Self-managed superannuation funds and the acquisition of assets

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The choice to set up one's own self-managed superannuation fund (SMSF) is becoming an increasingly popular one for many Australians in the lead up to the government’s reforms to simplify and streamline superannuation from 1 July 2007.

The major attraction of an SMSF is that the individual members become, as trustees, their own fund manager. Ultimately, they are responsible for both the investment decision-making and the administration of the fund. An SMSF provides its members with many benefits such as the opportunity to actively decide upon the fund’s investment strategy and to select appropriate asset classes.

There are general issues, however, that trustees need to consider when devising an investment strategy for their SMSF including the acquisition of asset rules. Issues surrounding these rules include what the SMSF is investing in and who the asset is being acquired from. Is it being acquired from a related party? And if so, does it fit under one of the exceptions within the provisions?

Deciding on whether an asset of the fund is being acquired from a related party has become a common query from planners in the lead up to the superannuation changes effective 1 July 2007 as investors look at taking advantage of the $1 million undeducted transitional contribution cap and consider transferring assets in-specie to their SMSF. This update will provide an overview of the provisions surrounding the acquisition of assets from related parties and the exceptions to those provisions.

ACQUIRING ASSETS FROM A RELATED PARTY

The first question that both members/trustees of SMSFs need to ask when acquiring an asset for the fund is who the asset is being acquired from. Is the asset being acquired from a related party of the fund? The trustees of SMSFs in general are prohibited from acquiring assets from related parties of the SMSF. This rule generally prohibits such parties from selling most assets to their SMSF, or from contributing assets in-specie.

A related party of a SMSF includes any of the following:

- A member of the SMSF.
- A standard employer sponsor of the SMSF.
- A Part 8 associate of an entity referred to in a) or b).

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Kate has over 10 years experience in the Financial Services Industry as a technical consultant.
A Part 8 associate of a member or a standard employer sponsor includes any of the following:
- The relatives of a member.
- For SMSFs with less than five members, each other member and each individual trustee or director of a corporate trustee.
- A business partner of a member or standard employer sponsor (and the spouse and child of each such partner).
- The trustee of a trust which the member or standard employer sponsor controls.
- A company or other entity that is sufficiently influenced by the member or standard employer sponsor or which has a majority voting interest in the standard employer sponsor.
- The Part 8 associates of companies or entities with sufficient influence over a corporate standard employer sponsor.
- Standard employer sponsors which are partnerships or individuals are also covered by the new rules.

There are, however, several exceptions to the prohibition against acquiring assets from related parties, which are outlined in greater detail below. These include:
- The acquisition is an in-house asset which, after being acquired by the trustees would not result in the level of In-house Assets of the SMSF exceeding more than 5 per cent of the SMSFs assets;
- The asset is a listed security (for example, shares, units or bonds listed on an approved stock exchange); or
- The asset is ‘business real property’.

**BUSINESS REAL PROPERTY**

The definition of business property in relation to an entity is defined in subsection 66(5) of the SIS Act and includes:
- Any freehold or leasehold interest in real property;
- Any assignable or transferable interest in Crown land (other than leasehold interest); or
- Any other interest in relation to real property as prescribed in the regulations;

where the real property is used wholly and exclusively in one or more businesses.

Real property on which an entity conducts a business, for example, a shop, a factory or office, will be business real property, provided the property satisfies the wholly and exclusively business use requirement.

**IN-HOUSE ASSETS**

An in-house asset is an asset of the fund that is a loan to, and investment in or lease with a related party of the fund. A related party investment is also an asset of the Fund that is a loan to, an investment in or lease with a related party of the fund that meets one of the exceptions of the in-house asset rules.

While they seem similar and one is in fact a subset of the other, the distinction is relevant because a fund is not permitted to invest more than 5 per cent of its capital in an in-house asset whereas no such cap applies to a related party investment. So, when is a related party investment not an in-house asset, that is, what are the exceptions to the in-house asset rules?

