I ❤ SMSF | THE STRATEGIST
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SMSF's and Property Strategies

1. Introduction

Welcome to the second edition of The Strategist and this edition's topic – *SMSF's and Property Strategies*[1] .

Upfront let me say unashamedly that over the past 25 years I have seen and been involved with over $5 billion of SMSF property deals from the $1M purchase of residential property to joint ventures and unit trusts worth more than $100M. I can guarantee that there is no one more experienced than I in Australia when it comes to SMSF's and Property. It has become my specialty and with more than $100 billion currently invested by SMSF's in property – residential, commercial, rural, retirement homes and holiday, the strategies are challenging, exciting and for an adviser, highly profitable.

Did you know that an SMSF Trustee can be fully empowered under the rules of the Fund (i.e. the trust deed), the sole purpose test and the Commissioner of Taxation to run and maintain a property development business?

That's something that I have argued since I first started in SMSF's in 1993. Yet even today, 99.9% of advisers and accountants shy away from an SMSF running a business. But the Commissioner has given his imprimatur - https://www.ato.gov.au/super/self-managed-super-funds/investing/carrying-on-a-business-in-an-smsf/ Of course from an advisory perspective, it is not that simple and there are a lot of hurdles when you take the non-arm's-length income rules plus the myriad of tax, bankruptcy and credit laws into account. But it is doable and FUN!

After all, how many property developers are doing it the hard way by using companies, upon their accountant's advice, to do their developments? Try ALL! Dumb move all around plus huge taxes with profits subject to 30% tax and any dividends subject to marginal tax rates with franking credits. *Far, far better to use the low tax rates in an SMSF* which includes the tax exemption on pension assets (subject to the member's TRBA) and the discounted capital gains tax on the disposal of property accumulation assets. For a property developer there is no

[1] With SMSF's and Property there are a lot of twists, turns and strategies, so make sure that you grab yourself a coffee and your SMSF advice team and listen to the SMSF and Property podcast or webinar focused on SMSF's and Property in the membership section of www.ilovesmsf.com.

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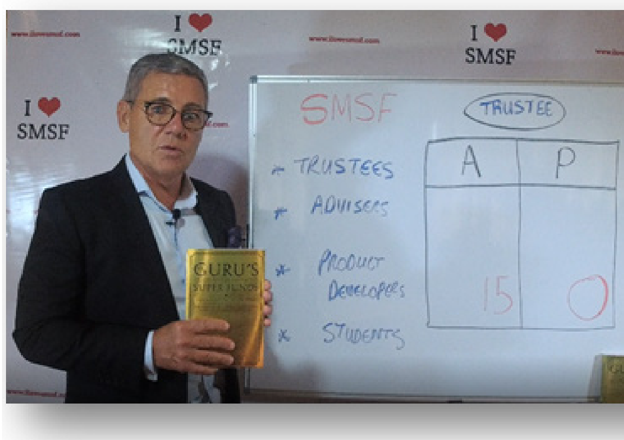
CGT discount as all profit is on revenue account. Plus, what asset protection is there in a company – it's either administration or liquidation if something goes wrong or horribly bad.

If you could only show small and mid-size developers a better way using an SMSF - that's a huge, highly-profitable niche that has our ex-legendary financial planner and Market Development Director, Phil Manhire salivating.

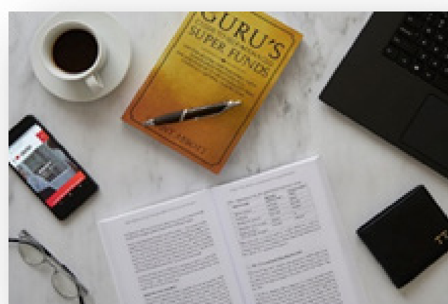
If you are a serious SMSF Strategist or a Family SMSF Adviser then you have to be on top of the ins and outs of property renovation, development and syndication. There is no other choice and a great place to earn your chops is right here with this Strategist and of course, I Love SMSF.

2. The Insider's View of SMSF and Property



Looking after the technical needs of our Strategist and Family SMSF Adviser members is a challenge but one that gets me up early in the morning building solutions, strategies and looking at a set of facts and circumstances in a hundred different ways. *Something, thank goodness, that AI can't do, yet.* In the end, there is not much I have not seen or done in my last 25 years in the SMSF property field and expect to be doing all and more in the next 25 years. Seriously who has time for retirement when you are having so much fun!

3. A Day in the Life of a Strategist



As a Strategist, there are a few things you need to get you to optimal strategy projections and creation. A coffee to get your mind started, the I Love SMSF website to research a video or two on a client issue or brainwave that you might have had plus a copy of The Guru's Guide to SMSF's to check that you are heading in the right direction.

4. The Scope of Property and SMSF-Transactions

There are various types of SMSF Property transactions that I have seen and they can generally be boiled down into the following.

4.1 Investing or Developing Directly

This is a tough one for the Trustee of an SMSF as it means taking on all of the risk but on the other hand, all of the reward. More importantly, it means that the Trustee retains control. Some of the various

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types of property transactions that an SMSF Trustee may undertake alone include:

- **Residential property investment:** In general, an investment by a Trustee of an SMSF is not an income play as income yields on residential property are very low. But if you get the cycle right, it can prove a great long-term capital gains play. A smart adviser will be running separate investment strategies, so residential property is best singled out on the acumulation side of the fence, particularly if there is a borrowing and the tax profile of the property is in the red with excess deductions being able to be be used for sheltering contributions tax in the fund. Plus if there is a pension and there is an LRBA, the outstanding liability becomes a credit to the pension members' TBA.

- **Commercial Property:** This is an income play although over the past few years the yields have been dropping where some commercial properties are yielding only 5%. Historically 8% - 11% is the norm and a great asset to back an income stream. So it is a must-use play for separate investment strategies where a pension is in the fund. But unlikely to have a big capital gain. Be careful of any outstanding LRBA balance as it will be apportioned as a credit to the pension member to the extent the property is sitting as part of Fund pension assets.

