

The ATO's focus on distributions from trusts to SMSFs



THIS ARTICLE CONSIDERS THREE WAYS THAT THE ATO HAS INDICATED THAT IT WILL REVIEW DISTRIBUTIONS FROM TRUSTS TO SMSFS; THE NON-ARM'S LENGTH INCOME RULES, TREATING DISTRIBUTIONS AS CONTRIBUTIONS AND REVIEWING UNPAID PRESENT ENTITLEMENTS OWING TO SMSFS

In the last few years the Australian Taxation Office (ATO) has significantly increased its focus on superannuation funds and specifically self managed superannuation funds (SMSF). One area of particular focus of the ATO, as shown in recent public announcements, has been the distribution from trusts to SMSFs.

This year the ATO has released numerous publications and rulings which consider three of the methods to be employed to attack distributions from trusts to SMSFs. These are:

- taxing the distributions as non-arm's length income, the applicable tax rate being 45%;¹
- treating a distribution from a trust to a SMSF as a contribution;
- treating an unpaid allocation of income from a trust to a SMSF as a breach of the superannuation regulatory provisions such as the sole purpose test, the in-house asset rules or the arm's length dealing requirements.

Legislative references in this article are to *Income Tax Assessment Act 1997 (ITAA97)*, *Income Tax Assessment Act 1936 (ITAA36)* and *Superannuation Industry (Supervision) Act 1993 (SISA)*. Reference to provisions will be in relation to their application to SMSFs rather than superannuation funds as a whole.

NON-ARM'S LENGTH INCOME

In a speech to the Taxation Institute of Australia on 31 March 2009,² Deputy Commissioner of Taxation, Mark Konza, confirmed that the ATO is reviewing arrangements where SMSFs received non-arm's length income (or special

income as it was known prior to 1 July 2007). Mr Konza confirmed that:

"We are currently litigating a number of special income cases which involve interposed entities being used to divert income to an SMSF. Some of these cases involve excessive rate of return on dividends paid to an SMSF by a related private company, or trust distribution amounts received by an SMSF arising from a fixed entitlement.

The Tax Office is also auditing and reviewing cases where trustees of discretionary trusts stream income to SMSFs. These kinds of transactions will always be considered special income and therefore taxed at a higher rate within the SMSF."

The author has previously discussed in this journal the application of the non-arm's length income provisions generally to distributions from a trust to a SMSF.³ This article concentrates on specific areas of uncertainty concerning the same question.

A distribution from a trust to a SMSF can be non arm's length income in two circumstances; where the SMSF does not have a fixed entitlement to the income of the trust⁴ and where it does have a fixed entitlement to the income of the trust.⁵

The derivation of income by a SMSF from a trust other than because of holding a fixed entitlement will always be non-arm's length income.

The derivation of income by a SMSF through the holding of a fixed entitlement to income will only be non-arm's length income where firstly, the entitlement to income of the trust was acquired 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, secondly, the amount of income is more than the amount that might be expected

to derive if those parties had been dealing with each other at arm's length.

The application of the non-arm's length income provisions raises a number of issues, including:

- do the non-arm's length income provisions apply to statutory income?
- do the non-arm's length income provisions apply to capital distributions?
- what is a fixed entitlement to income for the purposes of the non-arm's length income provisions?

Do the non-arm's length income provisions apply to statutory income?

The simpler super rewrite has confirmed that non-arm's length income derived from a scheme under s 295-550(1) ITAA97 applies to both ordinary income and statutory income derived by a SMSF and thus the previous uncertainty under s 273 ITAA36 as to whether statutory income was special income no longer exists.⁶

This uncertainty remains however for trust distributions as ss 295-550(4) and 295-550(5) ITAA97 simply 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 a SMSF from a trust would fall within the meaning of income under those two subsections. This is the view applied by the ATO under the old special income provisions.⁷

An argument counter to the view of the ATO is that the provisions in ss 295-550(1) and 295-550(2) ITAA97 which specify that they include statutory income are exhaustive and that absent the specific inclusion of statutory income within the

meaning of the income referred to in ss 295-550(4) and 295-550(5) ITAA97, income referred to in those subsections will retain its ordinary meaning.

