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Technical Bulletin

INVESTMENT RESTRICTIONS – A timely overview

Two relatively recent Federal Court cases give the SMSF Industry plenty of food for thought with regards to the investment decisions of a fund. An important factor in both cases was the commercial nature of the transactions undertaken. If we put the spotlight on some of the issues associated with each of the cases, we can highlight the key investment restrictions that could create problems for a fund.

This bulletin will provide a timely reminder of the investment restrictions, specifically focussing on those that catch out SMSF trustees the most.

Investment restrictions

The Superannuation Industry (Supervision) Act 1993 (SISA) and Superannuation Industry (Supervision) Regulations 1994 (SISR) imposes on the trustee of a superannuation fund a number of duties and restrictions that affect a fund's investment activities. Penalties can be imposed on anyone involved in breaches of the investment rules, such as the trustee or their adviser, and a fund that fails to comply with these rules may lose its complying fund status and not be entitled to tax concessions.

The below list highlights the main areas in which the SISA & SISR has an impact on the investment activities for SMSFs as well as providing the appropriate section and relevant ATO ruling.

The key investment issues are:

- a fund must formulate and put into effect an investment strategy (ss52B(2)(f) & Reg 4.09)
- a fund must be maintained to satisfy the sole purpose test (s62) – SMSFR 2008/2
- the fund must not lend or provide financial assistance to members or member's relatives (s65) – SMSFR 2008/1
- the fund must not borrow money except in some very limited circumstances (s67, s67A & s67B) – SMSFR 2009/2 & SMSFR 2012/1
- the fund must not acquire assets from members or related parties except in limited circumstances (s66) – SMSFR 2010/1
- the level of a fund's investment in in-house assets is restricted to 5% (s84 SISA)
- investments must be on an arm's length basis (s109)

It is the purpose of a fund's investments, not necessarily the nature of the asset that will determine whether a fund can maintain or hold a certain investment.

Court cases

The 2018 Case, *Aussiegolfa Pty Ltd (Trustee) v Federal Commissioner of Taxation (AussieGolfa)* focusses largely on the requirements of the Sole Purpose Test and the definition of an in-house asset, whilst the 2014 Case *Deputy Commissioner of Taxation (Superannuation) v Graham Family Superannuation Pty Limited (Graham Family)* is actually focussed on the imposition of penalties for breaches of various investment restrictions but the activities of the fund put a focus on the Sole Purpose Test and the provision of financial assistance to a member or member's relative. As such we will turn our attention to the Sole Purpose Test, the in-house asset requirements and the provision of financial assistance to a member or member's relative. Underwriting all of these issues is that the fund investments must be made and maintained on an arm's length basis.

Sole Purpose Test

The trustee of an SMSF must comply with the sole purpose test set out in section 62 of the SISA.

This test requires the trustee to ensure the fund is maintained solely for one or more of the "core purposes", or for one or more of the core purposes and for one or more of the "ancillary purposes". A fund which is not maintained solely for at least one of the core purposes fails the test, as does a fund that has a purpose that is not a core or ancillary purpose.

Core purposes

The core purposes are:

- the provision of benefits for each member of the fund on or after the member's retirement (whether the member's retirement was before or after the member joined the fund)
- the provision of benefits for each member on or after the member reaching 65 years, or
- the provision of benefits on or after the member's death if:
    - the death occurred before the member's retirement, or 65th birthday, and
    - the benefits are provided to the member's legal personal representative and/or dependents.

Ancillary purposes

The trustee may also maintain a fund for ancillary purposes which are in addition to one or more of the core purposes. The following are ancillary purposes:

- the provision of benefits on or after the termination of the member's employment with an employer-sponsor who contributed to the fund for the member
- the provision of benefits for each member of the fund on or after the member's cessation of work on account of ill health
- the provision of benefits in respect of each member of the fund on or after the member's death if:
    - the death occurred after the member's retirement, or attainment of 65, and
    - the benefits are provided to the member's legal personal representative and/or dependents
- the provision of such other benefits as are approved by the Regulators.

Consistent with the payment of benefit rules in the SIS Regulations, the provision of benefits approved as additional ancillary purposes include payments:

- in the event of a member's financial hardship
- on compassionate grounds, and
- as permitted or required to be paid under the preservation and payment standards.

Essentially, the sole purpose of the Fund is to pay retirement or death benefits to members or member beneficiaries of the Fund. To maintain the Fund for any other purpose is a contravention.

Benefit to members and/or others outside the scope of the test

Circumstances may result in benefits being provided to the members or the member's relatives that are outside the scope of the core and ancillary purposes. Such benefits will not necessarily result in the fund contravening the law.

In its Ruling SMSFR 2008/2, the ATO highlights factors that would help conclude that an SMSF does not meet the sole purpose test:

- Trustees negotiated for or sought out the benefit, even if the additional benefit is negotiated for or sought out in the course of undertaking other activities that are consistent with section 62
- The benefit has influenced the decision-making of the trustee to favour one course of action over another.
- The benefit is provided by the SMSF to a member or another party at a cost or financial detriment to the SMSF.
- There is a pattern or preponderance of events that, when viewed in their entirety, amount to a material benefit being provided that is not specified under subsection 62(1).

