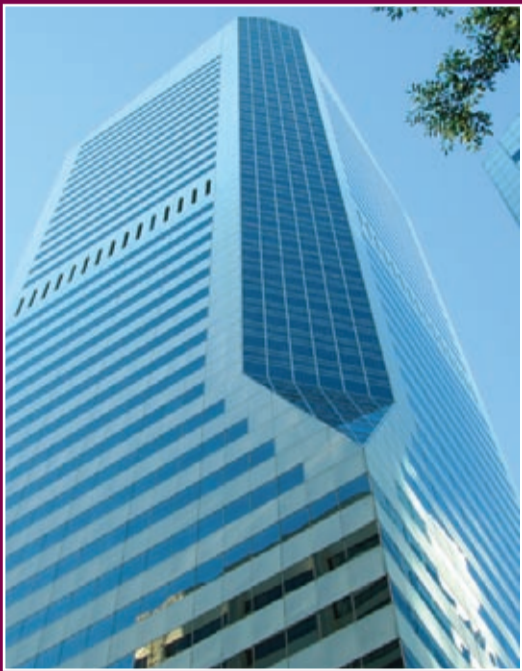


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In-House Assets

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Super Funds and In-House Assets

Whilst the concept of an in-house asset is nothing new, it is an area of law that is frequently misunderstood and we continue to see funds with these problems in their investment portfolios.

The area has become of such a concern that the ATO has released a draft tax ruling SMSFR 2008/D5 SMSF's and In-House Assets: Core Definitions.

This Ruling, explains the core concepts in the definition of "in-house asset" in s 71 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) as they apply to self-managed superannuation funds (SMSFs). The key definitions explained are:

- "asset";
- "loan";
- "investment in";
- "lease"; and
- "lease arrangement".

In-House Asset Rule & Definition

Broadly, unless one of the exclusions applies, the in-house assets rules prohibit a superannuation fund from acquiring in-house assets whereby the value of the fund's in-house assets exceeds 5% of the total value of the fund's assets.

An "in-house asset" is defined in s 71(1) of the SIS Act 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 a trustee of the fund and a related party of the fund..."

This part of the definition contains several terms which are also defined in the SIS Act and require further consideration.

Definition of a Related Party

A related party is defined as:

- (a) a member of the fund;
- (b) a standard employer sponsor of the fund; and
- (c) a part 8 associate of either (a) or (b).

A part 8 associate of a member is:

- a relative of the individual;
- members of the same super fund;
- a partner of the individual or a partnership in which the individual is a partner, or the spouse or a child of the individual partner;
- a trust that is controlled by the individual (power to control trustee or appoint or remove trustee); and
- a company that is sufficiently influenced by the individual, a part 8 associate of the individual, or by the individual together with another part 8 associate.

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Asset

An "asset" is defined to mean "any form of property" and includes money whether Australian currency or foreign currency. The ATO considers that the phrase "any form of property" has a very wide meaning and includes every type of right, interest or thing of value that is legally capable of ownership. While assignability generally is a characteristic of a proprietary right, the Tax Office says it is not in all cases an essential characteristic.

Loan

A "loan" includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings.

The Draft Ruling states that the term "loan" extends to include arrangements that are in substance financing arrangements deferring the payment of an amount. Such arrangements would include, but are not limited to, the loan of money, sale of goods or land on credit, instalment payment arrangements and arrangements for the deferral of payment of debts or entitlements.

However, the ATO states that not every situation where a payment is deferred necessarily amounts to a "loan" under the extended definition. The ATO also accepts that payment of goods on normal commercial terms will not amount to a "loan", nor will late payments which were not agreed to by the trustee of the superannuation fund.

In addition, it is the ATO's view that "loan" also encompasses arrangements where there is no objective purpose of gaining interest, income, profit or gain, for example an interest free loan. It therefore covers arrangements that may not be an "investment" under s 71(1).

Example

- (1) Elliott Superannuation Fund leases business real property to a medical partnership of which Terrence Elliott is a partner. Terrence is a trustee and member of the Elliott Superannuation Fund. In June 2008 the rental payment from the practice was overlooked and not rectified until July 2008 when the next rental payment was made. As the late payment was not part of an arrangement between the parties it is not a financial accommodation or provision of credit. Hence it is not a loan.
- (2) Unpaid trust entitlements between super funds and related trusts can be deemed a financial accommodation and hence a loan and an in-house asset. Clarification on this matter has been provided in SMSFR 2008/D1.