In the author's view it is unlikely that a court would accept such a narrow interpretation as it is in conflict with the intent of the provisions.

Do the non-arm's length income provisions apply to capital distributions?

The non-arm's length income provisions do 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 capital amounts derived by a SMSF can ever be non-arm's length income.

It is the author's view that the non-arm's length provisions do not apply to capital distributions because if the legislature intended to include capital payments under the non-arm's length income provisions it would have done so expressly as it has done in other provisions in the tax acts.⁸ In any event distributions of capital to a SMSF could be in breach of other prudential provisions.⁹

What is a fixed entitlement to income for the purposes of the non-arm's length income provisions?

The phrase "fixed entitlement" is not identified as a defined term in s 295-550 ITAA97.¹⁰

Fixed entitlement is defined in s 995-1(1) ITAA97 as a fixed entitlement to a share of the income or capital of a trust if the entity has a fixed entitlement to that share within the meaning of Div 272 of Schedule 2F ITAA36. It is not clear whether this definition is to apply to "fixed entitlement" in s 295-550 ITAA97.¹¹

If the definition in Div 272 of Schedule 2F ITAA36 is to apply, then for a SMSF to have a fixed entitlement to income it must have "a vested and indefeasible interest in a share of the income of the trust that the trust derives from time to time".¹²

This is a strict definition that is akin to an interest of a beneficiary of a fixed or bare trust. Under s 272-5(2) Schedule 2F ITAA36 a right to income in a unit trust will not be defeasible by reason only that units may be redeemed or issued provided that units can only be redeemed or issued on

the basis of the net asset value of the unit trust according to Australian accounting principles. This implies that a SMSF cannot have a fixed interest in the income of a unit trust that does not satisfy these requirements.¹³

The ATO's view is that "fixed entitlement" was not defined for the purposes of s 273 ITAA36.¹⁴ In its ruling and taxpayer alert on special income¹⁵ the ATO 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.

According to the ATO a SMSF 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".¹⁶

The ATO's view would appear to be consistent with the definition of fixed entitlement in Schedule 2F ITAA36 by requiring the interest to be vested and indefeasible.¹⁷

However in Taxation Ruling TR2006/7 the ATO does not distinguish between types of unit trusts and treats unit trusts as generally creating a fixed entitlement to income and capital.¹⁸ It would therefore appear that the ATO accepts that a SMSF can have a fixed entitlement in a "standard" unit trust without having to satisfy the new unit and redemption of unit requirements in s 272-5(2) Schedule 2F ITAA36.

Whether the ATO's views above will change under the ITAA97 rewrite of the special income/non-arm's length income provisions is not yet known.

In light of this uncertainty it is prudent that if a SMSF wishes to invest in a unit trust, that the unit trust meets the requirements in s 272-5(2) Schedule 2F ITAA36, commonly referred to as a "fixed unit trust".

DISTRIBUTIONS FROM TRUSTS AS CONTRIBUTIONS

In the recent draft ruling, TR 2009/D3,¹⁹ the ATO has come to a surprising preliminary view; that a distribution from a discretionary trust will be a contribution to a SMSF unless the SMSF's interest in the trust is an "investment". This conclusion appears to be derived from the definition of contribution adopted by the ATO in the

draft ruling that "an amount will be a superannuation contribution if it increases the capital of the [SMSF]" unless it is income profit or gain from an investment.²⁰

Specifically TR2009/D3 states:

"138. A distribution made by the trustee of a discretionary trust to a superannuation provider is a contribution to the fund unless the fund's interest in the discretionary trust is an investment. In these circumstances, the receipt clearly increases the capital of the superannuation fund. Further, the amount cannot be characterised as income, profit or gain from the use of the existing capital of the trust because the provider, being a mere object of a trust, does not have an interest in the discretionary trust that can be said to be an investment in the discretionary trust.

139. A distribution from a trust in which the superannuation provider has an interest will not be a contribution to the fund where the distribution is a return on, or of, the investment of fund moneys. In these circumstances, the distribution can be characterised as income, profit or gain arising from the use of the fund's existing capital."

However this view ignores the nature of a distribution from a trust.

