

# Investments in trusts by superannuation funds

**THE IN-HOUSE ASSET RULES AND THE NON-ARM'S LENGTH INCOME PROVISIONS ARE TWO IMPORTANT CONSIDERATIONS THAT A TRUSTEE OF A SUPERANNUATION FUND MUST REVIEW BEFORE INVESTING IN OR RECEIVING A DISTRIBUTION FROM A TRUST.**



The investment by the trustee of a superannuation fund (“fund”) in trusts, especially unit trusts, has been restricted since 11 August 1999 when the definition of an in-house asset in the Superannuation Industry (Supervision) Act 1993 (“SISA”) and the Superannuation Industry (Supervision) Regulations 1994 (“SISR”) was expanded to include an investment in a “related trust.”

This combined with the non-arm's length income provisions in the Income Tax Assessment Act 1997 (“ITAA97”) (formerly known as the special income rules in the Income Tax Assessment Act 1936 (“ITAA36”)) has led to a common perception that funds cannot hold an interest in a trust.

This common perception is incorrect as there are many circumstances in which a fund can hold an interest in a trust, although as with most dealings by funds any investment by a fund in a trust must meet strict criteria.

This article explores the in-house asset rules and non-arm's length income considerations when a fund invests in or receives a distribution from a trust. There are a number of other factors that must be considered before a fund invests in a trust, including: the investment strategy requirements (s 52(2)(f) SISA), the sole purpose test (s 62 SISA), the prohibition against acquiring assets from a related party (s 66 SISA), the arms-length dealing requirements (s 109 SISA), the prohibition against charging an asset of the fund (regulation 13.14 SISR) and the public trading trust rules (Div 6C of Part III ITAA36).

## CATEGORIES OF TRUSTS IN OR FROM WHICH A FUND COULD HOLD AN INTEREST OR RECEIVE A DISTRIBUTION

Broadly, these categories of trusts are:

### 1. Bare trusts

Under a bare trust the trustee holds the legal title of the trust assets absolutely for each beneficiary.<sup>1</sup>

### 2. Fixed trusts

Under a fixed trust the beneficiaries have fixed entitlements to a share or proportion of all of the income and capital of the trust. The beneficiaries entitled to the income and those entitled to the capital need not be the same. All that is necessary is that the specific income or capital rights are fixed.

### 3. Unit trusts

Under a unit trust each beneficiary has a proportionate interest in the income and capital of the trust. Usually each beneficiary of a unit trust has an interest in the trust fund as a whole but does not have an interest in any particular trust asset. As a result unlike a bare trust (and depending on its deed a fixed trust) a beneficiary of a unit trust usually cannot call for assets of the unit trust to be transferred to them.

### 4. Discretionary trusts

Under a discretionary trust the trustee has discretion as to the distribution of the income and capital of the trust. “Default beneficiaries” may be entitled to the income and capital of the trust if the trustee fails to exercise its discretion and generally beneficiaries do not have any interest in the trust's assets.

### 5. Hybrid trusts

Under a hybrid trust different classes of beneficiaries have different rights to the income and capital of the trust with those rights usually including some fixed and discretionary rights.

## WHEN WILL A FUND BE PERMITTED TO ACQUIRE AN INTEREST IN A TRUST FROM 11 AUGUST 1999?

Since 11 August 1999 a fund has only been permitted to acquire an interest in a trust if the interest acquired would not be an in-house asset within the meaning of s 71(1) SISA and would not breach the prohibition on the acquisition of an asset by a fund from a related party contained in s 66 SISA.

## THE IN-HOUSE ASSET RULES

In relation to in-house assets, a trustee of a fund must:

- not acquire an in-house asset if to do so would result in the market value of the in-house assets of the fund exceeding 5 per cent of the fund's assets (s 83(3) SISA);
- not acquire an in-house asset if the market value of the fund's in-house assets exceed 5 per cent of the fund's assets (s 83(2) SISA);
- if the fund's in-house asset exceeds 5 per cent of the fund's assets during a financial year (otherwise than by an acquisition of an in-house asset), prepare a plan to ensure that the trustee disposes of in-house assets by the end of the following financial year to ensure that the market value of the fund's in-house assets does not exceed 5 per cent of the fund's assets (s 82 SISA).

