SMSFR 2009/3 - Self Managed Superannuation Funds: application of the Superannuation Industry (Supervision) Act 1993 to unpaid trust distributions payable to a Self Managed Superannuation Fund

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There is a Compendium for this document: **SMSFR 2009/3EC** .

This document has changed over time. This is a consolidated version of the ruling which was published on *15 November 2023*

Self Managed Superannuation Funds Ruling

Self Managed Superannuation Funds: application of the *Superannuation Industry (Supervision) Act 1993* to unpaid trust distributions payable to a Self Managed Superannuation Fund

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Preamble

This publication represents the Commissioner's 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 this ruling indicates, the fact that you acted in accordance with 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.

*[**Note:** This is a consolidated version of this document. Refer to the Legal database (ato.gov.au/law) to check its currency and to view the details of all changes.]*

What this Ruling is about

1. This Ruling considers whether a Self Managed Superannuation Fund (SMSF) contravenes certain provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA)[1] when the SMSF is presently entitled to distributions from a related trust which are not paid to the SMSF.

2. The provisions considered are:

- the in-house asset rules in Part 8;
- the arm's length rules in section 109; and
- the sole purpose test in section 62.

3. This Ruling sets out the Commissioner's views in the context of the SISA. Nothing in this Ruling should be taken as applying to the

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

provisions of other legislation administered by the Commissioner such as income tax or fringe benefits tax.

Ruling

4. Where an SMSF is presently entitled to a distribution from a related or non-arm's length trust, and payment of this amount is not sought, contraventions of one or more provisions of the SISA may occur. This Ruling discusses three of the most relevant provisions and identifies the circumstances where a contravention might occur.

In-house asset rules

5. Part 8 of the Act limits an SMSF to holding no more than 5% of its assets as in-house assets. For the purposes of this Ruling, the definition of an in-house asset in subsection 71(1) includes:

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

Is the unpaid trust distribution a loan to a related party?

6. The recording of an unpaid trust distribution as a loan in the accounts will not of itself determine that the amount is a loan for the in-house asset rules. However, the trustee of the SMSF and the trustee of the trust may agree to bring into existence a loan between the parties. An example of this would be the execution of a loan agreement. If a loan is made in this way, there is a constructive receipt of the distribution by the trustee of the SMSF and a subsequent loan back of that amount to the trustee of the trust.

7. In addition, it is the Commissioner's view that, when an overall consideration of the factors surrounding the non-payment of the trust distribution is seen as an arrangement for the provision of credit or financial accommodation, it will satisfy the extended definition of 'loan' in subsection 10(1).

8. Consequently, the unpaid amount will be included in the in-house assets of the SMSF, where:

- the trust in question is a related party of the SMSF; and
- the circumstances indicate that a loan agreement has been entered into, or that a consensual agreement for the provision of credit or other form of financial accommodation has been reached between the parties.

Is the unpaid trust distribution an investment in a related party or a related trust of the SMSF?

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

10. The entitlement to receive a trust distribution is an asset of the SMSF and it is the Commissioner's view that, in the same circumstances where the unpaid trust distribution falls within the definition of a loan as discussed in paragraphs 6 and 7 of this Ruling, this will also be an application of that asset. Therefore, where the application of the asset is for income, interest, profit or gain, for example where interest is earned on the outstanding amount, this will constitute an investment in the unit trust. However, to be an investment of the SMSF, the source of any expected income must be from the application of this asset. Consequently, it is the Commissioner's view that the mere expectation of future profits through the existing units in the unit trust is not sufficiently connected to the unpaid trust distribution to characterise the asset as an investment. This is because the income, profit or gain expected has its source in the rights attached to the investment in the units, not in the application of the unpaid trust distribution.

11. Alternatively, the trustee of the SMSF may enter into an agreement whereby the equitable right to payment of the trust distribution is converted into a different equitable right.[2] This commonly could occur by the satisfaction of that right in the form of additional units in the trust. However, the issue of new units is not necessarily required for an investment of the distribution to occur. Instead, the trustee of the SMSF may enter into an agreement that the distribution be added to the corpus of the trust without the issue of additional units. The discharge of an equitable right and its replacement by a different equitable right is an application of the assets of the SMSF.

12. Where such an agreement exists, and is entered into for the purpose of gaining interest, income, profit or gain, the amount will also be an investment for the purposes of subsection 71(1).

13. Where the trust in question is a related party or a related trust of the SMSF, and the circumstances indicate that an investment in that trust has been made, the amount will be included in the in-house assets of the SMSF unless any of the exclusions in sections 71 to 71E apply.

Section 71D

14. If the SMSF held units in the unit trust on or before 11 August 1999 which were not in-house assets at that time, the

[2] The nature of trust distributions is discussed in paragraphs 64 to 70 of this Ruling.

trustee can, after that time but no later than 30 June 2009, reinvest trust distributions from that trust back into that same entity without breaching the in-house asset rules if certain criteria are satisfied. Consequently, where the unpaid distribution is an investment in the unit trust, that investment may be excluded from the in-house assets of the SMSF under section 71D. However the total amount that can be excluded from the in-house assets of the SMSF between 12 August 1999 and the end of 30 June 2009 is limited to the total of the distributions received from the unit trust. Therefore it is necessary to determine when the trust distributions are received by the SMSF for the purposes of section 71D.

When is the distribution received from the unit trust?

15. Self Managed Superannuation Funds Determination SMSFD 2007/1 explains that for a distribution to be received for the purposes of section 71D, it must be paid to the SMSF. As discussed in paragraph 25 of that determination, the application of the distribution on behalf of the SMSF is also considered to be payment of that amount. Examples of this will be where the payment is in the form of the issue of new units, or where a contractual loan agreement is entered into. However, where the application of the trust distribution is merely an informal arrangement for a financial accommodation between the beneficiary and the trustee, it is the Commissioner's view that this arrangement will not amount to the receipt of the trust distribution under section 71D. This is because the equitable right to immediate payment is not extinguished but instead there is merely an arrangement for the forbearance of the SMSF from enforcing that right. This analysis would apply even if interest is calculated on the unpaid distribution.

When was the investment in the unit trust made?

16. Section 71D applies to a 'post-test-time investment' which is defined in paragraph 71D(a) as an investment in the entity after 11 August 1999 and before the end of 30 June 2009. It is therefore necessary to identify when the investment in the unit trust is made.

17. Where new units are issued to the SMSF, this can be readily ascertained and will be the date when these units are issued. Likewise where the right to the trust distribution has been converted into a different equitable right the relevant date will be the time at which the conversion takes place.

18. Alternatively, where the investment in the unit trust arises from an informal arrangement for a financial accommodation at interest, the distribution entitlement has not been received by the SMSF and consequently there is no need to determine when the corresponding investment took place.

What is the purchase price of the investment?

19. Paragraph 71D(d) limits the level of investments that can be excluded from the in-house assets under that section by reference to the 'purchase price' of those investments. Where the relevant investment is the purchase of new units, the purchase price is easily ascertained. Alternatively, where the investment is a contractual loan, it is the Commissioner's view that the purchase price of that loan will be the principal of the original loan at the time it is made.