A distribution of income by the trustee of a trust to a SMSF as a beneficiary by an appointment or creation of right to that income will be income of the SMSF and not a contribution. An appointment of income by the trustee of a trust to a SMSF lacks the requisite intention from the trustee that an amount is contributed to a common stock or for a common purpose.

The trustee of a trust is required to determine to accumulate or appoint the income of the trust to the beneficiaries and therefore, in the absence of any evidence to the contrary, any share of the income of the trust so appointed will simply be income derived by the SMSF as a beneficiary and not a contribution.

The ATO appears to be attempting to expand the notion of contribution as a defacto regulatory tool. Additionally the ATO has not stated, if a distribution from a trust is a contribution, how such a "contribution" is to be allocated to members and how those "contributions" will be counted for the purposes of the contribution caps.

In the author's view there are already ample regulatory²¹ and taxation²² tools available to the ATO to attack distributions from a discretionary trust to a SMSF.

Hopefully the ATO will reconsider its views (expressed in TR 2009/D3 on the meaning of a contribution and those on many of the other issues raised in the draft ruling) when the ruling is released in final form.

UNPAID PRESENT ENTITLEMENTS OWING BY TRUSTS TO SMSFS

The ATO has recently released two rulings²³ in which it seeks to treat the presence of an unpaid present entitlement (UPE) as potentially being an in-house asset,²⁴ in breach of the arm's length dealing provisions²⁵ and in breach of the sole purpose test.²⁶

The ATO's argument that a UPE could constitute an in-house asset as a loan from the SMSF to the trust is primarily based on the expansive definition of a loan in s 10(1) SISA which extends the meaning of a loan to include "the provision of credit or any other form of financial accommodation."²⁷

The ATO's view that a UPE could breach the arm's length dealing requirements in s 109 SISA is based on the view that an arm's length beneficiary of a trust 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".²⁸

The ATO considers that these rules could apply even where the SMSF is a sole beneficiary/unit holder of a trust.²⁹

Significantly the ATO's view will apply to pre-12 August 1999 unit trusts as the ability of SMSFs to reinvest distributions for further units under s 71D and s 71E SISA ceased on 1 July 2009. In late June 2009 the ATO released a publication advising that trustees of SMSFs should reinvest any UPEs by 30 June 2009 or risk those UPEs being treated as in-house assets.³⁰

Effectively, in the view of the ATO, all appointments of income from a trust to a SMSF must be paid and any UPEs that remain unpaid could potentially breach the SISA rules referred to above.

This does raise the question of when an appointment of income to a SMSF must be paid in order to avoid the ATO applying these provisions against a SMSF. In example three of SMSFR 2009/3³¹ the ATO states that (in the circumstances set out in the example) the payment on 31 May 2008 of an amount representing

an appointment of income made on 30 June 2007 would not constitute a breach of the above regulatory provisions.

CONCLUSION – CONSIDERATIONS FOR A SMSF INVESTMENT IN A TRUST

The ATO has made its intention clear; it proposes to attack some distributions from trusts to SMSFs.

In order to reduce the likelihood of the ATO taking action against a distribution from a trust to a SMSF on the basis that it is non-arm's length income, a contribution, or an in-house asset, or has caused the arm's length dealing provisions or the sole purpose test to be breached, a trustee of a SMSF should review its investments in or distributions from any trust.

Considerations for such an investment or distributions should include:

- does the SMSF have a fixed entitlement to income of the trust?
- if the trust is a unit trust, is the unit trust a "fixed unit trust" that satisfies the requirements of s272-5(2) Schedule 2F ITAA36?
- have the appointments of income to the SMSF been paid (or at the very least will they be paid by 31 May following the end of the financial year)?

If the trustee of a SMSF answers no to any of these questions then, in order to reduce the likelihood of any ATO scrutiny, those investments or distributions should be urgently reviewed.

POSTSCRIPT – RECENT AAT DECISION ON SPECIAL INCOME

In the recent decision of *FFWX v FTC*³² the AAT has found that dividends derived by a SMSF from shares in a private company (the assets of which were shares in a public company) were special income. The reason was not that the SMSF received a disproportionate share in the dividends (it in fact received dividends in proportion to its shareholding) but rather because it acquired the shares in the private company for less than market value. This rationale could be applied to treat trust distributions received by a SMSF as non-arm's length income where the SMSF acquired its interests/units in the trust for less than market value consideration.

