

## SMSFs & business real property

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13 September 2008

In the new draft SMSFR 2008/D3, the ATO explains the meaning and application of the term “business real property” in relation to SMSFs for the purposes of the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* and the *Superannuation Industry (Supervision) Regulations 1994 (SIS Regs)*.

The meaning of the expression “business real property” is relevant to determining whether an SMSF has contravened the SIS Act. In particular, the meaning of the expression is relevant to:

- the prohibition on an SMSF intentionally acquiring assets from a related party (section 66 of the SIS Act); and
- the prohibition on an SMSF holding more than 5% of assets as in-house assets (Part 8 of the SIS Act).

The ATO describes the underlying basis for the investment restrictions as the necessity to ensure that concessional taxed superannuation is used only for retirement income purposes so as to deter any fraudulent behaviour SMSF trustees and related parties may undertake.

### Business real property definition

The expression ‘business real property’, in relation to an entity is defined in section 66(5) of the SIS Act as:

- (a) any freehold or leasehold interest of the entity in real property; or

- (b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer; or
- (c) if another class of interest in relation to real property is prescribed by the regulations for the purposes of this paragraph—any interest belonging to that class that is held by the entity;

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.

In the new SMSFR 2008/D3, the ATO sets out the 4 elements of the business real property definition to be the following:

- entity;
- interest in real property;
- business; and
- the business use test (SMSFR 2008/D3, paragraph 61).

We will now consider each of the above 4 requirements.

## **Entity**

The first element of the business real property definition relates to the entity to which the definition applies to. The business real property definition is applicable to both SMSFs and related parties. It is important to note that the entity to which the definition applies, varies according to the relevant transaction taking place and the SIS Act or SIS Regs provisions that govern the type of transaction.

## **Interest in real property**

The second element of the business real property definition is concerned with the specific interest the relevant entity must have to satisfy the definition. As noted above, the entity to which the business real property definition applies must possess a specified interest. These interests are:

- a) any freehold or leasehold interest of the entity in real property;

- b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer; or
- c) if another class of interest in relation to real property is prescribed by the regulations for the purposes of this paragraph - any interest belonging to that class that is held by the entity.

To date there have no classes of interest that have been prescribed by the SIS Regs. Accordingly, we are left to consider whether an eligible interest in real property is held under either of paragraphs (a) or (b) and in so doing discussing the following factors:

- what is 'real property';
- what is 'Crown land';
- what is a 'freehold interest' in real property;
- what is a 'leasehold interest' in real property;
- what is 'an interest that is capable of assignment or transfer' in Crown land';
- when will an entity hold an interest in the capacity of a beneficiary of a trust estate; and
- whether a share in a company confers an interest in real property held by the company.

### ***What is 'real property'?***

The ATO notes that fixtures, such as buildings, are 'real property' for the purposes of the business real property definition in the SIS Act (SMSFR 2008/D3, paragraph 71).

On the other hand, anything on the land that is not a fixture will be viewed as a separate asset to the land and thus not attract the concessional treatment that business real property attracts under the SIS Act.

### ***What is a 'freehold interest' in real property?***

For the purposes the business real property definition, a freehold interest in real property may be a joint tenancy, tenancy in common or strata title (SMSFR 2008/D3, paragraph 92).

***What is a 'leasehold interest' in real property?***

The ATO states that a 'leasehold interest' is a right to exclusively possess land for a period of time that is either predetermined or capable of being determined.

The interest must be from the holder of the freehold interest or a derivative leasehold interest (eg a sub-lease). Finally, the lease must be conferred under a legally binding arrangement (SMSFR 2008/D3, paragraphs 95-99).

***What is 'an interest that is capable of assignment or transfer' in Crown land?***

The ATO requires all rights and liabilities that exist under an interest to be capable of being transferred or assigned. In determining whether the interest has this ability it is necessary to examine the statute that created the interest (SMSFR 2008/D3, paragraph 102).

***When will a beneficiary of a trust hold an interest in the real property of the trust?***

An entity will hold a beneficial interest in a trust estate when that interest is either defined in the trust deed or is appointed under a power of appointment in the trust. However, such an interest will only amount to an equitable proprietary right in the trust estate.

The ATO states that such proprietary rights in a trust estate do not amount to an interest in the underlying real property held by the trust, for the purposes of the business real property provision. The exception to this is when the trust provides the beneficiary with a proprietary interest in the entirety of the asset. Only in that case will the beneficiary have a proprietary interest in the asset of the trust (SMSFR 2008/D3, paragraphs 103 to 105).

***Does a share in a company confer an interest in real property held by the company?***

A shareholder in a company has no right to the assets owned by the company and thus the holder of a share in a company does not hold business real property.

**Business**

In examining the third element of the business real property definition, the ATO refers to the concept of a 'business' as well as the following issues:

- not for profit enterprises;

- relevance of the entity carrying on the business;
- 'primary production business';
- 'provision of professional services'; and
- the meaning of employee.

### ***Definition of 'business'***

The term 'business' includes any profession, trade, employment, vocation or calling carried on for the purposes of profit, including:

- the carrying on of primary production; and
- the provision of professional services;

but does not include occupation as an employee (section 66(5) of the SIS Act).

