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SMSFs & unpaid trust distributions

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In the new SMSFR 2008/D1, the ATO examines whether any of the rules in the *Superannuation Industry (Supervision) Act* 1993 (**SIS Act**) are breached where a SMSF is presently entitled to distributions from a related trust and the trust does not pay those distributions.

SMSFs commonly hold investments in related unit trusts from which periodic income may be distributed. However, at times, these entitlements are not paid to the SMSF but are instead retained as an asset of the SMSF, sometimes recorded as a loan or an investment.

In SMSFR 2008/D1, the ATO states that allowing for such trust distributions to remain unpaid may potentially contravene the SIS Act and, in particular, it may breach any or all of the following rules:

- the in-house asset rules in Part 8 of the SIS Act;
- the arm's length rules in section 109 of the SIS Act; and
- the sole purpose test in section 62 of the SIS Act.

In-house asset rules

The ATO considers firstly whether unpaid trust distributions may breach the in-house asset rules.

The expression 'in-house asset' is defined, in the SIS Act, to include:

- a loan to a related party of the fund; or

- an investment in a related party or a related trust of the SMSF (section 71(1) of the SIS Act).

The issue, therefore, arises as to when unpaid trust distribution entitlements can be viewed as loans and investments to related parties and related trusts (hence coming within the definition of in-house asset).

Loan

A loan is defined in the SIS Act to be any or all of the following:

- a loan according to the general or legal usage of that term;
- the provision of credit; and/or
- any other form of financial accommodation (section 10(1) of the SIS Act and SMSFR 2008/D1, paragraph 49).

As ordinarily understood, the term 'loan' involves "the payment of a sum of money on condition that at some future time an equivalent amount will be repaid…" (see *Re Securitibank Ltd (No 2)* [1978] NZLR 136).

The provision of credit extends the ordinary meaning of the term loan to include arrangements allowing for delayed payment (See *Prime Wheat Association Ltd v Chief Commissioner of Stamp Duties* (1997) 42 NSWLR 505).

Finally, the provision of other forms of financial accommodation includes instances where assets of the SMSF are held as amounts receivable from another party, regardless of the form in which they are held.

Accordingly, an unpaid trust distribution may give rise to a loan within the in-house asset rules if:

- a formal loan agreement is entered into;
- a formal agreement is entered into for the deferral of payment of a distribution; or
- an arrangement for the deferral of payment of the distribution can be inferred from the circumstances.

Consequently, if an unpaid amount gives rise to a loan and the trust and SMSF are related parties, the unpaid amount will be characterised as an in-house asset of the SMSF. If such an in-house asset exceeds 5% of the fund's assets, then there will be a breach of the in-house asset rules in the SIS Act.

Investment

The meaning of the term 'investment' is derived from the definition of 'invest' found in the SIS Act. The term 'invest' is defined to mean to apply assets in any way or to make a contract for the purpose of gaining interest, income, profit or gain (section 10(1) of the SIS Act). The ATO, therefore, defines the term 'investment' to be the asset resulting from the application of the asset or contract (SMSFR 2008/D1, paragraph 86).

For instance, where a SMSF is entitled to trust distributions the SMSF may as an alternate form of payment, accept additional units in the trust, for the purpose of gaining a greater interest in the trust. In so doing, however, the SMSF extinguishes its right to the initial entitlement (SMSFR 2008/D1 paragraph 87).

Therefore, absent an exclusion, where the trust is a related party or a related trust and an 'investment' has been made in the trust, the amount of the investment will be added to the in-house assets of the SMSF.

Arm's length rule

The second rule the ATO examines for a potential breach, as a result of unpaid trust distributions, is the arm's length rule in section 109 of the SIS Act.

Of note, the rule in section 109 requires investments of SMSFs to be made and maintained on an arm's length basis. However, the section is aimed at parties who meet a level of influence or control over the trustee of the SMSF. This is determined having regard to all the factual circumstances of the particular case (SMSFR 2008/D1, paragraph 104).

In general, if the trustee of the trust in which the investment or loan is held is also the trustee of the SMSF the requisite level of control will exist (SMSFR 2008/D1, paragraph 104).

Where an SMSF is entitled to unpaid trust distributions from a related party or related trust and the trustee does not seek payment within a reasonable time, and no interest or compensation is paid for the time that the money is owing, this will indicate that the parties are not dealing with each other at arm's length. A breach of section 109 may, thus, result.

Sole purpose test

The third rule the ATO examines for a potential breach is the sole purpose test. Broadly, this rule requires an SMSF to use its funds for providing retirement or death benefits for or in relation to its members or for other stated ancillary purposes (section 62 of the SIS Act).

In assessing whether an SMSF has breached the sole purpose test its overall conduct must be analysed. However, according to the ATO, SMSF trustees who maintain unpaid trust distributions of considerable proportions in related trusts or related parties, are likely to fail the sole purpose test (SMSFR 2008/D1, paragraph 108).

However, the presumption of a breach may be rebutted if the SMSF is receiving some form of compensation for its unpaid entitlements (eg interest) (SMSFR 2008/D1, paragraph 108).

Conclusion

In general, should an SMSF wish to deal with a related party or related trust from which the fund is owed money, the SMSF trustee should ensure that:

- any dealing with the related party is done on an arm's length basis;
- the total in-house assets of the fund not exceed 5%;
- the total in-house assets include any unpaid entitlement from a related party or related trust; and
- the SMSF receives some form of compensation for any unpaid loan or investment that it is entitled to from the related party or related trust.

Absent compliance with the above requirements, the SMSF may be in breach of the rules in the SIS Act and lose its complying superannuation fund status and/or other penalties apply.