SMSFR 2008/D5 - Self Managed Superannuation Funds: the meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the Superannuation Industry (Supervision) Act 1993

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Draft Self Managed Superannuation Funds Ruling

Self Managed Superannuation Funds: the meaning of 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement' in the definition of an 'in-house asset' in the *Superannuation Industry (Supervision) Act 1993*

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Preamble

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which provisions of the *Superannuation Industry (Supervision) Act 1993*, or regulations under that Act, apply to superannuation funds that the Commissioner regulates: principally self managed superannuation funds.

Self Managed Superannuation Funds Rulings (whether draft or final) are not legally binding on the Commissioner. However, if the Commissioner later takes the view that the law applies less favourably to you than the final version of this ruling indicates, the fact that you acted in accordance with the final version of this ruling would be a relevant factor in your favour in the Commissioner's exercise of any discretion as to what action to take in response to a breach of that law. The Commissioner may, having regard to all the circumstances, decide that it is appropriate to take no action in response to the breach.

What this Ruling is about

1. This Ruling explains the core concepts in the definition of 'in-house asset' of a self managed superannuation fund (SMSF) as defined in section 71 of the *Superannuation Industry (Supervision) Act 1993* (SISA).[1] The core concepts are 'asset', 'loan', 'investment in', 'lease' and 'lease arrangement'.

2. The meaning of 'in-house asset' also relies on the definition of a 'related party' and a 'related trust' and is subject to the exceptions in paragraphs 71(1)(a) to (j) and subsection 71(8). The precise nature of some of the exceptions are set out in regulations 13.22B, 13.22C and 13.22D in the Superannuation Industry (Supervision) Regulations 1994 (SISR). The meaning of 'in-house asset' is also subject to the transitional provisions in sections 71A to 71D of the SISA. This Ruling summarises these definitions, exceptions and transitional provisions in Appendix 3, but does not analyse them in detail.

[1] All legislative references in this draft Ruling are to the SISA unless otherwise indicated.

3. This Ruling also does not provide the Commissioner's views on how other SISA and SISR provisions apply to any of the arrangements discussed in this Ruling.[2]

Ruling

4. Subsection 71(1) provides a basic definition of the in-house assets of a superannuation fund from which there are several exclusions contained in paragraphs 71(1)(a) to (j). Further transitional exclusions are contained in section 71A to 71E in respect of arrangements which were in place prior to 11 August 1999. Finally, Division 1 of Part 8 contains anti-avoidance provisions specifically for arrangements which fall outside of the in-house assets definition.

Basic definition of 'in-house asset'

5. 'In-house asset' is defined in subsection 71(1) as:

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

6. This part of the definition contains many terms which are defined in the SISA and require further consideration.

The meaning of 'asset'

7. The term 'asset' is defined in subsection 10(1) to mean 'any form of property' and includes money whether Australian currency or foreign currency. The term property is not defined in the Act and therefore takes on its ordinary meaning.

8. It is the Commissioner's view that the phrase 'any form of property' has a very wide meaning and includes every type of right, interest or thing of value that is legally capable of ownership. It encompasses real property and personal property and includes any right[3] or interest (including legal, equitable or statutory) that is of value and legally capable of ownership. While assignability generally is a characteristic of a proprietary right it is not in all cases an essential characteristic. Examples of things that are assets for the purposes of the Act include but are not limited to an estate or interest in land; a house; a car; a boat; machinery; shares; contractual rights; a mining exploration licence; a mining lease; a rental lease; patents; trademarks and copyrights.

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[2] Other provisions of the SISA and SISR that complement the in-house asset restrictions are outlined in paragraph 34 of this draft Ruling.

[3] It does not include personal rights for example, the right to vote or the right to work.

The meaning of 'loan'

9. Subsection 10(1) defines the term 'loan' as follows:

> ***loan*** includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings.

10. This definition is inclusive and expands the meaning of the term substantially beyond the traditional meaning of a 'loan' which involves a payment and repayment of an amount of money. Rather, the definition of the term 'loan' in subsection 10(1) extends the scope of arrangements covered to include arrangements that are in substance financing arrangements deferring the payment of an amount. Such arrangements would include but are not limited to:

- the loan of money;
- sale of goods or land on credit;
- instalment payment arrangements; and
- arrangements for the deferral of payment of debts or entitlements.[4]

11. The formality and the legal enforceability of the arrangement does not affect whether it is a 'loan' as defined in subsection 10(1). In addition, it is the Commissioner's view that 'loan' also encompasses arrangements where there is no objective purpose of gaining interest, income, profit or gain; for example, an interest free loan. It therefore covers arrangements that may not be an 'investment' for the purposes of subsection 71(1).

12. Not every situation where a payment is deferred necessarily amounts to a 'loan' under the extended definition. The Commissioner accepts that payment of goods on normal commercial terms will not amount to a 'loan', nor will late payments which were not agreed to by the trustee of the superannuation fund.

The meaning of 'investment in'

13. The term 'investment' is not defined in the SISA. However the term 'invest' is defined in subsection 10(1) as follows:

> ***invest*** means:
>
> (a) apply assets in any way; or
>
> (b) make a contract;
>
> for the purpose of gaining interest, income, profit or gain.

[4] Including unpaid trust entitlements in some circumstances. For more information refer to SMSFR 2008/D1.

14. In accordance with section 18A of the *Acts Interpretation Act 1901* the term investment can be derived from the defined term 'invest'. In this context, the corresponding meaning of the term 'investment' is the asset resulting from applying the assets of the SMSF or entering into a contract for the purpose of gaining interest, income, profit or gain. This interpretation also aligns with the general meaning of 'investment' established by the courts.

15. Having identified that an asset of the SMSF is properly classified as an investment, it is necessary to determine whether that investment is 'in' a related party or a related trust. Whether an investment is 'in' a particular entity is determined by reference to the legal rights acquired by the SMSF in return for its expenditure.

16. The word 'in' requires a direct link between the investment and the related party or related trust to be established. However the interest is not necessarily an interest in any particular asset of the other party.

17. It is the Commissioner's view that where money or assets are provided for the benefit of a related party or related trust for the purpose of receiving income, interest, profit or gain, a sufficiently close connection will be established between the investment and that entity to enable it to be described as an investment 'in' that entity. It is the reliance on the related party or the related trust for payment on the investment which will be determinative, as this is what gives rise to the financial risk that the rules in Part 8 are designed to reduce.

The meaning of 'lease' and 'lease arrangement'

18. The term 'lease' is not defined in the Act and therefore is given its ordinary meaning.

19. In respect of real property, a lease is a 'demise' that grants a leasehold estate in the property to the lessee for a term. That is, the lessee has an interest in the land (a 'chattel real'). This can be contrasted with a license to enter land, which does not confer any interest in the real property. Of particular importance to determining whether an agreement amounts to a lease or a license agreement, is whether exclusive possession is granted to the property. That is, the tenant has not only the right to occupy the premises, but to exclude access to all others, including the legal owner of the land.

20. It is the Commissioner's view therefore that a lease in respect of real property will occur where the lessee is granted exclusive possession of the property, generally in exchange for a rent.

21. A lease of non-real property is referred to as a lease of chattels. A key difference between a lease of real property and a lease of chattels is that no proprietary interest in the asset is created in respect of a chattel lease. However, the right of possession granted to the hirer under the agreement, although not referred to as 'exclusive possession', nonetheless includes the right to debar the legal owner from resuming possession.

22. It is the Commissioner's view therefore that the term 'lease' in subsection 71(1) in respect of non-real property means a legally enforceable hiring agreement involving the payment of consideration by the hirer in exchange for enforceable temporary possession of the asset.

Lease arrangements

23. The term 'lease arrangement' is defined is subsection 10(1) as follows:

> ***lease arrangement*** means any agreement, arrangement or understanding in the nature of a lease (other than a lease) between a trustee of a superannuation fund and another person, under which the other person is to use, or control the use of, property owned by the fund, whether or not the agreement, arrangement or understanding is enforceable, or intended to be enforceable, by legal proceedings.

24. An arrangement 'in the nature of' a lease will resemble a lease, that is it will have some, but not necessarily all, of the characteristics of a lease.

25. From the discussion above, it is apparent that for both real property and chattels, a lease involves the granting of possession of an asset in exchange for some form of rental. The quality of that possession must include the ability to control access to that asset as against other parties, including the legal owner of that asset. This must be contrasted to custodial arrangements, whereby the custodian is charged with holding the asset but without the requisite rights of possession and control over the asset, in particular, the right to exclude or debar the legal owner of the asset from taking possession of the asset.

26. It is the Commissioner's view therefore that the term 'lease arrangement' in subsection 71(1) expands the definition of in-house assets to include informal arrangements under which a person uses or controls the use of fund property. This includes arrangements where a related party gains possession of an asset of the superannuation fund, even where no rent is payable in exchange for that possession.

