



SMSFs and property development (including NALI)

BRYCE FIGOT
Special Counsel, DBA Lawyers
D: 03 9092 9406 M: 0410 403 182
E: bfigot@dbalawyers.com.au
W: dbalawyers.com.au T: @DBALawyers
Notes current as at 5 October 2021

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Overview

- ▶ NALI Changes
- ▶ SMSFRB 2020/1
<https://www.ato.gov.au/law/view/view.htm?docid=%22SRB/SRB20201/NAT/ATO>
- ▶ Practical application of SMSFRB 2020/1

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NALI Changes

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NALI changes

- ▶ Firstly, do auditors need to consider NALI?
- ▶ Practically, speaking, I believe the answer is yes and I recommend it
- ▶ However (*HPack Investments Pty Ltd* [2020] NSWSC 1638):
 - ▶ The Respondents also rely on an affidavit dated 14 October 2020 of Mr Scali, a Chartered Accountant, who indicates that his firm has acted for the Respondents since 15 May 2019. The Respondents tender, and rely on, the financial reports for the CSF for the years ended 30 June 2015 to 30 June 2017 which are exhibited to Mr Scali's affidavit and rely upon the fact that those financial reports were subject to a limited audit. Mr Golledge submits, and I accept, that that matter provides little assistance to the Respondents, where the auditor's report indicates that the relevant financial report has been prepared to assist the CSF meeting the requirements of its governing rules, the SIS Act and the SIS Regulations, rather than disclosing any focus upon tax compliance; and the description of the auditor's responsibilities and the tests performed also focuses on compliance with the SIS requirements rather than with tax obligations ...

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NALI changes

- ▶ The law NOW provides (ITAA 1997 s 295-550(1)):

*An amount of *ordinary income or *statutory income is non arm's length income of a *complying superannuation fund, a *complying approved deposit fund or a *pooled superannuation trust if, as a result of a *scheme the parties to which were not dealing with each other at *arm's length in relation to the scheme, one or more of the following applies:*

(a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;

(b) in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;

(c) in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.

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NALI changes

- ▶ What does this mean practically?
- ▶ The explanatory memorandum to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 (Cth):

...the trustee of a fund may undertake particular activities in performing its duties or choose to outsource those functions to third parties (for example, if the fund had a real estate portfolio, the trustee may be able to manage the properties or contract the services of a real estate agent)

The question of whether the non-arm's length income rules apply in respect of services or functions that are undertaken by the trustee depends on the capacity in which the trustee undertakes those activities

- ▶ What, in turn, does THAT mean practically?
- ▶ In other words, how to determine 'the capacity in which the trustee undertakes those activities'?

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NALI changes

- ▶ LCR 2021/2 states ([47]):

Factors that indicate that the individual is performing their activities in their individual capacity and not in their capacity as a trustee, or a director of a corporate trustee, include:

· The individual charges the complying SMSF for performing the services. However, there can be circumstances where the individual can be acting in their individual capacity even though they do not charge the SMSF for performing the services.

· The individual uses the equipment and other assets of their business, or equipment and other assets used in their profession or employment in a material manner. However, minor, infrequent or irregular use of equipment or assets will not, of itself, indicate the individual is acting in their individual capacity. For example, in the absence of any other factor indicating otherwise, minor, infrequent or irregular use of a business computer at the office by an individual would not, of itself, indicate the individual is acting in their individual capacity.

· The individual performs the activities pursuant to a licence and/or qualification relating to their business, or their profession or employment. That is, the activity can only be performed due to the individual or business holding the relevant licence and/or qualification.

· The activity is covered by an insurance policy relating to their business, or their profession or employment (for example, indemnity insurance).

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NALI changes

- ▶ So overall, that sounds somewhat promising
- ▶ So, what sort of issue might cause NALI concerns?
- ▶ SMSF property development!
- ▶ ATO have released 'SMSF Regulator's Bulletin SMSFRB 2020/1: Self-managed superannuation funds and property development

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SMSFRB 2020/1

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SMSFRB 2020/1

Para 3: "Property development can be a legitimate investment for SMSFs, and the Commissioner does not have any concern with SMSFs investing in property development where it complies with the [SISA] and [SISR]"

Para 8: a shopping list of SISA/SISR provisions that development could contravene

Para 10: "care needs to be taken ... dealing with each other at arm's length, including ... the return on investment and income or capital entitlement"

"What should you do? ... [para 16] ... "If your SMSF is currently developing property or has invested in a related property development ... it is important to regularly check in with your SMSF professional advisor"

"Ungeared related ... unit trusts ... [para 32] the SMSF invests \$800,000 [in a related unit trust] which equals 57.2% ownership ...