- **Business Property:** There is more than $40 Bn of business property such as factories and offices held by SMSF's and leased back to members or related parties of the Fund. In that regard section 66 provides a specific exemption in terms of the prohibition of the acquistion of related-party assets by the Trustee of an SMSF. In addition, section 71(1) excludes business real property from the in-house assets provisions of the SISA.

- **Farming Property:** This is more of a family farming business play and one where the farm is to stay in the Family for years to come. It is crucial to point out here that the "farming business" never gets put into the SMSF – too risky and dangerous. It is better to keep the farming business in a Family Trust with the farm in the Fund supporting a pension (if possible). The Family Trust will then pay the Family SMSF a deductible rent which is not a contribution.

Family SMSF, Family Trust and Family Farm – Perfect Partnership

Family SMSF Leading Member John aged 70 and his spouse Sally aged 66 are in the Smith Family SMSF. They were working graziers but have transferred the farming business to their son Mathew, aged 40, who is also a member of the Fund.

The property sits in the Family SMSF for the benefit of John and Sally who are both retired, have pensions with reversions to each other, then to Mathew upon their death to ensure the property is transferred to the son working the farm. Mathew has two children, Ben aged 17 and William aged 13 at boarding school,

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runs the business through the Family Trust and still employs John and Sally, paying them $70,000 pa each by way of a super contribution. John and Sally have more than $500,000 in dividend-paying stocks in the Fund and these are used to cover their contributions tax and that of Mathew, plus deductible Family Trust contributions made for Ben and William who do vacation work on the farm. John and Sally's daughter, Marie, is also a member of the Fund but has her own investment strategy.

John and Sally use part of their pension benefits to pay a school allowance directly to Ben and William to cover boarding and school fees. In their SMSF Wills, apart from the property to go to Mathew, a lump sum is payable to Marie with the grandchildren also paid a benefit, as an income stream or lump sum. At this point in time, John and Sally have been advised that their grandchildren are their financial dependants, while Marie and Mathew are not.

Key Issues with the Fund going it alone – Tread Carefully

It is not all plain sailing with the Fund going it alone and borrowing is a big issue. Just to let you know, we cover borrowing in extensive detail in this edition so we will not dwell on it too much here. However from a macro point of view, the limited recourse borrowing provisions in section 67A of SISA are tight and restrictive and with banks no longer lending to SMSF's, related-party or fringe third-party lenders make things tougher. There are some important issues the Trustee needs to look at upfront before getting into any property transaction.

a) Investment Strategy: This is generally an internal weakness of most superannuation funds for two reasons. Firstly, the Fund is not set up to run separate investment strategies, which is a significant strategic flaw with the TBA laws. Secondly, section 52B of SISA and the Commissioner of Taxation require detailed investment strategies for the Fund, yet so many Trustees run with one page, pseudo investment strategies that leave the Fund, adviser and members high and dry. Plus how is it possible to do an investment strategy that is executed and implemented months after the time it was meant to be put in place?

b) Death of a Member: What happens in the Fund if a key contributing member of the Fund dies, particularly if the property is part of or a large percentage of their superannuation benefits? If the spouse remains alive, such that a pension can be paid and the property left within the Fund. However, if it has to be passed out, then if not as a whole because it is being used by the Trustee to back other members' assets, then a joint venture between the dependant and the Fund may be required.

c) LRBA problems: If there is an LRBA in place this will generally need to be paid off. Ideally, life insurance to cover the member's death would extinguish the debt but what happens if there is no life insurance and the property has to be

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passed out of the Fund as a death benefit?

Specific insurance to cover outstanding LRBA liabilities are a MUST but can be problematic. This is due to the requirements of SISR 4.07C and 4.07D that the trustee of a regulated superannuation fund is prohibited from providing members with insured benefits other than those that satisfy the conditions of release in Schedule 1 of the SIS Regulations for death, terminal medical condition, permanent incapacity and temporary incapacity. However, as with any SMSF problem, there is always another way and nothing is too hard. You just have to look for a solution.

4.2 Special Purpose Related Vehicle – SIS Reg 13.22C Trust or Company

This is a unique structure and purpose built for SMSF's seeking to invest in a wholly-owned unit trust that is exempt from the in-house assets provisions. To that end, the SISR 13.22C provides an exception for a specific type of related trust or company (wholly-owned or exceeding the 50% rule) which can be owned by the SMSF Trustee and not breach the in-house assets test.

In that regard the key conditions for the SIS Reg13.22C Trust or Company are as follows:

i) There is no borrowing in the Trust or the Company including overdrafts and unpaid present entitlements or dividends.

ii) There is no guarantee or charge over the assets of the Trust or Company.

iii) The assets of the Trust cannot include any investment in another entity such as a publicly listed share, Managed Fund, cash management trust, unit trust investment, etc. This limits the investments to property – residential, holiday, business or rural but excludes an investment in a property trust.

iv) The Trust or Company does not carry on a business at any time. If it starts as an investment trust or company and then through its activities grows into an investment business then SISR 13.22D would see it void its exemption and be caught under the in-house assets test.

v) There is no lease of any asset of the Trust or Company to a related party unless it is business real property.

This structure is great if there are enough finances to hold passive property. In addition, it can be structured to include both income and capital units. This can make a huge difference where the Trustee of a Fund is using separate investment strategies. It makes practical, common and tax sense to place the capital units in the member's accumulation or retirement accumulation account and the income units in the member's pension account. This cannot be achieved with direct property in the Fund, so if no borrowing is required, then the SIS Reg 13.22C trust is a preferred vehicle. A little more costly in terms of accounting fees but well worth it and for a Family SMSF with different generational members, it is a no-brainer.

