

Transitional in-house assets post-30 June 2009

THIS ARTICLE WILL EXPLORE THE CONSEQUENCES AND ACTIONS THAT SHOULD NOW BE CONSIDERED AS A RESULT OF THE END OF THE TRANSITIONAL IN-HOUSE ASSET RULES FOR PRE-12 AUGUST 1999 ARRANGEMENTS ON 30 JUNE 2009.



On 23 December 1999¹ the in-house asset rules contained in Part 8 of the *Superannuation Industry (Supervision) Act 1993 (SISA)* were expanded² to include investments in a related party or a related trust³ of a superannuation fund (**Fund**⁴).

Prior to the amendments an investment by a Fund in a unit trust or a company would generally not be an in-house asset. As the investments in unit trusts and companies were generally not regulated by SISA, such entities (even those controlled by a Fund) could invest and conduct their affairs in a manner that potentially circumvented the provisions of SISA. Examples included the purchase by the trustee of a unit trust of a residential property used by members of the Fund which held units in the unit trust and the trustee of a unit trust in which a Fund held units borrowing or making loans to related parties of members of the Fund.

The purpose of the amendments was “to ensure superannuation benefits [were] safeguarded in a manner that was originally intended by the [SISA] investment rules”.⁵

Transitional arrangements were inserted as subdiv D of Part 8 SISA (**Transitional In-House Asset Rules**) to ensure “pre-Budget investments will not need to be unwound”⁶ and “allow the repayment of existing debt of related parties”.⁷

WHAT ARE THE TRANSITIONAL IN-HOUSE ASSET RULES?

The Transitional In-House Asset Rules permit a Fund, without breaching the in-house asset rules, to:

- maintain a loan made before the test time or made under a contract entered into before the test time;⁸

- maintain an investment made before the test time or made under a contract entered into before the test time;⁹
- hold a share acquired before the test time or made under a contract entered into before the test time;¹⁰
- hold a unit in a unit trust acquired before the test time or made under a contract entered into before the test time;¹¹
- hold an asset that is subject to an uninterrupted sequence of leases or lease arrangements with a related party of the Fund that began before the test time;¹²

provided that such an arrangement was permitted under the in-house asset rules in existence prior to the test time.

The test time is the end of 11 August 1999.¹³

This article will focus on the Transitional In-House Asset Rules as they relate to investments in unit trusts as this is the most common form of transitional in-house asset.

PRE-12 AUGUST 1999¹⁴ INVESTMENTS IN A PRE-12 AUGUST 1999 UNIT TRUST

Under s 71A(1)(a)(ii) SISA a unit in a unit trust¹⁵ (**Pre-Unit Trust**¹⁶) acquired before the test time or made under a contract entered into before the test time, will not be an in-house asset of a Fund, provided the unit would not have been an in-house asset of the Fund pre-12 August 1999.

This will be so regardless of the conduct of or investments made by the Pre-Unit Trust. For example the Pre-Unit Trust could maintain or increase its borrowings and have dealings with a related party of

the Fund, without the units becoming an in-house asset.

Even though the investment in a Pre-Unit Trust may not be an in-house asset, that investment may breach other SISA requirements such as the sole purpose test¹⁷ and the requirement to maintain investments on an arm’s length basis.¹⁸

INVESTMENTS IN A PRE-UNIT TRUST PRIOR TO 1 JULY 2009

If the requirements of either ss 71D or 71E SISA are satisfied the Fund may acquire further units in a Pre-Unit Trust prior to 1 July 2009 and those units will not constitute an in-house asset.

INVESTMENTS IN A PRE-UNIT TRUST UNDER SECTION 71E SISA

Under s 71E SISA, if a Pre-Unit Trust had outstanding borrowings immediately before the test time and the Fund made a written election by 12 August 2000, the Fund may acquire further units in the Pre-Unit Trust up to the level of the amount of the borrowing outstanding immediately before the test time.¹⁹

If a Fund has made an election under s 71E SISA the Fund cannot utilise any of the other Transitional In-House Asset Rules under ss 71A to 71D SISA for investments in a Pre-Unit Trust during the period 12 August 1999 to 30 June 2009.