Lease or lease arrangement in respect of part of the property

27. It is possible for the SMSF trustee to lease only part of some forms of property, for example, one flat in a block of flats or part of a paddock. Where an SMSF trustee enters into a lease or lease arrangement with a related party in respect to part of some property, the in-house asset is the part of the property that is leased to the related party.

Asset subject to lease or lease arrangement for part of the year

28. Where an asset is leased or subject to a lease arrangement for part of the year, the full value is an in-house asset for the period that it is leased or subject to a lease arrangement with a related party.

Funds to which the Ruling applies

29. This Ruling applies to SMSFs[5] and former SMSFs.[6] References in the Ruling to SMSFs include former SMSFs unless otherwise indicated.

Date of effect

30. It is proposed that when the final Ruling is issued, the Ruling will apply both before and after its date of issue. However, the Ruling will not apply to SMSFs to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling.

Commissioner of Taxation
5 November 2008

[5] As defined in section 17A.
[6] A former SMSF is a fund that has ceased being an SMSF and has not appointed a registrable superannuation entity (RSE) licensee as trustee: see subsection 10(4).

Appendix 1 – Summary of examples

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached.

31. Summarised below are examples that are included in Appendix 2 and Appendix 3 of this draft Ruling. The examples illustrate how section 71 applies in a given fact situation. Reference should be made to the example to fully understand the section 71 outcome.

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Appendix 2 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached.

Legislative history

32. A substantial revision of the in-house asset rules in Part 8 of the SISA was made with the passing of the *Superannuation Legislation Amendment Act (No. 4) 1999*. The Government's policy objective was explained in the Explanatory Memorandum to the Bill[7] as:

> The primary policy objective is to ensure that the investment practices of superannuation funds are consistent with the Government's retirement incomes policy. That is, superannuation savings should be invested prudently, consistent with the SIS requirements, for the purpose of providing retirement income and not for providing current day benefits.

33. In pursuit of these objectives, the definition of 'in-house asset' was expanded and new limits on the market value of in-house assets that can be held by an SMSF were introduced. Specifically, from the year ended 30 June 2001 onwards section 82 limits the market value of in-house assets that may be held by an SMSF at the end of each financial year to 5% of the market value of the total assets. In the event that this limit is breached, section 82 provides procedures which must be followed by the trustees of the SMSF to reduce the level of in-house assets within 12 months. In addition, section 83 prohibits the acquisition of an in-house asset if the 5% limit on in-house assets is exceeded or if the acquisition will cause the 5% limit to be exceeded. Section 84 imposes civil penalties on trustees where these requirements are not met in addition to the potential for the SMSF to be given a notice of non-compliance.

34. The in-house asset restrictions in Part 8 of the SISA are complemented by other rules in the SISA which apply to dealings with members, their relatives and other related parties of the SMSF. For example:

- a trustee is prohibited from maintaining an SMSF for any purpose other than for the provision of retirement and certain related benefits (referred to as the sole purpose test) – section 62. All of the activities of maintaining an SMSF are subject to this test;[8]

[7] Superannuation Legislation Amendment Bill (No. 4) 1999.
[8] See SMSFR 2008/2 Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits.

- an SMSF trustee or investment manager is prohibited from lending money, or providing any other financial assistance using the resources of the SMSF, to a member of the SMSF or relative of a member of the SMSF – section 65;[9]
- subject to exceptions in relation to certain derivatives contracts, an SMSF trustee cannot recognise or in any way sanction an assignment of a superannuation interest or a charge over or in relation to a member's benefits or an SMSF asset – regulations 13.12, 13.13 and 13.14 of the SISR;
- subject to specific exceptions, an SMSF trustee is prohibited from borrowing or maintaining an existing borrowing of money – section 67;
- all SMSF investment dealings must be at arm's length or must be conducted on arm's length terms and conditions – section 109; and
- subject to specific exceptions, an SMSF trustee is prohibited from acquiring assets from related parties of the SMSF – section 66.[10]

Basic definition of 'in-house asset'

35. 'In-house asset' is defined in subsection 71(1) as:

> an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund, but does not include…

36. This part of the definition contains many terms which are further defined in the SISA and which require further consideration.

The meaning of 'asset'

37. The term 'asset' is defined in subsection 10(1) to mean 'any form of property' and includes money whether Australian currency or foreign currency.

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[9] See SMSFR 2008/1 Self Managed Superannuation Funds: giving financial assistance using the resources of a self managed superannuation fund to a member or relative of a member that is prohibited for the purposes of paragraph 65(1)(b) of the *Superannuation Industry (Supervision) Act 1993.*

[10] See SMSFR 2008/D2 Self Managed Superannuation Funds: the application of subsection 66(1) of the *Superannuation Industry (Supervision) Act 1993* to contributions of assets to a self managed superannuation fund by a related party of that fund.

38. The Act does not provide a definition of 'property', however *Halsbury's Laws of Australia*[11] explains 'property' as:

> 'Property' means every species of valuable right and interest including real and personal property, incorporeal hereditaments such as rents and services, rights of way, rights of profit or use in land of another and choses in action, but does not include mere personal licences which are not assignable: *Minister for the Army v. Dalziel* (1944) 68 CLR 261 at 290; [1944] ALR 89; (1944) 17 ALJ 405 per Starke J. 'Property' may denote the right of a person or an object itself: *Pacific Film Laboratories Pty Ltd v. Cmr of Taxation (Cth)* (1970) 121 CLR 154 at 168; 44 ALJR 376 per Windeyer J.

39. In *Smelting Company of Australia Ltd v. Commissioner of Inland Revenue*[12] Pollock B described 'property' as a word of 'very general meaning and comprehensiveness'. As Lord Langdale M.R. stated in *Jones v. Skinner:*[13]

> It is well known, that the word property is the most comprehensive of all the terms which can be used, inasmuch as it is indicative and descriptive of every possible interest which the party can have.

40. A right or interest is also capable of being property even if the transfer of it can only be accomplished with the consent of some person or authority.[14]

41. It is therefore the Commissioner's view that the phrase 'any form of property' has a very wide meaning and includes every type of right, interest or thing of value that is legally capable of ownership. The property may be real or personal, common law, equitable or statutory, tangible or intangible. Examples of things that are assets for the purposes of the Act include but are not limited to an estate or interest in land; a house; a car; a boat; machinery; a chose in action including shares; a mining exploration licence; a mining lease; a rental lease; and intellectual property rights.

Meaning of 'loan'

42. Subsection 10(1) defines the term 'loan' as follows:

> ***loan*** includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings.

43. As this definition is inclusive, a 'loan' can be any or all of the following:

- a loan according to the general or legal usage of the term;
- the provision of credit; and/or
- any other form of financial accommodation.

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[11] (4th ed) paragraph 657.
[12] (1896) 2 QB 179 at 183.
[13] (1835) 5 LJ Ch 87 at 90.
[14] *Kelly v. Kelly* (1990) 92 ALR 74 at 78.

General meaning of 'loan'

44. The term 'loan' is defined in the *Macquarie Dictionary*[15] as:

> **1.** the act of lending; a grant of the use of something temporarily: *the loan of a book.* **2.** something lent or furnished on condition of being returned, especially a sum of money lent at interest…

45. Similarly, the *Shorter Oxford English Dictionary* 3rd Edition defines 'loan' as:

> …**2.** A thing lent; *esp*. a sum of money lent for a time, to be returned in money or money's worth, and usually at interest… **3.** The action, or an act, of lending…

46. In the Victorian Supreme Court case of *Brick and Pipe Industries Ltd. v. Occidental Life Nominees Pty. Ltd. and others,*[16] Ormiston J noted at pages 321-322:

> Strangely the word 'loan' has not been frequently defined and in the many authorities cited, although the concept of lending was assumed to be understood, only one definition appears, namely in the judgement of Richardson J. in *Re Securitibank Ltd. (No. 2)* [1978] 2 NZLR 136, at p. 167: '… the essence of a loan of money is the payment of a sum of money on condition that at some future time an equivalent amount will be repaid.' …

47. The fact that a debt exists is not of itself sufficient to characterise an arrangement as a loan. In the case of *Prime Wheat Association Ltd v. Chief Commissioner of Stamp Duties*[17] the New South Wales Supreme Court considered a share sale agreement which provided for payment by instalments over a 20 year period. The question being considered was whether the sale agreement was a 'loan security' attracting stamp duty. The answer turned on whether it could be said that the share sale agreement which provided for payment over a 20 year period evidenced a loan of money. At pages NSWLR 512; ATR 484; ATC 5019 – 5020 Gleeson CJ concluded that:

> Here there was no advance of money. There was, as required by the language of the definition of advance, financial accommodation, but that is not sufficient. An agreement for sale which allows credit to a purchaser does not, on that account alone, involve an advance of money… Ultimately, there was a debt, but not a loan.
>
> …
>
> The essence of a loan is an obligation of repayment. Here what was involved on the part of the purchasers was payment, not repayment…

[15] 5th Edition.
[16] [1992] 2 VR 279.
[17] (1997) 42 NSWLR 505; 97 ATC 5015; (1997) 37 ATR 479.