Some of the most commonly utilised exceptions to the in-house asset rules include:
- a life policy issued by a life insurance company, but not a life policy acquired from a member of the fund or a relative of a member;
- an investment in a pooled superannuation trust made on an arm’s length basis;
- real property subject to a lease, or to a lease arrangement enforceable by legal proceedings, between the trustee of the fund and a related party of the fund, if throughout the term of the lease or lease arrangement, the property is business real property of the fund;
- an investment in a widely held unit trust; a unit trust in which the unitholders have fixed entitlements to all of the income and capital of the trust, and fewer than 20 entities between them do not have fixed entitlements to 75 per cent or more of the income or capital of the trust;
- property owned by the fund and a related party as tenants in common, other than property subject to a lease or lease arrangement between the trustee of the fund and a related party.

Ref: SIS Act 1993 Section 71

In addition, regulations were passed on 28 June 2000 to allow an SMSF to invest in a unit trust or a company without that investment being considered an in-house asset if certain conditions are met. Ref: SIS Regs 1994 Section 13.22C and 13.22D

**EXAMPLE – INVESTMENT STRATEGIES AND IN-HOUSE ASSET RESTRICTIONS**

Mr and Mrs Lewis have established an SMSF in which they are the members and trustees. The fund has $70,000 in cash, with which they, as trustees, would like to purchase a one-third interest in a residential property in Byron Bay used for holiday letting.

Mr and Mrs Lewis as individuals will own the other two-thirds interest. They will borrow money to fund their purchase but their private residence will be used as security.

Mr and Mrs Lewis intend to use the holiday property when it is not being rented. It will, however, be available to rent for the whole year.

What areas of concern would a financial planner have to consider for the purposes of this example in relation to the in-house asset restrictions?

The SMSF and Mr and Mrs Lewis as trustees of the SMSF can invest as tenants in common in a residential property, as it falls within one of the exceptions of an in-house asset under SIS Act section 71. The property would need to be bought from an unrelated party.

A member or any related party would not be permitted to rent or reside in the property, otherwise it would constitute an in-house asset. The in-house asset rule is a day by day test and
any stay by Mr and Mrs Lewis or a related party would require the
trustee to include the full market value of the property as an in-house asset of the fund. If the market value exceeds the 5 per cent rule, then the trustee is in breach of the in-house asset rules.

OTHER GENERAL ISSUES TO BE CONSIDERED

The trustees of an SMSF must also comply with stringent duties and obligations when making investment decisions to ensure that assets are properly invested for retirement purposes which include:

Sole purpose test

The sole purpose test requires that any investment is undertaken for the sole purpose of providing retirement or retirement related benefits for members or dependants, and that any other benefits or advantages are merely incidental or ancillary to achieving this sole purpose.

Arm’s length transactions

All investment transactions of SMSFs must be maintained on an arm’s length basis. Transactions need not necessarily be at arm’s length (they may be between related or associated parties) but investment transactions must be on an arm’s length (commercial) basis.

Investments must be entered into and maintained on commercial terms, or on terms that are no more favourable to the other party than would reasonably be expected if the dealing was at arm’s length in the same circumstances. For instance, the purchase price of an investment should be at market value. In addition, the agreed or expected return from that investment should not be less than a true market rate.

All parties to the transaction should seek professional advice on the tax consequences where an investment is made and/or maintained on terms more favourable to the fund than to the other party.

In-specie transfers

Assets of a member or a relative of a member may be contributed in-specie to the fund as a contribution. Regulations limit such assets to listed securities (for example, shares, units or bonds listed on an approved Stock Exchange), business real property and to in-house assets which, after being acquired by the trustees, would not result in the level of in-house assets of the SMSF exceeding more than 5 per cent of the SMSFs total assets.

Where an asset is moved into an SMSF in-specie, capital gains tax (CGT) may apply upon transfer as this constitutes a transaction (sale and purchase). CGT is normally payable where the beneficial interest of an asset changes, notwithstanding the fact that the member may be transferring assets from non-superannuation to a superannuation investment fully vested in his or her own name.

SUMMARY

Trustees of SMSFs are required to prepare and implement an investment strategy for their fund and regularly review the strategy. The devising and documenting of an appropriate investment strategy is crucial to the success of an SMSF. Trustees of SMSFs need to be wary of the superannuation investment rules, in particular the acquisition of assets from related parties and the exceptions relating to these provisions, particularly in the lead up to 1 July 2007. They need to bear in mind that the primary purpose of superannuation is saving for retirement and that all investments must be suitable for this purpose.