

Superannuation Update

The Instalment Warrant revolution and recent developments

Introduction

Hot on the heels of the major changes to superannuation that took place as from 1 July 2007, we are now coming to grips with another major development – the so-called Instalment Warrant Revolution, which was discussed in some detail in our last update. While this “revolution” has opened up significant new investment opportunities for investment funds, considerable care and caution is required to ensure that any loan arrangement is properly documented and complies with the relevant legislation. In this update, we discuss the Tax Office’s concerns in relation to these new arrangements, as set out in a recent Taxpayer Alert, along with other recent developments.

If you require assistance in relation to any matter set out in this update, or require assistance or advice in relation to any other tax or superannuation matter, please contact either Arthur Athanasiou or James Shattock – contact details appear on page 4.

Certain borrowings by SMSFs

In our last update, we discussed in some detail how recent changes to the SIS Act (effective from 24 September 2007) mean that trustees of superannuation funds may now borrow in prescribed circumstances, and may in fact pursue a geared investment strategy, provided that the requirements specified in the SIS Act are followed.

In Taxpayer Alert TA 2008/5, the Commissioner of Taxation has expressed concern in relation to these new borrowing arrangements, where the arrangement has one or more of the following features:

- (a) the interest rate for the borrowing is zero or less than a commercial rate, particularly where the lender is a related party;
- (b) the interest rate for the borrowing exceeds a commercial rate, particularly where the lender is a related party;
- (c) interest on the borrowing is able to be capitalised;
- (d) a personal guarantee for the borrowing is given by a third party, particularly where the guarantee is given by a member or a related party of the SMSF;
- (e) the asset acquired (or any replacement) is one that a trustee is prohibited from acquiring under the SIS Act or any other law, or under the SMSF’s governing rules (for example, acquiring residential property, which is not business real property, from a related party).

The Tax Office considers that arrangements which exhibit one or more of the features outlined above may give rise to taxation and superannuation regulatory issues, including whether:

- monies advanced by a member or related party at zero or less than a commercial rate of interest could be characterised as a contribution to the SMSF. This may result in the trustee/member having to pay excess non-concessional contributions tax under Division 292 of the Income Tax Assessment Act 1997;
- monies advanced by a member or related party at greater than a commercial interest rate of interest may result in:
 - a breach of the sole purpose test outlined in section 62 of the SIS Act, on the basis that the excessive interest rate may mean that the SMSF is not being maintained solely for the purpose of providing superannuation benefits, and/or
 - the trustee breaching paragraph 65(1)(b) of the SIS Act, which prohibits the trustee from giving financial assistance to a member of the SMSF or to a relative of such a member using the resources of the SMSF;
- interest capitalised may result in the arrangement failing to meet the requirement that the money borrowed is or has been applied for the acquisition of an asset under paragraph 67(4A)(a) of the SIS Act;
- a personal guarantee of the type outlined in paragraph (d) above may result in recourse being made to the assets of the SMSF other than the asset acquired (or any replacement) in the event that the guarantee is enforced

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against the trustee as the principal debtor, contrary to the intent that the exception in subsection 67(4A) of the SIS Act only applies to limited recourse borrowings; and

- an asset of the type outlined in paragraph (e) above may result in breaches of the SIS Act or SIS Regulations (for example, intentionally acquiring an asset from a related party, which breaches subsection 66(1) of the SIS Act).

Trustees are also reminded that existing fund assets cannot be placed into a limited recourse borrowing without breaching the SIS regulatory requirements.

Application of the SIS Act to unpaid trust distributions payable to a SMSF

SMSF Ruling SMSFR 2008/D1 considers if a Self Managed Superannuation Fund (SMSF) contravenes certain provisions of the Superannuation Industry (Supervision) Act 1993 (SIS Act) when the SMSF is presently entitled to distributions from a related trust which are not paid over to it.

The provisions considered are (a) the in-house asset rules in Part 8; (b) the arm's length rules in section 109; and (c) the sole purpose test in section 62.