48. The same approach was taken in the Full Federal Court case of *Eastern Nitrogen Ltd v. Federal Commissioner of Taxation*[18] (*Eastern Nitrogen*) when considering whether a sale and leaseback arrangement was a loan. In deciding that a finance lease is not a loan Carr J. stated at FCR 39; ATC 4173; ATR 485:

> I accept the appellant's submissions that although the overall arrangement was a financing arrangement, it did not involve a loan. There was no obligation to repay a sum advanced. The authorities recognise that arrangements can be made for financial accommodation without a loan being involved…

49. The authorities clearly show that the term 'loan' in its normal legal use refers to an agreement consisting of a payment and a repayment of an amount. However, the existence of a limit on the recourse of the lender will not, of itself, prevent the arrangement from being a loan. In the case of *Federal Commissioner of Taxation v. Firth*[19] the Full Federal Court considered the character of interest payments made on a loan used to purchase shares which limited the lender's recourse to the value of the shares. At FCR 468; ATC 4360; ATR 17 Sackville and Finn JJ stated:

> More fundamentally, it is not in our view correct to say that a provision limiting a lender to recourse to particular funds or assets for repayment of an advance is inconsistent with the transaction being characterised as a loan.…
>
> Where a lender's recourse is limited to particular funds or assets, the possibility that the funds or assets will be insufficient to recoup the advance in full is a risk incurred by the lender. That risk will ordinarily be reflected in the rate of interest charged on the moneys borrowed. Nonetheless, the limited recourse feature of the transaction does not alter its character as a loan.

50. However, this is not to say that a substantial characteristic of a loan agreement is not that of payment and repayment. Indeed, Sackville and Finn JJ observed immediately prior to the above statement that:

> In the first place, it is not correct to say that the taxpayer was not obliged to repay the loans. The PEILs gave the taxpayer an option to repay the loans out of his own funds (an option he in fact exercised by refinancing the loans) or, relevantly, to repay the loans out of proceeds of the sale of the Approved Stocks, in which case the limited recourse provisions of cl 7 applied. Obviously the taxpayer was very likely to avail himself of the second option if the value of the Approved Stocks fell over the life of the loans. If the value did not fall, the loans were very likely to be repaid in full, either out of the taxpayer's own funds (including funds obtained from any refinancing of the loans) or from the sale of the Approved Stocks.

[18] (2001) 108 FCR 27; 2001 ATC 4164; (2000) 46 ATR 474.
[19] (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1.

51. Consequently, it is reasonable to conclude that in normal usage the term 'loan' still fundamentally describes an arrangement for the payment and repayment of an amount, even though a limited recourse feature may result in all amounts not finally being repaid to the lender. As a consequence, the term 'loan' would not normally encompass many forms of financial accommodation which may create an obligation of a payment of an amount owed, for example the sale of items on credit. However, subsection 10(1) contains a definition of the term 'loan' which significantly extends meaning for the Act.

Extended definition of a loan

52. As part of the revision of the in-house asset rules enacted by the *Superannuation Legislation Amendment Act (No. 4) 1999* an extended definition of the term 'loan' was inserted into subsection 10(1) as follows:

> ***loan*** includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings.

53. The use of the word 'includes' denotes that the definition extends the term 'loan' beyond its normal meaning to encompass additional arrangements.

'the provision of credit'

54. The term 'credit' is relevantly described as follows in the Encyclopaedic Australian Legal Dictionary:

> Time allowed to the buyer of goods by the seller, in which to make payment for them; granting the use or possession of goods and services without immediate payment. It includes the delivery of goods or the advancing of money with the trust that the debtor will have the means to pay and will pay at a future date: *Herbert v. R* (1941) 64 CLR 461; [1941] ALR 100
>
> The right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment.

55. The High Court case of *Herbert v. R*[20] considered whether a loan of money obtained by the appellant was to 'obtain credit' under section 212 of the *Bankruptcy Act 1924-1933*. At CLR 465 Rich ACJ discussed the meaning of credit as follows:

> In the *Oxford Dictionary* one of the meanings of 'credit' is 'trust in a person's ability and intention to pay, as give credit, deal on credit, long credit,' and a quotation is given from *Jevon's Primer of Political Economy,* p. 110, 'Anyone who lends a thing gives credit, and he who borrows it receives credit.' In *Johnson's Dictionary* 'credit' is defined as being 'correlative to debt.'

[20] 64 CLR 461.

56. Later, McTiernan J. noted that 'credit' involves the incidence of debt. At CLR 467 he stated:

> In commercial and financial affairs the word 'credit' may signify the financial arrangement in a transaction or the reputation for solvency and honesty which entitles a person desirous of incurring a debt or liability to do so on the terms that payment is to be deferred. In its former meaning it includes the delivery of goods or the advancing of money with the trust that the debtor will have the means to pay and will pay at a future date.

57. For credit to be provided there must be a present ascertainable debt. That is, there must be a definite amount payable either currently or in the future. In *Geeveekay Pty Ltd, Geoffrey Keogh and Veronica Keogh v. Director of Consumer Affairs Victoria*[21] Bell J considered whether a contract for the sale of land by instalments was a 'credit contract' for the purposes of Consumer Credit Code.

58. Under the Code credit is provided if payment of a debt owed by one person to another is deferred (for example forbearance on a pre-existing debt) or if a person incurs a deferred debt to another person. In this context Bell J. discussed the meaning of the term 'debt' at paragraphs 83 to 85:

> 83 I have expressed the view that this obligation to make a future payment is a present debt for which payment is not yet due (a *debitum in praesenti, sovendum in futuro*) that matures, when the time for payment arrives, into a present debt for which payment is due (*a debitum in praesenti*). These legal categories of debt emerge from the decided cases and, I repeat, are equally applicable when determining whether a terms contract for sale of land is a credit contract under the Code.

Lindley LJ was equally explicit:

> …I should say, apart from any authority, that a debt legal or equitable can be attached whether it be a debt owing or accruing; but it must be a debt, and a debt is a sum of money which is now payable or will become payable in the future by reason of a present obligation, *debitum in presenti, solvendum in futuro*. An accruing debt, therefore, is a debt not yet actually payable, but a debt which is represented by an existing obligation…
>
> 85 This decision has been frequently followed. For example, in *Re Australia and New Zealand Savings Bank Ltd; Mellas v. Everinadi*… The judgement of the Full Court was delivered by Pape J, who said: 'a debt 'accruing due' must be a debt based upon a present obligation but which is payable at a definable approachable future date'… So a debt that arose only on the performance of a condition precedent was not an accruing debt, that is, not a *debitum in praesenti, solvendum in futuro*…

[21] [2008] VSC 50.

59. Bell J contrasted a contract for sale of land with instalments due on specific dates with a normal contract for sale of land where a deposit is paid and the final amount is due on conveyance of the land. At paragraph 121 he concluded:

> ...The obligation of the buyer to make an unavoidable future instalment payment under a terms contract for the sale of land, like the one between Mr and Mrs Keogh and Ms Rand, constitutes a present debt not yet due. The obligation has that character whether or not the contract may subsequently be discharged before the consideration represented by conveyance is finally passed. It is not contingent or conditional because, after the obligation has been created by the making of the contract, the contract may subsequently be discharged, before or after payment is made. The possible discharge of the contract is not to be compared with the position under an ordinary cash contract, where payment of the balance of the price is conditional on conveyance at settlement, for under a terms contract the parties have agreed that instalment payments will be made in advance of conveyance.

60. Consequently, Bell J concluded that the instalment contract for the purchase of land in this case was the provision of credit under section 4 of the Consumer Credit Code.

61. Similarly, the 'provision of credit' in the definition of 'loan' in subsection 10(1) is a reference to an arrangement for the deferred payment of a debt. That is, an amount that is ascertainable and unavoidably due, whether currently or in the future, and not contingent on any future event or actions.

'any other form of financial accommodation'

62. The definition of 'loan' in subsection 10(1) further includes 'any other form of financial accommodation'. The term 'financial accommodation' is not defined in the Act therefore takes on its ordinary meaning.

63. The *Macquarie Dictionary 4th Edition* doesn't define the term 'financial accommodation' but defines the words individually as:

> **Financial** … **1.** relating to monetary receipts and expenditures; relating to money matters; pecuniary…
>
> **Accommodation** … **1.** the act of accommodating … **5.** anything which supplies a want; a convenience … **7.** readiness to aid others; obligingness. **8.** a loan or pecuniary favour …

64. Combining these two definitions indicates that the phrase 'financial accommodation' is a reference to a supply or grant of some form of pecuniary assistance or favour. This definition is very broad and could be construed to include a wide range of arrangements.