The unit trust wishes to subdivide the property and then construct both residential and commercial buildings

The trustee of the unit trust undertakes the process of developing the property

*But remember NALI
(and other tax provisions)!*

*Always ask clients for
projected cash flows. How
will it look if a \$200
investment generates a
return of \$2.5m+?*

*Great advice
from the ATO*

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SMSFRB 2020/1

Once the buildings are established, they sell the residential property making a profit and lease the commercial property to a related party at market value

... [para 37] the trustee could be carrying on a business, which would also cause the in-house asset exception to cease.

"The use of LRBA's ... [para 42] ... A property development will generally change the character of the property ...

[para 46] ... Other factors SMSF trustees should consider when using an LRBA to invest in a related property development entity are: the SMSF trustee cannot rely on mirroring the 'safe harbour' terms in [PCG 2016/5] to show that their terms are consistent with an arm's length dealing

*Sage warning.
I'll elaborate
on this later*

*At risk of over
simplification:
LRBAs and
property
development
DON'T MIX!*

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SMSFRB 2020/1

“Non-arm's length dealings and non-arm's length income ... [para 61]

Importantly, where parties are related, there is an inference that they will not deal with each other at arm's length

However, this inference can be reversed if the parties can show that despite being related they have conducted the transaction as if they were at arm's length.”

Para 64: “where a related party is engaged to provide services in their professional capacity (such as building or construction works) and they do not charge for these services, or are paid less than an arm's length rate”

“Joint venture arrangements ... [para 76] where the SMSF has only provided a capital outlay for the arrangement, and has no rights other than a contractual right to a return on the final investment, we would be concerned that they may instead hold an investment in or loan to the other party...”

JVs does NOT stand for 'just vexed', but maybe it should

Very important if considering JVs

Profoundly relevant, but SMSFRB 2020/1 doesn't elaborate

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SMSFRB 2020/1

Conclusions on SMSFRB 2020/1:

- ▶ An important reminder of what to remember when doing property development
- ▶ However, what SMSFs really need is a practical road map of how to most safely implement property development
- ▶ SMSFRB 2020/1 doesn't provide such a road map
- ▶ I will now provide such a road map, fully incorporating SMSFRB 2020/1

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Practical Application

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Barry Case Study

Consider Barry who is a shareholder and director of a construction company

Q: What do you think Barry wants to do with his super?

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Barry Case Study

A: Presumably Barry wants the following:

- ▶ commence an SMSF
- ▶ buy real estate
- ▶ develop real estate
- ▶ 'flip' real estate
- ▶ enjoy concessional taxed profits
- ▶ (sit on beach, sip mai tai, reward adviser handsomely)

Q1: How many different methods are there to structure this?

Q2: Which method is the 'safest'?

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Barry Case Study

Method 1

- ▶ commence an SMSF
- ▶ SMSF buys real estate (from un-related party), pays with SMSF's own cash
- ▶ SMSF buys physical items (from un-related party), pays with SMSF's own cash
- ▶ SMSF engages related party for all services, pays with SMSF's own cash
- ▶ SMSF sells developed real estate
- ▶ SMSF enjoy concessional taxed profits

What could go wrong?

- ▶ Possible issue 1: Does this constitute the SMSF running a business (and isn't that illegal)?
- ▶ Possible issue 2: What if the SMSF doesn't have enough cash to pay?
- ▶ Possible issue 3: What if Barry wants his building company to provide a 'cost plus' contract?
- ▶ Possible issue 4: What if Barry wants to do the work for his SMSF for free?

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Can an SMSF run a business?

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Can an SMSF run a business: ATO's view

Q: According to the ATO, can an SMSF run a business?

A: As per <https://www.ato.gov.au/super/self-managed-super-funds/investing/carrying-on-a-business-in-an-smsf/>:

Self-managed super funds (SMSFs) are not prohibited from carrying on a business, but the business must be:

** allowed under the trust deed*

** operated for the sole purpose of providing retirement benefits for fund members.*

Q: What does this have in common with the following 'flash fiction' (allegedly written by Ernest Hemmingway)?

