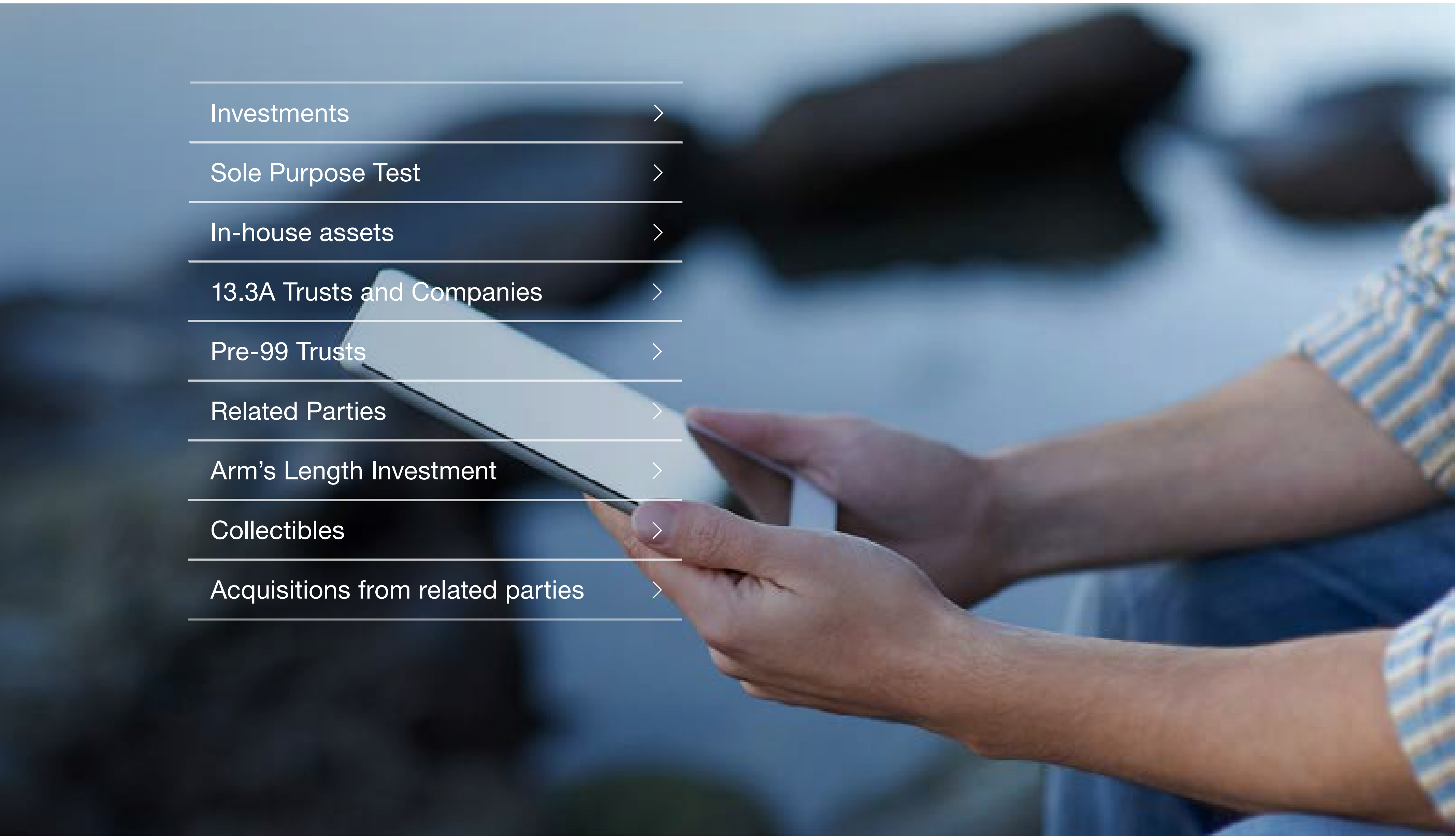
BT Panorama

TechKnowledge

Investments

While establishing an SMSF can give investors great flexibility in relationship to investment decisions, the trustees do not have full discretion regarding investments. The list of things to take into account is extensive. This document provides a summary of some of these considerations.



