



## SMSF Regulator's Bulletin

### Self-managed superannuation funds and property development

#### *Relying on this Bulletin*

*Self-Managed Superannuation Fund Regulator's Bulletins outline our concerns about new and emerging arrangements that pose potential risks to SMSF trustees and their members from a superannuation regulatory and/or income tax perspective. To the extent that this Bulletin provides guidance to you, and you apply it in good faith to your own circumstances, the Commissioner will administer the law in accordance with the guidance outlined in this Bulletin.*

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#### What has caught our attention?

1. We have seen an increase in the number of self-managed superannuation funds (SMSFs) entering into arrangements, with related or unrelated parties, involving the purchase and development of real property for subsequent disposal or leasing.

2. In particular, we are seeing a number of arrangements in which the investment activity is undertaken utilising joint venture arrangements, partnerships or investments through an ungeared related unit trust or company.

3. Property development can be a legitimate investment for SMSFs, and the Commissioner does not have any concern with SMSFs investing in property development where it complies with the *Superannuation Industry (Supervision) Act 1993 (SISA)* and *Superannuation Industry (Supervision) Regulations 1994 (SISR)*.

4. However, these types of investments can cause concerns where they are used to inappropriately divert income into the superannuation environment, or if SMSF assets are used to fund property development ventures in a manner that is inappropriate for and sometimes detrimental to retirement purposes.

5. Property development ventures may also involve complex structures and the manner in which they are implemented can lead to inadvertent but serious contraventions of the regulatory rules.

6. If you are considering developing property within your SMSF or investing in a related property development entity or venture, we strongly encourage you to seek independent professional advice. In some cases you may also wish to approach us for advice before doing so.

### What are our concerns?

7. There are no specific prohibitions preventing an SMSF investing directly or indirectly in property development. However where an SMSF seeks to undertake investments of this nature, care needs to be taken to ensure that there are no breaches of the SISA and the SISR.

8. Regulatory concerns that can arise in some arrangements include:

- whether the arrangement amounts to the SMSF being maintained for a purpose outside those permitted by the sole purpose test (referred to as a collateral purpose)<sup>1</sup>
- whether the SMSF continues to meet the relevant operating standards, including record-keeping requirements, ensuring assets are appropriately valued and recorded at market value, and keeping SMSF assets separate from members' assets<sup>2</sup>
- whether the arrangement includes the provisions of a loan or financial assistance (directly or indirectly) to a member or their relative<sup>3</sup>
- whether the arrangement includes the SMSF acquiring assets from a related party<sup>4</sup>
- if the arrangement features the SMSF borrowing money, whether that borrowing fails to meet the requirements to be exempted from the prohibition on borrowing for a limited recourse borrowing arrangement (LRBA)<sup>5</sup>
- whether the SMSF has contravened the in-house assets rules by exceeding the level of in-house assets allowed<sup>6</sup>
- whether payments out of the SMSF under the arrangement are in fact payments of benefits contravening the relevant payment standards (commonly known as illegal early release of superannuation)<sup>7</sup>
- whether the SMSF's investments are made and maintained on an arm's length basis and if they are not, whether the terms and conditions of the transaction are not more favourable to the other party than would be expected in an arm's length dealing<sup>8</sup>

<sup>1</sup> Section 62 of the SISA.

<sup>2</sup> Regulations 4.09A and 8.02B of the SISR.

<sup>3</sup> Subsection 65(1) of the SISA.

<sup>4</sup> Subsection 66(1) of the SISA.

<sup>5</sup> Section 67A of the SISA.

<sup>6</sup> Part 8 of the SISA.

<sup>7</sup> Section 31 of the SISA contains operating standards for regulated superannuation funds and Division 6.2 of the SISR regards the payment of benefits. Superannuation benefits in breach of legislative requirements are included in assessable income under section 304-10 of the ITAA 1997.

<sup>8</sup> Section 109 of the SISA.

9. SMSFs also need to be conscious of:

- income tax matters such as the non-arm's length income (NALI) provisions<sup>9</sup> and the general anti-avoidance rules<sup>10</sup>, particularly where the arrangement involves other related parties<sup>11</sup>, and
- goods and services tax (GST) matters such as GST registration requirements, correct reporting and the application of the margin scheme.<sup>12</sup>

10. Where an SMSF, or entities that the SMSF invests in, conducts a property development, care needs to be taken that the parties are dealing with each other at arm's length, including (but not limited to):

- the purchase of land or other assets
- the value of services provided
- the terms (including the use of personal or related party guarantees) of any borrowing arrangements of the SMSF or other entities involved in the development, and
- the return on investment and income or capital entitlements.