## WHEN IS AN INTEREST IN A TRUST AN IN-HOUSE ASSET?

Under s 71 SISA an in-house asset of a fund includes an investment in a related trust. Under s 10(1) SISA a trust, other than an excluded instalment trust, will be a related trust of a fund if a member or a standard employer sponsor of the fund controls the trust within the meaning of s 70E SISA.

Specifically s 70E(2) SISA provides that an entity controls a trust if:

- (a) a group in relation to the entity has a fixed entitlement to more than 50 per cent of the capital or income of the trust (“the entitlement control test”<sup>2</sup>); or
- (b) the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts) (“the direction control test”<sup>3</sup>); or
- (c) a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust (“the removal control test”<sup>4</sup>).

Under s 70E(3) SISA an entity and/or the entity’s Part 8 associates will comprise a group for the purposes of s 70E(2).

Accordingly where an entity being a member or standard employer sponsor of a fund and/or the entity’s Part 8 associates control a trust under the entitlement control test, the direction control test or the removal control test the trust will be a related trust for the purposes of the in-house asset rules.

To determine whether a group which includes a member or a standard employer sponsor will be taken to control a trust under either the entitlement control test (through the entitlement to income and capital of its beneficiaries) or the removal control test (through the power to remove the trustee) will involve a careful examination of the trust deed of the relevant trust. Even if a group does not “control” a trust under the entitlement

control test or the removal control test it may be taken to do so under the direction control test. The direction control test is not concerned with the legal control or the legal rights to the income or capital of a trust but whether a group has effective control of a trust through the trustee of the trust being accustomed to acting in accordance with the directions, instructions or wishes of the group.

It should be noted that in determining whether persons are members of a group for the purposes of each control test, individuals who are partners within the meaning of the ITAA97 will be taken to be Part 8 associates of each other.

As a general rule if the trustee of a fund, the members of that fund and the relatives and associated companies, partnerships and trusts of those members hold 50 per cent or less of the rights to income and capital and 50 per cent or less of the power to remove the trustee (for example through voting rights) the trust will not be a related trust of the fund for the purposes of the in-house asset rules.

## EXAMPLES OF A RELATED TRUST AND A NON RELATED TRUST

John is the sole member of the John Superannuation Fund and the sole director of the corporate trustee of a discretionary trust the John Trust. John is also the sole appointor of the John Trust. The John Superannuation Fund holds 10 per cent of the units in Property Unit Trust with the remaining units held by the John Trust (45 per cent) and John personally (45 per cent). Under ss 10(1) and 70E SISA the Property Unit Trust will be a related trust of the John Superannuation Fund if the member of that fund (John) has a right to receive more than 50 per cent of the income or capital of the Property Unit Trust (ie the entitlement control test) or can remove its trustee (ie the removal control test). Although John does not personally control the Property Unit Trust with those tests, as the trustees of both the John Superannuation Fund and the John Trust are his Part 8 associates and will be grouped with him for the purposes of s 70E(2) SISA, that group will control the Property Unit Trust and therefore it will be a related trust of the John Superannuation Fund.

However if the units in the Property Unit Trust were held by the John Superannuation Fund (10 per cent), John (40 per cent) and the Mary Superannuation Fund (50 per cent) where Mary as the sole member of the Mary Superannuation Fund was not related or in partnership with John, the Property Unit Trust would not be controlled by either John and his Part 8 associates (John’s group) or Mary and her Part 8 associates (Mary’s group) under the entitlement control test or the removal control test. Provided that the trustee of the Property Trust is not accustomed to act in accordance with the directions, instructions or wishes of either group (ie under the direction control test; for example if John was a “puppet” of Mary), then as the Property Unit Trust will not be controlled by either group the Property Unit Trust will not be a related trust of either fund.