For sale: baby shoes, never worn

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Can an SMSF run a business: ATO's view

A: They're both short stories!
However, are there longer stories available?

ATO also state on their website:

Sole purpose test

If the trustee of an SMSF carries on a business, we examine the activities closely to ensure the sole purpose test is not breached. Cases that attract our attention include those where:

- * the trustee employs a family member (we look at things such as, the stated rationale for employing the family member and the salary or wages paid)*
- * the 'business' is an activity commonly carried out as a hobby or pastime*
- * the business carried on by the fund has links to associated trading entities*
- * there are indications the fund's business assets are available for the private use and benefit of the trustee or related parties.*

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Can an SMSF run a business: ATO's view

So, yes, an SMSF can run a business and the ATO agrees so long as you:

- ▶ dot the i's
- ▶ cross the t's
- ▶ ... and ...
- ▶ also dot the lower case j's

Is the ATO list from the previous slides a list of absolutely positively exhaustively definitively without exception everything you need to think about?

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Unit Trusts

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Unit trusts: Barry case study revisited

Recall the next possible issue (issue 2) from the case study:

Method 1

- ▶ commence an SMSF
- ▶ SMSF buys real estate (from un-related party), pays with SMSF's own cash
- ▶ SMSF buys physical items (from un-related party), pays with SMSF's own cash
- ▶ SMSF engages related party for all services, pays with SMSF's own cash
- ▶ SMSF sells developed real estate
- ▶ SMSF enjoy concessional taxed profits

What could go wrong?

- ▶ Possible issue 1: Does this constitute the SMSF running a business (and isn't that illegal)?
- ▶ Possible issue 2: What if the SMSF doesn't have enough cash to pay?
- ▶ Possible issue 3: What if Barry wants his building company to provide a 'cost plus' contract?
- ▶ Possible issue 4: What if Barry wants to do the work for his SMSF for free?

How might a unit trust seek to overcome this?

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Unit trusts: Barry case study revisited

I need \$3.4M to pay for everything

Unit trust
Cash: \$3.4M

Unit trust then acquires real estate, develops, sells, distributes profits

What could go wrong?

Related family trust
Cash: \$1.7M

SMSF
Cash: \$1.7M

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Unit trusts: in-house assets

- ▶ Is the investment in the unit trust an in-house asset?
- ▶ Yes (SISA s 71(1)), unless an exception applies
- ▶ Key exception is if the unit trust is a div 13.3A unit trust
- ▶ One requirement in div 13.3A is that (SISR reg 13.22D(1)):

If regulation ... 13.22C applies to an asset, that regulation ceases to apply to the asset if any of the following events happens: ... (d) ... a trustee of the unit trust, conducts a business;
- ▶ So, do the activities of the trustee of unit trust constitute a business?

Most people call this a reg 13.22C unit trust — why is '13.22C' misleading?

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Unit trusts: What is a business? What ATO say

ATO list factors in TR 97/11 [13]:

- * ... significant commercial purpose or character ...
- * ... more than just an intention to engage in business ...
- * ... purpose of profit as well as a prospect of profit ...
- * ... repetition and regularity of the activity ...
- * whether ... same kind and carried on in a similar manner to that of the ordinary trade ...
- * whether ... planned, organised and carried on in a businesslike manner ... directed at making a profit
- * the size, scale and permanency of the activity ...
- * whether the activity is better described as a hobby, a form of recreation or a sporting activity...

How do these factors weigh for a unit trust that:

- (1) is 'brand new' and a 'clean skin'
- (2) will purchase real estate but engage another party to build
- (3) sells via a real estate agent and
- (4) distributes profits and then winds itself up?

How do practitioners apply these factors to try to ensure that an entity is not running a business? (And how success are such attempts?)

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JR Walker



Consider JR Walker (1985) 16 ATR 331:

- ▶ ~1979: Mr Walker (real estate agent) buys one goat (Mango Citrine)
- ▶ ~1980: Mango Citrine has two children:
 - Treesbound Dian and
 - Geraldine
- ▶ ~1981: Mango Citrine and Treesbound Dian die
- ▶ ~1982: Geraldine has two children
- ▶ ~1984: Mr Walker sells Geraldine and her two children
- ▶ Mr Walker ceases the goat business, but claims losses from his goat 'business'
- ▶ ATO said that this was NOT a business
- ▶ However, the court held it WAS a business, applying the following from an earlier case:

A person may conduct a business albeit of a limited nature the activities of which business are preparatory to or in preparation for the conduct of another business on a larger scale

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Unit trusts: When do real estate activities constitutes businesses?