Section 71E

20. Section 71E provides an alternative to the provisions in sections 71A to 71D for certain geared investments which were held at 11 August 1999. For this provision to apply the unit trust must have had an outstanding loan with another entity which is not the SMSF immediately prior to the end of 11 August 1999 and the trustee of the SMSF must have made an election by 23 December 2000.

21. Where section 71E applies, any investment made between 12 August 1999 and the end of 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 principal of the unit trust's loan that was owing on 11 August 1999. Therefore, where an unpaid trust distribution amounts to an investment in the unit trust these amounts may be excluded from the in-house assets of the SMSF under this section.

22. In addition, subsection 71E(6) deems loans made to the unit trust to be an investment in that unit trust for this subsection. It also deems the purchase price of the investment to be the amount of the original principal of that loan. Therefore, where an unpaid trust distribution amounts to a loan to the unit trust, this amount can be excluded from the in-house assets of the SMSF under this provision, whether or not any interest is payable on that loan.

Regulation 13.22C

23. The Superannuation Industry (Supervision) Amendment Regulations 2000 (No. 2) introduced Division 13.3A to the Superannuation Industry (Supervision) Regulations 1994 (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 where the relevant member limits are met.[2A]

24. 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 or 13.22C. Therefore, where an unpaid trust distribution amounts to an investment in the unit trust, paragraph 71(1)(j) may operate to exclude that investment from the in-house assets of the SMSF by virtue of either of these regulations. However, where a contractual loan agreement is entered into between the unit trust and the SMSF this will be a borrowing by the unit trust from the SMSF. Such a borrowing will result in all investments of the SMSF in that unit trust no longer being eligible for exclusion from its in-house assets under paragraph 71(1)(j).[3] This is because, to be eligible for this exclusion, the unit trust must not have any borrowings.

Arm's length rule

25. Where an unpaid trust distribution is considered to be an investment in the unit trust, section 109(1) will apply to that arrangement. Subsection 109(1) requires that any investments made by the trustee or investment manager of the SMSF either be conducted on an arm's length basis, or not be more favourable to the trustee of the unit trust than would be expected if the arrangement was conducted on an arm's length basis.

26. Further, subsection 109(1A) provides that, where an SMSF trustee or investment manager deals with a party who is not at arm's length in respect of an investment, that dealing must be undertaken in the same manner as it would if the other party were at arm's length. Therefore, where an SMSF holds an investment in a related trust, any dealings with the trustee of that trust must be undertaken in the same manner as it would if that trust was at arm's length. Decisions about whether to seek payment of trust distributions would form part of these dealings and should be done on the same basis as would be expected if the trust was not a related party.

[2A] *Treasury Laws Amendment (Self Managed Superannuation Funds) Act 2021* increased the maximum allowable number of SMSF members from 4 to 6, effective 1 July 2021. Regulation 13.22B of the SISR was not updated as it concerns facts existing before the commencement of Division 13.3A. Regulation 13.22C can apply to facts before or after the member increase. The amendment only applies prospectively from commencement.

[3] This is due to regulation 13.22D. For further information on the operation of this regulation see SMSFD 2008/1.

27. The Commissioner's view is that arm's length beneficiaries would not generally allow substantial amounts of distribution entitlements to remain in the trust without receiving an appropriate return on this amount, for example a market rate of interest. The possibility of receiving greater distributions from the trust in the future due to the provision of low cost capital would not be adequate compensation where the SMSF is not the sole beneficiary of the trust. As a consequence, a breach of subsection 109(1A) will likely occur in these circumstances.

28. Where the SMSF is the sole beneficiary it may be able to validate a view that the non-payment of a trust distribution was undertaken in the same manner as it would if the other party were at arm's length. However, it is the Commissioner's view that such a non-payment would be seen as a consensual arrangement meeting the extended definition of a 'loan'.

Sole purpose test

29. The sole purpose test in section 62 requires that an SMSF uses concessionally taxed superannuation savings for the specified core purposes of providing retirement or death benefits for or in relation to its members or for one or more of these purposes and other stipulated ancillary purposes.

30. Whether the SMSF is being carried on solely for the required purposes is determined by looking at the overall conduct of the fund and one factor alone is usually not decisive. However, the Commissioner is of the view that where an SMSF trustee maintains a substantial proportion of the assets of the SMSF in a related trust as unpaid trust distributions, upon which no or below market rate interest is being paid, this suggests that the fund is not being maintained in a way that satisfies the 'Sole Purpose Test' in section 62.

31. Rather, this might indicate that the SMSF assets are being employed as a low cost source of capital for the related trust. This conclusion would be further supported where the SMSF is not the sole beneficiary of the related trust, particularly where the other beneficiaries of the trust are related parties.

32. Where it is concluded that the SMSF is not being maintained for the requisite purposes specified in section 62, the trustee of the SMSF will be in contravention of this requirement.[4]

[4] Section 62 is explained in more detail in 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.

Funds to which the Ruling applies

33. 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

34. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does 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 Ruling.

Commissioner of Taxation
24 June 2009

[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 – Examples

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

Example 1 – unpaid distribution which is a loan – contravention of subsection 71(1) and subsection 109(1A)

35. Sonya and Henning are the sole members of the S&H SMSF. This SMSF has a corporate trustee, S&H Pty Ltd, of which Sonya and Henning are the sole shareholders and directors.

36. Since 1988 the S&H SMSF has held units in a related unit trust, the Jasmine Trust, which also has S&H Pty Ltd as its trustee. Sonya and Henning hold the remaining units in this trust. The Jasmine trust carries on a business, producing gourmet pâté. Sonya and Henning are employed in the business by S&H Pty Ltd as trustee of the unit trust. Correspondingly S&H Pty Ltd contributes superannuation to the S&H SMSF on their behalf.

37. The market value of the original units held by the S&H SMSF is $40,000.

38. Since 1988, the trustee of the Jasmine Trust has resolved to distribute income to the S&H SMSF totalling $800,000. However, rather than paying these distributions to the S&H SMSF, the funds have been retained in the Jasmine Trust to fund its expansion. These amounts have been recorded in the books of both entities as loans. There is no clause in the unit trust deed regarding the character of the unpaid trust distributions and no other documents describing or creating any contractual agreement in respect of the unpaid amounts.

39. After discussion with the Tax Office, Sonya and Henning state that they do not intend that the S&H SMSF will seek payment by a specific date but they do intend that payment will occur at a later time. In addition, Sonya and Henning state that no amount has been put aside in the Jasmine Trust for payment of the distributions to the S&H SMSF and consequently the Jasmine Trust is not in a position to pay the distributions to the S&H SMSF. No interest is paid on the unpaid amount.

40. The assets of the S&H SMSF are described as follows:

- units in Jasmine Unit Trust $40,000;
- loan account to Jasmine Unit Trust $800,000;
- investment in a managed fund $200,000; and
- shares $60,000.

41. Although there is no specific loan arrangement or definite date for payment, the facts enable the Commissioner to conclude that there is provision of financial accommodation by the S&H SMSF to the Jasmine Trust because the two trusts have the same trustee, the amounts of the distributions deferred are substantial, the time frame of the deferral is also large and a pattern of deferring payment of the distributions is well established over many years. As a consequence, the unpaid trust distributions of $800,000 are loans pursuant to the extended definition of 'loan' in subsection 10(1). However, as no interest is paid on this 'loan' it will not be an investment in the Jasmine Trust. Consequently the exception in section 71D can't apply to this unpaid amount.