Where an SMSF is presently entitled to a distribution from a related or non-arm's length trust, and payment of this amount is not sought, contraventions of one or more provisions of the SIS Act may occur. This draft Ruling discusses three of the most relevant provisions and identifies the circumstances where a contravention might occur.

Part 8 of the SIS Act limits an SMSF to holding no more than 5% of its assets as in-house assets. For this draft Ruling, the definition of an in-house asset in subsection 71(1) includes (a) a loan to a related party of the fund; or (b) an investment in a related party or a related trust of the fund.

The recording of an unpaid trust distribution as a loan in the accounts will not of itself determine that the amount is a loan for the in-house asset rules. However, it is possible for other documents to be executed between the trustee of the SMSF and the trustee of the trust to bring into existence a loan between the parties. An example of this would be the execution of a loan agreement.

In addition, it is the Commissioner's view that, when an overall consideration of the factors surrounding the non-payment of the trust

distribution may be seen as an arrangement for the provision of credit or financial accommodation, this will satisfy the extended definition of "loan" in subsection 10(1).

Consequently, the unpaid amount will be included in the in-house assets of the SMSF, where the trust in question is a related party of the SMSF; and the circumstances indicate that a loan agreement has been entered into, or that a consensual agreement for the provision of credit or other form of financial accommodation has been reached, or can be inferred, between the parties.

The meaning of the term "investment" may be derived from the definition of "invest" in subsection 10(1). In this context it refers to the asset resulting from applying the assets of the SMSF or entering into a contract for the purpose of gaining interest, income, profit or gain.

It is the Commissioner's view that when the trustee of the SMSF has merely failed to enforce the equitable right to payment of the distribution, they have not applied this asset (the equitable right) or entered into a contract for the purpose of gaining interest, income, profit or gain.

However, an investment of the unpaid trust distribution will occur where the trustee of the SMSF accepts payment of this amount in the form of additional units in the trust for the purpose of gaining interest, income, profit or gain. In addition, the trustee of the SMSF may enter into an agreement that the distribution be added to the corpus of the trust without the issue of additional units. Such an arrangement need not be in writing. However, to invest the distribution it is necessary that the equitable right to immediate payment of the distribution be extinguished and the amount reinvested into the main trust. Where such an agreement is entered into for the purpose of gaining interest, profit or gain, this will also be an investment for the purposes of subsection 71(1).

Consequently, where the trust in question is a related party or a related trust of the SMSF, and the circumstances indicate that an investment in that trust has been made, the amount will be included in the in-house assets of the SMSF unless any of the exclusions in sections 71 to 71E apply.

The Commissioner is of the view that where an SMSF trustee does not seek payment of trust distributions within a reasonable time, and no interest is paid or compensation is given for not seeking payment, that dealing is

not consistent with the other party being at arm's length. Consequently, a contravention of the requirements of subsection 109(1A) would occur if the other party is not at arm's length with the SMSF trustee.

Subsection 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. Therefore, where an SMSF holds an investment in a related trust, any dealings with the trustee of that trust must be undertaken in the same manner as it would if that trust was at arm's length. Decisions about whether to seek payment of trust distributions would form part of these dealings and should be done on the same basis as would be expected if the trust was not a related party.

The Commissioner's view is that arm's length beneficiaries would not generally allow substantial amounts of distribution entitlements to remain in the trust without receiving an appropriate return on this amount, for example a market rate of interest. The possibility of receiving greater distributions from the trust in the future due to the provision of low cost capital would not be adequate compensation where the SMSF is not the sole beneficiary of the trust. Where the SMSF is the sole beneficiary it may be able to validate a view that the non-payment of a trust distribution was undertaken in the same manner as it would if the other party was at arm's length. However, it is the Commissioner's view that such a non-payment would be seen as a consensual arrangement meeting the extended definition of a "loan".

The sole purpose test in section 62 requires that an SMSF uses concessional savings for the specified core purposes of providing retirement or death benefits for or in relation to its members or for one or more of these purposes and other stipulated ancillary purposes.