65. The breadth of the term 'financial accommodation' was demonstrated in *Eastern Nitrogen*[22] discussed above. In this case an ammonia plant was sold for $71.4m to financiers and leased-back from them. Although there was no option in the agreement for the lessee to repurchase the ammonia plant and no option to sell the plant in favour of the lessee, the plant was ultimately repurchased by the lessee at the expiration of a further lease period. The issue was whether the lease payments were deductible for income tax purposes or whether they were, at least in part, made on capital account. The overall arrangement was considered a financing arrangement although it did not involve a loan. Carr J said at FCA 366 that:

> From a practical and business point of view, payment of the rent not only secured the use of the ammonia plant, the rent also paid for the use of the $71.4 million. This was clearly the main purpose of the whole arrangement – to provide financial accommodation, though not by way of loan, for the appellant's business.

66. The case of *Federal Commissioner of Taxation v. Radilo Enterprises Pty Ltd*[23] the Full Federal Court held that meaning of the term 'financial accommodation' is limited by its legislative context. This case considered the definition of 'loan' in the former section 46D of the *Income Tax Assessment Act 1936* which was expressed in essentially the same terms as the definition in the SISA. The case concerned the issue of non-redeemable preference shares which paid a fixed annual dividend of 13.25% of the issue price and which converted to ordinary shares after a fixed time. The question at issue was whether the arrangement was a loan as defined in that section, consequently disentitling the respondent to imputation credits on the dividends. At FCR 312; ATC 4160 – 4161; ATR 645 Sackville and Lehane JJ stated:

> We have not overlooked the fact that s. 46D(1) defines 'loan' to include 'the provision of credit or any other form of financial accommodation'. However, there is nothing in the extended definition which detracts from the conclusion that s. 46D(2)(c) requires attention to be directed to the relationship between the company and the shareholder, pursuant to which the dividend is paid. The provision of credit implies a consensual transaction, such as the delivery of goods on terms permitting deferred payment or the granting of overdraft facilities by a bank; compare *Herbet v. The King* (1941) 64 CLR 461, at 467, per McTiernan J. Similarly, in its statutory context, the expression 'or any other form of financial accommodation' refers to a consensual arrangement between the person providing the accommodation and the recipient. Under a consensual arrangement for the provision of credit or financial accommodation a principal sum, or its substantial equivalent (by way of indemnity against a liability on maturing bills, for example, in the case of accommodation provided in the form of a bill acceptance facility), will ultimately be payable.

[22] (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1.
[23] (1997) 72 FCR 300; 97 ATC 4151; (1997) 34 ATR 635.

67. Similarly, the phrase 'any other form of financial accommodation' in subsection 10(1) is used in the context of a definition of a loan, and likewise is limited to arrangements where an amount is deferred but ultimately is payable. It therefore encompasses arrangements that are in substance financing arrangements, though not necessarily loans or the provision of credit.

68. Not every situation where a payment is deferred necessarily amounts to a 'loan' under the extended definition. The Commissioner accepts that payment for goods on normal commercial terms will not amount to a 'loan', nor will late payments which were not agreed to by the trustee of the superannuation fund.

Example 1 – Late payment of rent not a loan

69. *Tom and Judy are the sole members and trustees of the Tom and Judy SMSF. The superannuation fund leases business real property to a large medical partnership, of which Tom is a partner. Rent is due on the last day of each month but in June 2008 the payment was overlooked due to a clerical error. This was not discovered until the next payment was due at the end of August 2008 and payment was then received for both months at that time. As the late payment was not part of an arrangement between the parties it is not a financial accommodation or provision of credit. Therefore the outstanding amount was not a 'loan' on 30 June 2008 and consequently is not required to be included in the in-house assets of the Tom and Judy SMSF.*

Arrangements do not need to be legally enforceable

70. The extended definition of 'loan' in subsection 10(1) also includes arrangements:

> …whether or not enforceable, or intended to be enforceable, by legal proceedings.

71. This makes it clear that the definition is concerned with the substance of the arrangements rather than their form.

Summary

72. When subsection 71(1) refers to a 'loan' to a related party it is referring not only to the traditional 'loan' arrangement involving a payment and repayment of an amount of money. Rather, the definition of the term 'loan' in subsection 10(1) extends the scope of arrangements covered to include all arrangements that are in substance financing arrangements deferring the payment of an amount. Such arrangements would include but are not limited to:

- the loan of money;
- sale of goods or land on credit;

- instalment payment arrangements; and
- arrangements for the deferral of payment of debts or entitlements.[24]

73. The formality and the legal enforceability of the arrangement does not affect whether it is a 'loan' as defined in subsection 10(1). In addition, it is the Commissioner's view that, 'loan' also encompasses arrangements where there is no objective purpose of gaining interest, income, profit or gain; for example, an interest free loan. It therefore captures arrangements that may not be caught as an 'investment' for the purposes of subsection 71(1).

The meaning of 'investment in'

74. The term 'investment' is not defined in the SISA. However the term 'invest' is defined in subsection 10(1) as follows:

> ***invest*** means:
>
> (a) apply assets in any way; or
>
> (b) make a contract;
>
> for the purpose of gaining interest, income, profit or gain.

75. The Explanatory Memorandum[25] for the Bill which inserted the definition of 'invest' stated at item 35 that:

> This item inserts a definition of invest in subsection 10(1) of the SIS Act. Invest is to apply assets in any way or make a contract for the purpose of gaining interest, income, profit or gain. The definition applies to the application of all assets of a superannuation entity for the purposes of gaining interest, income or profit, and not just to the application of money and includes investment in derivatives where there may be no up front application of money.

76. Section 18A of the *Acts Interpretation Act 1901* provides that:

> In any Act, unless the contrary intention appears, where a word or phrase is given a particular meaning, other parts of speech and grammatical forms of that word or phrase have corresponding meanings.

77. In this context, the corresponding meaning of the term 'investment' derived from the definition of 'invest' in subsection 10(1) is the asset resulting from applying the assets of the SMSF or entering into a contract for the purpose of gaining interest, income, profit or gain.

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[24] Including unpaid trust entitlements in some circumstances. For more information refer to SMSFR 2008/D1.

[25] Superannuation Legislation Amendment Bill 1998; *Superannuation Legislation Amendment Act 1999*.

78. Having identified that an asset of the SMSF is properly classified as an investment, it is necessary to determine whether that investment is 'in' a related party or a related trust. Whether an investment is 'in' a particularly entity is determined by reference to the legal rights acquired by the SMSF in return for its expenditure. In *Melville v. Mutual Life and Citizens Assurance Co Ltd*[26] Lockhart J stated at FLR 207:

> It is not the purpose or object of the investment or the economic results sought to be obtained by expending the statutory fund that is determinative of whether the respondent invested such fund in a share or interest in a company or undertaking carrying on life insurance business; it is the legal rights enforceable by the respondent that it acquired in return for the expenditure.

79. On this basis, Lockhart J concluded that an investment in a holding company which owned shares in a life assurance company was not an investment directly or indirectly in that life assurance company.

80. Similarly, in the Federal Court case of *Trevisan (Trustees of the Forli Pty Ltd Superannuation Fund) v. Federal Commissioner of Taxation*[27] Burchett J concluded that an investment in units of a unit trust were not an investment in the trustee company. At FCR 163; ATC 4421; ATR 1655:

> An acquisition of units in the trust is, on authority of *Charles* (supra), an investment in the real estate and other property the subject of the trust of the deed; it is not an investment in Forli Pty Ltd, simply because the company happens to be the trustee for the time being.

81. It is clear therefore that the word 'in' requires a direct link to the activities of the related party or related trust to be established. However the interest is not necessarily an interest in any particular asset of the other party. In the High Court case of *Archibald Howie Pty Ltd v. Commissioner of Stamp Duties* (NSW)[28] Dixon CJ noted at CLR 152:

> While a shareholder has not a proprietary right or interest in the assets of an incorporated company, his 'share' is after all an aliquot proportion of the company's share capital. With reference to which he has certain rights. He is entitled among other things to have share capital applied in pursuance of the memorandum and articles of association and, so far as assets are available for the purpose, to have his paid up capital returned in liquidation or upon a reduction of capital if that method of returning it is decided upon pursuant to the articles of association.

82. In the later Full Federal Court case of *Sydney Futures Exchange Limited v. Australian Stock Exchange Limited, Australian Securities Commission*[29] Lockhart J described a share as follows:

> A share is a right to a specified amount of the share capital of a company, carrying with it rights and liabilities when the company is a going concern and in the course of its winding up. A share is a chose in action entitling its holder to the rights and subjecting him to the liabilities provided by the memorandum and articles of association and by legislation.