42. The Jasmine Trust is a related party of the SMSF and as a consequence, the $800,000 in unpaid trust distributions would be included in the in-house assets of the S&H SMSF unless any of the exceptions in sections 71 to 71E apply. In this case they do not. Consequently, $800,000 of the $1,100,000 assets of the superannuation fund are in-house assets, far in excess of the 5% allowed.

43. In addition, the trustee of the S&H SMSF is not at arm's length to the trustee of the Jasmine Trust. Consequently it is necessary to determine whether the dealings in relation to the units held by the SMSF in the unit trust have been carried out on the same basis as they would with an arm's length party. It is unlikely that the S&H SMSF would have allowed $800,000 to remain unpaid without appropriate compensation if the distribution entitlement lay with an unrelated unit trust. As a consequence, the trustee of the S&H SMSF is in contravention of subsection 109(1A) in respect to the units held in the Jasmine Trust.

44. Finally, the majority of the value of the assets of the S&H SMSF is being maintained in a related unit trust, which is providing no-cost capital for its business. This is not a permitted purpose for the SMSF under section 62 and it is very likely therefore that the trustee of the S&H SMSF contravenes this requirement as well.

Example 2 – unpaid distribution which is not a loan

45. Phillip and Carol are the sole directors and shareholders of PC Sales & Repairs Pty Ltd, a private company which operates the family business. Phillip and Carol are also sole trustees and beneficiaries of the PC Superannuation Fund, an SMSF.

46. As at 30 June 2007 the SMSF had total assets of $750,000, made up entirely of units in the PC Unit Trust. The PC Superannuation Fund holds 50% of the units in that trust and the remainder are held by Phillip, Carol and their 3 children. The trust's only major asset is the business premises on which the family business is conducted. This property is leased to PC Sales and Repairs Pty Ltd at commercial rates. The requirements of the SISR Regulation 13.22C are satisfied and consequently the value of the units in this trust are not included in the in-house assets of the PC Superannuation Fund by virtue of paragraph 71(1)(j).

47. On 30 June 2007 the trustee of the PC Unit Trust resolved to distribute all of the net income of the trust to the unit holders. Consequently the PC Superannuation Fund was presently entitled to 50% of the net income of the unit trust on 30 June 2007. However, the amount of the distribution was not ascertained until 30 April 2008 when the accounts were finalised to enable income tax returns for the entities to be lodged by the due date. The net distribution, $100,000, was subsequently paid to the PC Superannuation Fund on 31 May 2008. This arrangement was the same for all unit holders of the trust and was consistent with the practice observed in the previous 5 years in which the Unit Trust has been in operation.

48. The $100,000 trust distribution unpaid as at 30 June 2007 was not a loan to the PC Unit Trust for the purposes of subsection 71(1). This is because the payment arrangement was in line with the normal commercial operations of a trust. Also, the activities of previous years show that the distributions are regularly paid each year, rather than being accumulated as unpaid amounts.

49. Although the PC Superannuation Fund and the PC Unit Trust are controlled by the same trustee, it cannot be concluded that there was any consensual arrangement between the trustees of these entities for the provision of credit or other financial accommodation. The unpaid trust distribution is therefore not included in the in-house assets of the PC Superannuation Fund as at 30 June 2007 and the 5% limit was not exceeded in that year. As a result, the PC Superannuation Fund did not contravene the in-house asset rules.

50. In addition, the PC Superannuation Fund did not contravene the arm's length rule in subsection 109(1A). The terms for payment of the distribution were in line with normal arm's length practices and were consistent between the different unit holders.

51. Finally, the arrangement for payment of the distribution was consistent with the requisite purposes set out in section 62.

Example 3 – unpaid trust distributions which are loans

52. Dominic and Mary are the sole members and trustees of the DM SMSF, which holds units in the DM Unit Trust. The trustee of the DM Unit Trust is DM Pty Ltd, of which Dominic and Mary are the sole directors and shareholders. The units in the unit trust were held prior to 11 August 1999 and were not in-house assets under the rules at that time.

53. As at 30 June 2009 a total of $300,000 in trust distributions have been resolved since 11 August 1999, excluding the distribution made on 30 June 2009, the amount of which is unknown. All of the resolved distributions remain unpaid and no amounts have been reinvested in new units. There is no clause in the unit trust deed regarding the character of the unpaid trust distributions and no other documents describing or creating any contractual agreement in respect of the unpaid amounts. Interest is accumulating on the outstanding distributions and currently totals $100,000.

54. After discussion with the Tax Office, Dominic and Mary state that they do not intend that the DM SMSF will seek payment by a specific date but they do intended that payment will occur at a later time. In addition, Dominic and Mary state that no amount has been put aside in the DM Unit Trust for payment of the distributions to the DM SMSF and consequently the DM Unit Trust is not in a position to pay the distributions to the DM SMSF.

55. Although there is no specific loan arrangement or definite date for payment, the facts enable the Commissioner to conclude that there is provision of financial accommodation by the DM SMSF to the DM Unit Trust. This is because

- the two trusts are controlled by Dominic and Mary;
- the amounts of the distributions deferred are substantial; and
- the time frame of the deferral is also large and a pattern of deferring payment of the distributions is well established over many years.

Consequently, as at 30 June 2009 the $300,000 in unpaid trust distributions are considered to be loans under the extended definition in subsection 10(1) by the trustee of the DM SMSF to the trustee of the DM Unit Trust. This is because there has been the provision of a financial accommodation.

56. In addition, because interest is paid on the arrangement, these loans are also considered to be investments in the DM Unit Trust made after 11 August 1999 and before the end of 30 June 2009. Therefore these investments are post-test time investments of the SMSF which could potentially be excluded from the in-house assets of the SMSF under section 71D.

57. However, the rights to immediate payment of the distributions have not been surrendered and therefore no amount of the trust distributions have been received by the SMSF for the purposes of paragraph 71D(d). Consequently, none of the post-test time investments in the unit trust can be excluded from the in-house assets of the SMSF under section 71D.

Example 4 – contractual loan agreement

58. As per Example 3 of this Ruling except that a written loan agreement has been entered into each year in respect of the trust distribution. As a result, the trust distributions totalling $300,000 have been received by the DM SMSF each year, and reinvested in the form of a loan (under the ordinary meaning of that term) to the DM Unit Trust. This reinvestment is excluded from the in-house assets of DM SMSF under section 71D.

Example 5 – new units issued

59. As per Example 4 of this Ruling except that rather than entering into a written loan agreement the distribution is reinvested through the issue of new units in the DM Unit Trust. As a result, all of the distributions totalling $300,000 have been received by the DM SMSF each year and reinvested in the new units. All of these new units will be excluded from the in-house assets of the SMSF under section 71D.

Example 6 – contractual loan agreement

60. Susan and Leonie conduct a nursery business in partnership and also have their own SMSF. The business premises are owned by a unit trust of which Susan and Leonie are the trustees and all the units are held by the SMSF. The partnership leases the business premises from the unit trust at market rates. The units in the unit trust are excluded from the in-house assets of the SMSF under paragraph 71(1)(j) as the requirements of regulation 13.22C are satisfied in respect of this unit trust.

