Related-party investments in times of financial stress

Investments involving related parties can be problematic at the best of times for an SMSF and even more challenging when a financial crisis hits, writes Tim Miller.

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As it is well known, an SMSF may invest in a wide range of investments. The manner in which an SMSF invests is determined by the fund's investment strategy, its trust deed and, of course, the *Superannuation Industry (Supervision) (SIS) Act* and accompanying SIS Regulations.

Sometimes a fund can seemingly be doing everything in accordance with its investment strategy, its deed and the act, but due to an unforeseen life event the value of the assets held is thrown into turmoil. COVID-19 is that event and Part 8 investments, otherwise known as in-house assets, are the investments potentially in turmoil.

That's not to suggest other fund investments aren't suffering due to the financial impact of the coronavirus, because truth be told most other investments are being affected far more than most funds' in-house assets from a purely financial perspective. However, from a compliance standpoint, it is always in-house assets that create the heat for SMSFs because by nature their valuations often are not as fluid as other investments and that can be problematic when all else around is falling.

Investment restrictions

As it stands, the *SIS Act* imposes on SMSF trustees a number of duties and restrictions that affect the fund's investment activities. A fund failing to comply with these investment obligations may, in the worst-case scenario, lose its complying fund status and lose its entitlement to tax concessions. More likely a fund will be asked to fix its issues and, in some instances, penalties may be imposed on anyone involved in breaches of the investment rules.

So what does compliance look like when a financial tsunami hits? Are funds provided any leniency or is it just a matter of 'your choices, your responsibilities'? I will come back to that, but first let's look at the complexity of compliance.

Related parties – an irresistible SMSF force

For an SMSF, the term 'related party' is relevant for the purposes of defining whether an investment constitutes an investment in an in-house asset or an asset subject to an in-house asset exemption. More broadly, it is one of the strategic reasons why people set up SMSFs – so they can undertake related-party investments, regardless of their restrictive nature. These can include in-house assets or more significant transactions such as investing and leasing business real property (an exemption).

Whatever the reasons, there is inherent risk when investing with links to related parties because not only do you have to satisfy all of your normal trustee obligations, you must also be aware of the following issues:

- in-house asset rules,
- arm's-length rules, and
- financial assistance rules.

An in-house asset refresher

For all investments made in an SMSF post 11 August 1999, an in-house asset is:

- 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.

Key related-party exclusions to these rules are:

- business real property leased to a related party of the fund,
- property owned by the SMSF and a related party as tenants in common, other than property leased to a related party of the fund, and
- an asset included in a class of assets prescribed by the SIS Regulations not to be an in-house asset of any fund or a class of funds to which the fund belongs.

Asset prescribed by the regulations

The SIS Regulations prescribe that funds with fewer than five members are permitted to buy units in a trust (or shares in a company) that invests only in business real property or other approved assets, so long as certain conditions, outlined in SIS Regulation 13.22c, are met for all post-28 June 2000 investments. For the purposes of explanation, I will reference trusts, but the rules are applicable to companies as well. Satisfy the rules and an in-house asset exemption awaits.

As a summary, the concessions mean an SMSF may invest solely or with other parties, whether related or not, in a unit trust that owns real property. That real property, if used for business purposes, may be leased to members and/or other related parties. Non-business real property must be leased to non-related parties to satisfy the in-house asset exemption. There can be no gearing, no investing in other entities, no conducting businesses and all transactions must be on an arm's-length basis.

The in-house asset exemption ceases to apply to a fund's investment in a trust if an event listed under regulation 13.22D(1) occurs. If the exemption is lost, the investment will be treated as an in-house asset and, on the likely assumption that the asset exceeds 5 per cent of the fund's total assets, the trustees will need to take action as outlined below.

As the regulations apply to funds with fewer than five members, if fund membership increases to five or more, the exemption is lost. The exemption can also be lost if the trust:

- acquires an interest in another entity (that is, shares or units),
- makes a loan to another entity (a deposit with an authorised deposit-taking institution is excluded),
- allows a charge over a trust asset,
- borrows money,

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- conducts a business,
- becomes a party to a lease involving a related party of the fund that does not involve business real property,
- conducts a transaction other than on an arm's-length basis, or
- acquires an asset other than business real property from a related party of the fund.

