the entity had an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee.

As outlined above, other than the change to a self-assessment model, the replacement of the ‘special income’ regime with the ‘non-arm’s length income’ regime did not involve a change in underlying policy or legislative operation other than moving to a self-assessment model.

However, if the term, ‘fixed entitlement’ for present purposes is covered by the definition in Schedule 2F of the 1936 Act the move to self-assessment model would be largely defeated. That is, the Commissioner has discretion to deem a fixed entitlement under Schedule 2F of the 1936 Act where:

1. a beneficiary with an interest in a share of income that the trust derives from time to time, or of the capital of a trust, does not have a fixed entitlement to the share; and
2. the Commissioner considers that the beneficiary should be treated as having the fixed entitlement, having regard to:
    (a) the circumstances in which the entitlement is capable of not vesting or the defeasance can happen; and
    (b) the likelihood of the entitlement not vesting or the defeasance happening; and
    (c) the nature of the trust;

    the beneficiary has the fixed entitlement.

The Commissioner’s discretion is intended to provide for circumstances where, despite the trust not technically meeting the requirements to be a ‘fixed entitlement’, the likelihood of the

beneficiary's vested interest being defeated is low, and it would be unreasonable in the context of the statutory scheme to treat the beneficiary's interest as not constituting a 'fixed entitlement'.[35]

Further, in the Trust Consultation Sub-Group Issues Register, the Commissioner states in this regard:[36]

> "For unlisted unit trusts (including those that are not registered managed investment schemes for the purposes of the *Corporations Act* 2001) with a single class of units on issue, it would generally be expected that the Commissioner would exercise the discretion on a year by year basis or for a certain point in time (depending on the relevant legislative provision) provided that, for the relevant year of income:
>
> (a) any issue or redemption of units was actually done at a price determined on the basis of the net asset value at the time of the redemption or issue (that is, the price does not necessarily have to equate precisely to the net asset value, provided that the deviation from that value does not unduly favour or prejudice particular unit holders, is done in the best interests of all unit holders, complies with any relevant ASIC relief, and the Commissioner considers the extent of the deviation to be reasonable in all the circumstances); and
>
> (b) no amendments have been made to the trust's constitution that have had the effect of significantly defeasing a beneficiary's interest in the income or capital of the trust."

Returning to the non-arm's length income rule, the policy intent of moving to a self-assessment model would be significantly undermined by adopting the position that a fixed entitlement for present purposes was defined by reference to the meaning of that term under Schedule 2F to the 1936 Act as taxpayers would have to approach the Commissioner for the exercise of his discretion to treat a trust interest as a fixed entitlement which is not administratively distinguishable to approaching the Commissioner to treat special income as *ordinary* income under the former regime.

However, in *The Trustee for MH Ghali Superannuation Fund v FCT* [2012] AATA 527 ("***Ghali***"), Egon Fice SM held that the term was defined in Schedule 2F of the ITAA 1936 and covered the meaning of that term for the purposes of the (former) special income rules.

---

[35] See Explanatory Memorandum to the *Tax Laws Amendment (Trust Loss and Other Deductions) Bill* 1997 (Cth) at paragraph 13.13

[36] See https://www.ato.gov.au/General/Consultation/In-detail/Technical-and-special-purpose-working-groups---minutes/Trust-Reform-and-Compliance-Working-Group/Trust-Consultation-Sub-group-issues-register/ (accessed 16 January 2016)

In his Decision Impact Statement ("**DIS**") on *Ghali*, the Commissioner concluded:

> The Tribunal considered that 'fixed entitlement' in s 273 takes the meaning provided in s 272-5 in Schedule 2F to the ITAA36. This is contrary to, and would be less favourable to taxpayers than, the Commissioner's existing approach.