61. On 30 June 2007 the trustees of the unit trust resolved to distribute $50,000 in favour of the SMSF but this amount was not paid to the SMSF. Instead a contractual loan agreement was entered into between the SMSF and the unit trust. Interest is paid on the outstanding balance and is accumulated on the loan account.

62. This loan by the SMSF is a borrowing of the unit trust which is prohibited by paragraph (e) of subregulation 13.22C(2). Consequently, the unpaid trust distribution does not satisfy the requirements of regulation 13.22C and will not be excluded under paragraph 71(1)(j). In addition, the borrowing would be an event in subparagraph (c)(i) of subregulation 13.22D(1). This will result in all of the investments in the unit trust no longer being excluded from the in-house assets of the SMSF. A detailed discussion on the operation of regulation 13.22D is contained in SMSFD 2008/1.

Appendix 2 – Explanation

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

Background

63. SMSFs can hold investments in related trusts in a variety of circumstances, commonly via units in a unit trust. It is also common for the related trust to declare distributions of income in favour of the SMSF creating a present entitlement to income of the trust. However, often these entitlements are not paid to the SMSF but rather maintained as an asset of the SMSF, sometimes recorded as a loan. The Commissioner believes that the maintenance of these unpaid amounts can contravene several provisions of the Act, potentially resulting in the fund becoming non-compliant.

The nature of a beneficiary's entitlement to an unpaid trust distribution – Debt or Equity?

64. The right of a beneficiary to seek payment from the trustee of an unpaid trust distribution is, in the normal course, enforceable in equity, and is not a debt enforceable at common law.

65. In the 1996 case of *Re Euroasian Holdings Pty Ltd v. Ron Diamond*[7] the Federal Court considered an application to set aside a statutory demand in respect of a trust distribution. The applicant was the trustee of a trust who had resolved to distribute an amount of income to the respondent beneficiary. However, rather than pay the amount to the respondent, the applicant paid the amount directly to a third party creditor who held a crystallised floating charge over the assets of the respondent. The respondent consequently issued a statutory demand on the applicant in respect of the trust distribution amount. Heerey J considered the character of unpaid trust entitlements and noted at FCR 150:

> The resolutions in question did not bring about the relationship between the applicant and respondent of debtor and creditor. Whether or not the respondent may have been 'presently entitled' for the purposes of the Income Tax Assessment Act, it seems to be the position that rights of the respondent were enforceable in equity only.

66. As a result, Heerey J set aside the statutory demand because the resolution to distribute the income to the respondent did not result in a debt for which a statutory demand could be issued.

[7] (1996) 64 FCR 147.

67. The recording of the unpaid distribution as a loan from the beneficiaries to the trust does not of itself change the character of the unpaid trust distribution from an equitable right to a debt. Rather, the Administrative Appeals Tribunal (AAT) decided that unpaid trust distributions were held in a separate trust between the trustee and the specific beneficiary in cases where specific clauses were included in the trust deeds to this effect.[8] Further, the same conclusions were drawn by the AAT in cases where the trust deeds did not contain any such specific clauses.[9]

68. Equitable rights, however, can be converted into common law debt. In the Privy Council case of *Space Investments Ltd v. Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd and others*[10] a bank, acting as trustee, deposited trust money into accounts in itself in its capacity as a bank. The Privy Council held that as the trust deed authorised the trustee to deposit the trust money into bank accounts, including with itself, the money held in those deposit accounts was a normal debt, ranking alongside the other deposit holders.

69. Similarly, the equitable right to enforce payment of a trust distribution to which the beneficiary is presently entitled can also be converted into a common law debt. This was demonstrated in the 1990 Federal Court case of *East Finchley Pty Ltd v. Federal Commissioner of Taxation*[11] where a trustee prepared two letters for overseas beneficiaries in respect of a distribution of income from the trust. The first letter advised of the exercise of the trustee discretion in respect of the income and stated that the distribution would be credited to each beneficiary's loan account at call, subject to authorisation. The second letter was prepared from each beneficiary to the trustee authorising the amount to be credited to their loan account. The appropriate entries were also made in the books of the trust. Hill J accepted that these documents were sufficient to evidence that the distribution was paid to the beneficiaries in question and that this amount was loaned back to the trustee. At ATC 5291; ATR 1635 he stated that:

> Further I can see no reason why the combination of the two letters should not in any event have constituted a sufficient demand for payment to bring about a situation that there was an obligation in equity by force of the trust deed to pay to the beneficiaries and an obligation by virtue of the loan agreement between the trustee and beneficiaries in law to pay by way of a loan the moneys to the trustee by the beneficiaries so that the principle in *Spargo's* case brought about the result that there was in law a payment.

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[8] *Case U111* 87 ATC 667; *Case 83* (1987) 18 ATR 3602; *Case 5/94* 94 ATC 130; (1994) 27 ATR 1117.
[9] *Case U157* 87 ATC 912; *Case 108* (1987) 18 ATR 3772; *Case V4* 88 ATC 123.
[10] [1986] 3 All ER 75.
[11] (1989) 90 ALR 457; 89 ATC 5280; (1989) 20 ATR 1623.

70. As a result, although the recording of an unpaid trust distribution as a loan in the trust accounts would not by itself be sufficient to change its character to that of a common law loan, the trustee and the beneficiaries can, by agreement, bring about payment of the distribution and a subsequent loan back to the trustee. There would need to be evidence of such a loan being made, such as a written agreement. The recording of the amount as a loan in the accounts of the trust may form part of the evidence of a contractual loan having been made.

In-house asset rules in Part 8

71. Part 8 limits the percentage of assets held by an SMSF which are 'in-house assets'.

72. An 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…

73. Therefore, to be an in-house asset of the SMSF, the asset in question must be either:

- a loan;[12] and
- to a related party[13] of the SMSF; or
- an investment[14] in:
  - a related party[15] of the SMSF; or
  - a related trust[16] of the SMSF.

74. It is therefore necessary to first consider whether an unpaid trust distribution is a loan or an investment for the purposes of the Act.

Is the unpaid trust distribution a loan?

75. Subsection 10(1) defines the term 'loan' as including:

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

[12] See paragraphs 75 to 105 of this Ruling.
[13] See paragraphs 106 to 111 of this Ruling.
[14] See paragraphs 112 to 118 of this Ruling.
[15] See paragraphs 106 to 111 of this Ruling.
[16] See paragraphs 120 and 122 of this Ruling.

76. 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;[17]
- the provision of credit;[18] and/or
- any other form of financial accommodation.[19]

General meaning of 'loan'

77. The term 'loan' is defined in the Macquarie Dictionary:[20]

> **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…

78. Similarly, the Australian Oxford English Dictionary[21] defines 'loan' as:

> **1.** something lent, esp. a sum of money to be returned normally with interest. **2.** the act of lending or state of being lent…

79. The definitions above both point to a loan involving something being given temporarily with the intention that it will be returned and this is reflected in the case law considering the meaning of the term.

