Related party agreements & in-house asset rule

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In *Taxpayer Alert* TA 2009/16, the ATO identifies an arrangement whereby an SMSF enters into an agreement with a related trust in order to acquire certain assets. The ATO considers whether this arrangement contravenes the in-house asset rule in section 71 of the *Superannuation Industry (Supervision) Act* 1993 (Cth) (**SIS Act**). This article discusses the ATO's views and how *SMSFR Ruling* SMSFR 2009/4 relates to TA 2009/16.

Definition of 'in-house asset'

Subject to certain exceptions an in-house asset is defined as an asset of an SMSF that is a loan to, or 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 (section 71 of the SIS Act).

A SMSF may acquire an asset which constitutes an investment in a related party in certain circumstances if the asset is acquired at market value and the acquisition of the asset does not result in the level of in-house assets of the fund exceeding the 5% market value ratio limit for SMSFs (section 66(2A) of the SIS Act). In other words, an SMSF's market value of investments in in-house assets must not exceed 5% of the total market value of its assets (section 82 of the SIS Act).

Meaning of 'investment in'

The ATO's view is that where money or assets are provided for the benefit of a related party or a related trust for the purpose of gaining income, interest, profits or gains, 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 (SMSFR 2009/4, paragraph 18).

It is the reliance on the related party or trust for payment on the investment which will be determinative, as this is what gives rise to the financial risk that the rules in Part 8 are designed to reduce.

The ATO identifies the scheme discussed below as an investment in a related trust for the purposes of the in-house asset rule (SMSFR 2009/4, paragraphs 91-94).

Scheme

The scheme involves an SMSF entering into an arrangement such as a joint venture agreement with a related trust to acquire assets such as a rental property so as to obtain tax and superannuation benefits.

In broad terms, the scheme has the following features:

- the trustee of an SMSF pays an organiser a fee for setting up an arrangement (such as a joint venture agreement) between the SMSF and a related trust;
- the trust may be a hybrid trust whereby:
    - the trust deed may provide the taxpayer with an entitlement to income or capital which while appearing to be fixed may be defeated by the trustee exercising a discretion to distribute income and/or capital gains to other beneficiaries; or
    - the trust deed allows for the issue of units or other interests to the taxpayer's associates for no consideration or for consideration which is below market value; or
    - the trust deed allows for the redemption of trust interests held by an

individual or other entities for below market value or at face value (*Taxpayer Alert* TA 2008/4).

- the organiser alleges that the purpose of the arrangement is to acquire investments that provide benefits to both the SMSF and the related trust;
- the SMSF provides an amount of funds and the remaining amount is borrowed by the trust to acquire and develop the asset;
- the trust may borrow the money from a financial institution or from an individual who borrows from a financial institution and later subscribes for units in the trust. The asset acquired may be used as security;
- the SMSF does not usually acquire a legal, equitable or any other interest in the asset. The trust acquires legal title in the asset;
- the SMSF is given rights to a proportionate share of the profits from the commercial usage of the asset from the trust, thereby making the return on investment and risk of investment, determinant for the related trust;
- certain arrangements allow members to lease the asset at or below market rate;
- the SMSF may make further capital contributions by variation or amendment of the agreement; and
- the organiser may allege that this type of scheme does not contravene the SIS Act.

SIS Act issues

The ATO identifies the following provisions as being breached by the scheme:

- the in-house asset rules in Part 8 of the SIS Act will be contravened if the investment is over the 5% limit;
- section 85 of the SIS Act may be breached as an SMSF is prohibited from entering into a scheme or an arrangement which avoids the application of the in-house asset rules;
- section 66 of the SIS Act may be breached as an SMSF is prohibited from intentionally acquiring assets from a related party; and
- the sole purpose test in section 62 of the SIS Act may be breached as the purpose of the fund should be to provide retirement benefits to members and not to obtain present day benefits for fund members or related parties.

Taxation issues

The ATO identifies the following taxation provisions as applying to the scheme:

- the income derived from the arrangement may not be considered to arise from an arm's length dealing as required by section 295-550 of the *Income Tax Assessment Act* 1997 (Cth) and thus will be subject to higher taxes;
- the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act* 1936 (Cth) may apply;
- any entity involved in the arrangement may be a promoter of a tax exploitation scheme pursuant to Division 290 of Schedule 1 to the *Taxation Administration Act* 1953 (Cth); and
- capital gains tax consequences may arise once any trust interests are redeemed, new interests are issued and when there is disposal of property.

Penalty

The ATO's view is that the anti-avoidance provisions in section 85 of the SIS Act may apply and therefore, civil or criminal consequences may follow. A base penalty of up to 75% of the tax avoided may also apply.

Conclusion

The purpose of *Taxpayer Alert* TA 2009/16 is to prevent SMSFs from entering into arrangements with related trusts for the purpose of obtaining certain tax and superannuation benefits through the discussed scheme. It is important to note, however, that the alert is not a final determination by the ATO. However, the ATO's view, according to *SMSFR Ruling* SMSFR 2009/4, is that section 71 of the SIS Act regarding the in-house asset rule will apply to these types of arrangements. The main question that remains is whether the ATO will rule that this form of arrangement will also infringe the general anti avoidance provisions in Part IVA of the *Income Tax Assessment Act* 1936. Those who are engaged in such a scheme or one which is similar may wish to seek legal advice on its implications.