And further:

> Section 272-5 of Schedule 2F provides that if a beneficiary has a vested and indefeasible interest in a share of income of a trust that the trust derives from time to time, the beneficiary has a fixed entitlement to that share of income. The Tribunal made some observations regarding the nature of that test which are discussed further below. Because of the way the case was argued, the Tribunal did not have the benefit of submissions on the way in which the test operates including relevant case law.

And finally:

> In light of recent authority, it might be said that the fixed entitlement test in Schedule 2F is relatively difficult to satisfy. See, for example, *Colonial First State Investments Ltd v. FCT* , and the Commissioner's Decision Impact Statement in respect of that case. Having regard to the strictness of that test, the Commissioner perceives that the adoption of the Schedule 2F definition for the purposes of s 273 (or its successor, s 295-550) would give rise to adverse and unintended impacts on superannuation funds that hold arm's length trust investments.
>
> The Commissioner proposes to adhere to his existing view that the Schedule 2F definition is inapplicable for the purposes of s 273. Although not considered by the Tribunal, we note that the Commissioner's view is that the Schedule 2F definition also does not apply for the purposes of s 295-550: see TR 2006/7 and the minutes to NTLG Superannuation Subcommittee meeting of March 2010.

Despite the Commissioner's public views on *Ghali* in his DIS, in Private Ruling 1012585947911, the Commissioner ruled that an amount was non-arm's length income applying the definition of a fixed entitlement under Schedule 2F to the 1936 Act (that is, the complete opposite to what was publicly stated!).

The writer does note that Private Rulings are not binding other than in relation to the particular rulee and the Private Binding Rulings Register does contain unfavourable rulings from which taxpayers may have successfully objected.

However, the critical point is that advisers would be loath to advise on the operation of these provisions in the absence of extraordinarily rigid trust deed or a successful Private Ruling, whether in relation to:

1. the meaning of 'fixed entitlement' for present purposes falling outside the scope of the definition in Schedule 2F to the 1936 Act; or

2. if the Commissioner seeks to rely on *Ghali* – the exercise of his discretion to treat the relevant interest as a fixed entitlement.

6.4 Segregated current pension assets

Complying superannuation funds are generally taxed at 15% (except non-arm's length income). In addition, the trustee of a complying superannuation fund will be able to apply a 33.33% discount to the gross capital gain where:[37]

1. the CGT event giving rise to the gain occurred after 11:45am (ACT time) on 21 September 1999; and

2. the gain was determined without indexation; and

3. the CGT asset was held for at least 12 months prior to the CGT event.

In this scenario, the effective tax rate on capital gains is 10% (15% x [1-0.3333]).

However, where an asset of a complying superannuation fund is used to satisfy pension obligations (known as a segregated current pension asset), the income and capital gains generated by the asset is exempt (although a carve out for non-arm's length income applies).[38]

An asset is a segregated current pension asset if:[39]

1. both of the following apply:

   (a) the assets are invested, held in reserve or otherwise dealt with at that time solely to enable the fund to discharge all or part of its liabilities (contingent or not) in respect of superannuation income stream benefits that are payable by the fund at that time; and

   (b) the trustee of the fund obtains an actuary's certificate before the date for lodgement of the fund's income tax return for the income year to the effect that the assets and the earnings that the actuary expects will be made from them would provide the amount required to discharge in full those liabilities, or that part of those liabilities, as they fall due; or

[37] Section 115-5 of the 1997 Act.
[38] Section 295-385 of the 1997 Act.
[39] Subsection 295-385(3) and (4) of the 1997 Act.

2. the assets are invested, held in reserve or otherwise being dealt with at that time for the sole purpose of enabling the fund to discharge all or part of its liabilities (contingent or not), as they become due, in respect of superannuation income stream benefits:

   (a) that are payable by the fund at that time; and

   (b) prescribed by the regulations for the purposes of this section.