Having units rather than direct property also makes the process of passing out superannuation death benefits easier administratively, as it is the transfer of units, not part of any property. Advanced estate planning can see the SIS Reg

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13.22C created on death if need be.

In terms of borrowing it is a strategy killer, however, a related-party borrowing can be provided on the units or shares in the SMSF. Remember, the borrowing has to be in relation to the acquistion of the units or the shares plus the underlying asset cannot be subject to a charge.

Property Development and Special Purpose Related Trusts

Small scale property development or more a "flipping" style of strategy is best employed in a SIS Reg 13.22C company or trust as SIS Reg 13.22D breaks the in-house exemption if there is a business carried on by the Trustee. It may be better to hold the property in the SIS Reg 13.22C trust and have the development carried on by the Family Trust or external developer who can access borrowed monies. But remember again, the asset in the SIS Reg 13.22C trust cannot be charged or mortgaged.

Sweet Strategy: Transferring Related--Party Units into an SMSF

Section 66 of SISA is nasty and prohibits the Trustee of an SMSF from acquiring an asset from a member, Trustee or related party. There are some widely known exceptions to the rule including listed shares, listed units and business real property. However, one of the lesser known exceptions is the ability for the SMSF Trustee to acquire units and shares in a SIS Reg 13.22C trust or company. This is a sweet strategy as it enables a member and SMSF to invest in residential property by way of a SIS Reg 13.22C company or trust and then over time the member can contribute their units or shares into the SMSF.

4.3 Unrelated Investment Vehicles – Trust, Company and JV

I remember setting up numerous managed property funds in the late 1980's when working at KPMG as a tax consultant. Some of my clients were the biggest property fund managers in the game including Mirvac, Citibank and Barclays and the deals were in the hundreds of millions of dollars. The traditional structure was a unit trust with the development completed in the trust, using outside builders and the properties held or sold post development. In most of the unit trusts there were three different investment options:

i) **Developer units** where the unitholders acted in concert with the developer and took development profits out of the deal. Risky but highly rewarding with returns of up to 30%.

ii) **Mezzanine finance** where investors lent to the Trustee of the unit trust to finance construction funding. Again a great return if the development finished but if the development or builder goes broke the mezzanine bond holders lose their shirt. Westpoint.

iii) **Investment units** which come into play post development. These may be

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both an income and capital gains play depending on the underlying property class.

Similar structures can be put into play on a much smaller scale with one or more core SMSF unit holders, provided an SMSF and related entities does not control the unit trust or company. Any control would render the shares or units as in-house assets and the strategy a disaster. For a company, control is defined in section 70E(1) to be:

a) a company is sufficiently influenced by an entity or entities if the company, or a majority of its directors, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); and

b) an entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

For a unit trust, control is seen in section 70E(2) of SISA to be:

a) a group in relation to the entity has a fixed entitlement to more than 50% of the capital or income of the trust; or

b) the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); or

c) a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust.

Where there is no control, the SMSF investor is independent of the unit trust or company and these property structures can be used for development and any other property purposes, including the use of borrowings and construction finance.

A **Joint Venture** is simply a partnership between an SMSF and a developer. The key features are generally:

- The SMSF puts up the property as its capital contribution to the partnership.
- The developer or builder contributes the construction of the relevant buildings on the property.
- The developer takes on the borrowing with the SMSF Trustee acting as a passive partner.
- At the end of the project the profits are split or the SMSF may choose to keep some of the properties – usually strata titled apartments as its reward from the development.

5. Borrowing in an SMSF

Now when it comes to property, I have found that there is always a borrowing

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somewhere along the line. As we have seen above, it may be in a syndicated unit trust or company that does not breach the in-house assets rules, a JV where a family trust or other vehicle borrows in its own right, a borrowing by an SMSF on units in a 100%-owned unit trust that qualifies as a non-in-house asset under SIS Regulation 13.22C or the now ubiquitous limited recourse borrowing arrangements ("LRBA"). Borrowings, if done correctly, can increase the profit potential on any property or property development but if not completed correctly, may open the Trustee to serious SMSF compliance issues and at worst case, the application of the new Non-Arm's-Length Income ("NALI") rules to the transaction. The practical and nasty part of NALI is that if a transaction or arrangement is cast as NALI, then all income and capital gains from the disposal of the NALI-cloaked investment are subject to tax at 47%.

Borrowing in an SMSF is limited. In that regard, section 67 of SISA prevents a Trustee of an SMSF from borrowing money except on a short-term basis to meet a securities settlement or to pay out a member's benefits. The criteria for these short-term exemptions can be found in s67 of SISA and not the subject of this property discussion. But section 67A is ....

6. Exempt Limited Recourse Borrowing Arrangements

Apart from the short-term lending exemptions, a broader borrowing exemption can be found in section 67A [2]. In summary, s67A provides that a Trustee of a superannuation Fund may borrow monies where the following conditions are met:

6.1 The borrowing must be for a Single Acquirable Asset

The Trustee can only borrow for the purpose of acquiring a single acquirable asset such as property. A share in a company or unit in a unit trust is a single acquirable asset also, which means a separate borrowing must be established for each share or unit which in turn, can be an expensive exercise although the use of instalment warrants lightens the load (see below in relation to related-party instalment warrants). In addition section 67A(3) of SISA extends the meaning of single acquirable asset to any collection of assets including shares or units where:

(a) the assets in the collection have the same market value as each other; and

(b) the assets in the collection are identical to each other.

For example, a redeemable preference share could not be part of a collection of ordinary class shares and "A Class units" with pre-emptive voting rights cannot be part of a collection of all the "B Class units" in a unit trust.