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[26] (1980) 47 FLR 201.
[27] (1991) 29 FCR 157; 91 ATC 4416; (1991) 21 ATR 1649.
[28] [1948] 77 CLR 143.
[29] (1995) 56 FCR 236 at 255.

83. A share in a company is therefore a chose in action representing a proprietary right in the company entitling the holder to profit distributions and a share of the capital of the company, but it does not confer an interest in any particular assets of the company.

84. The object of the in-house assets rules in Part 8 is to limit the inherent risks to superannuation assets posed by investment in related parties or related trusts.[30] It is therefore the risks associated with the reliance on those entities for the return on the investment that the Part is concerned with minimising. Consistent with this, it is the Commissioner's view that where money or assets are applied to the benefit of a related party or related trust for the purpose of receiving income, interest, income, profit or gain from that entity, a sufficiently close connection will be established between the investment and that entity to enable it to be described as an investment 'in' that entity. It is the reliance on the related party or the related trust for payment on the investment which will be determinative, as this is what gives rise to the financial risk that the rules in Part 8 are designed to reduce.

Example 2 – Annuity arrangement

85. The trustees of the Johnson SMSF enter into an annuity contract with a related party, Johnson Pty Ltd. The contract stipulates a purchase price of $75,000 to be paid by the Johnson SMSF in exchange for 4 annual payments of $25,000 payable on 30 June of each year.

86. The annuity is a contract entered into by the trustee of the Johnson SMSF for the purpose of providing an income stream and therefore is an investment of the SMSF. In addition, the responsibility for payment of this income is with Johnson Pty Ltd. Consequently, the annuity is an investment in Johnson Pty Ltd and, as Johnson Pty Ltd is a related party not covered by any exceptions in Part 8, this investment will be an in-house asset of the Johnson SMSF.

Example 3 – contractual funding arrangement

87. Under a contract, Joe as trustee for the Venture SMSF has contributed money towards the acquisition of an asset that is acquired by JJ Pty Ltd. JJ Pty Ltd is a company controlled by Joe's family and is therefore a related party of the SMSF.

88. The contract stipulates that JJ Pty Ltd controls and manages the asset and is entitled to all receipts from the asset. The contract also states that the SMSF shall not be required to guarantee or indemnify the repayment of any borrowings or other obligations of JJ Pty Ltd.

[30] Pages 4 & 5 of the Explanatory Memorandum to Superannuation Legislation Amendment Bill (No. 4) 1999.

89. The SMSF is entitled to receive payments from JJ Pty Ltd under the contract. The amount of the payments is calculated as a proportion of the proceeds from sale, lease or other use of the asset. The relevant proportion equals the total amount of contributions made by the SMSF to the acquisition cost of the asset. The contract states that the SMSF acquires no legal, equitable or other interest in the asset. The SMSF's pecuniary interest in the arrangement is limited to its entitlement to receive the contractual payments from JJ Pty Ltd.

90. The arrangement is considered to be an investment by the SMSF in JJ Pty Ltd. Under the arrangement, the SMSF contributes capital to JJ Pty Ltd which is utilised for commercial benefit by JJ Pty Ltd. In exchange for the capital contribution, the SMSF obtains rights to a share of the profits obtained from the commercial usage of that asset in proportion to its contribution to it. Therefore, the return on the investment is reliant on JJ Pty Ltd and the financial risk of that investment is with it. Consequently, the arrangement represents an investment in JJ Pty Ltd.

The meaning of 'lease' and 'lease arrangement'

91. The term 'lease' is not defined in the Act and therefore is given its ordinary meaning.

92. The Shorter Oxford English Dictionary[31] defines the term 'lease' to mean:

> A contract between parties, by which the one conveys lands or tenements to the other for life, for a term of years, or at will, usually in consideration of rent or other periodical compensation…

93. The Macquarie Dictionary[32] similarly defines the term 'lease' as:

> an instrument conveying property to another for a definite period, or at will, usually in consideration of rent or other periodical compensation.

94. The term 'lease' also has an established legal meaning in respect of real property which has evolved from substantial judicial consideration over many years.

Real property

95. In relation to real property the terms 'lease' and 'tenancy' are interchangeable.[33]

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[31] 3rd Edition.
[32] 5th Edition.
[33] *Re Negus* [1895] 1 Ch 73 at 79; (1895) 71 LT 716.

96. Halsbury's Laws of Australia describes a lease of land at paragraph 245-1 as follows:

> A 'lease' or 'tenancy' of land is a means by which a lesser estate in the land than that originally held by the grantor (termed the 'lessor') is transferred, creating an on going relationship, to another person (termed the 'lessee'), so as to give the lessee exclusive possession of the demised premises for an ascertainable period of time, with the grantor retaining a reversionary interest in the property. The term 'lease' may refer to the grant, that which is granted and the document by which it is granted. A lease is a demise and as such confers an interest in rem in the legal estate of the subject matter of the lease. One usual incident of this interest is an obligation to pay rent. (footnotes removed)

97. Therefore, a lease of land is a 'demise' that grants a leasehold estate in the property to the lessee for a term. That is, the lessee has an interest in the land (a 'chattel real'). This can be contrasted with a license to enter land, which does not confer any interest in the real property. Of particular importance to determining whether an agreement amounts to a lease or a license agreement, is whether exclusive possession is granted to the property. Halsbury's Laws of Australia summarise the meaning of 'exclusive possession' at paragraph 245-15 as follows:

> …'Exclusive possession' is a right which permits the holder to exclude other persons from the property. A lessee having exclusive possession of the demised premises can restrict all persons, including the lessor, from the demised premises, subject to any contrary statutory provision or certain exceptions… (footnotes removed)

98. The High Court case of *Radaich v. Smith*[34] considered the question of how to determine whether an agreement is a license agreement or a lease agreement and is often referred to in later Australian cases. This case involved a contract to occupy premises and operate a milk bar for a period of 5 years. The contract was termed as a license agreement and contained many clauses regarding the operation and hours of the milk bar. In concluding that the agreement was a lease rather than a license to occupy the premises, the court made it clear that this was to be determined by looking at the rights created by the contract, not merely the terms used. At CLR 214 McTiernan J. noted that:

> The words 'lease', 'lessor' and 'lessee', however, are entirely excluded from the document, and the term 'license', and its appropriate mutations, are sedulously applied to the rights purported to be created. This fact is, of course, far from conclusive in favour of the respondents. It is the substance of the deed that matters. As *Denning* L.J. said in *Facchini v. Bryson* (1) '… the parties cannot by the mere words of their contract turn it into something else. Their relationship is determined by the law and not by the label they choose to put on it' (2). The true test of a supposed lease is whether exclusive possession is conferred upon the putative lessee.

[34] (1959) 101 CLR 209.

99. In analysing whether a right of exclusive possession was granted under the agreement the court looked at the terms used in the context of the circumstances surrounding making of the agreement. In particular, they looked at the layout of the premises and the manner in which they were intended to be used. At CLR 224 – 225 Windeyer J. stated that:

> I imagine all concerned would have been astounded if they had been told that the appellant had no right to exclude persons from her shop; that the respondent might, if he wished, license other people to carry on any activity there other than the sale of refreshments, provided their presence did not prevent her selling refreshments or conducting the milk bar; and that, although she might lock the shop up at night and on holidays, the respondents could not only enter it themselves whenever they wished but could admit as many persons as they chose, provide them with keys and license them to use the premises in the absence of the appellant for any purpose of pleasure or business they liked, provided only that they did not sell refreshments.

100. As a consequence, he concluded that the arrangement was clearly intended to confer exclusive possession to the appellant and that therefore it was a lease agreement.

101. A lease in respect of real property will therefore occur where the lessee is granted exclusive possession of the property, generally in exchange for a rent.

Lease of assets other than real property

102. The law distinguishes between a lease of real property and other assets, generally referred to as chattels. In *Chelsea Investments Pty Ltd v. Federal Commissioner of Taxation*[35] Windeyer J explained at CLR 7 that:

> The rights of a lessee under a lease of machinery are not I would think ordinarily an assignable proprietary interest in the machinery. A lease of machinery is not a demise. It is a hiring. The proprietary interest remains in the owner. The hirer gains a legal right of possession and during the period of the hiring the true owner is debarred from resuming possession against the hirer's will. The word 'reversion' seems to me inapt to describe the ownership of chattels let on hire.

103. A key difference between the lease of real property and the lease of chattels therefore is that no proprietary interest in the asset is created in respect of a chattel lease. However, the right of possession granted to the hirer under the agreement, although not referred to as 'exclusive possession', nonetheless includes the right to debar the legal owner from resuming possession.

[35] (1966) 115 CLR 1.