SMSFR 2008/2 also outlines the factors that could assist in the conclusion that a Fund satisfied the sole purpose test:

- The benefit is inherent or unavoidable part of other activities undertaken by the trustee that are consistent with the provision of benefits specified by subsection 62(1).
- The benefit is remote or isolated, or is insignificant (whether it is provided once only or considered cumulatively with other like benefits) when assessed relative to other activities undertaken by the trustee that are consistent with the provision of benefits specified by subsection 62(1).
- All of the activities of the trustee are in accordance with the covenants set out in section 52B in the case of an SMSF.
- All of the SMSF's investments and activities are undertaken as part of or are consistent with a properly considered and formulated investment strategy.

Clearly it is of significance, when measuring benefits other than provided for by the Sole Purpose Test, who is receiving the benefit. Benefits provided to members and related parties are more likely to create a potential current day benefit.

In both cases residential property was provided to relatives of the Fund members. In *Aussiegolfa* the property was held via an investment trust and was leased to the member's daughter on the same commercial terms as it had previously been leased to non-related parties. In *Graham Family* the property was leased at no cost to the member's son. Importantly, *Aussiegolfa* had considered the acquisition of student accommodation as part of its investment strategy and had a history of leasing the property to non-related parties. Whilst the ATO accepted the Courts decision that the Fund had not breached the Sole Purpose Test, it warned other funds, via the release of a Decision Impact Statement, that leasing residential property to a related party on commercial terms will not by itself satisfy the Sole Purpose Test. Ultimately it will come down to many factors, as highlighted above.

It should be noted that the Sole Purpose Test applies throughout the entire lifecycle of the Fund. To entertain the thought that using assets of the Fund can be attributable to paying a benefit is likely to result in a breach of the Sole Purpose Test. On satisfying a condition of release, the SIS Regulations provide cashing restrictions and how a benefit can be paid. A lump sum can be paid in cash or via an in-specie transfer of assets. A pension payment can only be made in cash. Trustees and members, being one and the same must take this into consideration.

Of course, what both of these cases then trigger is the need to consider the in-house asset rules.

In-house asset investments

The definition of an in-house asset is defined in section 71 of the SIS Act and from 12 August 1999, an "in-house asset" of an SMSF includes:

- a loan to, or an investment in, a related party of the fund
- an investment in a related trust, 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.

There are assets specifically excluded from this in-house asset definition set out in section 71(1)(a) to 71(1)(j) of the SISA. The key exclusions for SMSFs based on the above definition are:

- an asset which the Regulator, by written notice to the trustees of a fund or legislative instrument, determines is not an in-house asset of the fund or of a class of funds in which the fund is included.
- real property subject to a lease, or to a lease arrangement enforceable by legal proceedings, between the trustee and a related party of the fund if, throughout the term of the lease or lease arrangement, the property is "**business real property**" (SMSF and Small APRA only)
- an investment in a widely held unit trust
- property owned by the SMSF and a related party as tenants in common, other than property subject to a lease or lease arrangement between the trustee and a related party of the fund
- an asset included in a class of assets prescribed by the Regulations not to be an in-house asset of any fund or a class of funds to which the fund belongs.

A trust is a "widely held trust" if it is a unit trust in which entities have fixed entitlements to all of the income and capital of the trust where:

- no fewer than 20 unrelated entities between them have fixed entitlements to 75% or more of
- the income or capital of the trust.

A holding trust for a limited recourse borrowing arrangement is not an in-house asset unless the asset acquired by the borrowed money is an in-house asset.

In-house asset rules and in-house assets

An SMSF is subject to restrictions on its investments in in-house assets.
The in-house asset rules:

- impose a maximum limit of investments in in-house assets of 5% of total fund assets based on market value
- require a fund with in-house assets in excess of the 5% limit as at the end of the financial year to dispose of the excess in accordance with a written plan
- prohibit the acquisition of new in-house assets if the market value ratio of the fund's in-house assets exceeds 5%
- prohibit a fund from entering into any scheme which would avoid the application of the in-house asset rules.

For the purposes of determining the market value ratio of an SMSF's in-house assets, the trustees must value all of a fund's assets.

Applying the in-house asset rules to the Cases

The circumstances of *Aussiegolfa* are slightly different to *Graham Family* because the investment fits under the category of 'an investment in a related trust' whereas *Graham Family* was an 'asset of the fund subject to a lease or lease arrangement between the trustee of the fund and a related party'. Despite the different definition element the outcome is the same, the asset is classified as an in-house asset and subject to 5% investment restriction. It should be noted that whilst no income was received for *Graham Family*, this does not preclude it from having a lease. A lease arrangement is an arrangement where one party is given exclusive access to the asset.