A major reason that members establish an SMSF is to have a greater control of their retirement benefits, particularly in relation to investment decisions. And while it is true that SMSFs do provide greater flexibility in this regard, the trustees do not have full discretion regarding investments.

The list of things to take into account before making an investment is extensive and a trustee may wish to refer to a checklist such as the one shown on this page.

However, the first point to note is whether the trustee has delegated authority for investment decisions to another party. If so, the investment manager needs to ensure that the investment is made in accordance with the terms of that delegation but the trustee remains ultimately responsible for those investment decisions.

Investment Checklist

- [ ] Is the investment permitted by the trust deed?
- [ ] Is the investment in accordance with the requirements of the fund's investment strategy?
- [ ] Is the purpose of making the investment to further the retirement benefits of the members of the fund ie. Does it satisfy the sole purpose test?
- [ ] Ensure the investment doesn't provide financial assistance or a loan to the fund's members and their relatives.
- [ ] Ensure the investment would not cause the SMSF to breach the 5% threshold for in-house assets.
- [ ] If the trustee is not dealing with the other party of an investment on an arm's length basis, then ensure the deal isn't more favourable to the other party.
- [ ] Is the investment being acquired from a non-related party? Assets may only be acquired from related parties in limited circumstances.

You can request advice from the ATO

SMSF Specific Advice

While trustees should make their best effort to ensure that the investments are compliant with the legislation, it can often be difficult to tell whether a particular investment would be compliant or not.

For example, an SMSF trustee would be able to acquire a property from a member if that property was deemed to be business real property (BRP) but while for most BRP it is obvious that it satisfies the definition, for other properties it is far from clear.

In this case, the trustee could either decide not to proceed with the acquisition or else they could seek further guidance. While the trustee always has the option of seeking legal advice, they also have the ability to go straight to the ATO to seek their opinion before entering the transaction.

This guidance can be sought by using the 'Request for self-managed superannuation fund specific advice available' on the ATO website.

Sole Purpose Test

To comply with the sole purpose test, an SMSF trustee needs to ensure that the fund is maintained to provide benefits for members on or after retirement or after they turn 65, or to provide benefits to their legal personal representative and/or dependants where the member dies before retiring or turning 65.

On or after retirement or after they turn 65

Where a fund is maintained for the above purposes, it can also be used to provide benefits:

- on or after termination of the member's employment.
- after the member has ceased work due to ill health.
- death benefits to the legal representative and/or dependants after the member's retirement or after turning 65.
- other benefits approved in writing by the regulator.

Breaches of the sole purpose test will generally occur where the member and/ or their associates are receiving a benefit, either directly or indirectly, from the fund's investment before they would normally be able to draw a benefit from the fund.

An example of a breach of the sole purpose test can be found in the so-called Swiss Chalet case where an SMSF undertook the following investments:

- Shares in a company which came with the right to play golf and was used for private purposes;
- A Swiss chalet which was used by family members; and
- A beach house that was used for personal family purposes.

In Self Managed Superannuation Funds Ruling 2008/2 the ATO provides a number of examples of what would and wouldn't constitute a breach of the sole purpose test.

An important point to note is that where an SMSF trustee makes an investment which results in an incidental and minor benefit to a member, the fund will not be found to be in breach of the sole purpose test. An example of this might be where shareholders are entitled to a discount card from the company.

In-house Assets

An in-house asset (SIS Act sec 71(1)) is defined in the SIS legislation as:

- 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 the trustee of the fund and a related party of the fund.

While a fund is allowed to acquire and hold in-house assets, subject to the sole purpose test, the total market value of all in-house assets must be no more than the threshold of 5%. If at the end of the financial year the market value of the in-house assets is found to be greater than 5%, whether by a increase in the value of the in-house assets or a decrease in the value of other assets, the trustee must formulate a plan to dispose of one or more in-house assets the following financial year to ensure that the in-house assets fall under the threshold again. The trustee is then obligated to ensure that the steps in the plan are carried out.