104. The term 'hiring' would imply that the possession of the asset is provided in exchange for consideration. The Encyclopaedic Australian Legal Dictionary defines a hire contract as:

> To lend to another for consideration the possession and use of goods for a particular period or purpose…

105. This definition highlights the difference between an informal arrangement for the loan of an asset and a legally enforceable hiring agreement, that is, the payment of consideration by the hirer in exchange for enforceable temporary possession of the asset.

Lease arrangements

106. The term 'lease arrangement' is defined in subsection 10(1) as follows:

> ***lease arrangement*** means any agreement, arrangement or understanding in the nature of a lease (other than a lease) between a trustee of a superannuation fund and another person, under which the other person is to use, or control the use of, property owned by the fund, whether or not the agreement, arrangement or understanding is enforceable, or intended to be enforceable, by legal proceedings.

107. The Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999,[36] which strengthened the investment rules and introduced the definition of 'lease arrangement', gives an indication of the types of arrangements intended to be covered:

> This definition covers arrangements in the nature of a lease, and is not intended to include custodial arrangements for the holding of assets, or arrangements where the only purpose is to repair assets.

108. The phrase 'in the nature of' is defined in The Australian Oxford Dictionary as:

> …characteristically resembling or belonging to the class of

109. Stroud's Judicial Dictionary of Words & Phrases further states that:[37]

> The 'nature' of an invention which has to be stated in the provisional specification; this does not confine the complete specification to minute agreement with the provisional specification the object of which is to set forth fairly, though it may be roughly, the 'nature' of the invention for which a patent is sought (*United Telephone Co v. Harrison*, 21 Ch. D. 720 … see further *Siddell v. Vickers*, 39 Ch. D. 92)

110. From these definitions an arrangement 'in the nature of' a lease will resemble a lease, that is, it will have some, but not necessarily all, of the characteristics of a lease.

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[36] at Item 2.
[37] *Stroud's Judicial Dictionary of Words & Phrases,* 2006, 7th edition, Sweet & Maxwell, London.

111. To identify the 'nature' of a lease, it is necessary to identify the defining characteristics of a 'lease'. From the discussion above, it is apparent that for both real property and chattels, a lease involves the granting of possession of an asset in exchange for some form of rental. The quality of that possession must include the ability to control access to that asset as against other parties, including the legal owner of that asset. This must be contrasted to custodial arrangements, whereby the custodian is charged with holding the asset but without the requisite rights of possession and control over the asset, in particular, the right to exclude or debar the legal owner of the asset from taking possession of the asset.

112. Where the SMSF grants exclusive or full possession of the relevant asset to another entity the Commissioner is of the view that it is not necessary that this be for any rent for there to be a lease arrangement.

Example 4 – Display of artwork

113. *Dorien is the sole member of the Wilde SMSF and director of the corporate trustee. The SMSF owns a significant artwork which is displayed in the drawing room in Dorien's house. There is no formal arrangement for the lease of the asset and no rental is paid.*

114. *Dorien is a related party of the SMSF both by virtue of being a member and by virtue of being a director of the corporate trustee.*

115. *Several factors point to the artwork being subject to a lease arrangement between the SMSF and Dorien. The artwork is physically located in Dorien's house, giving him the right to control access to it and he displays it in his drawing room. Dorien has possession of the asset rather than mere custody of it. The nature of the arrangement is therefore similar to a lease despite there being no rental payments or formal lease agreement.*

116. *The artwork is therefore an asset of the fund that is subject to a lease arrangement while it is being displayed in Dorien's home, and is an in-house asset of the SMSF.*

Lease or lease arrangement in respect of part of the property

117. Where an SMSF trustee enters into a lease or lease arrangement with respect to part of a property, the in-house asset is the part of the property that is leased to the related party.[38]

[38] The Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999 at Item 27.

Example 5 – asset subject to lease

118. *An SMSF owns a residential home which is leased to an unrelated 3rd party with the exception of a garage at the rear of the property with its own street access. This garage is specifically excluded from the residential lease and the tenant has no access to it. Instead, one of the members of the fund uses the shed for storage of a vintage car and holds the keys and alarm code to it. No rent is paid but the member pays for insurance and a monitored alarm. The part of the property comprised of the garage is subject to a lease arrangement with the member (a related party) and consequently is an in-house asset of the SMSF.*

Asset subject to lease or lease arrangement for part of the year

119. Where an asset is leased or subject to a lease arrangement for part of the year, the full value is an in-house asset for the period that it is leased or subject to a lease arrangement with a related party.[39]

Example 6 – part year lease

120. *An SMSF owns a beach house.*

121. *The SMSF leases the beach house to a member, who is a related party, for two months of the year.*

122. *The full market value of the beach house would be included in the in-house asset ratio of the SMSF during that two month period which may cause a contravention of section 83 of the in-house asset rules.*

Contraventions – audit requirements and consequences

123. SMSF trustees are required to appoint an approved auditor to audit the financial accounts and statements of the fund each year.[40] When conducting an audit, the approved auditor is also required to conduct a compliance audit to ensure the SMSF has complied with the SISA and SISR. There is an approved form[41] for notifying the Tax Office of contraventions.[42]

124. Contravention or involvement in a contravention attracts both civil and criminal consequences and places at risk the SMSF's status as a complying superannuation fund under the SISA.[43]

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[39] The Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999 at Item 26.
[40] See section 35C.
[41] See section 11A.
[42] Section 129 requires an auditor of an SMSF to report contraventions immediately after forming the opinion that it is likely that a contravention may have occurred, may be occurring or may occur in relation to the SMSF.
[43] See subsection 42A(5) in relation to SMSFs. The status of an SMSF as complying or non-complying for SISA purposes will also have consequences for the SMSF under the income tax law and other parts of the superannuation law. Also see generally Law Administration Practice Statements PS LA 2006/17, PS LA 2006/18 and PS LA 2006/19.

Appendix 3 – Legislative framework

125. Division 1 of Part 8 provides a general definition of an 'in-house asset' which is then subject to a list of exceptions. Further exceptions are provided in transitional provisions which were introduced in respect of investments, loans and lease arrangements which were in existence prior to 11 August 1999. In addition, Division 1 of Part 8 contains anti-avoidance provisions.

126. This draft ruling considers the core concepts of 'loan to' 'investment in' and 'lease or lease arrangement' contained in subsection 71(1). However, these terms need to be considered in light of their legislative framework to establish whether an asset is an in-house asset. A brief explanation is therefore provided below of this framework.

Definition of 'related party' and 'related trust'

127. Subsection 71(1) only includes in the in-house assets of the SMSF assets which are a loan to a 'related party' of the fund, an investment in a 'related party' or a 'related trust' of the fund, or subject to a lease or lease arrangement with a 'related party' of the fund. Therefore, where it is established that a loan, investment or lease arrangement exists, it is necessary to determine whether the other party to the arrangement is a related party or a related trust of the fund.

Definition of 'related party'

128. The term 'related party' is defined in subsection 10(1) as any of the following:

(a) a member of the fund;

(b) a standard employer-sponsor of the fund; or

(c) a Part 8 associate of an entity referred to in paragraph (a) or (b).

129. The terms 'member' and 'standard employer-sponsor' are further defined in subsection 10(1).

Standard employer-sponsor

130. A standard employer-sponsor of an SMSF is defined in section 16 as an employer who contributes to an SMSF for the benefit of a member, under an arrangement between the employer and the trustee of the SMSF. It does not include an employer who contributes to the SMSF only under an arrangement with the employee/member.[44]

[44] Subsection 16(2).

Example 7 – employer-sponsor

131. *Nguyen and Cathy are the members and trustees of the Ngo Superannuation Fund, an SMSF. Nguyen is an employee of Intercount Ltd, a large public company.*

132. *Nguyen arranges for his superannuation contributions from Intercount to be paid into the Ngo Superannuation Fund. Intercount has no association with the Ngo Superannuation Fund other than through the arrangement with Nguyen, under which it makes the contribution. Intercount is an employer-sponsor of the Ngo Superannuation Fund, but is not a 'standard employer-sponsor' of the fund.*

Part 8 Associate

133. Subdivision B of Division 1 of Part 8 sets out the rules governing the determination of whether an entity is a Part 8 associate of a member or an employer-sponsor. It does this by reference to the form that the member or the employer sponsor (the '***primary entity***') takes as follows:

- Section 70B – Individuals
- Section 70C – Companies
- Section 70D – Partnerships.

134. As a member must be an individual, section 70B is the relevant provision for determining whether the entity in question is a Part 8 associate of that member. However, a standard employer-sponsor may be any type of entity and therefore the definition of a Part 8 associate will be ascertained using the provision which relates to the form that the standard employer-sponsor takes.