11. Similarly, we would be concerned where circumstances indicate that the arrangement has been used to manipulate the members' transfer balance accounts; for example, by deliberately undervaluing an asset when it enters retirement phase and counts towards the transfer balance cap, allowing a greater amount of earnings within the SMSF to be treated as exempt current pension income.

12. We have previously seen property purchases funded by poorly implemented LRBAs and/or funding arrangements in SMSF-related entities result in breaches of the superannuation regulatory provisions and/or give rise to application of the NALI provisions.

### What are we doing?

13. We will continue to monitor property development arrangements involving SMSFs, particularly those that include LRBAs and related party transactions, to ensure that SMSFs are not contravening any of the provisions listed in this Bulletin.

14. Further explanation regarding areas of concern is provided in the Appendix attached to this Bulletin.

### What should you do?

15. We strongly encourage you to seek independent professional advice before entering into these arrangements, as there may be significant adverse consequences for trustees and members including the forced sale of assets or having to wind up the SMSF. In some cases you may also wish to approach us for advice.

<sup>9</sup> See section 295-550 of the ITAA 1997.

<sup>10</sup> Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

<sup>11</sup> Trustees also need to be aware of other issues that are outside the scope of this Bulletin, such as the tax treatment of the proceeds on sale, and GST.

<sup>12</sup> Division 165 of the *A New Tax System (Goods and Services Tax) Act 1999*.

16. If your SMSF is currently developing property or has invested in a related property development entity or venture, it is important to regularly check in with your SMSF professional advisor and your auditor to ensure that the investment stays on track and that there are no contraventions or regulatory concerns.

17. Where contraventions or regulatory concerns are identified we would encourage you to disclose this information to us early and work with us to put rectification plans in place where possible.

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**Commissioner of Taxation**

13 March 2020

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# Appendix

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18. As the nature of property development depends on the type of development, the parties involved and the structure adopted, we cannot provide a comprehensive guide on all regulatory and income tax and GST matters that an SMSF trustee will need to consider when investing in property development through their SMSF.

19. This Appendix is designed to outline the concerns and insights that the Commissioner, as SMSF Regulator, has concerning superannuation regulatory rules that may be particularly important in the context of property development. The topics covered in this Appendix are:

- in-house assets
- un geared related companies or unit trusts
- the use of LRBAs
- non-arm's length dealings and non-arm's length income
- joint venture arrangements
- providing financial assistance to a member or a relative
- record keeping
- sole purpose test

## **In-house assets**

20. Subsection 71(1) of the SISA provides that, subject to certain exceptions, an in-house asset of a superannuation fund is an asset that is:

- a loan to a related party of the fund, or
- an investment in a related party of the fund, or
- an investment in a related trust of the fund, or
- an asset of the fund that is subject to a lease or lease arrangement between the trustee of the fund and a related party of the fund.

21. Under the SISA, trustees must ensure that no more than 5% of the market value<sup>13</sup> of the fund's assets in any financial year is invested in in-house assets.<sup>14</sup> Trustees are also prohibited from acquiring an in-house asset if the acquisition of the asset would cause the fund to exceed the 5% limit.<sup>15</sup>

22. Certain assets are excluded from being in-house assets depending on the type of investment or because the asset is held subject to certain conditions. Examples of some exceptions relevant to property development are:

- For an SMSF, business real property (BRP)<sup>16</sup> subject to a lease, or to a lease arrangement, between the SMSF and a related party of the fund, is not an in-house asset<sup>17</sup>.
- Property owned by the superannuation fund and a related party as tenants in common is not an in-house asset of the fund<sup>18</sup>, other than property subject to a lease or lease arrangement between the trustee of the fund and a related party.<sup>19</sup>

23. SMSFs undertaking property development or participating in property development ventures need to be aware of the in-house asset rules as these arrangements often include assets or arrangements that are only excluded from being an in-house asset because of certain conditions. Trustees should take particular care to understand:

- when another entity is considered a related party or related trust of the SMSF<sup>20</sup>
- how to calculate the value of the SMSF's in-house assets<sup>21</sup> each year and the requirements of the trustee if the SMSF's in-house assets exceed the 5% limit<sup>22</sup>, and
- if the asset is excluded from being an in-house asset, on what condition it is excluded and what is the consequence if that condition ceases to be satisfied.<sup>23</sup>

### **Ung geared related companies or unit trusts**

24. Of particular relevance to property development is the in-house asset exception for investment in un geared related companies or unit trusts as this is often a popular option for SMSFs undertaking property development investments.

<sup>13</sup> Refer to ATO website [Valuation guidelines for self-managed super funds](#). The value of a fund's total assets needs to be determined on 30 June of the financial year that the in-house assets are held.

<sup>14</sup> Section 82 of the SISA.

<sup>15</sup> Section 83 of the SISA.