One of the features of the exception to the single acquirable asset rules for a collection is that a collection must be treated as a single asset. This means

[2] The Commissioner of Taxation has released an extensive ruling on limited recourse borrowing arrangements - SMSFR 2012/1.

that if one of the shares/units is sold – all of the collection must be sold, there is no half-way house. *A word for the wise*, if you are advising on using the collection exemption then parcel up the assets into smaller parcels so that they can be disposed of easily. This overcomes the problem of being locked into a major disposal when a small cash flow bump is hit.

Commissioner of Taxation View – Single Acquirable Asset

Wherever possible, we shall use examples from Commissioner's rulings or the Explanatory Memorandum to the borrowing legislation to elaborate on a point. These examples are crucial to an understanding of what the parliament meant in enacting the legislation and also, how the Regulator intends to regulate it.

SMSFR 2012/1 - Single Acquirable Property Example - Property over more than one Title

ATO Example - a factory complex on more than one title

A Trustee of an SMSF wants to enter into an LRBA to acquire a factory which is constructed across three titles. The existence of the factory adds considerably to the value of the land and thus is a significant part of the value of the asset. The factory is therefore relevant as a unifying physical object.

The factory and the land comprised of the three titles, is a single acquirable asset and can be acquired under a single LRBA. However, if the factory was derelict and thus not of significant value relative to the land, this asset could not be acquired under an LRBA as the factory is not relevant as a unifying physical object and thus the assets are the three titles.

Equity and Unit Trust Instalment Warrants are LRBA's where an umbrella trust deed provides single acquirable asset status over one or more equity investments. This enables built-in borrowing with the added benefit that distributions or dividends may be used to pay interest and capital on the borrowing. There are a number of investment banks that parcel up ASX instalment warrants for use by SMSF's. Importantly, a related party financed instalment warrant can be built for a range of equity investments owned by a member or related party for transfer into an SMSF. For example, a member may acquire a residential property with units owned jointly by the SMSF Trustee and the Family Trust. There is no borrowing in the unit trust to ensure it meets the requirements of SIS Regulation 13.22C. However, the borrowing can be a related party LRBA on the units of the SISR 13.22C trust[3].

[3] The ATO guideline PCG 2016/5 discussed below has been expanded upon by the new NALI laws so the safe harbour offered by the Commissioner is not the be all and end all of related-party borrowing. It is simply one agreed method of accepting that an arm's-length transaction has occurred.

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6.2 Refinancing a LRBA

The borrowing may be for the purpose of the acquisition of the single acquirable asset or *importantly, enabling a refinancing of an existing borrowing arrangement*. Refinancing can include the transfer of a current commercial arrangement to a related-party lender, provided the loan is documented and under the same terms and conditions. Provided of course that the refinancing arrangement meets the conditions of s67A which is as follows:

Section 67A (1) (a)(ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset).

Every Deal needs to be signed off: A big deal came across my table recently where a related-party loan was being refinanced which included an accrued interest entitlement. However, the loan was also for future capitalised interest on the refinanced loan, yet to be commenced. The question was whether the interest could be capitalised on the loan or was the refinanced loan limited to the accrued interest only. It could be said that the capitalised interest was a borrowing on the refinanced loan contract and thus not in relation to the original single acquirable LRBA asset. In the end it was not an issue as the arrangement did not make it past NALI. A word of warning - when dealing with any property issue get legal sign-off to protect your business, professional life and personal assets. Of course, TGA Legal is ready and willing to provide advice but one of the best sources of legal advice is a Private Ruling from the Commissioner of Taxation – inexpensive and relatively quick.

6.3 Borrowing includes Incidental Costs plus Current and Future Repairs

The borrowing can cover the acquisition price, any legal or other fees in relation to the acquisition such as stamp duties plus repairs – current or future repairs of the asset. This may see an SMSF loan including the provision of future draw-downs to cover repairs. BUT repairs do not include improvements to an asset. The difference between a repair and an improvement is extensively covered by the Commissioner of Taxation and he provides the following guidelines for residential property:

SMSFR 2012/1 – Repair v Improvement

Residential Property Repair

A fire damages part of the kitchen (cooktop, benches, walls and ceiling). Restoration (replacement) of the damaged part of the kitchen with modern equivalent materials or appliances would constitute repair or restoration of a part of the entire asset, being the house and land.

If superior materials or appliances are used it is a question of degree as to whether the changes significantly im-

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prove the state or function of the asset as a whole. For example, the addition of a dishwasher would not amount to an improvement, even if a dishwasher was not previously part of the kitchen, on the basis that this is a minor or trifling improvement to the state or function of the asset as a whole.

Residential Property Improvement

If the house was extended to increase the size of the kitchen this would be an improvement. If, as well as restoring the damaged part of the internal kitchen (a repair), a new external kitchen was added to the entertainment area of the house, the external kitchen would be an improvement.

Funding an Improvement under an LRBA

S67A does not allow a Trustee of an SMSF to borrow to complete an improvement. This means that any improvement must be completed by the Trustee of the Fund from the assets or monies of the Fund. An external party, such as a member, may also fund the improvement, however, this would see the market value of the improvement, in terms of its impact on the property, being treated as a contribution – which can get murky administration and audit-wise. If there is no cash in the Fund, then consider contributing cash into the Fund by a member or on behalf of a member, to improve the property. Ensure the investment strategy of the Fund and also, the trust deed, allows the improvement to take place.

6.4 Legal Asset Title to be held on Bare Trust

Although the Trustee of the SMSF is borrowing to acquire the single acquirable asset ("SAA"), the legal title of the SAA must be held under a trust arrangement. This provides protection for the Trustee of the Fund such that they cannot be sued directly in the event of default under the loan agreement – a true limited recourse borrowing arrangement. The Commissioner in his guidelines has produced the following explanation of the type of trust required:

The Commissioner's Q&A

Does the super law specify the type of trust that must be used as the holding trust in a limited recourse borrowing arrangement?