<u>70B – Part 8 associates of individuals</u>

135. A Part 8 associate of an individual, whether or not in the capacity of trustee, includes the following:

- Relatives[45] of that individual;
- Members of the same SMSF or, if the SMSF is single member SMSF whose trustee is a company, each director of the company will be a Part 8 associate, or if the fund is a single member SMSF whose trustees are individuals, those individuals;
- A partner of the individual or a partnership in which the individual is a partner, or the spouse or a child of an individual partner;

[45] Relative is defined in subsection 70E(4).

- A trustee of a trust (in the capacity of trustee of that trust) where the individual controls that trust;[46]
- A company that is sufficiently influenced by, or in which a majority voting interest is held by the individual, by a Part 8 associate of the individual or by the individual together with Part 8 associates.

136. A company is sufficiently influenced by or has a majority voting interest in an entity or entities if the company, or a majority of its directors, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts).

Example 8 – Company a related party of an SMSF

137. *Ken and Deidre are members of an SMSF.*

138. *An analysis of the relationship is required to determine if the investment is in a company that is a Part 8 associate of Ken or Deidre.*

139. *Ken is appointed the managing director on the board of the company and in his role the majority of the directors of the company act within the directions of Ken.*

140. *The company is a Part 8 associate of the individual member of the SMSF as Ken sufficiently influences the company.*

141. An entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

Example 9 – Company a related party of an SMSF

142. *Ashley is a member of an SMSF. The SMSF has a lease arrangement with a company in which Ashley holds a 30% voting interest.*

143. *Ashley is also a member of a partnership with Mike and Leonie. Therefore Mike and Leonie are Part 8 associates of Ashley.*

144. *Mike and Leonie both hold a 15% voting interest in the company. Consequently, although Ashley only holds 30% of the voting interests in the company, together with his Part 8 associates, Mike and Leonie, they hold a voting interest of 60% in the company. As a result, the company is a related party of the SMSF.*

[46] Control of a trust and examples are included at paragraphs 150 – 154.

70C – Part 8 associates of companies

145. A Part 8 associate of a company, whether or not in the capacity of trustee, will include:

- A partner of the company or a partnership in which the company is a partner, or the spouse or a child of an individual partner;
- A trustee of a trust (in the capacity of trustee of that trust), where the company controls the trust (see paragraph 160 of this draft Ruling for an explanation of control);
- Another entity (the controlling entity) where the company is sufficiently influenced by, or a majority voting interests in the company is held by the controlling entity, or a Part 8 associate of the controlling entity or 2 or more of these entities will be a Part 8 associate;
- A Part 8 associate of the controlling entity;
- Another company (the controlled company) which the company sufficiently influences, or in which the company holds a majority voting interest or where sufficient influence or majority voting interest is held by the company and or its Part 8 associates or 2 or more of these entities;

Example 10 – Controlling entity of a company

146. *Rebecca and Shane are the sole members of the R&S SMSF and sole directors of R&S Pty Ltd which is the corporate trustee of the R&S SMSF.*

147. *Shane is employed by Matthew Pty Ltd who is a standard employer sponsor. All of the shares in Matthew Pty Ltd are held by R&S Investments Pty Ltd. R&S Investments Pty Ltd therefore controls Matthew Pty Ltd and consequently is a Part 8 associate of Matthew Pty Ltd.*

70D – Part 8 associates of partnerships

148. A Part 8 associate of a partnership includes a partner in the partnership and any Part 8 associates of those partners.

Definition of a 'related trust'?

149. A 'related trust' is defined in subsection 10(1) as:

> …a trust that a member or a standard employer-sponsor of the fund controls, other than an excluded instalment trust.

150. Control of a trust is defined in subsection 70E(2). An entity is taken to control a trust if a group:

- has a fixed entitlement to more than 50% of the capital or income of the trust; or
- has a relationship with the trustee(s) such that the trustee or a majority of the trustees is accustomed, obligated (whether formal or informal), or might reasonable be expected, to act in accordance with the directions, instructions or wishes of a group or in relation to the entity (weather those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); or
- a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust.

151. A 'group' is further defined to be the entity acting alone, or together with a one or more Part 8 associates of the entity, or one or more Part 8 associates of the entity acting alone or together.

Example 11 – Members and associates control a trust together

152. Tracey and Charlie are members of an SMSF. The SMSF holds 100% of the units in the unit trust. The unit trust has a corporate trustee. Tracey and Charlie are shareholders and directors of the corporate trustee.

153. Tracey and Charlie are both Part 8 associates of each other and therefore can act together to form a group. This group forms 100% of the directors and shareholders of the corporate trustee which therefore might reasonably be expected to act in accordance with their directions. Consequently, the unit trust is controlled by both Tracey and Charlie and is a related trust of SMSF.

Example 12 – Members and associates control a trust together

154. *Susan is the member of a single member SMSF. The SMSF invests in 25% of the units in a unit trust. The other 75% of the units in the unit trust are held by a company of which Susan holds 100% of the shares. The company is a Part 8 associate of Susan due to her shareholding. The company acting alone holds a fixed entitlement to 75% of the capital and income of the unit trust. Therefore, the unit trust is controlled by Susan and therefore is a related party and a related trust of Susan.*

Definition of 'excluded instalment trust'

155. The term 'excluded instalment trust' is defined in subsection 10(1) as a trust that arises because of an investment of the SMSF under which a listed security is held on trust until the purchase price is fully paid. The listed security and the property derived from it must be the only trust property and the underlying security must not be an asset that would be an in-house asset if invested in directly by the SMSF.

The exceptions

156. Having identified the basic definition of an in-house asset, subsection 71(1) then provides numerous exclusions for certain assets as follows:

(a) a life policy issued by a life insurance company;

(b) a deposit with an authorised deposit-taking institution (ADI), as defined in sec 10(1), (for example, a bank deposit);

(c) an investment in a pooled superannuation trust, where the trustee of the fund and the trustee of the pooled superannuation trust acted at arm's length in relation to the making of that investment;

(d) certain public sector fund assets, (not relevant to SMSFs);

(e) an asset which the Regulator, by written notice given to the trustee of the fund, determines is not an in-house asset of the fund;

(f) an asset which the Regulator by legislative instrument, determines is not an in-house asset of any fund or a class of funds in which the fund is included;

(g) if the superannuation fund has fewer than five members – 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' of the fund within the meaning of sec 66(5);[47]

(h) an investment in a 'widely held unit trust', (see paragraphs 157 and 158 of this draft Ruling);

(i) property owned by the superannuation fund 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; or

(j) 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, (see paragraphs 159 to 163 of this draft Ruling).

[47] see SMSFR 2008/D3 for a further explanation.

Investment in a widely held trust

157. 'Widely held trust' is defined in subsection 71(1A) as:

> For the purposes of paragraph (1)(h), a trust is a ***widely held unit trust*** if:
>
> (a) it is a unit trust in which entities have fixed entitlements to all of the income and capital of the trust; and
>
> (b) it is not a trust in which fewer than 20 entities between them have:
>
> (i) fixed entitlements to 75% or more of the income of the trust; or
>
> (ii) fixed entitlements to 75% or more of the capital of the trust.
>
> For this purpose, an entity and the Part 8 associates of the entity are taken to be a single entity.

158. An SMSF investment in a widely held trust is not an in-house asset of the SMSF. A hybrid trust does not meet the definition as all of the entitlements to the income and capital of the trust are not fixed.

Assets exempted by prescription in the regulations

159. The Superannuation Industry (Supervision) Amendment Regulations 2000 (No. 2) introduced Division 13.3A to the SISR for the purposes of paragraph 71(1)(j) of the SISA. The division has the effect of specifying a class of assets that will not be in-house assets of funds with fewer than 5 members.

160. The exempted assets are investments in a company or unit trust where the company or unit trust meets the requirements listed in regulations 13.22B and 13.22C of the SISR. The regulations apply to investments made both before and after 28 June 2000 (the commencement date of the regulations). The requirements are that the relevant company or unit trust:

- is not a party to a lease or lease arrangement in place with a related party of the fund except for a lease or binding lease arrangement that relates to an asset that at all times satisfies the definition of business real property in subsection 66(5) of the SISA, and
- is not a party to a lease or lease arrangement in relation to an asset that is subject to another lease or lease arrangement between any party and a related party of the fund unless the asset is business real property at all times, and
- does not have any borrowings or charges over its assets, and
- does not have an interest in another entity; and

- does not have any loans to any other entity, other than loans which are deposits with an authorised deposit-taking institution within the meaning of the *Banking Act 1959*, and
- does not own any assets that were acquired from a related party after 11 August 1999 other than:
  - business real property acquired at market value; or
  - money, or
  - a share in the company;
- does not own assets that were at any time assets of a related party to the fund (whether or not acquired directly from the related party) other than:
  - business real property acquired at market value; or
  - money; or
  - a share in the company,

since the later of 11 August 1999 or 3 years before the fund first invested in the company or unit trust.