<sup>16</sup> Subsection 66(5) of the SISA.

<sup>17</sup> Subsection 66(2A) and paragraph 71(1)(g) of the SISA.

<sup>18</sup> Note that the trustee cannot acquire part of the property from a related party to become tenant in common, see subsection 66(1) of the SISA.

<sup>19</sup> Paragraph 71(1)(i) of the SISA.

<sup>20</sup> Related party and related trust are defined in section 10 of the SISA with reference to the Part 8 associate rules in Subdivision B of Part 8 of the SISA. Also refer to paragraphs 134 to 162 of SMSFR 2009/4 *The meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the SISA*.

<sup>21</sup> Section 75 of the SISA.

<sup>22</sup> Sections 82, 83 and 84 of the SISA.

<sup>23</sup> Paragraphs 163 to 190 of SMSFR 2009/4 provide a detailed description of the various in-house asset exceptions.

25. Investments in a related company or unit trust that would otherwise be an in-house asset are excluded from being an in-house asset if the related company or unit trust is maintained subject to certain conditions.<sup>24</sup> These are sometimes referred to as ‘ungeared related companies or unit trusts’ or as ‘13.22C companies or unit trusts’.

26. To meet the exclusion to being an in-house asset it is critical that the related company or unit trust complies with the conditions both **at the time** that the investment is acquired and **at all times** the investment is held. Conditions that are relevant for property development include, but are not limited to, the requirements that the company or unit trust cannot:

- hold an interest in another entity (including units in another trust)
- lease property to a related party of the fund, or enter into a lease arrangement with a related party of the fund, except for a legally binding lease over BRP
- borrow money
- acquire an asset from a related party of the fund, or an asset that had been owned by a related party of the fund within the previous three years (unless the asset is BRP)
- conduct a non-arm’s length dealing
- **conduct a business**
- **give a charge over an asset or allow a charge to be given over an asset.**

27. **If any of these events happen, the investment in the related company or unit trust will no longer meet the exception to being an in-house asset<sup>25</sup> with the result that all investments held by the SMSF in that related company or unit trust, including future investments in it, will be in-house assets.<sup>26</sup> The asset **can never be returned to its former excluded state**, even if the trustee fixes the issue that caused the asset to cease meeting the relevant conditions.<sup>27</sup>**

28. While it is common to see SMSFs make use of ungeared related companies or unit trusts for the purpose of property development investments, SMSF trustees need to consider how they are going to meet and maintain the conditions. **If the shares or units cease to meet the in-house asset exception, the fund will be required to dispose of the shares or units it holds in excess of the 5% limit within 12 months.<sup>28</sup> In many cases this requires the sale of underlying property or a significant restructure that could be costly to both the development and the SMSF.**

<sup>24</sup> Paragraph 71(1)(j) of the SISA provides that an asset is not an in-house asset if it is included in a class of assets specified in the Regulations. Regulations 13.22C and 13.22D of the SISR are relevant to investments in related companies or units trust acquired on or after 28 June 2000.

<sup>25</sup> Assets acquired after commencement of Division 13.3A of the SISR.

<sup>26</sup> Subregulation 13.22D(3) of the SISR.

<sup>27</sup> See subregulation 13.22D(3) of the SISR. See also Self Managed Superannuation Funds Determination SMSFD 2008/1 *Self Managed Superannuation Funds: how does the happening of an event in subregulation 13.22D(1) of the Superannuation Industry (Supervision) Regulations 1994 affect whether a self managed superannuation fund’s investments in related companies or unit trusts are in-house assets of the fund?*

<sup>28</sup> Section 82 of the SISA.

29. We are concerned that in some cases, trustees do not understand in detail the structure of their property development investment or the how the ungeared related company or unit trust exception operates. Consequently, decisions are made or actions taken during the property development that cause the exception to cease, often without the knowledge of the trustee of the SMSF. This can lead to contraventions of the SISA in addition to costly rectification action to bring the SMSF back into compliance with the in-house asset rules.

30. Additionally, we have concerns that some of the lease arrangements being established or renewed are not being done so via a formal written process. This makes it difficult to determine the terms and conditions of the arrangement and may also lead to a finding that there was no valid lease in existence or the lease agreement was not legally binding. This has significant implications for the fund in respect of the in-house asset rules, and may also have NALI or arm's length transactions implications.