Meaning of "Investment In"

While the term "investment" is not defined in the SIS Act, the term "invest" is defined in s 10(1) to mean:

- apply assets in any way; or
- make a contract; for the purpose of gaining interest, income, profit or gain.

In this context, it follows that the corresponding meaning of the term "investment" is 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. This aligns the definition with the general meaning of "investment" established by the courts.

Having identified that an asset of the SMSF is properly classified as an investment, the ATO says it is then necessary to determine whether that investment is "in" a related party or a related trust. Whether an investment is "in" a particular entity is determined by reference to the legal rights acquired by the SMSF in return for its expenditure.

It is the Commissioner's view that where money or assets are provided for the benefit of a related party or related trust for the purpose of receiving income, interest, profit or gain, a sufficiently close connection will be established between the investment and that entity to enable it to be described as an investment "in" that entity. The ATO notes that it is the reliance on the related party or the related trust for payment on the investment which will be determinative, as this is what gives rise to the financial risk that the in-house assets rules in part 8 are designed to reduce.

Leases

The term "lease" is not defined in the SIS Act and therefore is given its ordinary meaning.

In respect of real property, the Draft Ruling states that a lease is a "demise" that grants a leasehold estate in the property to the lessee for a term. That is, the lessee has an interest in the land (a "chattel real"). This can be contrasted with a licence to enter land, which does not confer any interest in the real property. Of particular importance to determining whether an agreement amounts to a lease or a licence agreement, is whether exclusive possession is granted to the property. That is, the tenant has not only the right to occupy the premises, but to exclude access to all others, including the legal owner of the land.

Therefore, the ATO considers that a lease in respect of real property will occur where the lessee is granted exclusive possession of the property, generally in exchange for a rent.

The ATO says that a key difference between a lease of real property and a lease of chattels (non-real property) is that no proprietary interest in the asset is created in respect of a chattel lease. However, the right of possession granted to the hirer under the agreement, although not referred to as "exclusive possession", nonetheless includes the right to debar the legal owner from resuming possession.

It is therefore the ATO's view that the term "lease" in s 71(1) in respect of non-real property means a legally enforceable hiring agreement involving the payment of consideration by the hirer in exchange for enforceable temporary possession of the asset.

Example

An SMSF owns a beach house. The SMSF leases the beach house to a member, who is a related party for one month of the year. Market rental is paid for the period.

The full market value of the beach house would be included in the in-house asset ratio of the SMSF which may cause the 5% in-house asset limit to be breached.

Lease Arrangements

It is the ATO's view that the term "lease arrangement" (defined in s 10(1)) expands the definition of in-house assets to include informal arrangements under which a person uses or controls the use of fund property. This includes arrangements where a related party gains possession of an asset of the superannuation fund, even where no rent is payable in exchange for that possession.

Where an SMSF trustee enters into a lease or lease arrangement with a related party in respect to part of some property, the Tax Office says the in-house asset is the part of the property that is leased to the related party.

Where an asset is leased or subject to a lease arrangement for part of the year, the Draft Ruling states that the full value is an in-house asset for the period that it is leased or subject to a lease arrangement with a related party.

Example

A Super Fund owns a significant artwork which is displayed in the dining room of the member's home. There is no formal lease arrangement and no rental is paid.

The persuasive factors that indicate that this is a lease arrangement include:

- the artwork is located at the member's house;
- the member has access to and control over the artwork (i.e. he can display it); and
- it would appear that the member has taken possession of the asset rather than mere custody.

Hence the artwork is subject to a lease arrangement and an in-house asset of the fund.

Consequence of Holding an In-House Asset

Where a fund purchases an in-house asset that is greater than 5% of the net market value of the fund or an additional in-house asset purchase causes the total in-house assets of the fund to exceed 5% then the fund has breached S83 of the SIS Act.

If a fund has in-house assets in excess of 5% of the fund's net assets, the trustees must develop a plan to dispose of one or more in-house assets during the following year to reduce the in-house assets ratio to 5% or a lesser amount.

Each of these instances is a breach of the SIS Act and where the breach exceeds 5% of the net assets or \$30,000, it must be reported to the ATO in the prescribed format.