80. In the 1964 case of *De Vigier v. Inland Revenue Commissioners*[22] the House of Lords considered whether an amount lent by a trustee to a trust was a loan. The case concerned a family trust acting in favour of the children of one of the trustees. The trust became entitled to a rights issue of shares but had insufficient funds to subscribe for the shares. Consequently, the wife paid over £7,000 into the trust bank account in two cheques. This amount was repaid into the wife's bank account from the trust bank account less than 12 months later. The question being considered by the court was whether the £7,000 was a 'loan' and consequently subject to a surcharge under the *Income Tax Act 1952.*

81. The court held that; the fact that any legal rights for repayment of the amount would lie in equity was not fatal to the nature of the arrangement as a loan. At page 911 Lord Pearce stated:

> Where the circumstances of payment clearly indicate an intention by all concerned that there should be repayment, the court can properly infer that the money was lent. The precise legal rights of the persons concerned as between one another do not destroy the nature of the transaction and make it cease to be a loan.

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[17] See paragraphs 77 to 87 of this Ruling.
[18] See paragraph 88 of this Ruling.
[19] See paragraphs 89 to 103 of this Ruling.
[20] *The Macquarie Dictionary,* [Multimedia], version 5.0.0, 1/10/01.
[21] *The Australian Oxford Dictionary*, 1999, Oxford University Press, Melbourne.
[22] [1964] 2 All ER 907.

82. Lord Upjohn concurred with this view and stated at page 915:

> The mere fact, however, that under the old forms of pleading, in the circumstances of this case, an action of debt for return of a loan would not lie, does not prevent the transaction being properly described as a loan.

83. Later, in the Victorian Supreme Court case of *Brick and Pipe Industries Ltd. v. Occidental Life Nominees Pty. Ltd. and others,*[23] Ormiston J noted at pages 321 and 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] N.Z.L.R. 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.' …

84. 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* (ACN 000 245 269) *v. Chief Commissioner of Stamp Duties*[24] 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. This question 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…

85. The same approach was taken in the Full Federal Court case of *Eastern Nitrogen Ltd v. Commissioner of Taxation*[25] 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…

[23] [1992] 2 VR 279.
[24] (1997) 42 NSWLR 505; 97 ATC 5015; (1997) 37 ATR 479.
[25] (2001) 108 FCR 27; 2001 ATC 4164; (2000) 46 ATR 474.

86. The authorities clearly show that the term 'loan' in its normal legal usage refers to an agreement consisting of a payment and a repayment of an amount. In cases where the SMSF is presently entitled to a distribution from another trust which has not been paid, the characteristics of a loan being payment and repayment do not exist. Rather there is merely an equitable right to payment of the distributed amount.

87. Alternatively, where a further arrangement is entered into between the trustee of the SMSF and the trustee of the trust whereby the trust distribution is lent back to the trust as in *East Finchley*,[26] the resulting amount recorded in the beneficiary loan account would be characterised as a loan according to its ordinary usage.

Extended definition of a loan

88. The definition of the term 'loan' in subsection 10(1) extends the term to include 'the provision of credit or any other form of financial accommodation'. The reference to 'the provision of credit' extends the definition to include arrangements allowing for delayed payment, for example the situation in *Prime Wheat*[27] discussed above. However, the definition goes further to also include 'any other form of financial accommodation'.

89. The term 'financial accommodation' is not defined in the Act and therefore it takes on its ordinary meaning. The Australian Oxford English Dictionary[28] does not define the term 'financial accommodation'. However it does define the words individually as:

> **financial** … **1** of finance…
>
> **finance** ... **1** the management of (esp. public) money…
>
> **accommodation** ... **3** a convenient arrangement; a settlement or compromise…

90. Similarly, the Macquarie Dictionary[29] doesn't define the phrase '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 …

91. 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. It is

[26] (1989) 90 ALR 457; 89 ATC 5280; (1989) 20 ATR 1623.
[27] (1997) 42 NSWLR 505; 97 ATC 5015; (1997) 37 ATR 479.
[28] *The Australian Oxford Dictionary*, 1999, Oxford University Press, Melbourne.
[29] *The Macquarie Dictionary,* [Multimedia], version 5.0.0, 1/10/01.

therefore necessary to look to other material to discern the intended scope of this definition.

92. The extended definition of 'loan' in subsection 10(1) has not been judicially considered. However, the former section 46D of the *Income Tax Assessment Act 1936* (ITAA 1936) contained a definition of 'loan' using essentially the same terms. This definition was considered by the Full Federal Court case of *Federal Commissioner of Taxation v. Radilo Enterprises Pty Ltd*.[30] 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.

93. The court concluded that there was no such amount payable in this case as the company did not redeem the preference shares, rather they were converted to ordinary shares which the holder could sell if they wished. Importantly, the company would retain the capital rather than having to repay it. It was decided therefore, that the issue of the preference shares did not fit within the extended definition of 'loan' in section 46D of the ITAA 1936.

94. Similarly the words of the extended definition of 'loan' in subsection 10(1) need to be construed in their statutory context. It is the Commissioner's view that the extended definition was included to expand the definition of 'loan' to situations which do not have the elements of payment and repayment. That outcome is achieved by including 'the provision of credit' in the definition which would include the sale of goods on credit or deferred payment arrangements. The further inclusion of the words 'any other form of financial accommodation' points to an intention to further expand the definition beyond the provision of credit alone.

[30] (1997) 72 FCR 300; 97 ATC 4151; (1997) 34 ATR 635.

95. In addition, the inclusion of arrangements:

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

further indicates that the legislature was not concerned with the legal formalities of the arrangements but rather with the substance of the arrangement.

96. This is consistent with policy objectives stated in the Explanatory Memorandum to the *Superannuation Legislation Amendment Act (No. 4) 1999,* which introduced the definition of 'loan' into subsection 10(1). At page 5 it explained the policy objective as:

> The primary policy objective is to ensure that the investment practices of the 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.

97. Further, the purpose of the 5% limit on the level of in-house assets was explained at page 4 to be to:

> …limit(s) the risk to superannuation savings from investment in an employer-sponsor or associate

98. Read in this context, it is the Commissioner's view that the definition of 'loan' in subsection 10(1) is concerned with identifying arrangements which result in the assets of the superannuation fund being held as amounts receivable from another party, regardless of the form of the arrangement under which this arises.

99. In the normal course of events there will be a delay between the resolution to make a distribution in favour of a beneficiary and payment of that amount. This is due to the various administrative processes which need to be performed. The Commissioner accepts that in the majority of cases, the equitable right of the beneficiary to demand immediate payment of that amount would not fall within the definition of 'loan' (which has an expanded meaning) for the purposes of subsection 71(1). However, in some cases other factors could lead to a conclusion that a consensual arrangement exists between the trustee of the SMSF and the trustee of the unit trust that payment of the present entitlement will not be demanded immediately. That is, an arrangement for the SMSF trustee's forbearance from enforcing the equitable entitlement to payment of the distributed income. Where an examination of the facts and circumstances surrounding the non-payment of outstanding trust distributions leads to the conclusion that such an arrangement exists, the Commissioner is of the view that this arrangement will be a financial accommodation.

100. It is acknowledged that the arrangement would generally not be enforceable under legal proceedings and that the equitable right of the beneficiary to demand payment of the trust distribution could be exercised against the trustee at any time. However the extended definition of loan in section 10 states that legal enforceability is not a requirement. Classification of this type of arrangement as a 'loan' under the extended definition is open under the definition and is consistent with the purpose of the provision which is in broad terms to limit the exposure of the members to the financial risks of related parties.