SECTION 71D SISA REINVESTMENTS IN A PRE-UNIT TRUST

If a Fund has not made an election under s 71E SISA then under s 71D SISA the Fund may during the period 12 August 1999 to 30 June 2009 reinvest the share of the income of a Pre-Unit Trust to which

the Fund is entitled in further units in the Pre-Unit Trust. Any reinvestment in further units by a Fund under s 71D will not constitute an in-house asset of the Fund.

Further units may be acquired under s 71D SISA at any time during the period 12 August 1999 to 30 June 2009. For example if during the period 11 August 1999 to 30 June 2009 distributions totalling \$10,000 had been made to a Fund, the Fund could invest an amount of \$10,000 in the subscription for further units with a value of \$10,000 without those units constituting in-house assets of the Fund.

Further, prior to 1 July 2009, a Fund can reinvest distributions received from a Pre-Unit Trust in respect of units acquired from earlier reinvestments made during the period 12 August 1999 to 30 June 2009, that is, "income on income".

Assistance in determining the time when a reinvestment is made can be found in Self-Managed Superannuation Fund Determination SMSFD 2007/1 in which the Commissioner of Taxation (**Commissioner**) states that a Fund will be taken to receive units under a distribution reinvestment as soon as the distribution has been "applied with or dealt with as requested...for example...when the amount is appropriated for the purchase of additional...units... [or] as soon as the set-off happens."²⁰

In the determination the Commissioner takes both a practical approach and an impractical and restrictive approach. The ability to set-off the Fund's right to be paid a distribution from the Pre-Unit Trust with the Fund's obligation to pay the issue price of the "reinvested" units to the Pre-Unit will alleviate the need to perform the two transactions in cash. However the requirement that the distribution must be received by 30 June 2009 will cause a significant administrative burden for Pre-Unit Trusts as it will require them to calculate the Pre-Unit Trust's net income on the day of 30 June 2009 and on the same day make the determinations to distribute the net income to the Fund, to issue new units to the Fund and to offset the obligation to pay the distribution with the right to receive the issue price.

WHAT WILL HAPPEN TO PRE-UNIT TRUSTS AFTER 30 JUNE 2009?

After 30 June 2009, a Fund's pre-12 August 1999 units and any units acquired under ss 71D or 71E SISA in a Pre-Unit Trust will continue to not be in-house assets of the Fund.

However there will be a number of consequences for a Fund's investment in a Pre-Unit Trust post-30 June 2009 including:

1. Further investments may be in-house assets

Unless one of the in-house asset exemptions apply any post-30 June 2009 investments in a Pre-Unit Trust will be an in-house asset. If the aggregate of the market value of that in-house asset and the market value of the Fund's other in-house assets exceeds 5 per cent of the market value of the Fund's total assets, the Fund will be in breach of the in-house assets rules and potentially subject to penalties and tax.²¹

unpaid distribution will potentially be an in-house asset, breach the arm's length rules²³ and cause the Fund to be in breach of the sole purpose test.²⁴ The Commissioner also states that adding a "distribution" to the corpus of the trust may also be an investment in a related trust under the in-house asset rules.²⁵

Therefore unless the Fund wishes to challenge the Commissioner's ruling the prudent course of action would be to ensure that all distributions from a related Pre-Unit Trust are paid in cash soon after the relevant appointment/distribution of income is made.

3. Problems with repayment of loans by a Pre-Unit Trust after 30 June 2009

If a Pre-Unit Trust has an outstanding loan after 30 June 2009, the Commissioner's requirement that all distributions must be paid in cash could potentially cause the Pre-Unit Trust to make a decision that will either cause it to be in breach of its loan agreement or cause the Fund to be in breach of the SISA provisions.

“ the prudent course of action would be to ensure that all distributions from a related Pre-Unit Trust are paid in cash ”

In addition any further acquisition of units may breach the prohibition against a Fund acquiring assets from a related party.²²

2. Distributions from a Pre-Unit Trust must be paid

Post-30 June 2009 what will be the consequences of an amount of income to which a Fund is entitled from a Pre-Unit Trust remaining unpaid in part or in full? Will this constitute an investment by the Fund in a related trust or breach another provision of SISA?