The ATO will assess each breach on a case by case basis and should they decide the circumstances warrant it, the fund may be issued with a notice of non-compliance. This will cause the fund to have tax of 45% imposed on future earnings and contributions. Further the ATO can recoup earlier tax concessions enjoyed by the fund and apply 45% tax to the fund's asset value less undeducted contributions.

Conclusion

When making a non-traditional investment within your SMSF and you are unsure whether the in-house asset provisions could apply, please call your JR Super advisor and they will be able to discuss the relevant considerations with you.

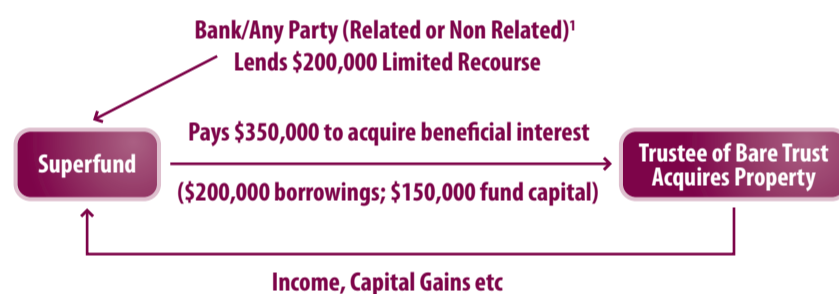
Superannuation Funds and Borrowings

Twelve months have passed since the borrowing exception was introduced to Superannuation Law and we thought it was time to report on the progress of borrowing strategies in the marketplace and the fundamentals behind the borrowing provision.

SIS contains a general prohibition against superannuation funds borrowing. This general prohibition has been modified to allow funds to borrow subject to the following five criteria:

1. the asset must be one that the super fund is not prohibited from acquiring;
2. the asset must be held in a separate trust so that the super fund trustee acquires a beneficial interest in the asset;
3. the super fund trustee must have the right to acquire legal ownership of the asset by making one or more payments after acquiring the beneficial interest;
4. the rights of the lender against the trustee of the fund for default on the borrowings are limited to rights relating to the original asset – that is the lender has limited recourse against the interest held by the superannuation fund trustee; and
5. the asset held in the trust must be the only asset held by that trust.

Assuming a purchase price of \$350,000 a diagrammatical summary of the arrangement is outlined as follows:



1 The lender can be any party including the member themselves. The borrowing must be on the terms outlined in this paper and be at a commercial interest rate.

We consider each of the requirements above in turn.

Requirement 1 – SMSF Must Not be Prohibited From Acquiring the Asset

An asset may be acquired by an SMSF as long as the acquisition complies with the various provisions of the SIS Act. Broadly speaking these are:

1. **Sole Purpose Test** – Section 62 of the SIS Act requires that the SMSF is to be maintained solely for the benefit of members for their retirement. This precludes investment in personal leisure assets for the members.
2. **Financial Assistance** – Section 65 prohibits the giving of any financial assistance using the resources of the SMSF. This means that no related party (defined below) can utilise or benefit from the asset so purchased.
3. **Related Parties** – Section 66 prohibits a super fund from acquiring assets from a related party of the fund, except for commercial real estate and listed securities acquired at market value. "Related party" includes a member of the fund, an employer sponsor of the fund, or an associate of them. "Associate" is defined broadly and includes a relative of the member, a person in partnership with the member or a relative of this person, a trust in which the member is capable of controlling and a company that is sufficiently influenced by the member or any associate previously mentioned or any two or more associates.
4. **In-House Asset Rules** – Part 8 of the SIS Act sets out the in-house asset rules. An "in-house asset" of a SMSF is one which is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund. The market value of in-house assets must not exceed 5% of the market value of the fund.
5. **Arm's Length Basis** – Section 109 of the SIS Act provides that, if the SMSF acquires assets from a related party, then the terms of the purchase must be as though the parties were dealing with each other at arm's length.
6. **Investment Strategy** – Section 52(2)(f) requires an SMSF to have an investment strategy, and investments must be consistent with that strategy. The investment strategy must take into account:
 - a) The risk involved in making, holding and realising, and the likely return from, the fund's investments having regard to its objectives and its expected cash flow requirements;
 - b) The composition of the fund's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
 - c) The liquidity of the fund's investments having regard to its expected cash flow requirements;
 - d) The ability of the fund to discharge its existing and prospective liabilities.

Therefore, the trustees of the SMSF will need to be satisfied that the acquisition of an asset subject to borrowings is consistent with the SMSF's investment strategy with particular reference to the risk and liquidity associated with a leveraged investment.