- ▶ Few SMSFs wish to get into the goat business
- ▶ But many SMSFs wish to be involved with real estate activities
- ▶ When do real estate activities constitute a business?
- ▶ What is a more relevant case?



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Unit trusts: WWXY and Rosgoe

- ▶ You might consider *McCarthy* [2021] AATA 1511
- ▶ But instead let's consider *WWXY* [2015] AAT 130, and appeal (*Rosgoe* [2015] FCA 1231)
- ▶ Mar 2006 : taxpayer (Rosgoe Pty Ltd ATF a family trust) acquires one property in Queensland
- ▶ The directors have a history of property development through other entities
- ▶ Aug 2007: taxpayer acquires second property, which adjoins the first
- ▶ Taxpayer acquired the real estate with intention to develop and sell as part of a joint venture
- ▶ (The real estate has a book value of ~\$3.07M)
- ▶ FY2010: Joint venture 'came to nothing'
- ▶ Taxpayer decided to rent out the two properties in its unimproved stated
- ▶ ~2013 taxpayer engaged a related party to obtain development approval for the real estate
- ▶ Sep 2013: related party obtains DA for real estate (approval for 10 storey development)
- ▶ The taxpayer engages real estate agents to sell the real estate
- ▶ Dec 2013: real estate sold at a profit
- ▶ Taxpayer asked for a ruling to confirm sale was the mere realisation of a capital asset
- ▶ ATO said it was beyond mere realisation of a capital asset: Taxpayer appealed to AAT

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Unit trusts: WWXY and Rosgoe

► What did AAT find?

... I do not accept the taxpayer's claim that it was not engaged in a business at all during the relevant period

Moreover I am satisfied the business described in the ruling ... contemplates a business that is broader than developing the property in a particular way with the participation of a particular joint venturer

... the taxpayer contemplated the property being resold at a profit after obtaining development approval, even if that was not the preferred option

... the sale occurred in the ordinary course of the taxpayer's business

This is a **BIG** deal

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Unit trusts: WWXY and Rosgoe

► HUGE implications! The AAT might find that a real estate development business exists even if the entity:

- was just set up
- has never engaged in any real estate development activities before
- did not intend on engaging in any real estate development activities itself (eg, if a joint venturer will do the literal developing)
- did not intend on selling any real estate itself (eg, a real estate agent will sell)
- does not obtain any DA itself (eg, if another entity obtains the DA for the taxpayer)

- doesn't ultimately physically improve the real estate (eg, it all gets too hard, and the entity simply passively leases the real estate and then sells)

Is this last dot point going too far?

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Unit trusts: WWXY and Rosgoe

- ▶ The taxpayer appealed: *Rosgoe* [2015] FCA 1231
- ▶ The FCA overruled the AAT, for two reasons, one of which was:
 - The sale was the mere realisation of a capital asset
 - More specifically, Logan J of the FCA held:

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Unit trusts: WWXY and Rosgoe

On the Commissioner's description of the facts which constituted the arrangement, the present was a case where property was acquired not for sale at a profit but rather for the carrying out of a profit-making scheme which later came to be abandoned

When, later, the property was sold, the profit here arose not from the purchase but from the sale and because the sale was not part of the profit-making scheme the profit did not arise 'from the carrying on or carrying out' of that scheme

