SMSFs, trusts and property development: part 1

by Phil Broderick, CTA, Sladen Legal

This two-part article considers the tax and regulatory issues of SMSFs undertaking property development either directly or through structures such as trusts.

Introduction

Self-managed superannuation funds[1] (SMSFs) have been carrying on property development activities ever since they came into existence. Such activities are either done directly by the SMSF or more commonly through a structure (typically, a trust). Yet, despite this, there is still a common concern that such activities will cause the SMSF to become non-complying, or subject to penalties, on the basis that such activities, and in particular undertaking a property development business, are prohibited.

There is no express prohibition on SMSFs undertaking property development activities or a property development business. Rather, the question is whether such activities cause the SMSF to breach the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA) or the *Superannuation Industry (Supervision) Regulations 1994* (SISR) or adverse tax consequences under the *Income Tax Assessment Act 1997* (ITAA97) or the *Income Tax Assessment Act 1936* (ITAA36).

In this first part of a two part article, I have first examined whether an SMSF can carry on a business. Second, I have reviewed the provisions of the SISA, the SISR and the tax legislation that must be considered when an SMSF carries on property development activities. In the second part of the article, I will review various structures under which an SMSF can carry out property development.

Can an SMSF carry on property development?

As noted above, there is no express prohibition on an SMSF carrying on property development activities, but rather the question is whether those activities, or dealings in relation to those activities, breach the SISA or SISR or have adverse tax consequences under the Tax Acts. These provisions are considered in more detail below.

Another issue, which I have not dealt with in this article but must be considered, is how the development will be funded (whether by the SMSF or an entity that the SMSF has invested in). Possible funding sources include:

- existing cash from the SMSF;
- cash from the members by way of contributions (subject to the contributions caps);
- borrowings (consider whether borrowings are permitted and what restrictions apply, eg limited recourse borrowing arrangements); and
- non-SMSF entities (provided they can invest and what restrictions apply).

Can an SMSF carry on a business?

A common question raised in relation to property development is whether an SMSF trustee can carry on a property development business. There is a common misconception that super funds cannot carry on businesses and a property development business in particular. You only have to look at some of the activities of some of the public offer super funds to see that super funds are commonly running business operations. For example, the construction of major commercial buildings.

There is no provision in the SISA, the SISR or the Tax Acts that expressly prevents an SMSF from operating a business or deriving income from a business in a manner different from other "passive" investment income. The ATO has confirmed this view in a number of non-binding publications over the years, including the NTLG Superannuation Sub-committee minutes of 26 October 2005, and its publication titled "Carrying on a business in a self-managed superannuation fund". Essentially, in these publications, the ATO's view is that, while running a business does not cause an SMSF trustee to breach the SISA, the activities of the business may breach one or more of the SIS rules (discussed in the next section).

SISA considerations

As noted above, property development and the carrying on of a property development business are not expressly prohibited by the SISA and the SISR. However, the activities necessary to undertake the property development activities may breach the SISA or the SISR. The provisions of the SISA and the SISR can make up an article in themselves and therefore I have only briefly considered them below.

The sole purpose test

Section 62 SISA provides, in effect, that super funds must be maintained for the purpose of providing retirement benefits. A common misconception with the operation of the sole purpose test is that a risky, or unusual, investment will cause a super fund to breach the sole purpose test. In simple terms, what the test is effectively about is whether a super fund's activities result in the members, or related parties of the members, receiving pre-retirement benefits. Or, to put it another way, do the activities result in money being taken out of, or deprived from, the super fund? This has been confirmed in the way that the sole purpose test has been applied by the courts[2] and interpreted by the ATO.[3]

An example of where the sole purpose test may be breached from a super fund's perspective is where the super fund "employs" related parties for more than market consideration (eg a related party builder is paid excessive building fees or profits under profit-share arrangements, or related parties are employed and receive inflated salaries).

Arm's length dealings

In simple terms, s 109 SISA requires SMSFs to deal with related parties on an arm's length basis or, if the dealings are not on an arm's length basis, the parties must not be dealing with each other on the basis that it favours the non-SMSFs. Like the sole purpose test, s 109 is aimed at preventing benefits from being taken out of the super fund rather than a prohibition against involvement in transactions that favours the super fund.

Examples of where s 109 may be breached include where an SMSF trustee pays a related party an inflated price for services (eg building services).

Prohibition against acquiring assets from related parties

Section 66 SISA prevents an SMSF from acquiring an asset from a related party unless one of the exemptions applies. Relevantly, for property development purposes, one of those exemptions is "business real property". This means that a member can contribute or sell their business real property to the super fund without breaching s 66, therefore allowing the super fund to potentially develop the property.