In the context of capital gains, the use of segregated current pension asset strategies can deliver an additional 10% tax saving which, on long-term capital gains, can deliver very significant tax savings. Consider the following example:

> **Example**
>
> Olive is (35) and Nina is (33) are siblings. Together with their respective spouses, they decide to start an SMSF and purchase an apartment complex in the inner Brisbane suburbs that has re-development potential now and is likely to be rezoned for even higher density in the future.
>
> The purchase price is $2.5m, the SMSF contributes $500k in equity ($2m borrowings) and the property is neutrally geared.
>
> Assume that the property is held until Olive is 65 and at that stage it is worth $25m (on account of general market movements over 30 years and rezoning). In the ordinary source, if the property was sold it would have a gross capital gain of $22.5m, a net capital gain $14.99m and CGT payable of $2.25m.
>
> However, if the property was converted to a segregated current pension asset (perhaps as part of Olive's and Nina's transition to retirement), the CGT payable on the disposal of the property would be nil!

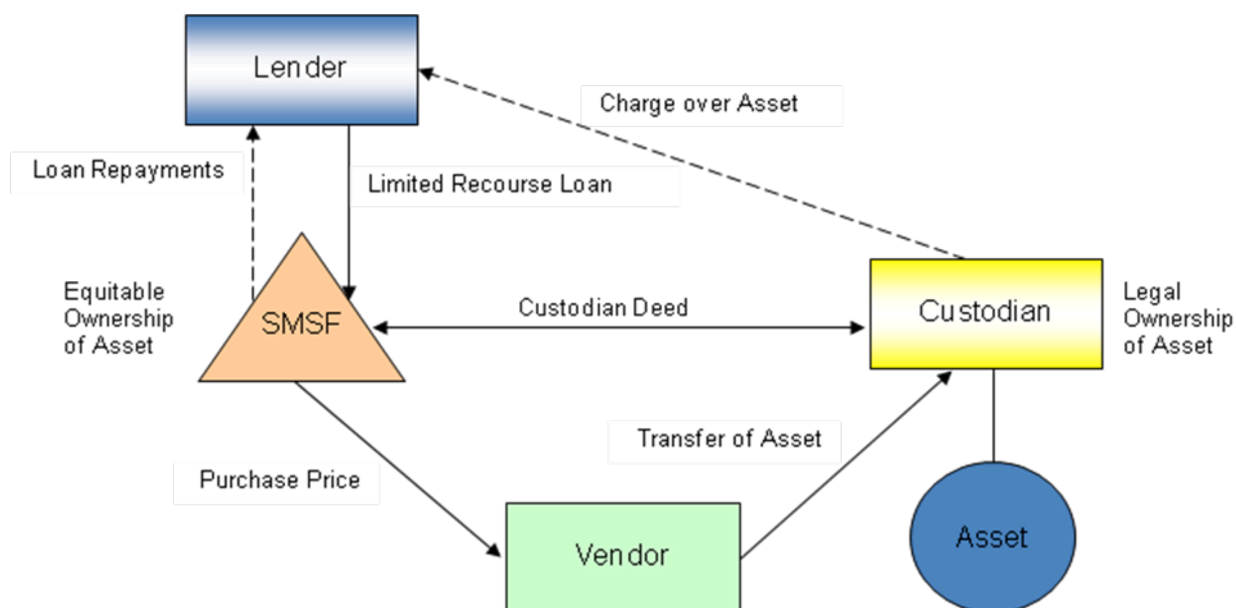
6.5 Borrowing By a SMSF

A trustee of an SMSF is permitted to borrow funds to acquire an asset, being a single asset, provided that the borrowing is structured as a limited recourse borrowing arrangement ("**Proper Borrowing Structure**").