Indeed the profit did not arise until the scheme had been abandoned

At first blush, this sounds great for SMSFs

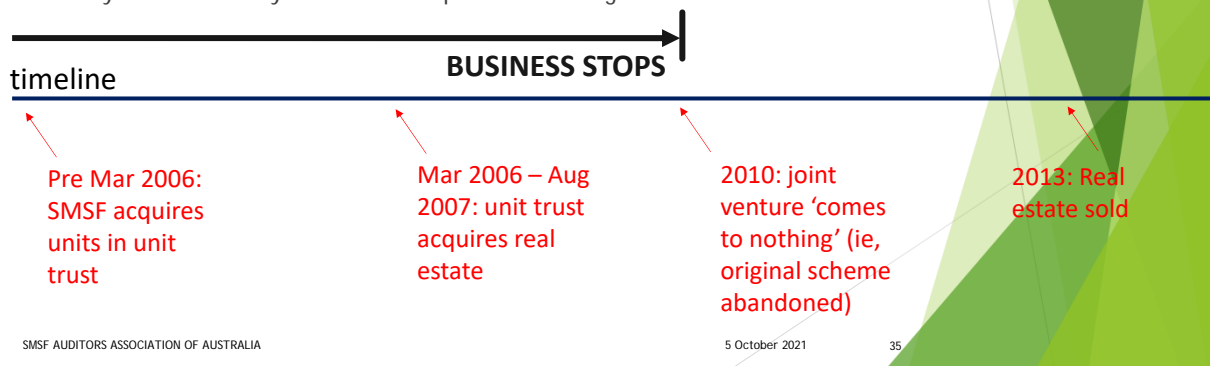
However, on proper consideration, why is this still bad news for SMSFs?

Assume that Rosgoe was a unit trust that wanted to be a div 13.3A (aka 13.22C) unit trust

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Unit trusts: WWXY and Rosgoe

- ▶ Why Rosgoe is still bad news for SMSFs (assuming that Rosgoe's facts are twisted to make it an SMSF/unit trust case):
- ▶ Based on Logan J's comments on the last slide, when did unit trust stop running a business?
- ▶ However, under SISR reg 13.22D, for what period of time can the unit trust carry on a business yet still be excepted from being an in-house asset?



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Unit trusts: WWXY and Rosgoe

- ▶ What sort of things do people do to the Rosgoe facts to try to ensure that Rosgoe was never running a business?
- ▶ Things practitioners do include:
 - Say that the unit trust is a passive joint venturer
 - (But so was Rosgoe)
 - Ensure that the unit trust is a 'clean skin' that was just set up
 - (But so was Rosgoe)
 - Say that Rosgoe did not intend to run a business
 - (But it intended to make profit, and certainly didn't intend to engage in a hobby)
- ▶ However, regardless of how 'pretty' the paperwork might be, what should we remember from *Scott (No 2)* and *Millar*?

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Unit trusts: Barry case study revisited

So, can I ever say that the following is NOT a business?

I need \$3.4M to pay for everything

Unit trust
Cash: \$3.4M

Unit trust then acquires real estate, develops, sells, distributes profits

SMSF
Cash:
\$1.4M

I would only have confidence if: ...

Related family trust
Cash:
\$1.4M

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Unit trusts: Barry case study revisited

- ▶ I would only have confidence that the unit trust is not carrying on a business if:
 - positive ATO input received (private ruling would be ideal, but don't hold your breath)
 - positive input from a QC/silk
- ▶ As already stated, SMSFRB 2020/1 warns that unit trust could be running a business (ie, an in-house asset): see para 37

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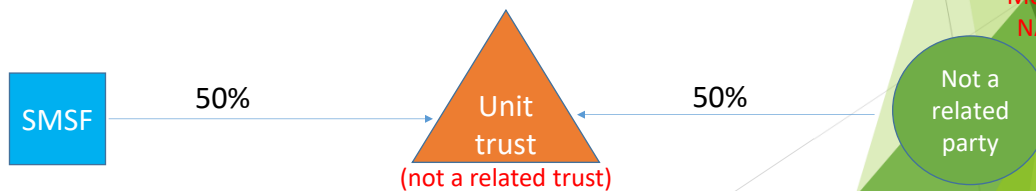
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Unit trusts: 50-50 not related trusts

- ▶ If this structure is implemented, can the unit trust run a business?
- ▶ Yes
- ▶ Anything to watch out for?
 - Never expressly contemplated by ATO in detail (cf NTLG super-sub committee 3/2013)
 - Distributions will be on revenue account (cf if SMSF engaged in activities directly)
 - Risk of distributions constituting non-arm's length income, for example:
 - Will SMSF members wish to perform any services for free for the unit trust (if so, NALI risk)?
 - Will SMSF members provide personal guarantees for the unit trust's lender (if so, NALI risk)?