101. Factors which might lead to the conclusion that a consensual arrangement for the provision of credit or financial accommodation does exist include:

- the trustees are the same or under substantially the same control;
- the amount of the unpaid trust distribution is substantial;
- the amount has remained unpaid for a substantial period of time;
- distributions for multiple years remain unpaid; and
- any documents executed by the parties evidencing an intention to defer payment of the trust distribution.

102. Where the delay in payment of a trust distribution is due to administrative processes which are completed in a timely manner, the Commissioner accepts that the resultant delay will not amount to an arrangement for a financial accommodation. In addition, special circumstances might exist which prevent payment of trust distributions for a further time, for example where a legal impediment to payment exists. Such further involuntary delays will also not lead to a conclusion that an arrangement for the provision of a financial accommodation exists. However, the Commissioner does not accept that delays due to insufficient cash being held to pay the distributions would normally be such special circumstances. Rather, the failure of the trustee of the unit trust to put any funds aside for the payment of trust distributions may evidence the existence of an arrangement for the provision of a financial accommodation by the trustee of the SMSF.

103. Where, looking at all of the circumstances it can be concluded that an arrangement or understanding exists between the trustee of the SMSF and the trustee of the trust for deferral of the payment of a distribution to a later time, that arrangement is considered to amount to financial accommodation under the extended definition of loan in subsection 10(1).

104. To summarise, a trust distribution which remains unpaid will be a loan for the purposes of subsection 71(1) where any of the following apply:

- a contractual loan agreement is entered into between the trustee of the trust and the trustee of the SMSF, for example as in *East Finchley*[31] discussed above (loan under common law principles); or
- it is concluded from the facts and circumstances that there is an arrangement between the trustee of the trust and the trustee of the SMSF for the deferral of payment of the distribution (provision of financial accommodation).

105. Where a loan does exist for the purposes of subsection 71(1), it will be necessary to consider whether the trust in question is a related party of the fund.

To a related party of the fund?

106. 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).

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

108. Subdivision B 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 employer sponsor or the member takes as follows:

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

109. As a member must be an individual, section 70B defines whether the trustee of the trust is a Part 8 associate of the 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 employer sponsor takes. In all cases the trustee of a trust is identified as a Part 8 associate of the member or standard employer sponsor by reference to the control of that trust. Control of a trust is further defined in subsection 70E(2).

[31] (1989) 90 ALR 457; 89 ATC 5280; (1989) 20 ATR 1623.

110. Whether the trustee of the trust from which the unpaid trust distributions originate is a related party of the SMSF[32] is a question of fact which must be determined in each individual case by reference to these definitions.

111. Where amounts of unpaid trust distributions are considered to be loans (including under the expanded definition) to a related party of the SMSF, these amounts are included in the in-house assets of the SMSF unless any of the exclusions set out in sections 71 to 71E apply.

Is the unpaid trust distribution an investment?

112. Subsection 71(1) also includes in the in-house assets of an SMSF an 'investment' in a related party or a related trust.

113. The term 'investment' isn't defined in the Act. 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.

114. Further, 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.

115. In this context, an 'investment' is the asset resulting from the application of the assets of the SMSF or from entering into a contract for the purpose of gaining interest, income, profit or gain.

116. The entitlement to receive a trust distribution is an asset of the SMSF and it is the Commissioner's view that, in the same circumstances where the unpaid trust distribution falls within the definition of a loan as discussed above, this will also be an application of that asset. It follows therefore, that where this application of the asset is for income, interest, profit or gain, for example where interest is earned on the outstanding amount, this will constitute an investment in the unit trust. However, to be an investment of the SMSF, the source of any expected income must be from the application of this asset. Consequently, it is the Commissioner's view that the mere expectation of future profits through the existing units in the unit trust is not sufficiently connected to the unpaid trust distribution to characterise the asset as an investment. This is because the income, profit or gain expected has its source in the rights attached to the investment in the units, not in the application of the unpaid trust distribution.

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[32] A more detailed explanation of the meaning of a 'related party' is contained in SMSFR 2009/4.

117. Alternatively, the trustee of the SMSF may enter into an agreement whereby the equitable right to payment of the trust distribution is converted into a different equitable right. This could occur by the satisfaction of that right in the form of additional units in the trust. However, the issue of new units is not necessarily required for an investment of the distribution to occur. Instead, the trustee of the SMSF may enter into an agreement that the distribution be added to the corpus of the trust without the issue of additional units. The discharge of an equitable right and its replacement by a different equitable right is an application of the assets of the SMSF.

118. Where such an agreement exists, and is entered into for the purpose of gaining interest, income, profit or gain, the amount will also be an investment for the purposes of subsection 71(1).

Is the distribution an investment in a related party or a related trust?

119. Where the unpaid trust distribution amounts to an investment in the trust, to be an in-house asset under subsection 71(1) that trust will need to be either a related party or a related trust of the SMSF.

120. Similarly to the term 'related party' discussed above, the term 'related trust' is defined in subsection 10(1) as:

> ***Related trust***, of a superannuation fund, means a trust that a member or a standard employer-sponsor of the fund controls (within the meaning of section 70E), other than an excluded instalment trust of the fund.

121. This definition is concerned with the control of the trust by members or standard employer-sponsors of the SMSF and is comprehensive. Whether a trust in which the SMSF holds an investment is a related trust is a question of fact which must be determined in each individual case by reference to these definitions.[33]

122. Where the unpaid trust distributions amount to an investment in a related trust or a related party, the value of this investment must be included in the in-house assets of the SMSF unless one or more of the exceptions contained in sections 71 to 71E apply.

[33] A more detailed explanation of the meaning of a 'related trust' is contained in SMSFR 2009/4.

Section 71D

123. If the SMSF held units in the unit trust on or before 11 August 1999 which were not in-house assets at that time, the trustee can, after that time but no later than the end of 30 June 2009, reinvest trust distributions from that trust back into that same entity without breaching the in-house asset rules if it satisfies certain criteria.[34] Consequently, where the unpaid distribution amounts to an investment in the unit trust that was made after 11 August 1999 but no later than the end of 30 June 2009, that investment may be excluded from the in-house assets of the SMSF under section 71D.

124. The total amount that can be excluded under section 71D is limited by paragraph 71D(d) as follows:

> The sum of the purchase price of the post-test time investment and any previous investment to which this section applies does not, at the post-test time, exceed the sum of the following amounts:
>
> (i) the sum of the amounts of all dividends or trust distributions received after the test time, but before the end of 30 June 2009, by the superannuation fund from the original entity, which were derived from an investment in the original entity made by the fund before the test time;
>
> (ii) the sum of the amounts of all dividends or trust distributions received after the test time, but before the end of 30 June 2009, by the superannuation fund, which were derived from investments of dividends and trust distributions taken into account under subparagraph (i) or this subparagraph.

125. To determine whether an unpaid trust distribution is excluded from the in-house assets of the SMSF under this section several key matters need to be determined.

When is the distribution received from the unit trust?

126. Self Managed Superannuation Funds Determination SMSFD 2007/1 explains that for a distribution to be received for the purposes of section 71D, it must be paid to the SMSF. As discussed in paragraphs 24 - 25 of that determination, the application of the distribution on behalf of the SMSF is also considered to be payment of that amount. However, for this to occur, the right to immediate payment of the trust distribution must be extinguished.

