IT 2293 - Income tax : statutory loan back rules for employer-sponsored superannuation funds

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TAXATION RULING NO. IT 2293

INCOME TAX : STATUTORY LOAN BACK RULES FOR EMPLOYER-SPONSORED SUPERANNUATION FUNDS

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	STATUTORY LOAN BACK RULES	23FB
		82AAC
		82AAT
		121C
		121CC

PREAMBLE Amendments of the Income Tax Assessment Act 1936 (the Act) to introduce statutory loan back rules for employer-sponsored superannuation funds were included in the Taxation Laws Amendment Act (No. 2) 1985 (the amending Act), which received the Royal Assent on 28 October 1985. The purpose of this ruling is to explain the operation of those rules.

RULING 2. The statutory loan back rules, which first apply for the 1985-86 year of income, are contained in section 121C of the Act and apply only to superannuation funds that would otherwise be exempt from tax under either section 23F or 23FB of the Act. In other words, a fund must be one to which section 23F or 23FB applies for a year of income before it is necessary to determine whether the fund complies with the loan back rules for that year. Specifically excluded from the operation of section 121C are funds that have no connection with Australia except that they invest moneys in Australia (sub-section 121C(8)). To come within this exclusion in a year of income, the relevant terms and conditions of the fund must not, at any time during the year, provide for benefits for Australian residents and there must be no contributions to the fund during the year for which any income tax deductions were allowed or are allowable.

3. The consequences of non-compliance with the rules are that the investment income of the fund is subject to tax, currently at the rate of 30% (section 121CC), contributions by an employer to a section 23F fund are not deductible (sub-section 82AAC(3)) and contributions by an eligible person to a section 23FB fund are not deductible (sub-section 82AAT(3)).

Loan back rules

4. The basic rule, that applies to funds established after 11 March 1985 (the date on which details of the statutory loan

back rules were announced) and to all funds from and including the 1995-96 year of income, is that, at all times during a year of income, the cost of the in-house assets (see paragraphs 6 and 7) of a fund must not exceed 10% of the cost of all the assets of the fund. A transitional rule that applies up to and including the 1994-95 year of income for those funds in existence at 11 March 1985 effectively provides a 10 year period over which such funds may satisfy the basic rule by natural growth. The transitional rule requires that the cost of in-house assets of those funds not exceed, at any time during a year of income, the greater of -

- the cost of the fund's in-house assets as at 11 March 1985; or

- 10% of the cost of all the assets of the fund.

Thus, for example, a fund that, at 11 March 1985, had in-house assets costing $50,000 and total assets costing $100,000 could not, without breaching the transitional rule, increase its level of in-house assets until the cost of its total assets exceeded $500,000.

5. For the purposes of the transitional rule, where as at 11 March 1985 the cost of a fund's in-house assets exceeded 70% of the cost of all its assets, sub-section 121C(6) deems the cost of the fund's in-house assets as at that date to be equal to 70% of the cost of all its assets as at that date. Such a fund could not, at 11 March 1985, have satisfied the previously applicable tax exemption rule that a fund hold at least 30% of its assets in arm's length investments and sub-section (6) ensures that it does not comply with the transitional rule on the basis of maintaining the level of its in-house assets as at 11 March 1985. The practical effect of this sub-section, in relation to a fund that at 11 March 1985 had, for example, total assets with a cost of $100,000 and in-house assets with a cost of $80,000, is that the cost of the in-house assets as at 11 March 1985 is deemed to be equal to $70,000 and the fund will not comply with the transitional rule until the level of its in-house assets falls to or below that level.

In-house assets

6. The term "in-house asset" is defined to mean an asset of a superannuation fund that consists of a loan to, or an investment in, an employer sponsor (see paragraphs 8-10) of the fund or an associate (see paragraphs 11 and 12) of an employer sponsor. The term does not include a fund asset that consists of a life policy in respect of an employee of a life assurance company that contributes to the fund for the benefit of the employee or the dependants of the employee.

7. An asset of a superannuation fund does not constitute an in-house asset by reason of the fact that the asset is, for example, leased to an employer sponsor or an associate of an employer sponsor. However, other aspects of such arrangements - for example, the effect on the ability of the fund to pay

benefits in the event of the death of a member - would need to be considered in determining whether the fund was a fund to which section 23F or 23FB of the Act applies.