What is also a key point of difference is that the SMSF in the *Aussiegolfa* case did not own all of the units in the Trust so the property was not 100% owned by the fund. In fact the 25% ownership that was attributable to the SMSF equated to less than 10% of the total SMSF assets. Therefore, had the SMSF invested a lower amount, the fund would have been ok given the Courts ruled in favour of it satisfying the Sole Purpose Test

Overall, the *Aussiegolfa* case provides an example of "nearly but not quite there" with regards to satisfying the investment restrictions, however, *Graham Family* failed on all accounts. The final issue for that fund was that in addition to having the family member living in the house rent free, the fund also lent money to the members.

Financial assistance to members or members relatives

Section 65 of the SIS Act prohibits an SMSF from providing financial assistance to members or their relatives. Each year based on ATO statistics, this is the number 1 breach reported by SMSF Auditors. Over 20% of all breaches reported are linked to s65.

Section 65 states, the trustees must not:

- lend money of the fund to:
    - a member of the fund; or a relative of a member of the fund; or
- give any other financial assistance using the resources of the fund to:
    - a member of the fund; or a relative of a member of the fund.

Related Individuals

For the purposes of fund investments, it is important to distinguish between related individuals and related parties. Without doubt many compliance issues arise because a loan to a related party is considered an in-house asset, as stated above, however, Section 65 states that nothing in Part 8 (in-house asset rules) shall have any bearing on the prohibition i.e. it doesn't matter what the in-house asset rules are, some lending is not possible under any circumstances.

Practical Implications

The effect of this restriction not only means that SMSFs are unable to lend money to related individuals, it also means that related individuals cannot use fund assets without providing appropriate commercial consideration to the fund such as paying commercial rent for the use of any direct property, as was the case with *Graham Family.*

In reality, the use of SMSF fund assets by members or their relatives for no cost will not only be considered to be providing financial assistance to the related individual, it is likely to cause the sole purpose test and the 'in-house asset' and the arm's length standards to be breached. This was clearly the case in *Graham Family.*

ATO Ruling

The ATO has issued a ruling, SMSFR 2008/1, re the prohibition on giving financial assistance to members or relatives. The interpretation is extremely broad and can also extend to interposed third parties or entities (i.e. indirect assistance). This is where the link between the in-house asset rules and the loan to member rules start to blur.

For example, if a fund lends money to a related company or trust, this would appear on face value to be in accordance with the in-house asset requirements. If, however that company or trust on-lends the money to a related individual then it's clearly in breach of Section 65.

SMSF trustees should ensure that they are aware of the contents of ATO SMSFR 2008/1.

What is financial assistance?

In the Ruling the ATO sets out a number of transactions or arrangements they would and would not consider as providing financial assistance.

Transactions that the Commissioner would consider to contravene the lending provisions:

- giving a gift of an SMSF asset to a member or relative of a member;
- selling an SMSF asset for less than its market value to a member or relative of a member;
- purchasing an asset for greater than its market value from a member or relative of a member;
- acquiring services in excess of what the SMSF requires from a member or relative of a member;
- paying an inflated price for services acquired from a member or relative of a member;
- forgiving a debt owed to the SMSF by a member or relative of a member;
- releasing a member or relative of a member from a financial obligation owed to the SMSF, including where the amount is not yet due and payable;
- delaying recovery action for a debt owed to the SMSF by a member or relative of a member;
- satisfying, or taking on, a financial obligation of a member or relative of a member;
- giving a guarantee or an indemnity for the benefit of a member or relative of a member;
- giving a security or charge over SMSF assets for the benefit of a member or relative of a member.

Factors that assist in determining whether the law has been contravened

- the arrangement or transaction exposes the SMSF to a credit risk, or exposes the SMSF to a financial risk, of a member or relative of a member;
- the arrangement or transaction is on non-arm's length terms that are favourable to a member or relative of a member;
- the arrangement or transaction is not a usual or normal commercial arrangement in the context in which SMSFs operate;
- the arrangement or transaction is not consistent with the investment strategy of the SMSF;
- under the arrangement or transaction an amount is paid by the SMSF, and later repaid to the SMSF, in amounts or in a manner that may be equated with the repayment of a loan whether with or without an interest component;
- the arrangement or transaction results in a diminution of the assets of the SMSF whether immediately or over a period of time.

Conclusion

The Sole Purpose test is an objective test, in the case of an SMSF the first thing all funds must do is formulate and give effect to an investment strategy and the objective of the strategy is to provide for the member or their beneficiaries primarily after retirement or death. As a result of formulating the strategy and contemplating the Sole Purpose Test the investment decisions of a fund must be made without influence of other benefits that may occur and at some point the trustees may be required to justify the investment to the regulator.

Finally, the important message is that all legislative provisions must be reviewed when considering any SMSF transaction and just because the fund satisfies one requirement i.e. the Sole Purpose Test, it doesn't mean it satisfies all others.

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