Whether the SMSF is being carried on solely for the required purposes is determined by looking at the overall conduct of the fund and generally one factor alone will not be decisive. However, the Commissioner is of the view that where an SMSF trustee maintains a substantial proportion of the assets of the SMSF in a related trust as unpaid trust distributions, upon which no or below market rate interest is being paid, this suggests that the fund is not being maintained in a way that satisfies the 'Sole Purpose Test' in section 62.

Rather, this might indicate that the SMSF assets are being employed as a low cost source of capital for the related trust. This conclusion would be further supported where the SMSF is not the sole beneficiary of the related trust, particularly where the other beneficiaries of the trust are related parties.

Where it is concluded that the SMSF is not being maintained for the requisite purposes specified in section 62, the trustee of the SMSF will be in contravention of this requirement.

Application of subsection 66(1) to contributions of assets to a SMSF by a related party

SMSF Ruling SMSFR 2008/D2 explains how subsection 66(1) of the Superannuation Industry (Supervision) Act 1993 (SIS Act) applies to contributions of assets to a self managed superannuation fund (SMSF) by a related party of that fund.

Subsection 66(1) prohibits a trustee or investment manager from intentionally acquiring assets from a related party of the SMSF. However, subsections 66(2) and 66(2A) provide for exceptions to this prohibition. If an exception applies to the acquisition of an asset a trustee or an investment manager can acquire the asset from a related party without contravening subsection 66(1). This draft Ruling does not discuss the exceptions in detail.

Subsection 66(3) prohibits a person from entering into, commencing to carry out, or carrying out, a scheme to avoid the application of subsection 66(1). This draft Ruling does not discuss the prohibition of avoidance schemes under subsection 66(3).

This draft Ruling also does not provide the Commissioner's views on how other SIS Act provisions apply to any of the arrangements discussed in this draft Ruling.

A trustee or investment manager of an SMSF contravenes subsection 66(1) if the trustee or investment manager intentionally acquires an asset from a related party of the SMSF and an exception does not apply to that acquisition.

The phrase 'acquire an asset' in subsection 66(1) encompasses the acceptance of a contribution of an asset.

For the purposes of section 66, an asset is any form of property and includes money whether Australian currency or currency of another country (foreign currency). However,

the phrase 'acquire an asset' does not include accepting money.

A trustee or investment manager of an SMSF intentionally acquires an asset from a related party of the SMSF if the trustee or investment manager means to acquire the asset from the related party.

Whether it is the trustee and/or the investment manager that acquires an asset is not determined by who acquires legal ownership of the asset as this, as a matter of law, is always the trustee(s) of the SMSF. Rather it is a practical enquiry as to who, in the particular circumstances of the case, can be said to have accepted or obtained the asset for the SMSF.

Whether the trustee or investment manager means to acquire an asset from a related party is a matter that either requires direct proof (for example, an admission by the trustee or investment manager) or may be established by inferential reasoning. Determining whether an inference that the trustee or investment manager meant to acquire the asset from a related party may be drawn requires consideration of all the facts and circumstances of the particular case. One relevant circumstance would be the trustee or investment manager's awareness of the likelihood that the party from whom the asset is acquired is a related party of the SMSF. The following factors are provided as guidance as to what may be relevant considerations. They are not intended as an exhaustive list. The presence or absence of such factors should not be taken to mean that it is conclusive that a trustee or investment manager did, or did not, intentionally acquire an asset from a related party. The factors include:

- that an SMSF is invariably a small closely held fund such that the trustee or investment manager is likely to know of the relationship between a contributing person or entity and the SMSF;
- whether the trustee or investment manager has had previous dealings with the contributing person or entity; and
- the nature of the asset and whether it is likely to be contributed by an unrelated party of the SMSF. For example, it may be possible to infer that the trustee or investment manager must have been aware that there was no possibility of shares in a closely held family company being contributed by an unrelated entity.