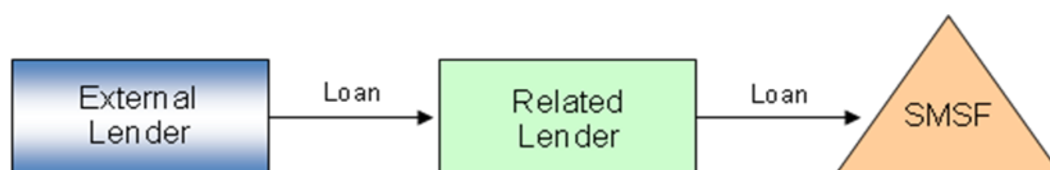
This paper explains the superannuation and taxation law applicable to Proper Borrowing Structures entered into on or after 7 July 2010. Different rules may apply to arrangements entered into prior to that date.

6.5.1 Diagrams of the Property Borrowing Structure

There may be a structure that borrows directly from a bank:



There can also be a structure that borrows indirectly from a bank. It is the same as the above structure but the funds flow through a related party as follows:



6.5.2 How Does the Borrowing Structure Work?

Apart from very limited exceptions, an SMSF is only permitted to borrow under a Proper Borrowing Structure. Broadly, for a borrowing to constitute a Proper Borrowing Structure <u>all</u> of the following conditions must be met:

1. the borrowed monies must be applied towards the acquisition of a single acquirable asset – this includes expenses incurred in connection with the borrowing, the acquisition, the maintenance and repair, but not the improvement, of a single acquirable asset;

2. the asset must be an asset which the SMSF is permitted to acquire under the prevailing superannuation law;

3. the acquired asset must be held on trust for the benefit of the trustee of the SMSF;

4. the SMSF must have a right to acquire the legal ownership of the asset by making one or more payments after acquiring the beneficial interest;

5. the rights of the lender or any other party involved in the arrangement (e.g. a guarantor) are limited to the rights relating to the acquired asset (i.e. the loan is limited recourse); and

6. the asset is not subject to any charge (including a mortgage, lien or other encumbrance) other than as provided above (see *Interpretative Decision* ATO ID 2010/185).

If you are in any doubt as to the Commissioner's requirements he has issued *Self Managed Superannuation Fund Ruling* SMSFR 2012/1 which explains key concepts relevant to the application of the Proper Borrowing Structure.

It is important that a SMSF's borrowing meet all of the above conditions. Failure to do so may cause the Super Fund to cease to be a complying superannuation fund. If this occurs significant adverse tax consequences are triggered. These consequences include loss of the tax concessions available to complying superannuation funds (e.g. the 15% tax rate on income and 10% income on capital gains[40]) and a 45% tax on the market value of the assets of the fund that do not represent non-concessional contributions.

Under a Proper Borrowing Structure an SMSF borrows funds from a Lender on a limited recourse basis so as to acquire the asset under an arrangement whereby the legal title to the asset is held on trust by a Custodian for the benefit of the SMSF during the term of the loan.

Typically the Lender will take a charge (usually a registered mortgage where the acquired asset is land) over the legal title to the asset during the term of the loan to secure its loan.

The documents needed to implement a Proper Borrowing Structure are:

1. a *Limited Recourse Loan Agreement* or *Limited Recourse Loan Deed* which outlines the terms of the loan; and

2. a *Custodian Deed* which outlines the basis on which the Custodian will hold the asset during the term of the loan and provides the SMSF with a right to acquire the legal ownership of asset once it has paid off the loan.

Where the SMSF borrows from a bank or a third party financier, then typically these entities will use their own loan documents but usually will require you to provide your own *Custodian Deed* for their approval. It remains important, however, to ensure that any documentation provided by these lenders is compliant such that the Super Fund's borrowing is made under a Proper Borrowing Structure.

[40] Unless the asset is segregated as supporting a pension, in which case the capital gain is disregarded.

Two SMSFS who jointly borrow under a limited recourse borrowing structure, involving a single holding trust, will contravene the relevant legislation (see *Interpretative Decision* ATO ID 2010/172).