SMSFRB
2020/1 [64]
and [67]
allude to this
risk

More about
NALI soon



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Unit trusts: conclusion

Mini-conclusion: I'm very reluctant for an SMSF to invest in a related trust if the related trust engages in real estate development

Why? Because I think there's a real risk that the related trust is carrying on a business (and therefore is an in-house asset: cf SISR div 13.3A)

If your client really wants to pursue this, consider ATO or QC/silk input first (but don't hold breath)

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Acquiring physical materials

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Acquiring physical materials: intro case study revisited

Recall the next possible issue (issue 3) from the case study:

Method 1

- ▶ commence an SMSF
- ▶ SMSF buys real estate (from un-related party), pays with SMSF's own cash
- ▶ SMSF buys physical items (from un-related party), pays with SMSF's own cash
- ▶ SMSF engages related party for all services, pays with SMSF's own cash
- ▶ SMSF sells developed real estate
- ▶ SMSF enjoy concessionally taxed profits

What could go wrong?

- ▶ Possible issue 1: Does this constitute the SMSF running a business (and isn't that illegal)?
- ▶ Possible issue 2: What if the SMSF doesn't have enough cash to pay?
- ▶ Possible issue 3: What if Barry wants his building company to provide a 'cost plus' contract?
- ▶ Possible issue 4: What if Barry wants to do the work for his SMSF for free?

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Acquiring physical materials

- ▶ Why is it an issue to acquire physical materials from related parties?
- ▶ SISA s 66!
- ▶ ATO discuss in some detail in SMSFR 2010/1
- ▶ What is the simple solution? SMSF acquires:
 - physical materials directly from unrelated parties
 - labour only from related parties
- ▶ Why might SMSF be resistant to doing this?
- ▶ Trade discounts!
- ▶ I can think of three key ways to address – what are they?
 - **Method 1:** Say to client ‘too bad – you wanna howl with the big dogs?* You gotta learn to say woof’†

* ‘Howl with the big dogs’ constitutes entering the heavily regulated environment of the SMSF, presumably with the subjective intention of obtaining significant tax benefits

† ‘Say woof’ means not necessarily being able to obtain every discount if an SMSF were not used

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Acquiring physical materials

- ▶ **Method 2:** building contract with related party says that any materials that related party acquires are as agent for SMSF
 - Q: Why do clients (eg, builders) tend to think this will be easy and preferred?
 - A: They think they simply get a document, and then its ‘business as usual’, maybe with one or two adjustment payments at the end
 - Worse still, they might think this method effectively allows borrowing (ie, the related party builder pays for physical materials from own pocket, and the SMSF doesn’t pay the related party builder until everything is sold and fully settled)!
 - Why is this wrong?
 - Consider ATO NTLG super sub-committee minutes from Dec 2011:

... where a related party only acts as an agent, arranging for the acquisition of building materials on behalf of the SMSF trustee from an unrelated vendor, and the related party at no times holds legal title to the building materials, the SMSF trustees have acquired the materials from that vendor, not the related party

Therefore, section 66 of SISA would not apply to the acquisitions.

However, yet again, there is a longer story...

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Acquiring physical materials

- ▶ **Method 2:** That sounds like good news, but ATO also state:

If the related party pays for building materials and invoices the SMSF either progressively (that is, at regular intervals) or at the end of the project ... this might be indicative of the purchase of the materials by the related party in their own right and on-sale to the SMSF trustee rather than a purchase by the SMSF trustee through the related party as agent

- ▶ When should an SMSF be reimbursing a related party?
- ▶ ATO have suggested an answer (albeit in a different regulatory context)
- ▶ When do the ATO suggest an SMSF should reimburse a related party?
 - **Option 1:** immediately
 - **Option 2:** as soon as possible
 - **Option 3:** as soon as practicable
 - **Option 4:** within 1 month
 - **Option 5:** before lodging that year's statutory annual return

Hint:
See SMSFR
2009/2 [16]

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Acquiring physical materials

- ▶ **Method 3:** (also considered by ATO in NTLG super sub-committee Dec 2011):
 - Bare trust opened in related party builder's name
 - SMSF puts all the money into this bank account
 - Related party builder uses this bank account exclusively to buy physical materials
- ▶ ATO also indicated that this could work

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Acquiring physical materials

Mini-conclusion: the most obviously compliant way to deal with related party builders is if:

- ▶ the SMSF acquires physical materials directly from third party supplies and
- ▶ the SMSF acquires only labour from related parties

Unfortunately, you can expect resistance from clients!