The phrase 'acquire an asset' is defined in subsection 66(5) to not include accepting money. Therefore, a trustee or investment manager does not contravene subsection 66(1) by accepting a contribution of money.

Money is a generally accepted medium of exchange for goods, services and other things. It confers complete liquidity on the holder.

In the context of subsection 66(1), a contribution of money includes a contribution of cash or a money order, or a contribution by way of electronic funds transfer.

A contribution of money also includes a contribution of a cheque or a promissory note that is not a commodity in its own right. The view recognises that the value to the SMSF of a cheque or promissory note that is not a commodity in its own right is in the payment of a sum of money to the SMSF and not as an asset other than money. Although a trustee or investment manager does not contravene subsection 66(1) by accepting a contribution of a promissory note this does not mean that the contribution of a promissory note does not give rise to other compliance issues under the SISA. For example, section 65 may be relevant if contribution of a promissory note gives rise to an amount owing by a member or a relative of a member to the SMSF.

A contribution of a promissory note that is traded as a commodity in its own right (that is, it is an object of exchange and not a medium of exchange) is not a contribution of money for the purposes of section 66. For example, a promissory note is a commodity if it is traded on secondary markets or is issued by one entity (the maker) to another entity (the payee or bearer) at a discount from face value with the face value payable to the payee or bearer upon maturity. The acquisition of such a promissory note is an acquisition of an asset other than money.

A contribution of collectable bank notes and coins or trade or barter dollars is also not a contribution of money for the purposes of section 66. It is therefore an acquisition of an asset other than money.

If a monetary payment is made by a related party of an SMSF to a third party to extinguish a liability the SMSF has with that third party, this does not result in a contravention of subsection 66(1).

Exceptions to the prohibition in subsection 66(1) are provided for in subsections 66(2) and 66(2A).

The Instalment Warrant revolution Continued

For certain of the exceptions to apply to an acquisition of an asset the asset must be 'acquired at market value'. An asset that is contributed to an SMSF is acquired at market value for the purposes of those exceptions if the acquisition of the asset is treated as a contribution equal to the asset's market value.

The Commissioner considers that an excepted asset may also be acquired from a related party of the SMSF if the asset is partly purchased by, and partly contributed to, the SMSF. In these circumstances the sum of the purchase consideration and the amount recorded as the contribution component must be equal to the market value of the asset.

If an exception in subsection 66(2A) is to apply to the contribution of an asset by a related party, paragraph 66(2A)(a) requires that the acquisition of the asset 'constitutes an investment'.

It is the Commissioner's view that an acquisition of an asset by way of acceptance of a contribution of that asset can constitute an investment for the purposes of satisfying paragraph 66(2A)(a). Therefore, subsection 66(2A) can apply to contributions of assets that are mentioned in subparagraphs 66(2A)(a)(i) to (iv).

This means that a trustee or investment manager does not contravene subsection 66(1) by accepting a contribution of such an asset provided it is acquired at market value and, in the case of those assets that are in-house assets under subsection 71(1), the acquisition of the asset does not cause the SMSF to exceed the 5% market value ratio limit for in-house assets.

Some doubt has been expressed as to the operation of the exception provisions in the case of an asset consisting of an interest in real property that is held as a tenant in common. The law is that the exceptions apply in the normal way to this type of asset. That is,

the trustee or investment manager does not contravene subsection 66(1) by accepting a contribution of an interest in real property from a related party, that results in the SMSF and another related party of the SMSF holding the property as tenants in common, if:

- the interest acquired is business real property of the contributing related party; it is acquired by the SMSF at market value and the SMSF has fewer than five members (that is, the exception in paragraph 66(2)(b) applies); or
- the interest acquired in the property is an in-house asset because it is subject to a lease or lease arrangement between the trustee of the SMSF and a related party, the interest is acquired at market value and the acquisition of the interest does not cause the SMSF to exceed the 5% market value ratio limit for in-house assets (that is, subparagraph 66(2A)(a)(i) applies).

More info



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