Business real property is defined as certain interests in real property "where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not), but does not include any interest held in the capacity of beneficiary of a trust estate".[4]

An important part of the definition is that the land must be used wholly and exclusively in one or more businesses. This would generally rule out residential property unless the owner of the land is carrying on a rental business or is a property developer and the land is held as trading stock. There is a legislative concession for farm land that meets the definition of business real property allowing farm land to still be classed as business real property even if up to two hectares of the land is used as a residence, provided the predominate use of the property is not private or domestic.[5]

The ATO's view on what comprises business real property is set out in its extensive ruling, SMSFR 2009/1. Examples of business real property include (presuming no non-business uses):

- your "classic" retail, commercial, industrial and farm land;
- a residential property used as a retail or commercial premises (eg a doctor's surgery);
- a residential property used by the owner in a rental business;
- leasehold interests in business real property;
- vacant land if it is used in a business (eg a car park); and
- land held by a property developer for the property developer's business (including where the property was held as pre-development vacant land, in the part development stage, at the completed stage, and as a showroom).[6]

The in-house asset rules

The in-house asset rules prevent an SMSF from holding an investment in a related party or related trust, and making loans to related parties, if the combined value of those assets exceeds 5% of the total value of the assets of the SMSF.

In a property development context, the in-house asset rules will be relevant in relation to investing in trusts and companies that will develop property or where loans are made to related party developers or builders.

When considering the in-house asset rules, it is important to determine who is a related party or a related trust. These rules are contained in Pt 8 SISA. In particular, that Part contains the provisions for working out who is a "Part 8 Associate". The rules are very complicated and therefore the following discussion is a simplified overview of those rules. When considering the application of the in-house asset rules, the particular provisions of the SISA should be carefully reviewed.

In simple terms, Pt 8 associates will include relatives and related companies and trusts of the members of the SMSF and the SMSF's standard employer sponsor (if any). When considering whether someone is a related party or a related trust, the members of the SMSF, the standard employer sponsor and the related parties of the members and the standard employer sponsor are grouped together (the group).

A company will be a related party where the group controls the company under either of the following control tests:

- the group has sufficient influence (ie control) over the board of the company; or
- the group controls more than 50% of the voting rights in the company.

A trust will be a related trust where the group controls the trust under any of the following control tests:

- the group controls the trustee/the board of the corporate trustee (directly or indirectly, formally or informally);
- the group has entitlements to income or capital of the trust that exceeds 50% (note that 50% is okay); or
- the group has the power to remove the trustee of the trust.

The prohibition against borrowing

Under s 67 SISA, SMSFs are prohibited from borrowing unless an exception applies. The most significant exception is the ability to enter into a limited recourse borrowing arrangement (commonly known as an LRBA) under ss 67A and 67B SISA. Limited recourse borrowing arrangements will be discussed in part 2 of this article. Importantly, if an LRBA is structured incorrectly, or ceases to be structured correctly, then the exemption will no longer apply and the borrowing will cause the SMSF trustee to breach s 67 SISA.

Prohibition against providing financial assistance to members

Section 65 SISA prevents an SMSF trustee from providing financial assistance to members or to relatives of members. This prohibition will generally have limited application in a property development scenario, but could be applicable if the SMSF made a loan to a member or sold a development asset to the member on favourable terms. It could also apply if the member is employed by the SMSF as a builder and is paid in an advantageous manner (eg paid for the full price upfront when the standard practice is to be paid in stages).

Investment strategy

Under s 52B SISA, SMSFs must prepare, and regularly review, an investment strategy. Although it would be prudent for an SMSF trustee undertaking property development to include this in its investment strategy, interestingly, the investment strategy requirements are quite vague in their operation as they require the SMSF to "formulate, review regularity and give effect" to the strategy. However, the investment strategy rules do provide a "safe harbour" for super fund trustees that prevent members from taking actions against them for poor returns, provided the investment is undertaken in accordance with the super fund's investment strategy.[7]

Prohibition against charging assets of the SMSF

Under reg 13.14 SISR, super fund trustees must not give a charge over, or in relation to, an asset of the fund. A charge is widely defined to include "a mortgage, lien or other encumbrance".[8] This is an important consideration to take into account when an SMSF undertakes property development. For example, it is a common (in a non-SMSF) development that a developer will require a mortgage over the land or a guarantee from the landowner in support of the developer's loan from a bank to finance the development.

It is also important that the SMSF does not inadvertently breach this provision in its contractual documentation. For example, the development agreement can contain a contractual term which creates an encumbrance as it prevents the SMSF from dealing with the land.

Trustee remuneration

Section 17A SISA provides that a fund will not be an SMSF if the trustee, or the director of the corporate trustee of the fund, receives any remuneration from the fund or from any person for any duties or services performed by the trustee or the director in relation to the fund. This is a draconian requirement as a breach of this provision will cause the SMSF to become non-complying and the ATO does not have discretion to treat it otherwise.