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Trustee Services

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Trustee services: intro case study revisited

Recall the next possible issue (issue 4) from the case study:

Method 1

- ▶ commence an SMSF
- ▶ SMSF buys real estate (from un-related party), pays with SMSF's own cash
- ▶ SMSF buys physical items (from un-related party), pays with SMSF's own cash
- ▶ SMSF engages related party for all services, pays with SMSF's own cash
- ▶ SMSF sells developed real estate
- ▶ SMSF enjoy concessional tax profits

What could go wrong?

- ▶ Possible issue 1: Does this constitute the SMSF running a business (and isn't that illegal)?
- ▶ Possible issue 2: What if the SMSF doesn't have enough cash to pay?
- ▶ Possible issue 3: What if Barry wants his building company to provide a 'cost plus' contract?
- ▶ Possible issue 4: What if Barry wants to do the work for his SMSF for free?

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Trustee services: new NALI provisions

Remember that from 1 July 2018, NALI can arise even if (ITAA 1997 s 295-550(1)(c)):

... in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme...

But this effectively doesn't always apply:

- EM: *The requirement that parties not be dealing with each other at arm's length means that the non-arm's length income rules do not apply in respect of a superannuation entity's arrangements that are purely internal.*
- ATO (LCR 2021/2): *Given the statutory restrictions that prevent a trustee or director of a corporate trustee from receiving remuneration, paragraphs 295-550(1)(b) and (c) will not be enlivened due to the trustee or director not charging for the services performed in relation to the fund when acting in a trustee capacity*

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Trustee services: new NALI provisions

Q: So, should a director/trustee be remunerated?

A: From a NALI point of view, it all depends on whether performing their activities in their:

- ▶ personal capacity or
- ▶ capacity as a trustee

How can you tell in which capacity someone acts?

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Trustee services: new NALI provisions

- ▶ As stated previously, the ATO state (LCR 2021/2 [47]):

Factors that indicate that the individual is performing their activities in their individual capacity and not in their capacity as a trustee, or a director of a corporate trustee, include:

- *The individual charges the complying SMSF for performing the services. However, there can be circumstances where the individual can be acting in their individual capacity even though they do not charge the SMSF for performing the services.*
- *The individual uses the equipment and other assets of their business, or equipment and other assets used in their profession or employment in a material manner. However, minor, infrequent or irregular use of equipment or assets will not, of itself, indicate the individual is acting in their individual capacity. For example, in the absence of any other factor indicating otherwise, minor, infrequent or irregular use of a business computer at the office by an individual would not, of itself, indicate the individual is acting in their individual capacity.*
- *The individual performs the activities pursuant to a licence and/or qualification relating to their business, or their profession or employment. That is, the activity can only be performed due to the individual or business holding the relevant licence and/or qualification.*
- *The activity is covered by an insurance policy relating to their business, or their profession or employment (for example, indemnity insurance).*

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Trustee services: remunerating trustees

However, what is the real mischief?

Too much money being pumped into the concessionally taxed SMSF environment!

If there's an ATO review of your client's SMSF, surely you want to be able to say:

The SMSF is in the exact same position as it would be if all work had been done by a non-related party

Therefore, generally, err on side of wanting to remunerate trustee/director for their work

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Trustee services: remunerating trustees

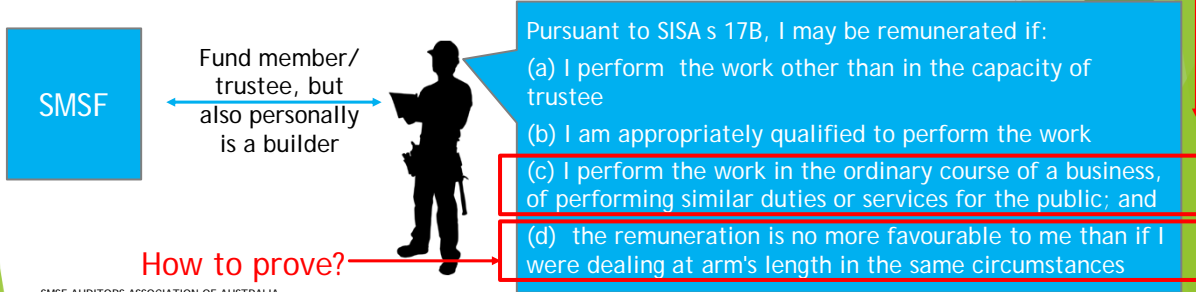
- ▶ What are potential dangers of remunerating trustees/directors?
 - **Potential danger 1**: Could fail the definition of SMSF (SISA s 17A: definition of SMSF)
 - **Potential danger 2**: Could contravene SISA s 65 (prohibition on provision of financial assistance) and/so SISA s 62 (sole purpose test)
 - **Potential danger 3**: Could contravene SISR reg 6.17 (no benefit payments except in accordance with SISR pt 6: that is, a form of early release)
- ▶ Nevertheless, remunerating trustee/directors (ie, ensure profits in SMSFs are entirely consistent with arm's length dealing) is lesser of two evils
 - (Why do I consider NALI to be the greater of two evils?)
- ▶ How to deal with these potential dangers?