## CAN AN INVESTMENT BY A FUND IN AN UNRELATED TRUST BE TAKEN TO BE AN INVESTMENT IN A RELATED TRUST?

Subsection 71(2) SISA is an anti-avoidance provision to ensure the related party and related trust provisions are not circumvented through interposed entities.

Under s 71(2) SISA an investment by a fund in an unrelated trust will be taken to be an investment in a related trust if the investment was made by the fund in the unrelated trust as a result of entering into or carrying out an agreement and any of the persons who entered into or carried out the agreement were aware that as a result of carrying out the agreement an investment would be made in a related trust of the fund.

Accordingly where an investment is made by a fund in an unrelated trust this will be treated as an investment in a related trust and an in-house asset if any person who entered into or carried out the agreement was aware that the carrying out of the agreement would result in an investment by the unrelated trust in a related trust of the fund.

## CAN A FUND HOLD AN INTEREST IN A NON-RELATED TRUST THAT IS GEARED OR THAT HAS ASSETS SUBJECT TO A CHARGE?

The prohibitions against borrowing (s 67 SISA) prohibit a fund from borrowing or maintaining an existing borrowing.

The prohibition does not apply to a trust that is not a related trust of the fund. Therefore a fund could invest in a non-related trust that is geared.

Likewise s 31(1) SISA and regulation 13.14 SISR prohibit the trustee of a fund from giving a charge over an asset of the fund but do not prohibit the fund from investing in a trust where the trustee of that trust has given a charge over its assets.

### EXCEPTIONS TO THE IN-HOUSE ASSET RULES

If the trust is an excluded instalment trust as defined in s 10(1) SISA, the trust will not be a related trust. These types of trusts are used for holding derivative products as the only property of excluded instalment trusts can be listed securities held on trust until the purchase price is paid.

Investments in a related trust that are exceptions to the in-house asset rules include:

- an investment in a widely held trust – that is a trust that has fixed entitlements to income and capital, with at least 20 or more beneficiaries and is not a trust where less than 20 beneficiaries have between them an entitlement to 75 per cent of the income or capital (ss 71(1)(h) and 71(1A) SISA);
- subject to ss 71A to 71F SISA an investment or reinvestment in a pre-11 August 1999 unit trust – a discussion of these unit trusts is beyond the scope of this article;
- an investment prior to 11 August 1999 in a regulation 13.22B unit trust or from 11 August 1999 in a unit trust that complies with regulation 13.22C SISR (s 71(1)(j) SISA and regulations 13.22A to 13.22D SISR) – as discussed below; and
- an investment in an “instalment warrant” trust (s 71(8) SISA) – as discussed below.

### WHEN WILL A UNIT TRUST COMPLY WITH REGULATION 13.22C SISR?

In order for an investment in a unit trust not to be an in-house asset under regulation 13.22C SISR, the fund and unit trust must meet the strict criteria of regulation 13.22C including:

- the fund has less than 5 members;
- the trustee of the unit trust is not a party of a lease with a related party of the fund unless it is legally binding and relates to business real property;
- the trustee of the unit trust does not have any outstanding borrowings;
- the assets of the unit trust do not include an interest in another entity;
- the assets of the unit trust do not include a loan to another entity;
- the assets of the unit trust do not include an asset over which there is a charge;
- the assets of the unit trust do not include an asset that was acquired from a related party after 11 August 1999 (unless it is business real property acquired at market value); or
- the assets of the unit trust do not include an asset that has been an asset of a related party of the fund at any time during the 3 years prior to the fund acquiring its interest in the unit trust (unless it is business real property acquired at market value).