6.5.3 What Assets May be Acquired

Specific rules contained in the limited recourse borrowing provisions in sections 67A and 67B of the SIS Act and general superannuation investment rules regulate the assets that can be acquired under a Proper Borrowing Structure. These rules apply independently of each other. Accordingly an SMSF's proposed acquisition must satisfy all of these rules or otherwise it risks losing its complying superannuation fund status.

As always, the acquisition must also satisfy the particular SMSF's governing rules and Deed.

6.5.3.1 Acquirable Assets

An asset is an "acquirable asset" if it is not money (whether Australian or foreign currency) and the SIS Act or ay other law does not prohibit the SMSF from acquiring the asset (s 67A(2)). The most common example of any other law is the *Trustee Acts* of the States and Territories. This exclusion of money does not apply to arrangements that involve money as an asset (eg arrangement over multiple assets that are traded for money and managed in a similar fashion to margin accounts).

Generally an SMSF is only permitted to acquire a single "acquirable asset" under a Proper Borrowing Structure.

A narrow exception to the rule that only a single acquirable asset may be acquired relates to collections of assets. An SMSF may acquire a collection of assets provided that the assets in the collection have the same market value as each other and the assets in the collection are identical to each other (s 67A(3) of the SIS Act). This exception allows an SMSF to acquire more than one asset of the same kind (e.g. 10,000 ordinary Commonwealth Bank shares). This exception does not, however, extend to different kinds of the same particular asset. For instance, an SMSF cannot use this exception to acquire ordinary and preference shares in the Commonwealth Bank or ordinary shares in both of NAB and Westpac, under one Proper Borrowing Structure.

The single acquirable asset rule means that an SMSF is prohibited from acquiring a basket of different types of assets under one Proper Borrowing Structure. For instance, if the SMSF wishes to acquire a portfolio of shares comprising NAB, Westpac and Woolworths, the SMSF would need to enter into 3 separate Proper Borrowing Structures for each type of share.

Other common examples – especially for property investors – where the single acquirable asset rule creates practical issues include where an SMSF wishes to acquire an investment property (usually apartments) but the property has 2 titles (one for the apartment and one for the car space attached to the apartment), and where the Super Fund acquires an apartment and furnishings are included in the purchase. In both situations the SMSF would need to either buy the 2 different kinds of assets in 2 separate Proper Borrowing Structures or, alternatively, buy one of the assets outright and then only purchase one of the assets under a Proper Borrowing Structure.

An acquirable asset is acquired at the time when the Custodian gains a legal interest in the asset. At the same time the SMSF gains a beneficial interest in the asset as required by s 67A(1)(b).

To ensure that an acquirable asset is always interpreted in the singular, the words "collection" and "identical" should be interpreted as ensuring that an acquirable asset is one or more things that within the arrangement are seen and treated as a whole. For example, a collection of shares must be acquired and disposed of as a collection and could not, for example, be sold down over time.

6.5.3.2 Replacement Assets

Changes to the asset acquired by an SMSF under a Proper Borrowing Structure over time may require that the arrangement be wound up. This is where the asset changes and the new asset does not fall within the concept of a "replacement asset".

A "replacement asset" is an extremely narrow concept and currently only covers situations where there is a replacement of shares or units held under a Proper Borrowing Structure as a consequence of a takeover, merger, demerger or restructure of the company or unit trust in which the original shares or units were held.

An example of how an asset change can be forced a wind up of the Proper Borrowing Structure is where an investment property of the Super Fund burns down. The SMSF cannot re-build the property with insurance proceeds and is required to wind up the Proper Borrowing Structure relating to the property.

The narrow concept of a replacement asset means that an SMSF may not directly use a Proper Borrowing Structure to develop property. For instance, the SMSF cannot buy land and then subdivide into a number of separate land holdings. This narrow conception of a replacement asset also means that an SMSF cannot purchase a property off-the-plan since what occurs is that their contractual rights change into an interest in real estate.

