

SIS Act breaches & ATO's discretion - factors

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A failure to comply with the in-house asset rule in the SIS Act results in the relevant SMSF losing its concessional tax treatment for the income year in which the breach happens. However, an application may be made to the ATO, for the ATO to exercise its discretion to treat the fund as complying despite the breach. This article examines the factors that should be considered by the ATO in the exercise of its discretion. The factors to consider are found in the recent AAT decision of *JNVQ and Commissioner of Taxation* [2009] AATA 522.

Facts

A husband and wife (**Trustees**) were the trustees of an SMSF (**Fund**). The husband's company (**Company**) was going through a difficult period and the Company's usual banker refused to provide finance to the Company. In the 2004/05 income year, the Fund made certain loans to the Company which caused the level of its in-house assets to exceed the 5% market value ratio limit required by the in-house asset rule (sections 71 and 83 of the SIS Act).

The Company was a related party of the Fund as the husband was the sole director of the Company (section 10 and Part 8 of the SIS Act). Hence, any loan by the Fund to the Company would be an "investment in" a related party breaching the in-house asset rule. The Trustees admitted that they were aware that they were breaching certain provisions of the SIS Act, but did so anyway so as to enable the Company to continue trading (paragraph 10, *JNVQ*).

In July 2004, the Fund had approximately \$123,000 in assets. The Fund agreed to loan the Company an amount not exceeding \$130,000 for a term of 5 years at 10%

interest per annum. In the 2004/05 income year, \$211,999 was loaned to the Company and \$85,000 of the amount loaned was repaid to the Fund in the same year. In May 2005, the net amount of the loan was \$126,000. On 30 June 2005, the company paid the nominated 10% interest (paragraphs 8 to 14, *JNQV*)

In the 2004/05 income year, actions taken by the Trustees resulted in the Fund lending over 95% of the Fund's assets to the Company. On 23 July 2007, the Fund's auditor lodged a contravention report with the ATO stating that the Fund had contravened the in-house asset rule.

The Trustees later submitted to the ATO two offers of "enforceable undertakings" detailing a timeframe for repayment of the loan to the Fund in accordance with section 262A of the SIS Act. The ATO rejected the offers and issued a notice of non-compliance on 15 July 2008 under section 40(1) of the SIS Act. As a result the Fund would lose its concessional tax treatment and be taxed at the highest marginal tax rate (paragraphs 7 and 8, *JNQV*).

The Trustees subsequently appealed to the AAT on the ground that under section 42A(5) of the SIS Act the ATO should have exercised its discretion in favour of the Fund to cause it to be a complying fund. Further, the Trustees alleged that the ATO placed too much weight on the seriousness of the contravention of the in-house asset rule by the Fund rather than the circumstances surrounding the contravention in making its decision (paragraph 20, *JNQV*).

Section 42A(5) discretion

If a trustee of an SMSF contravenes the SIS Act, the ATO after considering the following factors may give a notice stating that the SMSF is a complying superannuation fund:

- the seriousness of the contravention/s; and
- all other relevant circumstances (section 42A(5) of the SIS Act).

AAT decision

The AAT held that any exercise of a discretion under section 42A(5) of the SIS Act must have regard to issues of unfairness in a particular case, but must be applied in

a manner consistent with the objects of the SIS Act. The Tribunal held that the ATO made the correct decision in issuing the notice of non-compliance in light of the seriousness of the contravention and also the time taken by the Trustees to redress the breach (paragraphs 41 to 43, *JNQV*).

Other factors

The other factors the AAT took into account in holding against the Trustees are set out in the tables below.

Favourable factors

Factors	Comments
Health issues	One trustee and a related family member suffered from serious health issues during the relevant period. This affected both individuals ability to act as trustees.
Natural disasters	Cyclones in 2004 and 2005 in Queensland affected economic activity and thus hindered the Company's ability to repay the loans.

Unfavourable factors

Factors	Comments
Extent of contravention	The greater the amount over 5% the investment is the more significant the seriousness.
Appreciation of seriousness of breach	The Trustees did not appreciate the seriousness of the breach and/or their role as trustees of the SMSF.
Length of time loan outstanding	The loan was outstanding until 2009 even though the Fund's accountants notified the ATO of the breach in 2007.
Experience of trustees	The Trustees were experienced business people and obtained professional accounting advice.
Timing of undertakings to remedy breach	Four years after the breach is considered too late to be providing undertakings.
Present condition of Fund	The improved position of the Fund at the time of the AAT's decision was not relevant.

Conclusion

The decision in *JNQV* is significant in understanding how the ATO should apply its discretion in section 42A(5) of the SIS Act. From the AAT decision in *JNQV*, it is clear that trustees' apparent lack of contrition, the seriousness of their contravention and a failure to take appropriate steps in time to rectify the breach may all lead to a failure to invoke the discretion in section 42A(5) of the SIS Act. Hence, it is advisable that trustees of an SMSF seek legal advice as soon as they suspect there may be a possible breach of the SIS Act by their SMSF.