If the criteria of regulation 13.22C SISR are met then even where a unit trust is a related trust of a fund an investment in that unit trust by that fund will not be an in-house asset. Therefore in the first example of a related trust above, if the Property Unit Trust complied with the provisions of regulation 13.22C SISR (including that the Property Unit Trust had not leased an asset to a related party of the fund other than business real property and had no borrowings, loans, interests in other entities or charges over its assets) the units in the Property Unit Trust held by the John Superannuation Fund would not be in-house assets.

### INVESTMENT IN AN “INSTALMENT WARRANT” TRUST – BORROWING BY THE TRUSTEE OF A FUND

It is beyond the scope of this article to discuss in detail the new s 67(4A) SISA that permits the trustee of a fund to borrow.<sup>5</sup>

The subs requires the asset acquired with the borrowed funds to be “held on trust so that the ... trustee [of the fund] acquires a beneficial interest in the ... asset.”

The nature of this instalment warrant trust is likely to be a fixed or bare trust.

The interest of the fund in such an instalment warrant trust will not be an in-house asset as it is specifically excluded under s 71(8) SISA.

### NON-ARM'S LENGTH INCOME

Section 295-550 ITAA97 contains the meaning of non-arm's length income. The non-arm's length income provisions were inserted into the ITAA97 in the simpler super rewrite replacing the concept of special income contained in s 273 ITAA36. Any non-arm's length income received by a fund will be taxed at the highest marginal rate of 45 per cent (rather than the concessional rates of 15 per cent or 0 per cent).

Under s 295-550(4) ITAA97 income of a fund derived from a trust as a beneficiary of a trust other than because of holding a fixed entitlement to the income is non-arm's length income of the fund. A fixed entitlement to income is not defined for the purposes of s 295-550 ITAA97 but is defined for the purposes of Schedule 2F ITAA36 to be “a vested and indefeasible interest in a share of the income of the trust.” This is a strict definition and would appear to mean that the holding of units in most common unit trusts will not result in the unit holders holding a fixed entitlement.<sup>6</sup>

In his ruling on special income<sup>7</sup> the Commissioner of Taxation (“Commissioner”) has expressed the view that the meaning of fixed entitlement for the purposes of non-arm's length income/special income will always depend on the rights and entitlements under the relevant trust deed. Income from an interest in a unit trust, a bare trust, a fixed trust and even a non-fixed trust (provided the fund is entitled to a fixed entitlement to the income) will not be non-arm's length income. An entitlement to a distribution from a trust should not depend upon the exercise of the discretion of the trustee or any other person.

According to the Commissioner a fund must have “an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee. An interest in the income of a trust estate will be vested in interest

if it is bound to take effect in possession at some time and is not contingent upon any event occurring that may or may not take place. In contrast to a vested interest, a contingent interest will be one which gives no right at all unless or until some future event happens such as the exercise of a discretion by the trustee or some other person.”<sup>8</sup> Therefore a discretionary distribution of income from a discretionary trust will be non-arm’s length income as a fixed entitlement requires a beneficiary to have “an interest that is susceptible to measurement; a right merely to be considered as a potential recipient of income is not sufficient.”<sup>9</sup>

Even if the fund holds a fixed entitlement to income in a trust under s 595-550(5) ITAA97 income from that trust can still be non-arm’s length income if:

- (a) the [fund] acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm’s length; and
- (b) the amount of the income is more than the amount that the [fund] might have been expected to derive if those parties had been dealing with each other at arm’s length.

It is therefore important to ensure that where an investment by a fund in a trust that provides a fixed entitlement to income and that fixed entitlement is more than might be expected if the parties had been dealing at arm’s length that the fund acquire the interest under an agreement the parties to which were dealing with each other at arm’s length.<sup>10</sup>