The narrow concept of a replacement asset also prevents an SMSF from progressively selling down shares held in a Proper Borrowing Structure. For instance, a Super Fund who beneficially

owns 10,000 ANZ shares under a Proper Borrowing Structure cannot sell 50% of those shares and keep the remaining 50% in the Proper Borrowing Structure. If the Super Fund wishes to sell the ANZ shares then it is required to sell the whole of the ANZ shares held under the arrangement.

What the SMSF can do is replace an asset – such as a share in a company – with other another asset – such as shares of the same class in the company – with the same market value at the time of the replacement. It can also replace a share or a collection of shares in another company (or unit in or collection of units in another trust) if the replacement occurs as a result of a takeover, merger, demerger or restructure of the company or unit trust.

Given the significant cash flow issues which may arise for an SMSF when it is required to wind up a Proper Borrowing Structure (since it would have to repay the outstanding loan balance), care should be taken in selecting the particular asset to be acquired under the Proper Borrowing Structure and also in instigating sufficient insurance to cover this contingency.

6.5.4 Use of borrowed funds

Besides using the borrowed monies to acquire the asset, an SMSF is also permitted to use funds borrowed under a Proper Borrowing Structure to pay expenses incurred in connection with the acquisition and borrowing. This includes conveyancing fees, stamp duty, brokerage and loan establishment fees.

Borrowed funds may also be used to maintain and repair the asset the subject of the Proper Borrowing Structure. A distinction needs to be made between repairing the asset and improving the asset. As stated above an SMSF may not use borrowed funds to improve the asset. The distinction between an improvement and a repair can sometimes be difficult to determine. For instance, the replacement of a roof with a better functioning roof may be considered an improvement as opposed to a repair.

6.5.5 Establishing the Correct Structure

6.5.5.1 Lenders

An SMSF may borrow from any person under a Proper Borrowing Structure. This includes related and unrelated parties of the SMSF.

If borrowing from a related party then the loan must be on an arm's length basis (including having a commercial interest rate relative to the security provided) and should be documented in a written agreement.

Due to the difficulties that an SMSF may face in obtaining funding from external parties, it may sometimes be easier for a related party to borrow funds from an external lender and to on-lend the funds to the SMSF. This is the indirect lending diagram above.

Consideration of the relative interest rates of both loans us required from both the superannuation and tax law perspective. A related party is not permitted to use the asset which is the subject of the Proper Borrowing Structure arrangement as security for their borrowing. The related party would have to borrow using other security, say the family home.

6.5.5.2 Custodians

It is a key requirement of a Proper Borrowing Structure that the asset the subject of the arrangement be held on trust for the Super Fund until such time as the loan is repaid. The Custodian performs the duty of holding the asset on trust for the SMSF. The Custodian is sometimes referred to as the “trustee”, “bare trustee” or the “security trustee” and the trust in respect of which they hold the asset for the benefit of the SMSF is sometimes referred to as the “custodian trust”, “bare trust” or “security trust”.

The Custodian can be any person or entity provided it is not identical to the trustee of the SMSF.

It is generally recommended that the Custodian be a special purpose company that has been newly incorporated for the purpose of being the Custodian. Such a company would have nominal assets (say $2 in share capital paid to incorporate the company) and should never trade or undertake other activities whilst it is a party to the Proper Borrowing Structure. The reason for this recommendation is that it provides a level of asset protection. For instance, if the Super Fund acquires real estate under a Proper Borrowing Structure and that real estate is leased to the general public then having a $2 company as custodian would provide some protection against public liability claims that may arise in respect of the leasing.

Under the Proper Borrowing Structure the property is purchased in the name of the Custodian. The purchaser on the contract should be described as either “XYZ Custodian Pty Ltd" or "XYZ Custodian Pty Ltd as trustee". The Custodian only has the legal interest in the property. The equitable ownership of the property resides with the SMSF. However, the Custodian may mortgage and/or charge the property in order to secure repayment of the loan to the Lender by the SMSF.