No. The law specifies only that the SMSF Trustee must have a beneficial interest in the asset being held in the holding trust and the right to acquire legal ownership of that asset after making one or more payments. Additionally, for the special in-house asset rule to apply, the asset must be the only property of the holding trust.
More complex trusts are unlikely to satisfy the requirement that the SMSF Trustee has the necessary interest in a particular asset of the holding trust. For example, a discretionary trust could not be used nor could the SMSF Trustee be one of a number of unitholders in a unit trust.

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6.5 Lender has access only to LRBA Asset for Lending Recourse

The lender is to have recourse only against the property, the subject of the borrowing. Coupled with the Holding Trust this prevents the Trustees of the SMSF being sued for any outstanding borrowing and the remaining assets of the Fund being used as security for the borrowing.

For example, the Trustee of the Smith SMSF borrows $250,000 to acquire an office property valued at $500,000 from SMSF's Bank. The borrowing is an LRBA and due to the key member of the Fund being retrenched, the cash in the Fund has hit rock bottom with no further contributions able to be made. With the current property unable to be leased, the Trustee cannot repay any borrowings. The Bank forecloses on the property and fire sales the property for $400,000. After outstanding fees, repayments and costs, the Trustee of the Smith SMSF receives $150,000.

If the property had declined in value and the fire sale proceeds were only $200,000, the Bank would be precluded from suing the Trustee of the Smith SMSF for the outstanding loan amounts. However, it should be noted that most banks will generally require a personal guarantee from members as non-SMSF parties to cover any possibility of a default. Personal guarantees do not breach the LRBA laws in section 67A.

The Explanatory Memorandum to the introduction of the LRBA laws in 2010 noted the following in terms of recourse by the lender or guarantor in the event of a default of the LRBA by the Trustee of the SMSF:

"Paragraph 67A(1)(d) will ensure that the rights of the lender or any other person against the RSF Trustee are limited to rights relating to the acquirable asset. No guarantee arrangement can be enforceable against the RSF Trustee other than the rights relating to the acquirable asset.

Paragraph 67A(1)(f) will ensure that the acquirable asset cannot be subject to any other charge than that associated with the direct borrowing arrangement.

With the exception of the asset that is the subject of the borrowing arrangement, the assets of the superannuation fund cannot be given as security for a borrowing without breaching regulation 13.14 of the Superannuation Industry (Supervision) Regulations 1994."

6.6 Related-Party LRBA – Allowed or Not?

The LRBA rules have never precluded related-party borrowing, neither the original LRBA lending arrangements in section 67(4A) or its predecessor – section 67A of SISA introduced in 2010. In fact, the Commissioner's guidelines on related-party loans states as follows: *Is an SMSF allowed to borrow from a related party?*

The law does not prohibit the lender from being a related party. However, SMSF's must continue to comply with other legislative requirements. For example, the SMSF must satisfy the sole purpose test and comply with existing investment

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restrictions, such as those applying to in-house assets and prohibitions on acquiring certain assets from a related party of the Fund.

Does interest on a borrowing from a related party need to be at commercial rates?

A Trustee of an SMSF or its investment manager must ensure that all investments are conducted on an arm's-length basis or, if the parties are not at arm's length, that the terms of the investment are no more favourable to the other party than they would be if the parties were dealing at arm's length.

This means that an SMSF Trustee or investment manager cannot allow a related-party lender to charge the Fund more than an arm's-length rate of interest under the arrangement.

The SMSF Trustee must be able to demonstrate that the SMSF was not paying in excess of an arm's-length rate of interest to a related party. *The calculation of a rate that represents an arm's-length rate of interest needs to be based on reasonably objective and supportable data – for example, the rates charged by arm's-length financial institutions for a similar borrowing.*

Paying a member or relative of a member an excessive rate of interest would also contravene the prohibition on SMSF Trustees giving financial assistance to members or their relatives using the resources of the SMSF.

6.7 Discounted and Zero Interest Loans

The issue of loans at less than market value interest rates, created considerable discussion from the time of the introduction of limited recourse borrowing arrangements in 2007. This was further exacerbated by the Commissioner, stating that a less than market interest rate was not a contribution, nor did it breach the non-arm's-length provisions in section 109 of SISA. This created a tidal wave of loans that were offered by related parties to Trustees of SMSF's at less than market value interest rates.

The Commissioner stemmed the tide when he released guideline PCG 2016/5 stating that a less than market interest rate was non-arm's-length income ("NALI"). The Commissioner noted in the guideline that:

"When an SMSF acquires an asset under an LRBA, the non-arm's-length income (NALI) provisions in s-295-550 of the ITAA 1997 may apply to ordinary or statutory income generated from the asset, if the terms of the LRBA are not consistent with an arm's-length dealing. This Guideline sets out the 'Safe Harbour' terms on which SMSF Trustees may structure their LRBA's consistent with an arm's-length dealing. That is, for income tax compliance purposes, the Commissioner accepts that an LRBA structured in accordance with this Guideline is consistent with an arm's-length dealing and that the NALI provisions do not apply purely because of the terms of the borrowing arrangement."

The Commissioner's guideline requires the Trustee of the Fund and the related-party lender to restructure any existing related party loan, to accord with published safe harbour provisions or, the

quantum of NALI is to be taxed at the highest marginal personal income tax rates – which for the year beginning 1 July 2017 onwards is 47%.