In Draft Self-Managed Superannuation Fund Ruling SMSFR 2008/D1, the Commissioner stipulates that where a Fund is presently entitled to a distribution from a related trust, that

If a Pre-Unit Trust's loan agreement requires the Pre-Unit Trust to pay principal and interest, and the Pre-Unit Trust has no other cash, necessarily it will apply some of its income towards the payment of interest and principal if it is to avoid defaulting under the loan agreement. This is potentially in conflict with the Commissioner's view that all of a Pre-Unit Trust's net income must be paid to the unitholders. Pre-1 July 2009 this problem can be overcome by a Pre-Unit Trust paying all of its distributions to a Fund which in turn could reinvest those distributions for the subscription of further units, but post-30 June 2009 this option will not be available.

For example if, post-30 June 2009, a Pre-Unit Trust (with a Fund as its sole unitholder) earned \$100 of gross income and had an obligation to pay \$20 of interest and repay \$30 of principal, the Pre-Unit Trust would have net income of \$80 (ie gross income of \$100 less deductible interest of \$20) and an obligation to pay \$30 to the lender as a repayment of principal. If that Pre-Unit Trust had no other cash sources it would have two options; firstly it could pay the \$30 to the lender in which case it could only pay \$50 of the \$80 of income appointed to the Fund and the remaining unpaid appointment of income of \$30 will potentially be in breach of the in-house asset rules or the sole purpose test. Secondly it could pay the \$80 of income appointed to the Fund and be in breach of its loan agreement with the lender.

To avoid these difficulties it would seem to be necessary for either the Fund to dispose of its units in the Pre-Unit Trust or the trustee of the Pre-Unit Trust to sell the asset to which the relevant loan attaches or vest the Pre-Unit Trust and/or for the Pre-Unit Trust to accumulate some or all of its income. As discussed below, potential capital gains tax, income tax, stamp duty and SISA consequences should be reviewed before determining the action to be taken.

4. Unpaid purchase price on units held in Pre-Unit Trusts may become in-house assets

Under s 71A(2) SISA, if at 11 August 1999 a Fund held units in a Pre-Unit Trust where part of the purchase/issue price was unpaid, the payment of all or part of that purchase price before 1 July 2009 would not constitute an in-house asset.

However from 1 July 2009 an amount paid towards the purchase price of units held by a Fund will cause those units to be an in-house asset with the in-house asset value of those units equalling the market value of the units multiplied by the proportion that the post-30 June 2009 payments make up of all of the payments made towards the purchase price of the units in accordance with the formula in s 71A(3) SISA.

WHAT ACTION SHOULD A PRE-UNIT TRUST TAKE BEFORE AND FROM 1 JULY 2009?

What action, if any, a Pre-Unit Trust or a Fund that holds units in a Pre-Unit trust should take before and from 1 July 2009 will depend on individual circumstances. That action could include:

1. Pay all entitlements to income

Post-30 June 2009 a Pre-Unit Trust could pay all entitlements to income.

Pre-12 August 1999 units held by a Fund, and all units acquired under ss 71D or 71E SISA will continue to not be in-house assets post-30 June 2009 and all distributions of income which are paid in full will not give rise to in-house assets.

As units in a Pre-Unit Trust will not constitute in-house assets of a Fund, there will continue to be no direct restrictions under SISA on the transactions and investments of the Pre-Unit Trust. For example a Pre-Unit Trust could maintain a borrowing, enter into a new borrowing arrangement and transact with related parties of the Fund. However as discussed above the actions of the Pre-Unit Trust may cause the investment by the Fund in that trust to breach a provision of SISA, such as the sole purpose test and prohibition from acquiring assets from a related party.²⁶

2. Accumulate income of the Pre-Unit Trust

If a Pre-Unit Trust could not distribute all of the income as a result of cash flow difficulties, the Pre-Unit Trust could determine to accumulate some or all of the income of the Pre-Unit Trust (subject to its deed providing it with that power). Any income accumulated will be subject to tax at the rate of 46.5 per cent²⁷ but may be a better result than the sale of assets or the vesting of the Pre-Unit Trust.

3. Maximise reinvestments under section 71D SISA before 1 July 2009

If a Fund has not reinvested all of its distributions made during the period 12 August 1999 to 30 June 2009, the Fund has until 30 June 2009 to do so. This can include any distributions

made during that period even if they have been previously paid.