### **Example 1 – Ungeared unit trust leases property to a related party of the SMSF**

31. *Al and Emily would like to invest in property with their SMSF. Al and Emily have \$600,000 (\$300,000 each) to invest and the SMSF has \$800,000.*

32. *An ungeared unit trust is established where Al invests \$300,000 which equals 21.4% ownership, Emily invests \$300,000 which equals 21.4% ownership and the SMSF invests \$800,000 which equals 57.2% ownership.*

33. *A property is then purchased within the unit trust, which bears all the costs associated with purchase and ongoing property costs. The net income is distributed to the unit holders in proportion to their investment therefore Al and Emily would both receive 21.4% and the fund would receive 57.2% of the net rent.*

34. *The unit trust wishes to subdivide the property and then construct both residential and commercial buildings. The trustee of the unit trust undertakes the process of developing the property. Once the buildings are established, they sell the residential property making a profit and lease the commercial property (considered to be business real property) to a related party at market value for a five-year term as specified in the lease contract. At the end of the lease contract, due to an oversight, no renewed lease is entered into. The original lease agreement did not include a 'continuation clause' or other provision to deal with the period of time after the end of the five-year term.*

35. *There may be an event that causes the in-house asset exception to cease to apply to the investment by the SMSF in the unit trust. As the previous lease contract did not provide for a continuing legal relationship after its five-year term, and the trustee has not renewed the lease, upon the end of the term the lease arrangement that was in place with the related party ceased to be legally binding.<sup>29</sup> This event would result in the fund being subject to the 5% in-house asset rule requiring the fund to dispose of some of the units.*

36. *The SMSF has total assets with a market value of \$1,000,000. Therefore the investment in the unit trust represents 80% which is well above the allowable 5%. As Emily and Al do not have available funds to further invest and are not in a position to borrow, they may need to sell the property to allow the SMSF to redeem units.*

37. *While this example does not consider the broader activities of the unit trust, the trustee should also be aware that in some circumstances, depending on the scope of its*

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<sup>29</sup> See paragraph 13.22D(1)(h) of the SISR.



operations and activities, the trustee could be carrying on a business, which would also cause the in-house asset exception to cease.<sup>30</sup>

### The use of limited recourse borrowing arrangements

38. Subject to limited exceptions allowed under the SISA, trustees of SMSFs are prohibited from borrowing money or maintaining an existing borrowing of money.<sup>31</sup>

39. An LRBA is one of the limited exceptions to the borrowing prohibition and involves an SMSF trustee taking out a limited recourse loan from a lender.<sup>32</sup> Those funds are then used in the purchase of a single acquirable asset (which may include a collection of identical assets that have the same market value) that is held in a separate trust, where the SMSF has a beneficial interest in the acquirable asset. The SMSF trustee also has the right to acquire the asset from the holding trust once the SMSF has repaid the loan in full.

40. LRBA's are often utilised by SMSFs investing in property development, either to fund the purchase of the real property to be developed or to acquire shares or units in a property development entity. However, SMSF trustees need to be mindful of certain requirements of the LRBA exception that may impose limitations that need to be factored in when undertaking property development.

41. For example, the LRBA requirements do not allow for amounts borrowed under the LRBA to be used to improve the acquirable asset. Therefore, while a LRBA can be used to acquire the real property to be developed no amount of the borrowed funds can be put towards development costs.

42. This restriction doesn't prevent money from other sources being used to develop the property. However, SMSF trustees need to be aware that if the development fundamentally changes the character of the property, it may fail the LRBA requirements by ceasing to be the same acquirable asset.<sup>33</sup> A property development will generally change the character of the property.

43. Alternatively, the property development may be undertaken by another entity such as a company or trust, with the SMSF using an LRBA to acquire shares or units in that entity. In these circumstances, as the single acquirable asset is the shares or units, the SMSF trustee does not need to be concerned with either the use of borrowed funds to improve the asset or the asset fundamentally changing in character.

44. However, this arrangement is only permitted if the acquirable asset is an asset that the SISA allows the SMSF to acquire. Where the LRBA is being used to acquire shares or units in a property development entity it is essential that SMSF trustees ensure that:

- the property development entity is not a related party or related trust of the SMSF, or
- if the property development entity is a related party or related trust, the investment in the related property development entity is acquired at market value and covered by one of the in-house asset exceptions, or

<sup>30</sup> See paragraph 13.22D(1)(d) of the SISR. Whether you are in business is determined by examining the relevant facts in relation to a particular scenario – see Taxation Ruling TR 2019/1 *Income tax: when does a company carry on a business?*, Taxation Ruling TR 97/11 *Income tax: am I carrying on a business of primary production?* and Taxation Ruling TR 92/3 *Income tax: whether profits on isolated transactions are income*.

<sup>31</sup> See section 67 of the SISA.

<sup>32</sup> Section 67A of the SISA.

<sup>33</sup> Self Managed Superannuation Funds Ruling SMSFR 2012/1 *Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts* provides further explanation of single acquirable asset and examples on whether a change to this asset results in a different asset.