[34] A more detailed explanation of the operation of section 71D is contained in SMSFR 2009/4.

127. Where a contractual loan agreement is entered into as discussed in paragraph 87 of this Ruling, the distribution is considered to have been received at the time that the corresponding amount is lent back to the unit trust. This would be evidenced by the written agreement between the parties. Likewise, where new units are issued, or an agreement is entered into to convert the right to immediate payment of the trust distribution into increased corpus of the trust, the distribution will be received by the SMSF on the same day that the rights are converted. However, where the application of the trust distribution is merely an informal arrangement for a financial accommodation between the beneficiary and the trustee, it is the Commissioner's view that this arrangement will not amount to the receipt of the trust distribution under section 71D. This is because the equitable right to immediate payment is not extinguished but instead there is merely an arrangement for the forbearance of the SMSF from enforcing that right. This analysis would apply even if interest is calculated on the unpaid distribution.

When was the investment in the unit trust made?

128. Section 71D applies to a 'post-test-time investment' which is defined in paragraph 71D(a) as an investment in the entity after 11 August 1999 and before the end of 30 June 2009. It is therefore necessary to identify when the investment in the unit trust is made.

129. Where new units are issued to the SMSF, this can be readily ascertained and will be the date when these units are issued. Likewise where the right to the trust distribution has been converted into a different equitable right the relevant date will be the time at which the conversion takes place.

130. Alternatively, where the investment in the unit trust arises from an informal arrangement for a financial accommodation at interest, the distribution entitlement has not been received by the SMSF and consequently there is no need to determine when the corresponding investment took place.

What is the purchase price of the investment?

131. Paragraph 71D(d) limits the level of investments that can be excluded from the in-house assets under that section by reference to the 'purchase price' of those investments. Where the relevant investment is the purchase of new units, the purchase price is easily ascertained. Alternatively, where the investment is a contractual loan, it is the Commissioner's view that the purchase price of that loan will be the principal of the original loan at the time it is made.

Section 71E

132. Section 71E provides an alternative to the provisions in sections 71A to 71D for certain geared investments which were held at 11 August 1999.[35] For this provision to apply the unit trust must have had an outstanding loan with another entity which is not the SMSF immediately prior to the end of 11 August 1999 and the trustee of the SMSF must have made an election by 23 December 2000.

133. Where section 71E applies, any investment made from 12 August 1999 until the end of 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 principal of the unit trust's loan that was owing on 11 August 1999.[36] Therefore, where an unpaid trust distribution amounts to an investment in the unit trust these amounts may be excluded from the in-house assets of the SMSF under this section.

134. In addition, subsection 71E(6) deems loans made to the unit trust to be an investment in that unit trust for this subsection. It also deems the purchase price of the investment to be the amount of the original principal of that loan. Therefore, where an unpaid trust distribution amounts to a loan to the unit trust, this amount can be excluded from the in-house assets of the SMSF under this provision, whether or not any interest is payable on that loan.

Regulation 13.22C

135. 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 where the relevant member limits are met.[36A]

136. The exempted assets are investments in a company or unit trust where the company or unit trust meets the requirements listed in regulation 13.22C.[37] Therefore, where an unpaid trust distribution amounts to an investment in the unit trust, paragraph 71(1)(j) may operate to exclude that investment from the in-house assets of the SMSF by virtue of regulation 13.22C. However, where a contractual loan agreement is entered into between the unit trust and the SMSF this will be a borrowing by the unit trust from the SMSF. Such a borrowing will result in all investments of the SMSF in that unit trust no longer being eligible for exclusion from its in-house assets under

[35] Section 71E is only available for funds with no more than the maximum allowable number of members. The maximum allowable number of members is fewer than 5 prior to 1 July 2021 and no more than 6 on or after 1 July 2021.
[36] A more detailed description of the operation of section 71E is contained in SMSFR 2009/4.
[36A] See footnote 2A of this Ruling.
[37] The requirements in regulation 13.22C are discussed in SMSFD 2008/1 and SMSFR 2009/4.

paragraph 71(1)(j). This is because to be eligible for this exclusion, the unit trust must not have any borrowings.

Arm's length rule

137. Section 109 requires that investments of an SMSF are made and maintained on an arm's length basis. Subsection 109(1) applies to the dealings surrounding the making of the investment and subsection 109(1A) applies to the non-arm's length dealings during the term of an investment.

Subsection 109(1)

138. Subsection 109(1) provides:

> A trustee or investment manager of a superannuation entity must not invest in that capacity unless:
>
> (a) the trustee or investment manager, as the case may be, and the other party to the relevant transaction are dealing with each other at arm's length in respect of the transaction; or
>
> (b) both:
>
> (i) the trustee or investment manager as the case may be, and the other party to the relevant transaction are not dealing with each other at arm's length in respect of the transaction; and
>
> (ii) the terms and conditions of the transaction are no more favourable to the other party than those which it is reasonable to expect would apply if the trustee or investment manager, as the case may be, were dealing with the other party at arm's length in the same circumstances.

139. Where it is concluded in relation to an unpaid trust distribution that an arrangement for a financial accommodation exists between the trustee of the SMSF and the trustee of the unit trust which is an investment of the SMSF, section 109(1) will apply to that transaction.

140. Similarly, where a contractual loan agreement is entered into between the trustee of the SMSF and the trustee of the unit trust, or the trustee of the SMSF enters into an arrangement whereby the equitable right to payment of the trust distribution is converted into a different equitable right, subsection 109(1) will also apply to these arrangements.

141. Where subsection 109(1) does apply, it will be necessary to determine if the trustee or investment manager of the SMSF are dealing with the trustee of the unit trust at arm's length. The phrase 'not at arm's length' was considered in the Full Federal Court case of *Australian Trade Commission v. WA Meat Exports Pty Ltd*[38] in the context of section 4 of the *Export Market Development Grants Act 1974*. At ALR 291 the court concluded that:

> There is no reason to suppose that the ordinary meaning of the phrase was not intended to be applied here. That is to say, the context of s 4 is consistent with the disqualification of expenditure by one party in favour of another where one of them has the ability to exert personal influence or control over the other. It is evident that the policy of the legislation would seek to exclude payments to such persons, because, if such payment were not excluded, abuse of the incentive scheme provided by the Act would be open.

142. Whether the trustee or investment manager of the SMSF and the trustee of the unit trust are at arm's length will be a question of fact. Where the trustee of the trust in which the investment is held is also the trustee of the SMSF, a sufficient level of control will exist to conclude that the parties are not at arm's length. Similarly, where the investment is held in a related party or related trust of the SMSF, it is likely that the requisite level of control will also exist. However, the fact that the parties to a transaction are not at arm's length does not preclude them from dealing with each other at arm's length. In the Federal Court case of *The Trustee for the Estate of the late AW Furse No 5 Will Trust v. Federal Commissioner of Taxation*[39] Hill J explained at ATC 4015; ATR 1132 that:

> The fact that the parties are themselves not at arm's length does not mean that they may not, in respect of a particular dealing, deal with each other at arm's length…
>
> What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.

143. For subsection 109(1) therefore, it needs to be considered whether the arrangements which the trustee or investment manager enter into when investing the unpaid trust distribution are on the same basis as they would be with arm's length parties. If they are not, then subparagraph 109(1)(b)(ii) requires that the terms and conditions of the transaction be no more favourable to the trustee of the unit trust than would be expected if the parties were dealing with each other on an arm's length basis.