As noted above the Commissioner's view is that any reinvestments for the 2008-09 year must be made by 30 June 2009 and therefore it is important that Pre-Unit Trusts determine the net income of the trust and make any reinvestments on that date.

In addition the Pre-Unit Trust could consider realising assets before 1 July 2009. If the realisation resulted in the increase of the net income of the Pre-Unit Trust and as a result the distribution available for reinvestment, this could result in the Pre-Unit Trust holding additional cash which could be used to retire debt, make further investments or pay future distributions. Before an asset is sold the capital gains tax consequences and anti avoidance provisions must be considered.

4. Ensure further investments in a Pre-Unit Trust are not in-house assets

Under s 71(1)(j)(ii) SISA a post-30 June 2009 acquisition by a Fund of a unit in a Pre-Unit Trust will not be an in-house asset if the Pre-Unit Trust satisfies the criteria set out in regulation 13.22B of the Superannuation Industry (Supervision) Regulations 1994 (SISR). Regulation 13.22B SISR requires that:

- the Fund have fewer than five members;
- the Pre-Unit Trust not be a party to a lease with a related party of the Fund unless the lease is legally binding and relates to business real property;
- the Pre-Unit Trust not have any outstanding borrowings;
- the assets of the Pre-Unit Trust not include an interest in another entity;
- the assets of the Pre-Unit Trust not include a loan to another entity;
- the assets of the Pre-Unit Trust not include an asset over which there is a charge;
- the assets of the Pre-Unit Trust 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); and

- the assets of the Pre-Unit Trust not include an asset that was an asset of a related party of the Fund from 12 August 1999 to 28 June 2000 (unless it is business real property acquired at market value).

If a Pre-Unit Trust complies with regulation 13.22B SISR a Fund could continue to invest any of its income or capital in further units in the Pre-Unit Trust post-30 June 2009. Further, the Fund could acquire units in the Pre-Unit Trust from a related party of the Fund.²⁸

5. Sale of units in or vesting of a Pre-Unit Trust

If it is not possible to pay distributions in cash or to ensure the Pre-Unit Trust meets the requirements of regulation 13.22B SISR, the Fund could consider selling its units or the Pre-Unit Trust could consider redeeming the Fund's units or vesting the Pre-Unit Trust before 1 July 2009.

To reiterate, before any of these actions are undertaken the potential capital gains tax, income tax and stamp duty consequences must be considered. Further if the relevant Pre-Unit trust is vested and its assets transferred to a Fund, care should be taken to ensure this does not result in the Fund acquiring an asset from a related party in breach of s 66 SISA. This could occur for example, if residential property was transferred from the Pre-Unit Trust to the Fund.

6. Distribute the Fund's units to a member as a benefit

If a member has met a condition of release (other than as a result of receiving a transition to retirement income stream), the Fund could consider transferring the units in the Pre-Unit Trust in-specie to the member by way of a lump sum benefit.²⁹

The distribution of the Fund's units to a member will remove a potential in-house asset from the Fund. However before the units are transferred the advantages of the retention of the units by the Fund should be considered along with the potential capital gains tax, income tax and stamp duty consequences to the Fund and the member.

OTHER TRANSITIONAL IN-HOUSE ASSETS

The Fund must review all of its other transitional in-house assets. Subject to the provisions in ss 71A and 71B SISA, transitional investments, loans and lease arrangements will continue to not be in-house assets from 1 July 2009. However the Fund must be careful to ensure its actions do not cause transitional arrangements to become in-house assets.

CONCLUSION

It is important that the trustee of a Fund review all of the relevant transitional in-house asset arrangements. In particular the trustee should, in light of all of the SISA requirements, review its investments in Pre-Unit Trusts to determine whether any further investments can be made under ss 71D or 71E SISA and whether the Pre-Unit Trust can pay income entitlements post-30 June 2009 or if it cannot, whether the Fund should dispose of its interest in the Pre-Unit Trust.

With the 30 June 2009 deadline approaching it is important that these matters be reviewed sooner rather than later.