Employer sponsor

8. A contributor to a superannuation fund in respect of an employee, or dependants of an employee, having a right to receive benefits from the fund is an employer sponsor of the fund for the purposes of the loan back rules if the contributor is -

- an employer of the employee;
- a company in which an employer of the employee has a controlling interest (for example, a company contributing to a fund for the benefit of employees of its parent company or for the benefit of employees of an individual shareholder with more than 50% of total voting rights);
- a person who has a controlling interest in a company employer of the employee (for example, a parent company contributing to a fund for the benefit of employees of its subsidiary company);
- a company in which a controlling interest is held by a person who also holds a controlling interest in a company employer of the employee (for example, a subsidiary company that contributes to a fund for the benefit of employees of another subsidiary company in the same group); or
- a person who is a beneficial owner of shares in a company employer of the employee.

9. A company employee who has, or whose dependants have, a right to receive benefits from a superannuation fund may be also an employer sponsor of the fund by reason of being both a contributor to the fund and a beneficial owner of shares in the company. An asset of the superannuation fund consisting of a loan made to such an employee/employer sponsor would therefore constitute an in-house asset of the fund. Similarly, a loan made by the fund to a dependant (being an associate) of such an employee/employer sponsor would constitute an in-house asset. However, sub-section 121C(16) provides that, in these circumstances, the loan is deemed not to be an in-house asset of the fund if the Commissioner is satisfied that, having regard to the amount of the loan, the value of the shares of which the employee is the beneficial owner and any other relevant matters, it would be reasonable because of special circumstances to treat the loan as not being an in-house asset. The other relevant matters referred to would include the amount of fund benefits to which the employee is entitled relative to the amount of the loan and the effect that default by the employee would have on the security of other fund members' benefits. Of course, such matters may also be relevant in determining whether the fund is

one to which section 23F or 23FB applies and sub-section 121C(17) makes it clear that nothing in sub-section (16) is to be taken as implying that a fund trustee may make a loan to a member or a member's dependant without contravening section 23F or 23FB.

10. An example of a situation where sub-section 121C(16) should be applied would be where a fund makes a short term loan to a fund member (perhaps because of temporary personal financial hardship faced by the member) who holds a small number of shares in his or her employer company that were acquired under an employee share acquisition scheme open to employees generally - the amount of the loan being less than, and secured by, the member's entitlement to benefits from the fund. On the other hand, where it is clear that a loan made to a fund member who is an employee/shareholder of the employer company has been made available to the employer - for example, where the loan moneys were on-lent by the employee to the employer company - sub-section (16) is not to be applied, even if it was decided that the conditions for the application of section 23F or 23FB were not breached.

Associate

11. For the purposes of the loan back rules, the definition of "associate" contained in sub-section 26AAB(14) of the Act applies. That definition specifies who is an associate in relation to a natural person, a company, a trustee of a trust estate or a partnership and, in broad terms, refers to those persons who, by reason of family or business connections, might properly be regarded as being associated with a particular person. As the definition is a very wide one, any person not completely at arm's length from an employer sponsor would generally be an associate of the employer sponsor.

12. Assets of a superannuation fund consisting of loans to, or investments in, an associate of an employer sponsor are in-house assets of the fund. For example, units in a unit trust held by a fund would be in-house assets if the trustee of the unit trust is an associate of the employer sponsor, as would be the case where the employer sponsor is also a unitholder in the unit trust.

Fund assets/cost of assets

13. It is not uncommon for superannuation funds, particularly smaller funds, to invest with an external investment manager who conducts a superannuation investment pool on behalf of a number of such funds. In a year of income in which the investment income of a fund consists of or includes a portion of the income arising from assets in such a pool, sub-section 121C(9) deems the pool assets to be assets of the fund for the purposes of the loan back rules. The sub-section also provides that the cost of those pool assets, including any assets that would be in-house assets if owned by the fund, is such amount as, in the opinion of the Commissioner, is reasonable in the circumstances. It should generally be

accepted, in determining the cost of all the assets of a fund for the purposes of the loan back rules, that the cost of assets deemed by sub-section (9) to be assets of the fund is equal to the amount that bears the same proportion to the cost of all the assets of the investment pool as that part of the income from the pool to which the fund is beneficially entitled bears to the total income from the pool. In determining the cost of the in-house assets of the fund, the same proportion should be applied to those assets of the pool that, if owned by the fund, would be in-house assets of the fund.