The safe harbour provisions as published are:

ATO: PCG 2016/5 Safe Harbour Provisions:

Safe Harbour for Property

	ATO Acceptable Terms
Interest Rate	Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors. Applicable rates: • For the 2015-16 year, the rate is 5.75% • For the 2017 and 2018 it is 5.8% and for later years, the rate published for May (the rate for the month of May immediately prior to the star of the relevant financial year)
Fixed and Variable Interest Rates	Interest rate may be variable or fixed: • Variable – uses the applicable rate (as set out above) for each year of the LBRA • Fixed – Trustees may choose to fix the rate at the commencement of the arrangement for a specified period, up to a maximum of 5 years. The fixed rate is the rate published for May (the rate for the May before the relevant financial year). The 2016-17 rate of 5.8% may be used for LRBA's in existence on publication of these guidelines, if the total period for which the interest rate is fixed does not exceed 5 years (see 'Term of the loan' below)

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Term of the Loan	• Variable interest rate loan (original) – 15-year maximum loan term (for both residential and commercial) • Variable interest rate loan (re-financing) – maximum loan term is 15 years less the duration(s) of any previous loan(s) relating to the asset (for both residential and commercial) • Fixed interest rate loan – a new LRBA commencing after publication of these guidelines may involve a loan with a fixed interest rate set at the beginning of the arrangement. The rate may be fixed for a maximum period of 5 years and must convert to a variable interest rate loan at the end of the nominated period. The total loan term cannot exceed 15 years. • For an LRBA in existence on publication of these guidelines, the Trustees may adopt the rate of 5.8% as their fixed rate, provided that the total fixed-rate period does not exceed 5 years. The interest rate must convert to a variable interest rate loan at the end of the nominated period. The total loan cannot exceed 15 years.
Loan to Value Ratios	• Maximum 70% LVR for both commercial and residential property • If more than one loan is taken out to acquire (or refinance) the asset, the total amount of all those loans must not exceed 70% LVR. • The market value of the asset is to be established when the loan (original or re-financing) is entered into. • For an LRBA in existence on publication of these guidelines, the Trustees may use the market value of the asset as at 1 July 2015.
Loan Security	A registered mortgage over the property is required
Personal Guarantee	Not Required
Repayments	Each repayment is of both principal and interest. Repayments are monthly
Is a Loan Agreement Required?	A written and executed loan agreement is required

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Safe Harbour for Listed Shares and Managed Funds

LRBA Condition	ATO Acceptable Terms
Interest Rate	Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors plus 2%. Applicable rates: • For the 2015-16 year, the interest rate is 5.75% + 2% = 7.75% • For the 2017 and 2018 it is 7.8% and later years, the rate published for May plus 2% (the rate for the month of May immediately before the start of the relevant financial year)
Fixed and Variable Interest Rates	Interest rate may be variable or fixed: • Variable – uses the applicable rate (as set out above) for each year of the LBRA • Fixed – Trustees may choose to fix the rate at the commencement of the arrangement for a specified period, up to a maximum of 5 years. The fixed rate is the rate published for May (the rate for the May before the relevant financial year). • The 2015-16 rate of 5.75% may be used for LRBA's in existence on publication of these guidelines, if the total period for which the interest rate is fixed does not exceed 5 years (see 'Term of the loan' below)
Term of the Loan	• Variable interest rate loan (original) – 7-year maximum loan term • Variable interest rate loan (re-financing) – maximum loan term is 7 years less the duration(s) of any previous loan(s) relating to the collection of assets • Fixed interest rate loan – a new LRBA commencing after publication of these guidelines may involve a loan that has a fixed interest rate set at the beginning of the arrangement. The rate may be fixed up to for a maximum of 3 years and must convert to a variable interest rate loan at the end of the nominated period. The total loan term cannot exceed 7 years. • For an LRBA in existence on publication of these guidelines, the Trustees may adopt the rate of 7.75% as their fixed rate, provided that the total period of the fixed rate does not exceed 3 years. The interest rate must convert to a variable interest rate loan at the end of the nominated period. The total loan cannot exceed 7 years.
Loan to Value Ratios	• Maximum 50% LVR • If more than one loan is taken out to acquire (or refinance) the collection of assets, the total amount of all those loans must not exceed 50% LVR. • The market value of the collection of assets is to be established when the loan (original or re-financing) is entered into. • For an LRBA in existence on publication of these guidelines, the Trustees may use the market value of the asset as at 1 July 2015.

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Loan Security	A registered charge/mortgage or similar security (that provides security for loans for such assets).
Personal Guarantee	Not Required
Repayments	Each repayment is of both principal and interest. Repayments are monthly
Is a Loan Agreement Required?	A written and executed loan agreement is required

6.8 Related Party Loans – Commissioner's Questions and Answers

a) Can I apply the safe harbours in PCG 2016/5 to assets other than real property or listed units and shares?

The safe harbours provided in PCG 2016/5 only apply to LRBA's that are used to acquire real property or stock exchange listed shares or units. SMSF Trustees who use an LRBA to acquire other assets – such as shares in an unlisted company or units in an unlisted unit trust – will need to be able to demonstrate that the arrangement was entered into and maintained on terms consistent with an arm's-length dealing when considering the application of the non-arm's-length income (NALI) provisions.

One example of how a Trustee may demonstrate this is by obtaining evidence that shows their particular arrangement is established and maintained on terms that replicate the terms of a commercial loan that is available to them in the same circumstances. A printout from a bank's website of general loan terms is not sufficient to meet this requirement.

Where, for example, an LRBA is over an asset for which the SMSF could not find a commercial third-party lender to provide finance to acquire that asset and so entered into a related-party loan, the Trustee will be unable to demonstrate that the LRBA has been made on arm's-length terms.

b) Can refinancing of an existing loan be with a related-party lender?

There is no prohibition on the refinancing of an existing loan with a related--party lender. However, to ensure that the NALI provisions do not apply, SMSF Trustees will need to provide evidence that the refinanced loan is established and maintained on terms consistent with an arm's-length dealing; for example, by applying the safe harbour guidelines in PCG 2016/5 if applicable.

c) Do the NALI provisions apply to all of the income generated by the asset or just the non-arm's-length portion?

An amount of income either has the character of being NALI or it does not. When an amount of income is NALI, the whole

amount is NALI. An amount of income that is characterised as NALI cannot be divided between an amount that is NALI and an amount that is not NALI. The amount of income that is NALI is not only the amount by which an amount of income is greater than the amount that might have been derived if the parties had been dealing at arm's length, it is the whole amount of income derived, including any capital gains (refer to Taxation Ruling TR 2006/7, paragraphs 10 and 12).