Subsection 109(1A)

144. Where an entitlement to a trust distribution is not sought by the trustee of an SMSF from a non-arm's length trustee, this may

[38] (1987) 75 ALR 287.
[39] 91 ATC 4007; (1990) 21 ATR 1123.

indicate that the investment in that trust [that is the units held] is not being dealt with on an arm's length basis and could contravene subsection 109(1A).

145. Subsection 109(1A) states:

> If:
>
> (a) a trustee or investment manager of a superannuation entity invests in that capacity; and
>
> (b) at any time during the term of the investment the trustee or investment manager is required to deal in respect of the investment with another party that is not at arm's length with the trustee or investment manager;
>
> the trustee or investment manager must deal with the other party in the same manner as if the other party were at arm's length with the trustee or investment manager.

146. The Explanatory Memorandum to the Bill which introduced subsection 109(1A)[40] stated at Item 36:

> This item inserts after subsection 109(1) of the SIS Act subsection 109(1A). Subsection 109(1A) introduces a requirement that investments must at all times be maintained as if they were arm's length investments. This works in conjunction with existing section 109 which ensures that all dealings regarding entering into an investment are also carried out on an arm's length basis.

147. This subsection operates during the term of the investment where the trustee (or investment manager) of the SMSF is required to deal with a party who is not at arm's length. It is therefore necessary to clarify whether the trustee of the SMSF is 'required to deal in respect of the investment with another party' when making decisions in respect of distributions entitlements.

148. The definition of 'deal' contained in The Australian Oxford Dictionary[41] includes:

> …**1** *intr.* (foll. by *with*) **a** take measure concerning … **b** do business with…

149. The definition of 'deal' in the Macquarie Dictionary[42] includes:

> **1.** to conduct oneself towards persons…
>
> **6.** *Colloquial* a business transaction…
>
> **7.** a bargain or arrangement for mutual advantage, as in commerce or politics, often a secret or underhand one…
>
> **14.** any undertaking, organisation, etc; affair…
>
> **22. deal with,**
>
> a. to do business with.
>
> b. to occupy oneself or itself with: *deal with the first question, botany deals with study of plants.*

[40] Superannuation Industry (Supervision) Legislation Amendment Bill 1995.
[41] *The Australian Oxford Dictionary*, 1999, Oxford University Press, Melbourne.
[42] *The Macquarie Dictionary,* [Multimedia], version 5.0.0, 1/10/01.

> c. to take action with respect to: *law courts must deal with law-breakers…*

150. The Commissioner considers that the term 'deal' can refer to an agreement between parties or it can also be used to describe an entity's activities or business activities. Looked at in the context of section 109 as a whole, the broader meaning is preferred, that is that the term 'deal' is a reference to the conduct of the SMSF in respect of the investment.

151. Likewise, the Commissioner believes that the term 'required', in the context of section 109, is a reference to the commercial and fiduciary requirements imposed on the trustee of the SMSF.

152. The Commissioner considers that a decision that the trustee or investment manager of the SMSF makes (as to whether to require payment of a trust distribution to which the SMSF is entitled) forms part of dealing with the investment in that trust.

153. Subsection 109(1A) only operates where the trustee's or investment manager's dealings are with a party who is 'not at arm's length'. In the context of subsection 109(1A) the Commissioner considers that this is a reference to parties who have a level of influence or control over the trustee or investment manager of the SMSF. This is a question of fact. Where the trustee of the trust in which the investment is held is also the trustee of the SMSF, the requisite level of control will exist. Similarly, where the investment is held in a related party or trust to the trustee of the SMSF, it is likely that the requisite level of control will exist. Where this level of control does exist, decisions by the trustee or investment manager of the SMSF regarding the maintenance of the investment of that trust, including decisions on whether to seek payment of distributions, must be made on an arm's length basis.

154. The Commissioner does not consider that arm's length beneficiaries would generally allow substantial amounts of distribution entitlements to remain in the trust without receiving an appropriate return on this amount, for example a market rate of interest.

155. The possibility of receiving greater distributions from the trust in the future due to the provision of low cost capital would generally not be adequate compensation where the SMSF is not the sole beneficiary of the trust. Where the SMSF is the sole beneficiary it may be able to sustain a view that not requiring the payment of the distribution is consistent with the way the investment in the units would be dealt with if the trust were at arm's length.[43] However, it is the Commissioner's view that such a non-payment would be seen as a consensual arrangement meeting the extended definition of a 'loan' discussed above.

156. Therefore, where an SMSF trustee holds an investment of units in a non arm's length unit trust and

- does not seek payment of substantial trust distributions within a reasonable time; and

[43] However the SMSF holding all units in the trust and not requiring distributions to be paid does not of itself lead to the conclusion that the SMSF is dealing with the trust as though it was at arms length.

- no interest is paid or compensation is given in respect of not seeking that payment,

this would strongly lead to the conclusion that the dealing is not in the same manner as if the other party was at arm's length. Consequently, the requirements of subsection 109(1A) would be contravened.

Sole purpose test

157. The sole purpose test in section 62 ensures that an SMSF uses concessionally taxed superannuation savings for the specified core purposes of providing retirement or death benefits for or in relation to its members[44] or for one or more of these purposes and other stipulated ancillary purposes.[45]

158. Whether the SMSF is being carried on solely for the required purposes is determined from looking at the overall conduct of the fund and generally one factor alone will not be decisive. However, where a substantial proportion of the assets of the SMSF are held in a related trust as unpaid trust distributions, upon which no or below market rate interest is being paid, this would suggest that the fund is not being carried on for the required purpose. Rather, this might indicate that the SMSF assets are being employed as a low cost source of capital for the related trust. This conclusion would be further supported where the SMSF is not the sole beneficiary of the related trust, particularly where the other beneficiaries of the trust are related parties.[46] Where it is concluded that the SMSF is not being carried on for the requisite purposes specified in section 62, the trustee of the SMSF will be in contravention of this requirement.

Contraventions – audit requirements and consequences

159. SMSF trustees are required to appoint an approved auditor to audit the financial accounts and statements of the fund each year.[47] 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 the SISR. There is an approved form for notifying the Tax Office of contraventions.[48]

160. Non-compliance with these rules may expose trustees or investment managers of SMSFs to penalties.[49] Contravention or involvement in a contravention of the rules attracts both civil and

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[44] Paragraph 62(1)(a).
[45] The application of section 62 to the provision of benefits is explained in more detail in SMSFR 2008/2.
[46] However, the holding of all of the units in the trust by the SMSF does not, of itself, necessarily support a conclusion that the SMSF is being carried on for the required purpose. This will need to be determined by reference to the overall conduct of the SMSF.
[47] See section 113.
[48] See section 129.
[49] See subsection 62(2).

criminal consequences and places at risk the SMSFs status as a complying superannuation fund under the SISA.[50]

[50] See subsection 42A(5) in relation to SMSFs. The status of a fund as complying or non-complying for SISA purposes will also have consequences for the fund 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 – Detailed contents list

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NO:	2007/17886
ISSN:	1835-2138
ATOlaw topic:	Superannuation Entities ~~ Self managed superannuation funds