14. For the purposes of the loan back rules, the cost of an asset would ordinarily be the price (whether or not paid at the relevant time) for which the asset was purchased. Brokerage and stamp duty in connection with the purchase of shares or securities would not be regarded as part of their cost unless a consistent practice is adopted in relation to the whole of a fund's assets - in other words, brokerage or stamp duty is not to be taken as forming part of the cost of some assets but not of other assets.

15. Sub-section 121C(10) applies where a superannuation fund acquires an asset, including an in-house asset, for no consideration, for inadequate or excessive consideration or for consideration other than money and provides that the cost of the asset shall be such amount as, in the opinion of the Commissioner, is reasonable in the circumstances. The sub-section is directed at countering arrangements designed to circumvent the loan back rules and under which in-house assets are acquired by a fund for no consideration (note paragraph 16) or for inadequate consideration or non-in-house assets are acquired by a fund for excessive consideration. Market value should generally be taken to be the cost of an asset acquired for no consideration or for inadequate or excessive consideration, unless it is clear that the consideration, if any, was determined in accordance with arm's length principles, in which case the amount of actual consideration, if any, may be accepted as being the cost of the asset. The cost of an asset acquired for consideration other than money should be determined on the foregoing basis as if the consideration had been an amount of money equal to the market value, at the time the asset was acquired, of the consideration in kind.

16. In considering the application of sub-section 121C(10) in a case where bonus shares or rights are issued by a company employer sponsor (or associate) to a superannuation fund, regard should be had, in particular, to whether the fund was the sole or principal beneficiary of the issue (which may indicate a non-arm's length arrangement) and/or whether the bonus shares or rights were issued in lieu of a dividend. In this latter regard, it has been common practice for employer sponsors to credit a superannuation fund's loan account with the amount of a dividend payable to the fund by the employer in lieu of paying a cash dividend. This practice may now have the effect that the fund breaches the loan back rules and the employer sponsor may seek to overcome this effect by issuing bonus shares to the fund in lieu of paying a dividend. In such cases, the cost of the

total assets of the fund and of the in-house assets of the fund should be increased by the amount that could reasonably have been expected to have been paid as a dividend. In the absence of evidence to the contrary, that amount should be taken as being equal to the market value of the bonus shares immediately after their issue.

17. Sub-section 121C(11) is a safeguarding provision to prevent circumvention of the loan back rules by means of devices under which a superannuation fund indirectly lends money to, or otherwise invests in, an employer sponsor or an associate of an employer sponsor. The sub-section applies where, pursuant to an agreement, a superannuation fund makes a loan to or an investment in a person, not being an employer sponsor or an associate of an employer sponsor, and any of the parties to the agreement had as a purpose of entering into the agreement the purpose of having a loan made to or an investment made in an employer sponsor, or an associate of an employer sponsor, of the fund. In those circumstances, the loan or investment made by the fund is an in-house asset. It should be noted that "agreement" is defined to mean any agreement, arrangement or understanding whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings. The devices that the sub-section counters include on-lending (for example, where a fund lends to a third party who in turn lends to, or buys shares in, an employer sponsor) or cross-lending (for example, where the fund sponsored by employer A invests in the business of employer B and the fund sponsored by employer B in turn invests in the business of employer A).

18. Sub-section 121C(12), which applies only where sub-section (11) does not apply, provides another safeguard against circumvention of the loan back rules by the interposition of other persons between a superannuation fund and an employer sponsor or an employer sponsor's associate. It applies where an asset of a superannuation fund consists of a loan to or an investment in a person who, although not an employer sponsor or an associate of an employer sponsor of the fund, has a "financial link" with such an employer sponsor or associate and operates to increase the cost of the in-house assets of a fund by such amount as, in the opinion of the Commissioner, is reasonable in the circumstances. In terms of sub-section 121C(13), a person has a financial link with an employer sponsor or associate if an asset of that person consists of a loan to, or an investment in, the employer sponsor or associate - for example, a financial link would exist between a unit trust and an employer sponsor that is a company where the unit trust's assets included shares in that company. A person also has a financial link with an employer sponsor or associate if that person has a financial link with another person who has a financial link with the employer sponsor or associate - for example, a financial link would exist between a unit trust and an employer sponsor company if the unit trust's assets included shares in a company that in turn owned shares in the employer sponsor company. Provided that there is a continuing financial link from person to person, sub-section 121C(12) is, in

conjunction with sub-section 121C(13), capable of applying irrespective of the number of persons interposed between an employer sponsor or associate and a person to whom or in whom a superannuation fund has made a loan or investment.