This raises the question as to whether trustees/directors can be paid for performing some or all of the development services for the SMSF. Such activities will not be caught by s 17A if the provisions of s 17B are complied with. These provisions include:

- the trustee/director performs the duties or services other than in the capacity of trustee/director;
- the trustee/director is appropriately qualified, and holds all necessary licences, to perform the duties or services;
- the trustee/director performs the duties or services in the ordinary course of a business, carried on by the trustee/director, of performing similar duties or services for the public; and
- the remuneration is no more favourable to the trustee/director than that which it is reasonable to expect would apply if the trustee/director were dealing with the relevant other party at arm's length in the same circumstances.

Consequences of breaching the SISA and the SISR

Up until recently, the ATO's ability to punish SMSF trustees for breaching the SISA and the SISR comprised only of "big stick" measures. These included:

- making the SMSF non-complying — with the result that the assets of the SMSF, less any non-concessional contributions, are taxed at the top marginal rate (potentially losing almost half of the assets of the SMSF in tax);
- disqualifying the SMSF trustees/directors;
- taking the SMSF trustees/directors to the Federal Court to seek civil or criminal penalties; and
- for a breach of s 66, a penalty of up to 12 months imprisonment.

Due to the drastic nature of these penalties, the ATO was often reluctant to enforce them except in the most serious of breaches. As a result, a new penalty regime was introduced from 1 July 2014. Under this regime, the ATO has a number of penalty options, including:

- fining SMSF trustees/directors for breaches of the SISA (the fines range from $850 to $10,200 per offence);
- directing the SMSF trustee to rectify a breach; and
- directing that the SMSF trustee/director attend an SMSF education course.

Tax considerations

The starting point when considering tax for property developments by SMSFs is that s 295-85 ITAA97 deems that (almost all) CGT assets will be held on capital account. This means, for example, that even land bought with the intention to sell for a profit, or used in a property development business, will still be held on capital account and qualify for the CGT discount (if held for 12 months).

However, this rule does not apply to assets held by companies or trusts that an SMSF has invested in, even if the SMSF holds all of the units or shares. For trusts, if the land is deemed to be on income account, the proceeds from the sale of the land will flow through to the SMSF as income, even if the asset would have been on capital account if held directly by the SMSF. Dividends from companies will also be on income account.

That said, there is not a large tax differential between the 10% rate for a discounted capital gain and the 15% rate for income, and there is no difference if the SMSF is in pension phase as both income and capital are not taxed.

There are a couple of specific tax measures which can apply to super funds. These are considered below.

Non-arm's length income

The non-arm's length income rules tax certain types of income at the top marginal tax rate (currently 47% (including the deficit levy)). It is beyond the scope of this article to go through the non-arm's length income rules in detail.[9] However, briefly, they will catch:

- income derived as a result of non-arm's length dealings;
- private company dividends that are derived as a result of non-arm's length dealings;
- distributions from non-fixed trusts (eg discretionary trusts); and
- distributions from fixed trusts where the trust entitlement is acquired or the income was derived from non-arm's length dealings.

In a property development context, the non-arm's length rules will generally be avoided if all of the dealings with related parties are undertaken on an arm's length (commercial/market value) basis.

Public trading trust rules

The public trading trust rules apply so that a trust is taxed like a company. These rules apply where a unit trust or an entity that the unit trust controls is carrying on a trading business and certain other conditions apply. One of those conditions for the application of the rules is that super funds (and other exempt entities) hold at least 20% of the units in the unit trust. There is a claw out where the unit trust only holds land for the purpose of deriving rent.

In a property development context, this means that, if an SMSF invests in a unit trust that in turn conducts a property development business, then that unit trust will be taxed like a company and the flow-through nature of the unit trust will be lost. Therefore, income derived by the unit trust will have to be paid through to the unit holding SMSF as a franked distribution.

Again, a detailed discussion of the public trading trust rules are beyond the scope of this article.[10]

Part 2 of this article

In part 2 of this article, I will examine various structures, including trust structures that can be used by super funds to conduct property development.

Phil Broderick, CTA
Principal
Sladen Legal

References

1 References in this article to self-managed superannuation funds, or SMSFs or super funds, includes, where the context requires, a reference to the trustee of the SMSF or the super fund in its trustee capacity.

2 See *Case* 43/95, 95 ATC 374 (the *Swiss Chalet* case) and *Case* X60, 90 ATC 438.

3 SMSFR 2008/2.

4 S 66(5) SISA.

5 S 66(6) SISA.

6 SMSFR 2009/1, paras 366 to 370.

7 S 55A(5) SISA.

8 Reg 13.11 SISR.

9 For a detailed examination of the non-arm's length rules, see Simon Tisher's paper "Non-arm's length income — how does it apply and where is it at?" which he presented at The Tax Institute's 2014 National Superannuation Conference, held in Melbourne on 14 August 2014.

10 For a detailed examination of the public trading trust rules, see my article "Superannuation funds and public trading trusts" at http://sladen.com.au/news/2014/8/25/superannuation-funds-and-public-trading-trusts.