- the acquisition of the asset is at market value and would not result in the SMSF exceeding the 5% limit on in-house assets.<sup>34</sup>

45. Where the SMSF trustees are relying on the ungeared related company or unit trust exception to being an in-house asset, the same requirements and concerns as set out at paragraphs 20 to 30 of this Bulletin are applicable. SMSF trustees should also be mindful that if an event occurs that causes the in-house asset exception to cease, and there is an LRBA over the shares or units, the SMSF will have a borrowing contravention<sup>35</sup> in addition to in-house asset issues.

46. Other factors SMSF trustees should consider when using an LRBA to invest in a related property development entity are:

- the SMSF trustee cannot rely on mirroring the 'safe harbour' terms in Practical Compliance Guideline PCG 2016/5 *Income tax – arm's length terms for Limited Recourse Borrowing Arrangements established by self managed superannuation funds*<sup>36</sup> to show that their terms are consistent with an arm's length dealing. This is because these safe harbour terms only apply to borrowings over real property or listed shares/units. Therefore the trustee would need to demonstrate that their terms reflect an arm's length dealing, for example by showing that they replicate terms of a commercial loan that is available under the same circumstances.<sup>37</sup> However, it may be difficult for a trustee to identify an arm's length lender that would generally provide finance for this kind of transaction, given the unique nature of the single acquirable asset, and the fact that a lender can only be provided a personal security over the units and not the underlying real property.<sup>38</sup>
- if the arrangement involves multiple LRBAs over discrete bundles of units in the unit trust, the LRBAs could fail to meet the requirements of section 67A of the SISA if the lender's right to recourse on default of one LRBA extends to the underlying property or the units under a different LRBA.

47. Trustees must also ensure that all LRBAs are set up correctly, including ensuring the ownership of the underlying asset and units is recorded for the correct entities.

### **Example 2 – Ungeared unit trust gives a charge over an asset**

48. *Kaito and Ponyo have an SMSF with investments totalling \$500,000. An amount of \$400,000 is invested in a related ungeared unit trust that owns a residential apartment which is not leased to a related party of the fund. At this time, the related unit trust is not an in-house asset as it meets the requirements of regulation 13.22C of the SISR. The remaining \$100,000 is invested in cash.*

49. *The SMSF wishes to enter a property development project through the related ungeared unit trust. The unit trust sells the residential apartment and uses the sale amount of \$400,000 to buy the land that is to be developed.*

50. *To fund the development the SMSF subscribes for additional units for an amount of \$300,000 in the unit trust and funds the \$300,000 by way of an LRBA. The plan is to build a duplex with this amount.*

<sup>34</sup> Paragraph 66(2A)(b) and (c) of the SISA.

<sup>35</sup> Paragraph 67A(2)(b) of the SISA. The asset is not an 'acquirable asset'.

<sup>36</sup> This Guideline outlines 'safe harbour' terms on which SMSF trustees may structure their LRBAs consistent with an arm's length dealing where the asset acquired is either real property or a collection of stock exchange listed shares or units.

<sup>37</sup> Paragraph 4 of PCG 2016/5.

<sup>38</sup> Subparagraph 13.22D(1)(c)(ii) of the SISR.

51. *In order to grant the loan the lender asks for security over the land which is granted by the trust.*

52. *As the unit trust has allowed a charge over the asset of the trust a 13.22D event arises.<sup>39</sup> This causes the investment in units of the related ungeared unit trust by the SMSF to now be considered in-house assets.*

53. *The total amount invested in the unit trust of \$700,000 is more than 5% of total assets of the fund (\$800,000).<sup>40</sup> The trustee will need to prepare a plan on how to get this amount below the allowable 5% which will most likely result in the unit trust having to sell the land and abandon the development.*

### **Non-arm's length dealings and non-arm's length income**

54. There are both regulatory and income tax rules that require the trustee of an SMSF to deal at arm's length with other parties.

55. The regulatory rules require the SMSF trustee when entering into a transaction to deal with the other party to the transaction at arm's length, or if the dealing is not at arm's length ensure that the terms are not more favourable to the other party.<sup>41</sup> Therefore if the parties are not dealing with each other at arm's length and the terms are more favourable to the SMSF there will be no breach of section 109 of the SISA.<sup>42</sup> However, if terms are more favourable to the SMSF there may be income tax consequences. The NALI provisions remove the tax concession provided to superannuation funds where the SMSF and other parties are not dealing at arm's length in relation to a scheme and the SMSF ordinary or statutory income from the scheme is more than if the SMSF and the other party had been dealing at arm's length.<sup>43</sup>

56. The NALI provisions seek to tax at the highest marginal rate schemes that inappropriately seek to benefit the SMSF.

57. The NALI provisions can apply to:

- ordinary or statutory income derived from schemes
- dividends or amounts attributable to dividends, and
- entitlements to trust income (both fixed and non-fixed entitlements).<sup>44</sup>

58. For the 2018-19 income year and later income years, NALI will also include income derived from a scheme where a loss, outgoing or expenditure is less than the amount (including a nil amount) that the entity might have been expected to incur in gaining or producing income.