6.9 The new NALI Laws

a) Introduction

Even though the Commissioner of Taxation published PCG 2016/5, there was still a need for legislative certainty in relation to the application of the NALI provisions to cases where less than market rate was paid by the Trustee of a Fund in relation to Fund expenses.

In 2018 the Government covered a range of superannuation measures in Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018, including addressing NALI. The Explanatory Memorandum states that the amendments in Schedule 3 ensure that the non-arm's-length income rules for superannuation entities apply in situations where a superannuation entity incurs non-arm's-length expenses in gaining or producing the income.

The best way to explain its far-reaching operation, particularly in relation to capital gains, is to consider two examples provided in the EM:

Example 3.1 - Non-Arm's-Length Expenses of a Superannuation Entity

An SMSF acquired a commercial property from a third party at its market value of $1,000,000 on 1 July 2015. The SMSF derives rental income of $1,500 per week from the property ($78,000 per annum).

The SMSF financed the purchase of the property under limited recourse borrowing arrangements from a related party on terms consistent with section 67A of the SIS Act. The limited recourse borrowing arrangements were entered into on terms that include no interest, no repayments until the end of the 25-year term and borrowing of the full purchase price of the commercial real property (i.e., 100 per cent gearing).

The SMSF was in a financial position to enter into limited recourse borrowing arrangements on commercial terms with an interest rate of approximately 5.8 per cent.

The SMSF has not incurred expenses that it might have been expected to incur in an arm's-length dealing in deriving the rental income.

As such, the income that it derived from the non-arm's-length scheme is non--arm's-length income. The rental income of $78,000 (less deductions attributable to the income) therefore forms part of the
SMSF's non-arm's-length component and is taxed at the highest marginal rate. However, there will be no deduction for interest, which, under the scheme was nil.

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Non-arm's-length interest on borrowings to acquire an asset will result in any eventual capital gain on disposal of the rental property being treated as non-arm's-length income.

Example 3.2 - Unit Trust

A retail superannuation fund trustee acquires units in a unit trust as a beneficiary with a fixed entitlement but *pays a substantially lower amount for the units* than stated in the promotional material for the unit trust due to a scheme that the fund has entered into with the broker.

In acquiring the entitlement to a share of the unit trust's earnings, the retail superannuation fund trustee did not incur expenditure it might have been expected to incur if dealing at arm's-length with the broker in purchasing the units.

The income derived from the units would have been the same whether or not they were acquired under an arm's-length transaction. The amount earned is non-arm's-length income of the retail superannuation fund. Any net capital gain made on disposal of the units may also be non-arm's-length income due to the amendments to subsection 295-550(1).

b) How are Arm's-Length terms determined?

The safe harbour provisions from the ATO are an important safeguard for SMSF Trustees and advisers when putting in place related-party loans. However, they are extremely limited to property and listed shares. Moreover, key features such as LVR and terms don't correlate to the NALI Bill's focus on actual expenses, not terms and conditions of the loan. The EM to the NALI Bill provides an explanation of the determination of arm's-length outside of the safe harbour provisions.

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

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

Transactions that are on arm's-length terms, for example, borrowing arrangements financed by Authorised Deposit-taking Institutions and other commercial lenders or that meet the safe harbour terms in ATO Practical Compliance Guideline PCG 2016/5, are not impacted by these amendments.

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6.10 Replaceable Assets

Section 67A of SISA applies to single acquirable assets. So, when a term or foundation of the LRBA is fundamentally changed, the LRBA comes to an end. Refinancing is one area where there is latitude in terms of changing the terms and conditions of the loan and still maintaining the original LRBA. In addition, section 67B provides instances where replacement assets may take the place of an original asset and not impact the original LRBA. For the most part the circumstances relate to shares or units issued as a consequence of a merger, takeover or pursuant to an instalment receipt.

There are no provisions for property in section 67A such that any replacement would be treated as a termination of the LRBA. The Commissioner has provided a number of examples of what is and what is not a replacement asset in SMSFR 2012/1 Self-Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts

Not a Replacement – LRBA Remains

i) **Residential house and land** - A fire destroys a four- bedroom house and a new superior residential house is constructed on that land using both insurance proceeds and additional SMSF funds. Rebuilding another residential house (whether of the same size or larger) does not fundamentally change the character of the asset held under the LRBA. The addition of a garage, for example, would also not change the character of the asset.

Replacement Asset – LRBA Terminated

i) **Vacant block of land on single title** - A residential house is built on vacant land which is on a single title. The character of the asset has fundamentally changed from vacant land to residential premises. This is a different asset.

ii) **Residential house and land** - A house is demolished following a fire and is replaced by three strata titled units. The character of the asset has fundamentally changed along with the underlying proprietary rights. This has created three different assets.

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Transfer of Business Real Property — CGT small business rules and the non-concessional component

We have a client that is looking at transferring their factory into their SMSF in late 2017. They have just had the factory valued at $1,200,000. The client – Joe is 65 and his wife – Sally, is 61. The factory is in their joint names and their business trades via a family company. They are semi-retired and their son and daughter run the business. They have not sold the business to the son and daughter as they want to retain control for as long as possible. At this stage, they own all the shares and are the only directors. They work in the business for about 20 hours per week and receive a car allowance and $80,000 salary.
The business is not being sold but can they make an in-specie contribution of the factory of $600k each? The capital gain on the factory is currently $600,000, or $300,000 each.

The factory has been owned for 10 years but they have been in business 25 years. Do they get the retirement concession for CGT on transfer of the factory as effectively being sold?
They have had an SMSF for fifteen years and his balance is $1.2M, all in accumulation with a $600,000 tax-free component and hers is $1M with $400,000 tax-free component. Will this take us over the allowable contribution limits?