19. Because there may be any number of interposed persons between the fund and the employer sponsor and the financial links between each of the parties may be either equity or debt (secured or unsecured) or a combination of both, it is not possible to specify a precise formula for use in those cases to which sub-section (12) applies. As a general rule, however, the cost of a fund's in-house assets should be increased in such a case by an amount equal to an appropriate proportion of the fund's loan to or investment in the first interposed person, determined on the basis of the extent to which that loan or investment is represented by the loan to or investment in the employer sponsor (or associate) by the last interposed person. As a simple example, if a superannuation fund held half of the issued capital of company A, that held half of the issued capital of company B, that held shares costing $10,000 in employer sponsor company C, the cost of the in-house assets of the fund would, in ordinary circumstances, be increased by $2,500 (that is, one-half of one-half of $10,000). On the other hand, if the circumstances are such that the whole of a fund's loan to or investment in an interposed entity can be attributed to an interposed entity's loan to or investment in the fund's employer sponsor (or associate), the fund's in-house assets should be increased accordingly. For example, if a fund made a loan of $10,000 to an interposed entity that directly or indirectly made $10,000 available to the fund's employer sponsor in circumstances where sub-section 121C(11) (see paragraph 17) did not apply, the fund's in-house assets should be increased by $10,000.

20. The cost of the in-house assets of a superannuation fund is not to be increased by the application of sub-section 121C(12) in circumstances where it would be clearly unreasonable to do so. For example, the sub-section should not be applied in respect of a period during which the trustees of the fund can establish that they could not reasonably be expected to have known that a person with whom the fund invested had a financial link with an employer sponsor, or an associate of an employer sponsor, of the fund. (Although the sub-section should thereafter be applied, consideration should be given to the application of sub-section 121C(7) - see paragraphs 23 to 25 - in relation to resultant non-compliance with the loan back rules). As a practical matter, a fund's in-house assets should not be increased where it is reasonably evident that the fund's indirect interest in the employer sponsor or associate is so remote as to have little effect on the fund's compliance with the loan back rules - for example, where a fund's investment in an employer sponsor is by way of number of interposed entities and it can be seen, without actual calculation, that the indirect interest is minor.

21. By virtue of sub-section 121C(14), the cost of the in-house assets of a fund is deemed to be increased by an amount

that the fund may become liable to pay to, or on behalf of, an employer sponsor or an associate of an employer sponsor under a guarantee or mortgage or in respect of unpaid calls on shares in the employer sponsor or associate that is a company. In respect of a guarantee given by the trustee of a fund in relation to an employer sponsor or an associate of an employer sponsor (for example, where the trustee has guaranteed repayment of moneys borrowed by the employer sponsor from a third party), the amount by which the cost of the fund's in-house assets is to be increased is the amount that the fund would be liable to pay if the guarantee were enforced. Similarly, where fund assets are subject to a mortgage (as that term is defined in sub-section 6(1) of the Act) for the benefit of an employer sponsor or an associate of an employer sponsor,
the amount by which the cost of the fund's in-house assets is to be increased is the amount owing in respect of the loan for which the mortgage was given. Before considering the application of sub-section 121C(14) in relation to a guarantee or mortgage, the circumstances surrounding the giving of the guarantee or mortgage should be carefully examined to ensure that section 23F or 23FB applies to the fund - refer Taxation Ruling No. IT 2253. In this regard, sub-section 121C(17) makes it clear that nothing in sub-section (14) is to be taken as implying that a fund trustee may give such a guarantee or mortgage without contravening section 23F or 23FB.

22. Sub-section 121C(14) also provides that the cost of the in-house assets of a fund is deemed to be increased by the amount of any calls that a fund trustee is, or could become, liable to pay in respect of shares in a company that is an employer sponsor or an associate of an employer sponsor of the fund. However, under sub-section 121C(15), the amount of calls that a trustee could become liable to pay may be disregarded if it is clear that the assets of the company are sufficient to enable it to meet its debts (incurred or reasonably likely to be incurred) without having to call up the amount outstanding in respect of the fund's shares. Again, the question whether section 23F or 23FB applies to a fund that subscribes for partly paid-up shares in a company that cannot meet its debts would need to be carefully examined and sub-section 121C(17) is also relevant in that regard.