59. Additionally, if the SMSF trustee has an LRBA that is not on arm's length terms, the SMSF trustee needs to consider if the income from the arrangement is greater than the income from a 'hypothetical borrowing arrangement' that was at arm's length terms.<sup>45</sup>

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<sup>39</sup> The security also fails the requirements in paragraph 67A(1)(d) of the SISA as it provides rights that are not limited to the acquirable asset.

<sup>40</sup> Section 82 of the SISA.

<sup>41</sup> Section 109 of the SISA.

<sup>42</sup> For more information refer to ATO Interpretative Decision ATO ID 2010/162 *Self managed Superannuation Fund: limited recourse borrowing arrangement - borrowing from a related party on terms favourable to the self managed superannuation fund.*

<sup>43</sup> Section 295-550 of the ITAA 1997.

<sup>44</sup> For a further explanation on the operation of the non-arm's length income provisions see Taxation Ruling TR 2006/7 *Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income.*

60. The factors to be taken into account when considering if an LRBA is an arm's length dealing will depend on the structure of the development arrangement. The following aspects of the LRBA should be considered by trustees when determining whether the LRBA is an arm's-length dealing:

- repayments and ability to repay
- arrangements to provide security to a lender, and
- related party fees, particularly where these would be considered to be outside the ordinary course of normal commercial arrangements.

61. The meaning of arm's-length dealing has been considered in numerous court cases.<sup>46</sup> Importantly, where parties are related, there is an inference that they will not deal with each other at arm's length. However, this inference can be reversed if the parties can show that despite being related they have conducted the transaction as if they were at arm's length.

62. SMSFs investing in property development will often deal with related parties as part of that development. It is important therefore for SMSF trustees to recognise in dealing with those related parties that each transaction must be conducted on arm's length terms and clearly recorded as such.

63. Even where the other party to the transaction and the SMSF are not related, SMSF trustees should still ensure that the independent minds and wills of the parties are applied to the transaction and their dealing is a matter of real bargaining.<sup>47</sup>

64. SMSF trustees in property development investments need to have regard to ensuring that both the overall structure, as well as the specific transactions that make up the property development, are conducted on arm's length terms. Some examples of transactions SMSFs trustees should ensure are an arm's length dealing are:

- the purchase of land or other assets
- the terms (including the use of personal or related party guarantees) of any borrowing arrangements of the SMSF or other entities involved in the development
- where a related party is engaged to provide services in their professional capacity (such as building or construction works) and they do not charge for these services, or are paid less than an arm's length rate<sup>48</sup>
- the return on investment and income or capital entitlements.

65. The parties to the arrangement should also be aware that there is the potential for non-arm's length property development arrangements to attract the application of Part IVA of the ITAA 1936 and/or Division 165 of the *A New Tax System (Goods and Services Tax) Act 1999* if it is objectively concluded that there was a sole or dominant purpose of obtaining a tax benefit.

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<sup>45</sup> For further information refer to Taxation Determination TD 2016/16 *Income tax: will the ordinary or statutory income of a self-managed superannuation fund be non-arm's length income under subsection 295-550(1) of the Income Tax Assessment Act 1997 (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?*

<sup>46</sup> See the succinct summary by Dowsett J in *Commissioner of Taxation v AXA Asia Pacific Holdings* [2010] FCAFC 134 at [26].

<sup>47</sup> Paragraph 76 of TR 2006/7.

<sup>48</sup> See LCR 2019/D3 *Non-arm's length income – expenditure incurred under a non-arm's length arrangement* and TR 2010/1 *Income tax: superannuation contributions*.

### **Example 3 – Whether dividends received by SMSFs are NALI**

66. John and Vanessa are unrelated individuals who come together to enter into a property development venture. John is the sole member of the J SMSF and Vanessa is the sole member of the v. SMSF. John and Vanessa incorporate a company, JV Co, to conduct the property development activities. J SMSF and v. SMSF each acquire 200,000 shares in JV Co at \$1 per share.

67. JV Co uses the \$400,000 invested to acquire vacant land. It then borrows \$4 million from an unrelated bank. The bank will not lend this amount without additional security, and John and Vanessa need to provide personal guarantees and assurances, taking on the full financial and commercial risk of the development. JV Co also borrows a further \$3 million from related parties for additional working capital.