Three regulation 13.22D events spring immediately to mind when related parties experience financial hardship. They are the trust may use its assets as security, the trust may borrow or the trust may conduct transactions other than on an arm's-length basis. But more on that later.

In-house asset rules

The in-house asset rules impose a maximum limit on in-house assets of 5 per cent of total fund assets based on market value. Further, these rules:

- prohibit the acquisition of new in-house assets if the market value ratio of the fund's in-house assets exceeds 5 per cent, and
- prohibit a fund from entering into any scheme that would avoid the

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application of the in-house asset rules.

Exceeding the limit

A fund that exceeds the 5 per cent in-house asset limit as at the end of the financial year is required to prepare a written plan that outlines the size of the excess and the steps the trustees will take to reduce the market value ratio below 5 per cent by way of disposal. This must be done by the end of the following financial year.

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

As a result of these rules, in-house assets that hold their valuation can become problematic when all other assets are falling and it may not take much to exceed the 5 per cent.

Example

At 1 July 2019, the Jones Superannuation Fund has $1 million in total fund assets. One asset is a $45,000 investment in Jones Pty Ltd, a building company owned and operated by Bill and Jessie Jones, who are the two members of the fund. This is an in-house asset and represents 4.5 per cent of the fund's assets. As at 30 April 2020, the fund's portfolio has dropped significantly and the total asset pool is $800,000. If this continued, the in-house assets at 30 June would represent 5.63 per cent of the total assets. Bill and Jessie would need to prepare a written plan to ensure their holding in Jones Pty Ltd was reduced below 5 per cent by 30 June 2021.

Arm's-length rules

The trustee of an SMSF must ensure all investments are made on an arm's-length basis. That is, the investment must be on commercial and businesslike terms.

For compliance purposes, when dealing with a related party the SMSF must ensure the dealings are no more favourable to the related party than they would be if the parties weren't related.

> SMSF trustees must not lend money of the fund or give any financial assistance to a member of the fund or their relatives.

Further, from a pure taxation point of view if the parties enter into a scheme where the parties are not dealing with each other on an arm's-length basis, then the income associated with the scheme can be taxed at 45 per cent.

It is imperative all related-party transactions are undertaken on an arm's-length basis, especially when contemplating relief measures.

Financial assistance

SMSF trustees must not lend money of the fund or give any financial assistance to a member of the fund or their relatives.

The ATO has identified a number of arrangements it would consider as providing financial assistance to a member or their relatives. The complete list can be found in SMSF Ruling 2008/1. The following would most certainly create problems in the current environment:

- purchasing an asset for greater than its market value from a member or relative,
- acquiring their services in excess of what the SMSF requires or paying an inflated price for such services (services other than in their capacity as trustee, that is, a related-party builder),
- forgiving a debt owed to the SMSF or releasing a member or relative from a financial obligation owed to the SMSF, including where the amount is not yet due and payable (rent relief), and
- delaying recovery action for a debt owed to the SMSF (such as unpaid rent).

Ultimately, a fund may have compliance issues if the SMSF is exposed to a credit risk, transacts on a non-arm's-length basis more favourable to the member or there is a diminution of the fund assets immediately or over time.

This just highlights care must be taken to avoid related-party issues.

What does all this mean and is there any help available?

Firstly, there is no prohibition on an SMSF assisting related parties as a result of COVID-19. Rent relief for commercial properties is available as long as the relief is consistent with the government-issued guidelines. The key is to make sure everything is done at arm's length. This is especially critical for non-geared trusts as the fund doesn't want the double whammy of the asset becoming an in-house asset, which would inevitably require it to be sold, regardless of future recovery, but also the income from the trust being treated as non-arm's-length income because that is disastrous.

With reference to in-house assets there is also some relief, albeit not a removal of responsibility. For a fund that finds itself in a position of exceeding the 5 per cent limit at 30 June, the trustees will still need to prepare a plan to dispose of the assets next financial year. If, however, the markets still haven't recovered by 30 June 2021 or alternatively they have recovered, and the in-house assets are no longer in excess of 5 per cent, then the plan does not need to be executed.

In the example above, as long as Bill and Jessie have prepared the plan, then there will be no need to execute it in the event the fund assets increased above $900,000.

For any clients close to the 5 per cent limit last year, chances are the fund will exceed the threshold this year, so the best thing is to be prepared.