### ***'Business' as ordinarily understood***

Whether a particular activity constitutes a business needs to be considered on a case by case basis. However, the ATO has set out a non-exhaustive list of factors indicative of whether a business is being carried on:

- keeping of business records separate to personal records;
- the size of the operation and the extent of capital investment involved;
- whether activities are connected continuously and systematically rather than on an ad hoc basis;
- engagement of employees;
- purpose and intention to carry on business;
- level of repetition and regularity of activities;

- whether activities are carried on in a similar manner to other like businesses;
- scale and permanency of operations; and
- existence of a business plan (SMSFR 2008/D3, paragraph 112).

### ***Not for profit enterprises***

The ATO has made it clear that an activity that is not being carried out for the primary purpose of profit may still, after some consideration, satisfy the above indicators of a business and subsequently be characterised as a 'business' for the purposes of section 66(5) (SMSFR 2008/D3, paragraph 115).

### ***Relevance of the entity carrying on the business***

The business real property definition is sufficiently wide to ensure that the business in which the real property is used need not be carried on by the entity which holds the eligible interest in the real property.

### ***Primary production business***

The 'carrying on of primary production' is specifically included in the section 66(5)(a) of the SIS Act definition of 'business' and has the same meaning as in the *Income Tax Assessment Act 1997*.

### ***'Provision of professional services'***

The 'provision of professional services' is also included in the definition of 'business'. The ATO considers that professional services are being provided where a person holds out to the public that they are qualified to practice a profession and do in fact provide services in a business that would generally be associated with the practice of that profession (SMSFR 2008/D3, paragraph 126).

Professional services include those provided by physicians, lawyers, engineers, architects, dentists, accountants as well as literary, artistic, educational or teaching services.

### ***Employee***

Occupation as an employee is specifically excluded from the definition of 'business' (section 66(5) of the SIS Act).

### **Business use test - 'used wholly and exclusively in one or more businesses'**

There are 3 elements the ATO considers in assessing whether real property is being 'used wholly and exclusively' in one or more businesses, namely:

- what is 'use' of real property;
- when is use of real property 'in' a business; and
- what limitations does the 'wholly and exclusively' threshold impose on the test.

### ***What is 'use' of real property?***

The ATO distinguishes physical and non-physical use of a property and considers operations or actions occurring *on* the land to amount to physical use of the property whereas when an entity uses the interest it holds in the property to generate income or gains, for example, by leasing or licence, this is referred to as non-physical use (SMSFR 2008/D3, paragraphs 135 to 139).

In the context of the business real property definition, 'use', is limited to physical use of real property (SMSFR 2008/D3 paragraph 145).

However, the ATO considers the following as falling within the ambit of 'physical use':

- there is no need for human presence on the land for there to be use of that land.  
Therefore, activities such as automated grazing, or having mobile communication towers and wind turbines would equally involve use of the land. However, the ATO has hinted that some level of human intervention may be required. This level requires minimal involvement, for instance, the construction or maintenance of towers would suffice;

- physical use of land can follow an entity's non-physical use. Therefore, a SMSF is not itself necessarily required to use the property in a physical way, rather, there must be an entity that does use the property in a physical way. This permits, SMSFs to lease real property to entities which carry on businesses.

### ***When is the use of real property 'in' a business?***

The relevant property must be used 'in' one or more businesses for the business real property definition to be met. The ATO considers that the use of real property which is incidental and relevant to a business, or identifying a business as the occasion of the property's use, is the starting point (SMSFR 2008/D3, paragraph 172).

Based on this, a connection between what the use of the property is for and one or more businesses must be proved. As such, a property that does not have direct business purposes and is not otherwise incidental and relevant to a business would be characterised as not being used in a business.

### ***What limitations does the 'wholly and exclusively' threshold impose on the business use test?***

The phrase 'wholly and exclusively' requires an examination of all aspects that the real property is being used and is a question of fact and degree. The ATO has taken a single-test approach where, 'wholly and exclusively' seeks to identify the use of the property in a business in contrast to any other type of use (SMSFR 2008/D3, paragraph 195).

However, a property can continue to meet the requirements of the test where part of the property is not used at all.

The draft ruling then considers cases where some part of the property is not used at all (**partial no use cases**) and cases where the property is used in one or more businesses but is also used other than in one or more businesses (**dual use cases**).

#### Partial no use cases

In considering how much of a property is required to be used for it not to fail the 'wholly and exclusively' test is a question of degree. However, the ATO will consider the test to be met where part of the property is not used at all provided the property is used in the stipulated way to some appreciable extent (SMSFR 2008/D3, paragraph 200).



Further, only when the area used in business is so small that it would not be considered an appreciable part of the land will questions be raised about whether the test has been satisfied (SMSFR 2008/D3 paragraph 201).

#### Dual use cases

In cases where the property is partly used in one or more businesses as well as partly used in other than one or more businesses the test will most likely not be met. The only exception the ATO has discussed is the *de minimus* principle which would permit dual use cases only where the non-business use of the property is relatively 'minor or trifling' (SMSFR 2008/D3, paragraphs 205 to 207).

#### ***How to apply the business use test at a point in time***

The business real property definition is used by various sections of the SIS Act and each section requires that the status of an eligible interest held by an entity be determined at a particular point in time.

The ATO, however, takes a broader approach when applying the business use test. It finds it appropriate to account for all of the circumstances associated with the use of the property surrounding the time at which the business real property definition is applied (SMSFR 2008/D3, paragraph 212).

#### **Conclusion**

The new SMSFR 2008/D3 provides useful guidance on the coverage of the business real property definition. Without such guidance SMSFs may have found it difficult to determine when real property is and when it is not being used in the business of an entity.