68. After two years of development JV Co realises a profit and pays tax. JV Co distributes its profits as fully franked dividends to J SMSF and v. SMSF, funding these distributions by taking further loans from related parties. As the SMSFs are fully in retirement phase, they do not pay tax on these dividends and receive a substantial refund of franking credits.

69. Although the documented arrangements on face value appear to be at arm's length, when viewed holistically it is clear that these dividends are not consistent with an arm's length dealing.<sup>49</sup> An unrelated SMSF would not have been able to access these dividends by investing in JV Co for the same value as the J SMSF and v. SMSF, (as) the risk was born by John and Vanessa personally. It is also unlikely that unrelated lenders would be willing to lend to JV Co for additional working capital and to fund dividends, which would prevent JV Co from realising its profit and distributing to the SMSFs.

70. As such, the dividends from JV Co may be NALI for the two SMSFs.<sup>50</sup> Consideration may also be given to whether the arrangement is a scheme to which Part IVA of the ITAA 1936 applies.

### **Joint venture arrangements**

71. A joint venture<sup>51</sup> is defined in the Butterworths Concise Australian Legal Dictionary<sup>52</sup> as:

An association of persons for particular trading, commercial, mining, or other financial undertakings or endeavours with a view to mutual profit. It is not a technical legal term with a settled common law meaning: *United Dominions Corp Limited v. Brian Pty Ltd* (1985) 157 CLR 1; 60 ALR 741. The association is usually for the participation in a single project rather than a continuing business. A joint venture may be carried out by way of a partnership, company, trust, agency, joint ownership, or other arrangement. It may include an activity carried on by a body corporate which was formed to carry on the activity by means of joint control or ownership or shares in the body corporate: (Cth) *Trade Practices Act 1974* s4J(a).

72. This definition indicates that a joint venture may be carried out in the form of a partnership, company, trust or other arrangement. While there may be different tax outcomes depending on the chosen structure, for the purpose of the risks that this Bulletin is concerned with, the term joint venture is used under its general meaning.

<sup>49</sup> Subsection 295-550(3) outlines factors to be considered in deciding whether an amount is consistent with an arm's length dealing.

<sup>50</sup> Section 295-550(2) of the ITAA 1997.

<sup>51</sup> A joint venture may also have GST consequences, refer to Goods and Services Tax ruling GSTR 2004/2 *Goods and services tax: What is a joint venture for GST purposes?*

<sup>52</sup> *Butterworthsconcise Australian legal dictionary*, 2nd edn, (Nygh P. E. (Peter Edward); Butt, Peter), (Butterworths), (Sydney) (1998).

73. Care must be taken by SMSF trustees undertaking property development via a joint venture to ensure the arrangement, particularly when undertaken with a related party, is a true joint venture. That is, the contribution (whether it be financial or time) made by the SMSF and its members must be reflected in the proceeds received (whether it be rental income or sale proceeds).

74. If the SMSF's return from the arrangement is excessive when compared to their input into the arrangement, we would be concerned that the income derived from the joint venture is NALI.

75. In a joint venture with a related party, SMSF trustees also need to ensure that their stake in the joint venture does not amount to an investment in or loan to that related party and is therefore an in-house asset. We would expect the SMSF to hold a proprietary interest in the real property that is being developed, and to be comfortable that the SMSF's investment is 'in' that property and not an investment 'in' the related party.

76. However, where the SMSF has only provided a capital outlay for the arrangement, and has no rights other than a contractual right to a return on the final investment, we would be concerned that they may instead hold an investment in or loan to the other party, depending on the terms of the joint venture agreement.<sup>53</sup>

### **Providing financial assistance to a member or relative**

77. In these kinds of circumstances we may also be concerned that the SMSF has provided financial assistance to members or their relatives. SMSFs are prohibited from providing loans or financial assistance (direct or indirectly) to members or their relatives.<sup>54</sup>

78. Within a property development context, circumstances that could cause us concerns in respect of financial assistance would be where:

- the SMSF becomes an investor in the property development being carried out by the related entity because otherwise there would be insufficient funds to complete the property development
- a related party is engaged to provide services as a means of providing them with work or where they are paid more than market value
- SMSF funds are used to finance elements of the property development on non-arm's length terms, or in situations where the SMSF receives little or no consideration.

### **Record keeping**

79. In determining whether the requirements in the SISA and SISR are met it is also important that the fund keep the necessary records to establish its position. All transactions should be carefully documented to ensure that:

- there is proof of arm's length dealings
- the arrangements put in place reflect the legal status
- the parties intend, and they are permitted by the SMSF's deed and investment strategy<sup>55</sup>, to undertake the property development transactions.

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<sup>53</sup> See for example the arrangement outlined in Taxpayer Alert TA 2009/16 *Circumvention of in-house asset rules by self-managed superannuation funds using related party agreements*.