The Guru's Strategic Response

Over the years it has become a popular strategy to contribute business real property into an SMSF. In fact, there is more than $50 billion of business real property in SMSF's. From a compliance perspective, the Trustee is able to acquire the asset under the exemption in s 6(2) of SISA and any lease back to the business is not caught by the in-house assets test in s84(1) of SISA. This means it ticks all the right boxes for SISA compliance and there are great tax benefits – the real driver of the strategy which include:

- Tax deductible rents paid to the SMSF by the Trustee of the Family Trust which will minimise taxable income distributions to beneficiaries;
- Rents are not contributions for excess contributions cap purposes;
- Rent provides good cash flow to Fund an accounts-based pension for the clients. Generally commercial yields can be up to 10% per annum;

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- Future capital gains and rents in the property will be tax-free if the asset forms part of the Fund's segregated current pension assets – subject to the Total Superannuation Balance Rules;
- If the asset is an active asset of the business, the small business CGT concessions may result in the contribution/transfer to the Fund, being CGT-free.

The CGT small business rules

The following is only a summary, and a detailed review of the small business concessions in Div 152 of the ITAA 1997 is required to ensure that all of the conditions for claiming a small business CGT concession are met. Before embarking on any CGT concession matter, it is highly recommended to seek advice from a CGT expert and particularly a CGT expert who also has detailed knowledge of SMSF's, so that the CGT non-concessional contribution exemption in s292-100 may be taken into account. This is key to the strategy.

As an incentive for small business owners to become self-funded retirees, a number of CGT exemptions and discounts are available when they dispose of their business or a business asset. Apart from the CGT small business concessions on the sale of any CGT asset, business or otherwise, an individual, family trust or partnership is entitled to a 50% CGT discount where the asset has been held for more than 12 months — s102-5(1) of the ITAA 1997. This does not apply in relation to a family company-owned asset where there is no CGT discount. The Trustee of a regulated complying superannuation Fund is entitled to a 33 1/3% discount.

Where the CGT small business concession rules apply to the disposal of a business asset by a taxpayer, the available concessions include:

(i) Subdivision 152-B: 15-year exemption. If the taxpayer has held the asset for 15 years, there is no capital gain realised on the disposal of the asset. Importantly, capital losses are not offset against the tax-free gain.

(ii) Subdivision 152-C: 50% exemption. There is an additional 50% discount available under section 152-205.

(iii) Subdivision 152-D: The CGT retirement exemption applies up to a lifetime limit of $500,000 under section 152-310. The taxpayer may choose to apply the CGT retirement exemption before section 152-205. This is beneficial as the CGT retirement exemption is not a non-concessional contribution but sub-division 152-C is a non-concessional contribution.

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Small Business Concession Requirements – the ATO view

To claim the small business concessions, the taxpayer must show firstly that they are a small business. In that regard the Commissioner notes that you will be a small business entity if you are an individual, partnership, company or trust that:

- is carrying on a business , and
- has an aggregated turnover of less than $2million.

What is aggregated turnover?

Aggregated turnover is your annual turnover plus the annual turnovers of any business entities that are your affiliates or that are connected with you. The aggregation rules help you determine whether you need to include the annual turnover of another business entity (a relevant entity) when calculating your aggregated turnover. These rules aim to prevent businesses splitting their activities in order to inappropriately access the small business entity concessions.

Once the small business entity test is met, which we assume is the case in this instance, then the following three conditions are required — *these are summaries only of the significant conditions; further conditions do apply:*

(a) The business owner must have net assets of $6 million or less. Net assets include assets owned by the business owner, their spouse, children and any entities connected with them such as family trusts and companies where the business owner controls the entity. However, assets such as personal use assets, superannuation Fund benefits or life insurance policies are not to be taken into account in determining whether the taxpayer has breached the $6 million threshold.

(b) The asset disposed of must be an active asset — this would include property used by the business, such as goodwill and real property. S152-40 includes as an active asset an asset that is held by a person but used as part of a business of an entity connected with them, such as a family trust. For more detail on passively held assets – such as property held by a person and then used in a business that is an entity connected with the person, go to the ATO website and search for the detailed analysis and examples under CGT retirement concessions.

(c) If the relevant asset is a share in a company or unit in a unit trust, the taxpayer or their spouse must be a significant individual in relation to the entity — they must hold 20% or more of the capital and voting power either directly or indirectly.

Application to the case study

I have assumed that the clients in question are able to meet the above conditions in relation to a small business entity and being under the $6M threshold. Provided the SMSF

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trust deed allows, the property may be contributed into the Fund as an in-specie contribution. This would require a formal transfer of the property from joint names to the name of the Trustee of the Fund. As there is a disposal, it will result in stamp duty and a capital gain. Interestingly in Victoria and to some extent in WA and SA, if the trust deed and transactions are structured properly, there will be no stamp duty on the transfer.

In terms of the CGT small business concessions, the property is held in joint names and used in a business run by a controlled entity — the family company. This would qualify the property as an active asset under s152-40 of ITAA 1997.

Provided the net assets of the clients are less than $6 million, they will be able to utilise the various CGT concessions as follows – note the 15-year exemption is not available as the asset has only been held for ten years.

Table — Application of the CGT small business rules to each member

Asset disposal	Business property case 1	Business property case 2
Transfer Amount	$600,000	$60,000
Capital gain	$300,000	$300,000
Ordinary 50% discount	$150,000	$150,000
Subdivision 152-C discount	$75,000	$0
Subdivision 152-D CGT retirement exemption	$75,000	$150,000

Note: Being able to choose whether to apply Subdivision 152-C or 152-D first makes a difference in terms of the non-concessional contribution rules as can be seen below. It also reduces the lifetime limit of $500,000 of CGT retirement exemption.

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