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Requirement 2 – Separate Trust Ownership

The legal title of the asset must be held by a trustee (not the SMSF trustee) as bare trustee for the SMSF. The trust must be in place before the contract for purchase is signed or otherwise additional stamp duty could be payable.

The trust is established and governed by a trust deed (referred to as the bare trust deed). The bare trust deed is a legal document and comment on its requirements is outside our expertise. We have been dealing with a few reputable Queensland law firms that have deeds that comply with SIS and these range in cost from \$4-8K.

Assuming the original bare trust and borrowing arrangement in place complies with the SIS Act, it is important that this arrangement is not tainted in anyway such that the arrangement then falls outside the requirements of the SIS Act. This could occur for instance in the following circumstances:

1. The trustee modifies the terms of the bare trust deed.
2. The bare trust can only hold the original asset purchased. A new bare trust should be established for each new asset acquired by the SMSF for which borrowing is required. Whilst the SIS Act does provide for a "replacement asset", this may in future be interpreted narrowly as applying, for example, only to replacement assets arising from an insurance claim.
3. If the asset was refinanced. The Australian Tax Office has indicated that it is as yet undecided on whether refinancing would comply with the SIS Act.
4. The terms of the loan are modified. In particular, the loan should not permit capitalisation of interest or multiple drawdowns, or be in the nature of a line of credit. Nor should the loan ever be modified to remove the non-recourse provision, as this would cause the borrowing to no longer comply with the requirements of section 67(4A) of the SIS Act.

Legal advice should be sought if any of the above variations to the arrangement are considered by the trustees.

Requirement 3 – SMSF Trustee Has the Right to Acquire Legal Ownership of the Asset

The SMSF trustee must have the right to acquire legal ownership of the asset by making one or more payments after acquiring the beneficial interest. This requirement is documented within the bare trust deed.

Requirement 4 – The Loan Must be Limited Recourse

The loan and mortgage documentation will need to comply with the requirements of Section 67(4A) of the SIS Act that the loan be limited recourse permitting the lender to recover for non-repayment of the loan only against the original asset and not from other assets of the SMSF. It is likely that the financier will lend to the bare trustee as it will be the party to the sale contract. As such the bare trustee could be the legal borrower but the obligation for the debt will rest with the superannuation fund. Should personal guarantees be required by the financier some form of deed of release to right of indemnity should be signed to document that no further indemnity is available to the guarantor under default.

It should be noted that this does not mean that the loan is risk free to the SMSF. Any funds contributed by the SMSF to purchase the asset or for contributions to its net operating cost, in addition to the borrowed funds will be at risk in the event of default.

If a bank facility is not utilised and instead the lender is a related party it is critical that the terms of the loan, including the interest rate, are on a commercial basis. This means that the terms must be effectively the same as the terms that would be required by a third party financier.

In the marketplace it has been common for the lending ratios to be lower due to the limited recourse nature of the loan. This has varied between 50-70% depending on the bank selected.

Treatment of SMSF Equity Contributions

Any contribution required by the SMSF to the bare trust for the funding of the asset (for example, the equity and principal reductions required by the financier) is sourced from the capital within the SMSF.

The SMSF member(s) or employer sponsor may contribute to the SMSF to enable it to make the equity contribution. This contribution may be tax deductible and you should speak to your JR advisor to discuss your personal circumstances.

Treatment of Income and Expenses of the Asset

The income derived and expenses incurred, including interest on debt to fund the acquisition, ultimately form part of the income and expenditure of the SMSF. This may also include any liability for Goods and Services Tax.

Similarly, any capital gain or capital loss arising from the sale of the asset would be returned to the SMSF.

General Taxation Treatment of an SMSF

SMSF's by comparison to most tax paying entities, are concessional taxed. In the case of a complying SMSF the maximum applicable income tax rate is 15%. Due to the conditional availability of a 33.3% Capital Gain Tax (CGT) discount, the maximum effective tax rate on capital gains is 10% (provided the investment is held for a period of not less than 12 months).

An SMSF that is in pension phase may not be taxed on its income or capital gains. This too is relevant where the arrangement is negatively geared as there will be no deduction for the losses incurred.

The compliance of the SMSF with relevant SIS and income tax provisions are essential for the concessional tax treatments to apply.

Should you be considering such an arrangement please call your JR Superannuation advisor to discuss.



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