6.5.5.3 Guarantees

Often external lenders require that a related party of the SMSF (such as a member of the SMSF) guarantee the SMSF borrowing. The Commissioner accepts that a Proper Borrowing Structure may involve a guarantee. However, the usual rights of a guarantor need to be varied and care

needs to be had to ensure that the rights of the guarantor under the arrangement are limited recourse to the property.

If the guarantee is called upon it may also be a contribution to the SMSF (see *Taxation Ruling* TR 2010/1 at [38]), so caution is required to ensure the contributions limits are not breached.

6.5.5.4 Refinancing

An SMSF can refinance a Proper Borrowing Structure without jeopardising the complying nature of the arrangement provided certain conditions are met.

6.5.6 What Happens at the End of a Borrowing Arrangement

A Proper Borrowing Structure may be ended either by:

(a) the SMSF paying off the loan and then collapsing the custodian trust by having the legal title to the asset transferred into its name; or

(b) the Custodian selling the asset and then using the sale proceeds to pay out the loan (this would occur where the SMSF is in default of its loan obligations).

Different tax consequences arise depending on how a Proper Borrowing Structure is ended. Specific advice should be sought at the time.

7 Tax Issues

The starting point when considering tax for property developments by SMSFs is that s 295-85 of the 1997 Act deems that (almost all) CGT assets will be held on capital account. This means, for example, that even land bought with the intention to sell for a profit, or used in a property development business, will still be held on capital account and qualify for the CGT discount (if held for 12 months).

However, this rule does not apply to assets held by companies or trusts that an SMSF has invested in, even if the SMSF holds all of the units or shares. For trusts, if the land is deemed to be on income account then the proceeds from the sale of the land will flow through to the SMSF as income even if the asset would have been on capital account if held directly by the SMSF. Dividends from companies will also be on revenue account.

Unlike other taxpayers, however, the difference between revenue account and capital account is not significant. SMSFs are entitled to a 1/3rd discount if they hold an asset on capital account for over twelve months: Division 115 of the 1997 Act. The relevant tax rates are therefore 15% on revenue account and 10% on capital account.

The non-arm's length income and the segregated pension assets discussed above at 6.3 and 6.4 respectively are also relevant here.

8 Structures for SMSF Developing

The paper now looks at various structures under which an SMSF can undertake property development or invest in an entity which undertakes property development activities.

8.1 SMSFs

Property development activities can be undertaken directly by the trustee of an SMSF provided that the SIS Act and the SIS Regs are complied with.

Advantages of using this structure include:

1. there is no need for other entities and therefore there can be less cost and administration;
2. the SMSF's cash can be used directly in the development;
3. existing SMSF assets can be developed (although not with borrowings – see 6.5 above);
4. income and capital are taxed at the concessional superannuation rates; and
5. the SMSF can undertake a property development business.

Disadvantages of using this structure include:

1. SIS Act and SIS Regs restrictions can make development difficult;
2. there is no asset protection – the SMSF assets are subject to claims from the development;
3. it is difficult to use borrowing where making improvements;
4. SMSF's cannot use borrowing to improve existing assets;
5. it is difficult to bring other parties into the development (i.e. they would have to become members of the SMSF); and
6. the difficulties of using related party developers / builders.

8.2 As a Tenant 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 discussed above. Additional disadvantages include:

1. 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 (as it would breach s 66 of the SIS Act);

2. 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;

3. the tenants in common will be treated as a tax law partnership.

8.3 Pre-1999 Unit Trust

These were discussed at 5.4 above.

Where an SMSF acquired units in a unit trust (or company) on or prior to 11 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 1997 Act and the 1936 Act, will continue to apply to the holding of the units. This includes the sole purpose test and the non-arm's length income rules. Therefore, it is important that the activities of the pre-99 unit trust be undertaken on an arm's length basis.