Importantly, a trustee must not acquire an in-house asset where it would take the value of in-house assets above the threshold. The breach will occur at the time of the acquisition, not at the end of the financial year.

There are a number of assets (SIS Act sec 71(1)) which are exempted from the in-house asset threshold, including the following:

- business real property subject to a legally enforceable lease to a related party,
- an investment in a widely held trust such as a retail managed fund and
- property owned by the SMSF and the related party as tenants in common.

In addition, other exemptions apply to investments in 13.3A companies and trusts and investments in pre-99 trusts which satisfy the transitional rules.

13.3A Trusts and Companies

Where an SMSF invests in the class of trusts and companies described in division 13.3A of the SIS Regulations, the value of that investment will not count towards the 5% rule. To be eligible for this exemption, the entity must satisfy the following requirements:

- there is no lease, either directly or using an intermediary, between the entity and a related party of the SMSF unless the lease relates to business real property
- has not borrowed funds
- does not have an interest in another entity such as units in a trust or shares
- has not loaned money except as a deposit in a bank
- has not put a charge over any of its assets
- does not conduct a business
- has no asset, other than business real property, which was owned by a related party of the SMSF after the later of
  - 11 August 1999
  - 3 years before the entity acquired the asset

the value of the investment will not count towards the 5%

A 13.3A trust or company is generally used by an SMSF to hold property with a related party. For example, an SMSF could acquire 20% of the units in a 13.3A trust and a member could acquire the other 80%. The trust could use the funds to acquire a property.

While an SMSF and a member can own a property as tenants-in-common, the SMSF would be prohibited from acquiring further interests in the property. However, by using a 13.3A trust, the member could sell their units over time to the SMSF.

Furthermore, these trusts are also becoming popular as part of Limited Recourse Borrowing Arrangement strategies to get around the prohibition on replacing the acquired asset.

Pre-99 Trusts

On 11 August 1999 legislation was introduced to broaden the definition of in-house assets so that investments in related trusts could be considered in-house assets. However, at this time the government exempted existing loans and investments from the new rules where they were not considered an in-house asset just before the new rules came into effect.

> the new investment will be subject to the threshold 5%

Where an SMSF increases its investment in a pre-99 trust, only the value of the new investment will be considered an in-house asset and subject to the 5% threshold. The previous holding will remain grandfathered.

In addition, where an SMSF's investment in a pre-99 trust satisfies the transitional rules, the trust can continue to invest outside of the in-house asset rules. Therefore, the trust could acquire a holiday property and lease it out to related parties at market rates without that property being counted as an in-house asset.

In addition, pre-99 trusts are not subject to the prohibition on borrowing and therefore, they can increase their lending or even take out new borrowings.

While these trusts initially appear to provide great flexibility, there are still many SIS rules to be complied with. Investments made by the trust should be prudent to ensure that the SMSF's investment in the trust will be considered as satisfying the sole purpose test.

Further, the ATO have stated that they will look through interposed entities to ensure that the fund complies with its obligation not to provide financial assistance to a member or their relative.

Who are the related parties of an SMSF?

Related Parties

We need to understand who are related parties of an SMSF for two reasons, to ensure compliance with the acquisition from a related party rules and to determine the in-house assets.

A related party is defined in the SIS Act sec 10(1) as:

- Fund member
- Standard employer-sponsor of the fund or
- Part 8 associate of a fund member or a part 8 associate of a standard employer-sponsor of the fund.

A standard employer sponsor of a fund is an employer who contributes to the fund due to an agreement between the employer and the trustee of the fund. Where an employer only contributes to a fund due to an agreement between the member and the employer such as under a salary sacrifice arrangement, they will not be considered a standard employer sponsor.

If an SMSF has a standard employer sponsor, which would be uncommon, the relationship will be noted either in the trust deed or in an attached schedule to the deed.