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Trustee services: remunerating trustees

- ▶ Q: If the related party is a corporation (of which SMSF trustees are directors) does remunerating the related party equate to remunerating the SMSF trustees?
- ▶ A: No (see *Lee's Air Farming* [1961] AC 12 and *Salomon* [1897] A C 22)
- ▶ However, what if related party is not a corporation, but an individual, such as:
- ▶ When can builder be remunerated in this circumstance?

Let's focus on this



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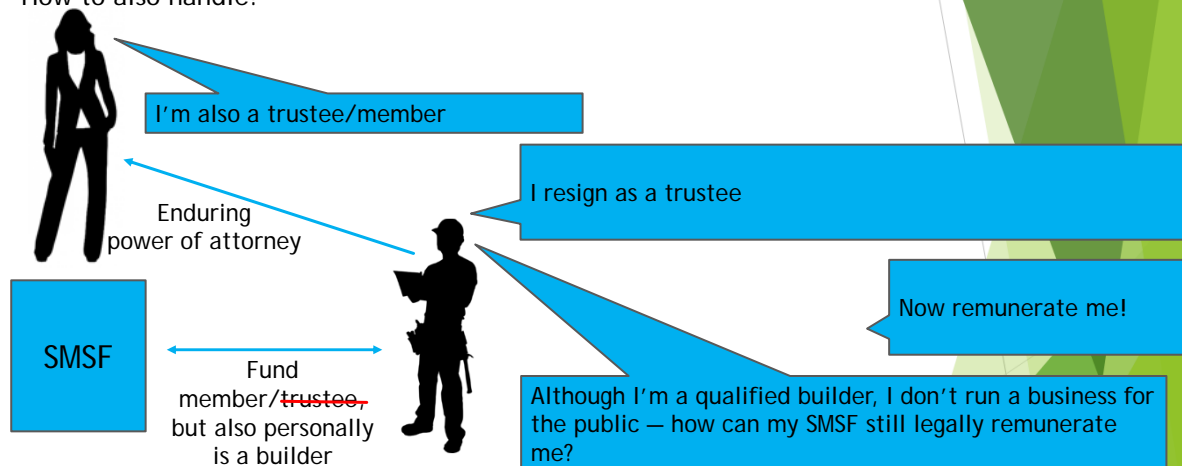
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Trustee services: remunerating trustees

How to also handle?



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Trustee services: conclusion

Mini-conclusion: less of two evils is to remunerate trustee/director BUT it is vital that:

- ▶ you can prove all remuneration is entirely consistent with an arm's length dealing and
- ▶ you are remunerating in a way that does not contravene the law

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Conclusion

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Conclusion

I think following is 'safest' way for an SMSF to engage in a real estate development business:

- ▶ buys real estate (from un-related party), pays with SMSF's own cash
- ▶ buys physical items (from un-related party), pays with SMSF's own cash
- ▶ engages related party for all services, pays with SMSF's own cash and retains evidence that all services/labour acquired at arm's length
- ▶ sells developed real estate
- ▶ no borrowings
- ▶ no unit trusts
- ▶ no joint ventures
- ▶ no free work from related parties (related parties must only provide labour on arm's length terms)
- ▶ a thorough investment strategy exists

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Conclusion

I acknowledge some won't like my 'safest' method, and might view it as cumbersome and impractical

Fine – but to proceed otherwise involves RISK and clients should understand that risk before assuming that risk

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Questions

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