### CAN THE DISTRIBUTION OF CAPITAL BE NON-ARM’S LENGTH INCOME?

The simpler super rewrite has confirmed that non-arm’s length income derived from a scheme under s 295-550(1) and from dividends paid by private companies under s 295-550(2) applies to both ordinary income and statutory income derived by the fund and thus removes the previous uncertainty under s 273 ITAA36 as to whether statutory income was special income.<sup>11</sup> This uncertainty remains however for trust distributions as ss 295-550(4) and 295-550(5) ITAA97 refer to “income” derived from a trust. Presumably this was a drafting error and it was intended that

both ordinary income and statutory income derived by the fund from a trust would fall within the meaning of income under those two subss. This is the position that the Commissioner took under the old special income provisions.<sup>12</sup>

A counter argument to the Commissioner’s position is that the provisions in ss 295-550(1) and 295-550(2) ITAA97 which specify that they include statutory income are intentional and that absent the specific inclusion of statutory income in the income referred to in ss 295-550(4) and 295-550(5) ITAA97 income referred to in those subss will retain its ordinary meaning.

Non-arm’s length income does not appear to apply to amounts derived from a trust that are not ordinary income or statutory income. This raises the question as to whether such amounts could be derived by a fund and not be deemed to be non-arm’s length income.

For example in a financial year a discretionary trust made a capital gain of \$500,000, has carried forward capital losses of \$500,000, has \$10 of ordinary income and makes no other income or capital gains. The trustee of the discretionary trust resolves to make a capital distribution of the cash received of \$500,000 to a fund and to distribute the \$10 of ordinary income to the same fund. Under s 102-5 ITAA97 net capital gains are included in the assessable income of the discretionary trust by reducing the capital gain by any previously unapplied capital losses from earlier income years. After reducing the capital gain by the carried forward loss the discretionary trust has a nil net capital gain, and therefore has no statutory income (but it has \$10 of ordinary income). As the fund receives a capital amount and no statutory income it is arguable that the capital distribution from the trust to the fund will not be caught by the non-arm’s length income provisions (the \$10 of ordinary income will be non-arm’s length income and taxed at 45 per cent, ie \$4.50 of tax).

Even if a distribution from a trust to a fund was not non-arm’s length income other regulatory issues could arise such as the prohibition against acquiring assets from a related party under s 66 SISA (eg an in-specie distribution of an asset), whether the distribution could be classed

as a contribution that is subject to the contribution limits contained in ITAA97 or whether the distribution would be caught by the anti-avoidance provisions of Part IVA ITAA36.

### CONCLUSION

Any investment by a fund in a trust raises a number of regulatory and taxation issues. The trustee of a fund must be mindful of such issues especially whether the investment will be an in-house asset and whether the income will be non-arm’s length income.

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#### Reference notes:

- 1 *The High Court decision of CPT Custodian v Commissioner of State Revenue (2005) 224 CLR 98 has created some doubt as to whether a beneficiary of a bare trust will always have a vested and indefeasible interest where the trustee has a right to indemnity – see Bean “Tax treatment of beneficial ownership, equitable interests and “absolutely entitled” interests” (2007) Vic Div TIA Convention Paper.*
- 2 *This definition is the author’s terminology.*
- 3 *This definition is the author’s terminology.*
- 4 *This definition is the author’s terminology.*
- 5 *For a discussion of the new instalment warrant borrowing provision see Thompson “Current issues in investing via a SMSF – instalment warrants and private unit trusts” (2007) 42 Taxation in Australia 268-281 and Chang “How to gear your SMSF” (2007) 42 Taxation in Australia 336-340.*
- 6 *Bean pages 8 and 9.*
- 7 *See Taxation Ruling TR2006/7, see also Interpretative Decision ATO ID 2003/230 (Withdrawn) and Taxpayer Alert TA 2003/1.*
- 8 *TR2006/7 para 208.*
- 9 *TR2006/7 para 209.*
- 10 *a discussion of the meaning of arm’s length is beyond the scope of this paper – see TR2006/7 paras 189-199, Barnsdall v Federal Commissioner of Taxation 88 ATC 4546 and Collis v FC of T 96 ATC 4831.*
- 11 *See TR2006/7 paras 143-153 and 211-224.*
- 12 *TR2006/7 paras 143-153.*