161. These requirements must be satisfied at the time the asset is acquired.[48]

162. Subregulation 13.22D(1) provides a list of events that cause the exemption provided by regulations 13.22B and 13.22C to cease to apply to investments in a particular company or unit trust, or in the case where a fund admits more than 4 members, investments in any company or unit trust. This provision applies if:

- the fund admits new members and is no longer in the class of funds to which the exemption applies because it has more than 4 members, or
- the company or unit trust enters into a transaction or another event occurs that means the specific requirements of regulations 13.22B or 13.22C are no longer satisfied, or
- the company or unit trust conducts a business, or
- the company or unit trust conducts any transaction otherwise than on an arm's length basis.

163. Where one of the disqualifying events in Regulation 13.22D occurs, subregulation 13.22D(3) prevents any investments held in the affected company or unit trust from being eligible for the exemptions in Regulation 13.22B or 13.22C at any time after that event occurred, regardless of whether the event is corrected. The effect of subregulation 13.22D(3) is discussed in more detail in Self Managed Superannuation Funds Determination SMSFD 2008/1.

[48] If the investment existed at the time the regulations commenced on 28 June 2000, the requirements must have been satisfied at the time the regulations commenced.

Instalment warrants

164. Subsection 67(4A) provides an exemption to the general prohibition on borrowing by the trustee of a regulated superannuation fund. The exemption applies to certain limited re-course borrowing under an arrangement where the borrowed money is applied to the acquisition of an asset that is held in a security trust pending the making of payments by the trustee.

165. Subsection 71(8) ensures that the trustee's interest in the security trust under an arrangement pursuant to subsection 67(4A) is not an in-house asset of the superannuation fund unless the underlying asset held in the security trust would be an in-house asset if directly acquired by the fund.

Transitional rules

166. The in-house asset rules were substantially extended by *Superannuation Legislation Amendment Act (No. 4) 1999*. As a result, many investments held by superannuation funds which were not considered in-house assets prior to these amendments are now caught under the revised rules. As a consequence, transitional rules were inserted in Subdivision D of Division 1 of Part 8 for certain assets held pre 11 August 1999.

167. The transitional rules exclude fund investments or leases that were in place by 11 August 1999 (and were not in-house assets under the old rules) to continue without being subject to the amended in-house asset rules that apply from 23 December 1999. The transitional rules also allow for certain additional investments after 11 August 1999 but before 30 June 2009. While the allowable level of in-house assets held by a fund remains capped at 5% of the market value of a fund's total assets, assets that are covered by the transitional rules are not counted towards the cap because they are excluded from being considered as in-house assets.

Section 71A – 11 August 1999 investments and loans

168. Investments in, or loans to, related parties of the self managed superannuation fund are not considered in-house assets if they were in place at 11 August 1999 and were not in-house assets under the previous rules. These include fund investments or loans under a contract entered into by 11 August 1999, but where the investment or loan actually occurred after that date.

169. This exclusion from the in-house asset rules also applies to partly paid shares and units purchased prior to 11 August 1999 provided that no payments are made after 30 June 2009. Payments made after 30 June 2009 on these shares or units will result in their becoming in-house assets of the fund. However, subsection 71A(3) provides for a reduction in the value of the share or unit included in the calculation of the value of in-house assets.

Section 71B – 11 August 1999 leases and lease arrangements

170. Section 71B excludes from the in-house assets, assets which have been subject to a continuous lease or an uninterrupted series of leases between the trustee of the SMSF and a related party prior to 11 August 1999.

171. Where a legally enforceable lease or lease agreement first came into force after 11 August 1999, subsection 71B(2) deems the asset to have been subject to the lease or lease arrangement prior to 11 August 1999 if the agreement was entered into prior to 11 August 1999.

172. Section 71B does not require that the terms of each lease in a series of leases be on identical terms, but does require that there are no gaps in the periods of the leases.

173. If the renewed lease or lease arrangement is in relation to a new asset or there is a gap between lease renewals then the market value of the asset that is subject to the lease or lease arrangement will be considered an in-house asset.

Section 71C – Transition period: post 11 August 1999 and pre-Royal Assent

174. The legislation amending the in-house asset rules did not receive Royal Assent until 23 December 1999.

175. Any investments and loans made between 12 August 1999 and 23 December 1999 that would be in-house assets under the amended in-house asset definition were not counted as in-house assets until 1 July 2001.

176. Leases and lease arrangements in respect of fund assets entered into with a related party after 11 August 1999 but before 23 December 1999 were also not counted for in-house asset purposes until 1 July 2001 under the transitional arrangements.

177. This provision no longer has application to any fund asset.

Section 71D – Reinvesting earnings

178. If a fund had an investment in a related entity on or before 11 August 1999 which was not an in-house asset under the old rules, the trustee can, after that time but no later than 30 June 2009, reinvest earnings from that entity back into that same entity.

179. To be exempted from the in-house assets under this section, the purchase price of the investment together with all previous investments included under this section cannot exceed the total earnings received[49] from the entity from 12 August 1999 to 30 June 2009. The earnings included in this limit are those from the investments held prior to 11 July 1999 together with any reinvests.

180. Any reinvestment made in a related entity after 30 June 2009 will be an in-house asset.

Section 71E – Geared investments

181. Section 71E provides an alternative to the provisions in sections 71A to 71D for certain geared investments. The requirements for this section to apply are as follows:

- the superannuation fund has less than 5 members; and
- has an investment in a unit trust or company made between 12 August 1999 and 30 June 2009; and
- the fund had an investment in the unit trust or company before 11 August 1999 which was not an in-house asset; and
- prior to 11 August 1999 the unit trust or company had the principle of a loan owing to another entity that was not the superannuation fund; and
- the investment made after 11 August 1999 would be an in-house asset of the fund without section 71E; and
- the trustee of the SMSF must have made a written election by no later than 23 December 2000 that section 71E would apply to all investments in that unit trust or company made after 11 August 1999.

182. Where an election is made under subsection 71E in respect of investments in a unit trust or company, the options under sections 71D and 71A are not available to a trustee in respect of investments in that entity.

183. Where section 71E applies any investment made between 12 August 1999 and 30 June 2009 in the unit trust or company will not be included in the in-house assets of the SMSF provided that the purchase price of that investment together with the purchase price of any previous post 11 August 1999 investments does not exceed the principle of the loan that was owing on 11 August 1999. Investments made in excess of the principle of the loan will be in-house assets of the fund but the value of those investments will be valued at a reduced amount calculated under subsection 71E(4).

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[49] Self Managed Superannuation Funds Determination SMSFD 2007/1 considers when a trust distribution or dividend is received by the SMSF for the purposes of this section.

Anti-avoidance provisions

Agreements where asset taken to be in relation to a related party or related trust (subsection 71(2))

184. Subsection 71(2) provides that where:

- an asset of a superannuation fund is a loan, an investment or an asset subject to a lease or lease agreement, but that asset is not an in-house asset of the superannuation fund (for example where a loan is not made with a related party of the fund); and
- the loan, investment, lease or lease arrangement was made as a result of entering into or carrying out an agreement; and
- any of the persons who entered into or carried out the agreement was aware that as a result there would be:
  - a loan to a related party of the SMSF; or
  - an investment in a related party or a related trust of the SMSF; or
  - an asset would be subject to a lease or lease arrangement with a related party of the SMSF; and

the asset will be deemed to be a loan to, an investment in, or an asset subject to a lease or lease agreement with, a related party or related trust of the fund.

185. As this subsection deems the relevant asset to be with a related party or related trust, the asset may therefore be an in-house asset of the fund if it is not excluded by any of the exceptions discussed above. However, subsection 71(2A) prevents subsection 71(2) from applying to assets which are subject to the exceptions in paragraphs 71(1)(a), (b), (c) or (h).

Avoidance schemes (section 85)

186. Section 85 prohibits persons from participating in a scheme to artificially reduce the value of a fund's in-house assets to avoid the application of the in-house asset restrictions. Section 85 is a civil penalty provision and there are therefore potential civil and criminal consequences of contravening, or being involved in a contravention of, that section.

Appendix 4 – Your comments

187. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

188. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**19 December 2008**
Contact officer:	**Peter Hawkins**
Email address:	**peter.hawkins@ato.gov.au**
Telephone:	**(08) 8208 1262**
Facsimile:	**(08) 8208 1898**
Address:	**Australian Taxation Office** **GPO Box 9990** **Adelaide SA 5001**

Appendix 5 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

SMSFR 2008/1; SMSFR 2008/2; SMSFR 2008/D1; SMSFR 2008/D2; SMSFR 2008/D3; SMSFD 2007/1; SMSFD 2008/1

Subject references:

- complying superannuation fund
- related party
- self managed superannuation fund
- superannuation fund – in house assets

Legislative references:

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