<sup>54</sup> Section 65 of the SISA.

80. Where there is poor or no record keeping, we would be concerned that the arrangements may contravene the SISA or SISR, or give rise to NALI.

81. Where SMSF trustees are dealing with related party businesses, it is also important that they ensure good record-keeping procedures are followed for the payment of expenses that relate to the property development.<sup>56</sup>

82. We recognise that property development can be a complex and involved investment with many transactions and unexpected expenses. SMSF trustees should establish and maintain good procedures to ensure the correct entity is paying for the correct expense and when acquiring assets that the accounts correctly record and establish the property development venture.

83. This ensures that trustees can establish when payments are being made for the purpose of the property development so there is no confusion that the amount may instead be the payment of retirement benefits.

#### **Example 4 – Property development – SMSF engages related party business**

84. *Tahini is 45 years old. Tahini's SMSF is undertaking the development of property on land owned by her SMSF. Tahini also owns and operates a carpentry business. As part of the property development, Tahini has engaged her business to provide carpentry services. As part of the terms of engagement it was agreed that the SMSF would pay for materials to be used in the property development but that all tools and related costs were to be borne by the business.*

85. *During the course of the development, over a five-year period, Tahini buys materials to be used in the development and tools and equipment for her business on her credit card. The business does not invoice the SMSF for the materials and instead the SMSF's records show payments directly onto Tahini's credit card during the period. Tahini also charged personal expenses against the credit card. Tahini then pays the outstanding balance of the credit card using funds from the SMSF.*

86. *In these circumstances the Commissioner may consider that there has been a breach of the payment standards as the SMSF has made payments against Tahini's personal credit card in circumstances that don't clearly evidence that the payments were solely related to the SMSF's property development investment.*

87. *If so, Tahini will be assessed personally for these amounts, which are now considered assessable income,<sup>57</sup> in her tax return.*

88. *The SMSF trustee may also have contravened section 66 of the SISA by acquiring an asset from a related party, as they have in fact acquired the materials from Tahini after she purchased them personally.*

#### **Sole purpose test**

89. If an SMSF trustee wishes to participate in property development ventures or make use of businesses owned or controlled by a member in property development, care needs to be taken to ensure decisions that SMSF trustees make in maintaining these investments is at all times for the sole purpose of providing retirement benefits for the SMSF members.

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<sup>55</sup> Regulation 4.09 of the SISR prescribes as an operating standard that a trustee must formulate, give effect to and review regularly an investment strategy. The trustee declaration (section 104A of the SISA) also recognises this.

<sup>56</sup> Section 35AE and 35B of the SISA. Also section 103 of the SISA requires trustees to keep and retain for at least 10 years minutes of all meetings of the directors at which matters affecting the entity were considered.

<sup>57</sup> Section 304-10 of the ITAA 1997.

90. The sole purpose test requires trustees of a regulated superannuation fund to ensure the fund is maintained for certain core and ancillary purposes. Broadly these are focused on such as providing benefits for retirement, death, and/or ill-health.<sup>58</sup> Any trustee who maintains an SMSF for other purposes will contravene section 62 of the SISA.

91. Where the trustees of an SMSF have other roles within the property development venture, either through businesses or control of other entities, it is important they can demonstrate that their decision making in respect of the property development is solely pursuing the retirement purpose of the SMSF, and is not being influenced by other goals or purposes in relation to those businesses or other entities.

92. For example, if an SMSF trustee decided to cease paying its members a pension so that the SMSF could use its cash reserves to make an additional capital contribution to a struggling property development venture, this decision may demonstrate that the SMSF is being maintained for the purpose of ensuring the property development's success above the retirement requirements of the SMSF's members. As such, this may cause a contravention of the sole purpose test.

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<sup>58</sup> Section 62 of the SISA.



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## References

### Related Rulings/Determinations:

- SMSFR 2008/1
- SMSFR 2009/4
- SMSFR 2010/1
- SMSFR 2012/1
- TR 2006/7
- TR 2009/1
- TR 2010/1
- LCR 2019/D3
- GSTR 2004/2

### Legislative references:

- ITAA 1997 295-550
- ITAA 1997 295-550(2)
- ITAA 1997 295-550(3)
- SISA
- SISA 31
- SISA 34(1)

- SISA 62
- SISA 65
- SISA 65(1)(b)
- SISA 66(1)
- SISA 66(2A)(b)
- SISA 66(2A)(c)
- SISA 66(5)
- SISA 67A
- SISA 67A(2)(b)
- SISA 67A(1)(d)
- SISA 71
- SISA 71(1)(i)
- SISA 71(1)(j)
- SISR 1994 4.09

### Other references:

- PCG 2016/5
- TA 2009/16

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