Non-compliance disregarded

23. Non-compliance with the loan back rules may, in terms of sub-section 121C(7), be disregarded if either the trustee of the fund made a genuine and bona fide attempt to ensure that the fund complied with the rules at all times during the year of income or the failure to comply was caused by a temporary delay in investment and, in either case, if the circumstances are such that it would be reasonable to disregard the failure to comply. The question whether sub-section (7) should be applied needs to be considered having regard to the facts of each particular case. However, where no special circumstances exist, occasional or accidental breaches of the loan back rules should be disregarded in those cases where -

- the trustees of the fund have adopted systematic procedures that would ordinarily be expected to ensure compliance with the loan back rules throughout the income year; and

- at not less than monthly intervals, checks are made of the levels of both in-house and other assets and any necessary adjustments are then made.

24. Some specific examples of situations where non-compliance with the loan back rules should be disregarded on the basis of sub-section 121C(7) are set out in the following paragraph. The examples are intended to illustrate, not to describe exhaustively, such situations.

25. Provided that the fund trustee, within a reasonable period after non-compliance is detected, takes action to remedy the situation - for example, by disposing of sufficient in-house assets (not necessarily the in-house assets that gave rise to the non-compliance) to bring the level of in-house assets below the specified level - non-compliance with the loan back rules should be disregarded -

- where non-compliance resulted from action taken by the trustees of the fund prior to the date of introduction of the loan back legislation (19 September 1985) and the trustees can establish that, in taking that action, they had due regard to but genuinely misunderstood the operation of the loan back rules as announced on 11 March 1985;

- where shares held by a fund, not otherwise being in-house assets, became in-house assets as a result of a takeover of the company by an employer sponsor (or an associate) in circumstances where the trustees of the fund can establish that they could not reasonably have been expected, in the time available, to have disposed of the shares prior to the takeover; or

- where non-compliance resulted from the application of sub-section 121C(9) (see paragraph 13) and the trustees of the fund can establish that reasonable steps were taken to be assured that the manager of the investment pool of which the fund is a member would either not make any investments in an employer sponsor (or associate) or not make such investments to an extent likely to result in non-compliance by the fund.

What is a reasonable period for the taking of action to remedy non-compliance with the loan back rules will depend on the circumstances of each case but, in relation to the disposal of in-house assets, regard should be had to the effect that disposal as matter of urgency would have on the consideration receivable and thus on the security of members' benefits.

Transitional provisions

26. Sub-section 34(5) of the amending Act, which applies only in respect of the 1985-86 and 1986-87 income years, deems a fund in existence at 11 March 1985 to have complied with the loan back rules in relation to those 2 years if the Commissioner is satisfied that an asset became an in-house asset of the fund on or after 12 March 1985 because of a decision made before that date and that there are special circumstances by reason of which it would be reasonable to accept the fund as having complied with the rules. The time limit on the application of the sub-section effectively provides the fund with a 2 year period in which to satisfy the rules by natural growth. The following conditions should be satisfied before a fund is accepted, by virtue of sub-section 34(5), as having complied with the loan back rules -

- there is evidence that a firm decision was made - not merely contemplated - before 12 March 1985;
- there is a clear nexus between the making of that decision and the acquisition of the in-house asset;
- but for the acquisition of that in-house asset, the fund would have complied with the loan back rules; and
- the acquisition of the in-house asset was in the best interests of the members of the fund.

The sub-section would be accepted as applying where, for example, the trustees of a fund can establish that they took a firm decision before 12 March 1985 to exercise a right to acquire a specific number of shares in an employer sponsor and the in-house assets of the fund exceeded the specified levels by reason of the exercising of that right on or after 12 March 1985 in circumstances where failure to exercise it would have had a detrimental effect on the value of shares already held by the fund.

27. The statutory loan back rules first have application in relation to the 1985-86 income year. In terms of sub-section 34(4) of the amending Act, where that income year is a substituted accounting period that commenced before 12 March 1985, the fund in question is only required to comply with the loan back rules in respect of the period of that year after 11 March 1985.

COMMISSIONER OF TAXATION
13 May 1986

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