Further, as any additional units will be in-house assets and the distributions cannot be left unpaid without, in the Commissioner's view, becoming in-house assets (as a 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 the interest.

8.4 Reg 13.22C Unit Trusts

A “Reg 13.22C” unit trust are also referred to as non-geared unit trusts due to the specific prohibition against the trustees of such a trust 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 r 13.22C (or 13.22B) of the SIS Regs and not breach r 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 SMSF, unless the lease relates to business real property;
- the trustee of the unit trust is not a party to a lease arrangement with a related party of the SMSF, unless the lease arrangement:
    - is legally binding; and
    - relates to business real property;
- 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 SMSF (unless the asset is business real property;
- the trustee of the unit trust does not have outstanding borrowings (from which the “non-geared unit trust” name derives);
- 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 (Cth); 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 the Division in which those regulations sit, an asset of a related party of the SMSF; and

- the trustee of the unit trust does not conduct a business.

Although restrictive, the r 13.22C unit trust has the significant advantages that units in such a trust held by the SMSF will not be an in-house asset and the SMSF can acquire units in such a trust from related parties: s 66(2A)(a)(iv) of the SIS Act. A r 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 r 13.22C unit trust can acquire property and develop it but it must do so without borrowing money, charging the asset, acquiring the asset from a related party (including materials or supplies 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.

8.5 Unrelated Trusts

An unrelated trust is a unit trust that does not fall within the definition of a "related trust" under s 10(1) of the SIS Act. Although determining who is a related trust is a complex tax, a simple rule of thumb is if the SMSF and its group hold no more than 50% of the:

- units in the trust;
- shares in the corporate trustee; and
- 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.

In this regard it is important to ensure that the other parties have never been a tax law partnership or carried on business together, as this may render them part of the same group and otherwise defeat this structuring play.

An example of an unrelated trust is where two unrelated SMSFs both hold 50% of the units in the unit trust and their related parties hold no more than 50% of the share sin the corporate trustee and the directorships thereof.

Untreated trusts have significant advantages, as, like pre-99 unit trusts, the units an SMSF holds will not be in-house assets regardless of what activities the unrelated trust conducts. 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 non-arm's length provisions or the sole purpose test. It is therefore, again, important to ensure that the unrelated trust deals on an arm's length basis to avoid the potential application of these rules.

Leveraging using an untreated trust has a particular advantage over a limited recourse borrowing arrangement 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 the SMSFs to have an interest in property development.

The biggest drawback of an unrelated trust, however, is that an SMSF and its group can only have up to 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.

8.6 Joint Ventures

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

9 Use of Related Party Builders

A significant recent development for SMSFs undertaking, or wanting to undertake, property development is the Commissioner's view on the application of the prohibition of SMSF's acquiring assets from related parties: see the discussion of s 66 of the SIS Act at 5.3 above. Specifically is this relevant in relation to building contracts with related party builders.

As discussed earlier, the Commissioner has made it clear that where, under a building contract, a related party builder supplies material to the SMSF, that the supply of materials will be in breach of s 66 of the SIS Act.

It is therefore important to separate out the buildering services from the supply of any materials and goods used in the provision of those services. In these circumstances the trustee of the SMSF must be vigilant to ensure that it does, and that the related party builder does not, pay for any of those materials or goods.

The agency issue discussed at 5.3 also remains relevant.

10 Conclusion

There is obviously much benefit in undertaking a property development in a SMSF:

1. there may be funds that would permit a development that cannot be undertaken absent access to the funding;

2. concessional tax rates apply;

3. any profit, going forward, is taxed at lower rates; and

4. there are asset protection benefits in doing so.

But the Commissioner is tasked with regulating SMSFs in accordance with the SIS Act, the SIS Regs, the 1997 Act and the 1936 Act. He will ensure the various intricacies are complied with.

The benefits are there provided effort is placed getting the procedures correct.