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Reference notes:

- 1 Under the Superannuation Legislation Amendment Act (No. 4) 1999.
- 2 Not without controversy – see A Gray, *Unpalatable Measures the 1999 superannuation investment amendments*, *Taxation in Australia*, Volume 33, No. 10 May 1999 and A Gray, *The future of small fund investments threatened?*, *Taxation in Australia*, Volume 34, No. 5 November 1999.
- 3 Prior to the amendments the in-house asset rules under s 71 SISA prohibited investments in “a standard employer-sponsor, or an associate of a standard employer-sponsor, of the fund”.
- 4 A reference to a Fund in this article refers to the Fund and the trustee of the Fund in that capacity.
- 5 Page 7 of the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999.
- 6 Page 8 of the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999.
- 7 Page 9 of the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 4) 1999.
- 8 Section 71A(1)(a)(i) SISA.
- 9 Section 71A(1)(a)(i) SISA.
- 10 Section 71A(1)(a)(ii) SISA.
- 11 Section 71A(1)(a)(ii) SISA.
- 12 Section 71B SISA.

- 13 See s 71F SISA – this means that an arrangement entered into on 11 August 1999 (ie before the end of 11 August 1999) will be covered by the Transitional In-House Asset Rules. This is so even though the headings in ss 71A and 71B SISA refer to pre-11 August 1999 investments and leases and presumably it is for this reason that the transitional in-house arrangements are commonly known as pre-11 August 1999 arrangements. In this article the transitional in-house arrangements will be referred to as pre-12 August 1999 arrangements.
- 14 See footnote 13 for an explanation as to why this article refers to pre-12 August 1999 arrangements rather than the common name of pre-11 August 1999 arrangements.
- 15 In light of the High Court decision of *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98 (where the court found that the term unit trust does not have a constant or fixed normative meaning) the question arises what is a unit trust? For example would it include a “hybrid trust”? SISA defines a unit trust as a unit trust within the meaning of Div 6C of the Income Tax Assessment Act 1936. Division 6C, which relates to “public trading trusts”, does not define unit trust but does define a unit in s 102M as a “beneficial interest, however described, in any of the income or property of the trust estate.” This chain of definitions is not enlightening. In the Federal Court case of *Re Romano Trevisan and Valerie Anne Trevisan the Trustees of the Forli Pty Ltd Superannuation Fund v Commissioner of Taxation of the Commonwealth of Australia* [1991] FCA 172 the Federal Court appears to accept the general concept of a unit trust without delving into definition of a unit trust. It is probable that the courts will accept that a “standard” unit trust falls within the definition under SISA however it is not so clear for a “non-traditional” unit trust.
- 16 A reference to a Pre-Unit Trust in this article refers to the Pre-Unit Trust and the trustee of the Pre-Unit Trust in that capacity.
- 17 See s 62 SISA.
- 18 See s 109 SISA – ie this section may apply in relation to the units held by the Fund rather than the assets of the unit trust.
- 19 If the Pre-Unit Trust had multiple Funds as unit holders on 11 August 1999, then each Fund can invest in units up to the value of the borrowing on 11 August 1999 – see ATO Interpretative Decision ATO ID 2002/998.
- 20 See para 25 of the determination.
- 21 The Fund can potentially be subject to civil or criminal penalties under s 84 SISA or the Fund could lose its complying status with a result that the market value of the Fund's assets less undeducted/non-concessional contributions being subject to tax at 46.5 per cent under s 295-325 of the Income Tax Assessment Act 1997.
- 22 Section 66 SISA.
- 23 See s 109 SISA.
- 24 See s 62 SISA.
- 25 See para 10 of the determination.
- 26 See s 66(3) SISA which prohibits persons from carrying out schemes with the intention to acquire an asset from a related party of the Fund. For example if the Pre-Unit Trust enters into a scheme to acquire an asset from a related party of the Fund, where if the Fund had acquired that asset directly it would have breached s 66(1) SISA.
- 27 See s 99A Income Tax Assessment Act 1936.
- 28 See s 66(2A)(a)(iv) SISA but note s 66(3) SISA as discussed in footnote 26.
- 29 An asset cannot be cashed or transferred in-specie as a pension benefit – see para 10 of APRA's Superannuation Circular N.I.C.2 Payment Standards for Regulated Superannuation Funds.