Part 8 associate

Part 8 associates are broken down in the legislation to Part 8 associates of individuals, companies and partnerships. However, if there is no standard employer sponsor, we only need to examine the part 8 associates of the members which will always be individuals. The part 8 associates of a member are:

1. a relative of the member (parent, grandparent, brother, sister, uncle, aunt, nephew, niece, linear descendant or adopted child of the member or their spouse or a spouse of the aforementioned)
2. other members of the SMSF (and other trustees/ directors of a corporate trustee of the fund)
3. a partner of the member (legal partnership, not 'business partners' i.e. company directors) and their spouses and children
4. the trustee of a trust the member controls and
5. a company sufficiently influenced by, or in which majority voting interest is held by the member and their Part 8 associates either individually or together.

50%

A member of the fund will be deemed to control a trust where the member and/or their part 8 associates are:

- entitled to a fixed entitlement of more than 50 per cent of the capital of the trust,
- entitled to a fixed entitlement of more than 50 per cent of the income of the trust,
- able or accustomed (formally or informally) to direct the trustees to act in accordance with their directions or
- able to appoint or remove trustees.

A company will be deemed to be controlled by a member where the directors are accustomed or under an obligation to act under the instructions of the member and/ or their Part 8 associates or the member and/ or their part 8 associates have more than 50 per cent of the voting rights.

Non arm's length income may be taxed at the top rate

Arm's Length Investment

The arm's length investment rule (SIS Act sec 109) states that an SMSF trustee must deal with the other party to an investment transaction at arm's length or where they aren't dealing at arm's length, the terms of the transaction are no more favourable to the other party than they would have been if they were dealing at arm's length.

A good example of the issues to be taken into account can be found in ATO ID 2012/162 which looked at the consequences of a related party financed limited recourse borrowing arrangement (LRBA) where the interest charged was less than market rate.

In this case the parties were found to not be dealing with each other at arm's length, however they were not in breach of the legislation as the terms were more favourable to the SMSF, not the other party.

Importantly, trustees need to be mindful of two recent ATO Interpretative Decisions (ATO ID 2014/39 & 40) that demonstrate that if related party loans are not made on commercial terms the income received by the SMSF from the LRBA may be classified as non arm's length income and subject to tax at the top marginal rate.

Collectibles

While SMSFs have always been permitted to invest in collectibles and continue to be able to do so, since 1 July 2011 there have been new requirements to be satisfied. These requirements apply immediately to collectibles acquired from 1 July 2011 and collectibles owned by the SMSF at that time are subject to transitional rules and will only need to comply with the rules from 1 July 2016. The requirements are that the fund:

- must not lease the item to a related party
- must not store the item in the private residence of related party
- must keep a written record for 10 years of the reasons for its decision on storing the item
- must insure the item with 7 days of acquisition in the name of the fund
- must not allow a related party to use the item
- must obtain a market valuation from a qualified independent valuer when transferring the item to a related party

Collectibles are defined in the SIS regulations as:

- artwork (within the meaning of the Income Tax Assessment Act 1997)
- jewellery
- antiques
- artefacts
- coins, medallions or bank notes
- postage stamps or first day covers
- rare folios, manuscripts or books
- memorabilia
- wine or spirits
- motor vehicles
- recreational boats
- memberships of sporting or social clubs.

Acquisitions from related parties

SMSFs are generally prohibited from acquiring assets from related parties due to section 66 of the SIS Act however there are a number of exceptions including:

- listed securities
- business real property
- in-house assets which wouldn't take the fund over the 5% threshold
- investment in widely held trust such as a retail managed fund
- investments in 13.3A companies and trusts

In addition, where acquisitions are allowed they are generally required to be valued at market value for the purpose of the transaction though the ATO has not given guidance on how market value is to be determined. A proposal requiring formal valuations at the time of acquisition was never enacted though, particularly for large difficult to value assets such as business property, a formal valuation may be prudent.

in-house assets stay under the threshold 5%

Importantly, schemes to avoid this legislation are treated very seriously. An example of such a scheme would be where a member transfers a residential property to an entity unrelated to the SMSF before acquiring it by the SMSF.

Finally, the restrictions are all on acquisitions from related parties, there are no equivalent restrictions on disposals to related parties. Therefore, where an SMSF owned a residential property, they could sell that property to a member. And if the member had access to their superannuation, the trustee could transfer the property as a benefit payment. Importantly, in-specie payments can only be made as lump sum payments as pension payments have to be made from cash.

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