Philip Broderick
Senior Associate
Harwood Andrews Lawyers

Reference notes

- 1 Section 26 Income Tax Rates Act 1986.
- 2 "Is the Tax Office widening its crackdown on lawyers and accountants?" Mark Konza Deputy Commissioner, Australian Taxation Office, speech to the Taxation Institute of Australia, Canberra, 31 March 2009. See also *Taxpayer Alerts 2008/3 and 2008/4*.
- 3 Broderick P. "Investments in trusts by superannuation funds", 42 *Taxation in Australia*, 7, 2007.
- 4 Section 295-550(4) ITAA97.
- 5 Section 595-550(5) ITAA97.
- 6 *Taxation Ruling TR2006/17 Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund, or a pooled superannuation trust in relation to the year of income at 143 to153 and 211 to 224*.
- 7 *Ibid* at 143 to 153.
- 8 For example the trust loss rules of Schedule 2F ITAA36 expressly refer to capital rights in a trust.
- 9 For example the sole purpose test under s 62 SISA, the prohibition against acquiring assets from a related party under s 66 SISA or the requirement to acquire assets on an arm's length basis under s 109 SISA.
- 10 That is, it does not have an asterisk in front of it. Whereas the terms such as "ordinary income", "statutory income" and "derived" are identified in s 295-550 ITAA97 as defined terms with an asterisk.
- 11 An argument for the application of the definition is the first line of s 995-1(1) ITAA97 which provides "In this Act, except so far as the contrary intention appears..." Arguments against the application of the definition include that s 2-15 ITAA97 provides that most defined terms are asterisked and that many other defined terms in s 295-550 ITAA97 are identified as defined terms with the use of an asterisk.
- 12 Section 272-5(1) Schedule 2F ITAA36.
- 13 *Bean Dr G*, "Tax Treatment of Beneficial Ownership, Equitable Interests and "Absolutely Entitled" Interests" (Paper presented at the Taxation Institute of Australia's 46th Victorian State Convention, Lorne, 13 October 2007).
- 14 See above n 6.
- 15 See above n 6 and *Taxpayer Alert TA 2003/1 Distribution to Superannuation Fund from Interposed Fixed Trust*.
- 16 See above n 6 at 208.
- 17 See ATO Interpretative Decision ATO ID 2002/750 *Superannuation Fund – vested and indefeasible interest in a trust – where the ATO determined that a unit trust, where the deed granted the trustee the discretion upon the vesting of the unit trust to distribute the capital to a class of beneficiaries, did not grant the unit holding SMSF a vested and indefeasible interest in the unit trust*.
- 18 See above n 6. For example at para 207 the ATO states "Parliament sought to distinguish between investment returns on "fixed entitlements" in "unit trusts" and distributions made to persons as beneficiaries of "discretionary trusts" resulting from the exercise of discretions...the former should only be treated as special income if the acquisition of the fixed entitlement or the derivation of the income failed to satisfy an arm's length test".
- 19 *Draft Taxation Ruling TR 2009/D3 Income tax: superannuation contributions*.
- 20 *Ibid* at 5.
- 21 For example the sole purpose test under s 62 SISA, the prohibition against acquiring assets from a related party under s 66 SISA or the requirement to acquire assets on an arm's length basis under s 109 SISA.
- 22 For example the non-arm's length income provisions of s 295-550(4) and (5) ITAA97.

- 23 *Self Managed Superannuation Funds Ruling 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 and Self Managed Superannuation Funds Ruling
SMSFR 2009/4 Self Managed Superannuation Funds:
the meaning of "asset", "loan", "investment in", "lease" and
"lease arrangement" in the definition of an "in-house asset"
in the Superannuation Industry (Supervision) Act 1993.
- 24 *Part 8 SISA.*
- 25 *Section 109 SISA.*
- 26 *Section 62 SISA.*
- 27 *Self Managed Superannuation Funds Ruling 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 at 88 to 105.
- 28 *Ibid at 154.*
- 29 *Ibid at 155.*
- 30 *ATO release "Review your unpaid trust distributions before*
30 June" released on 22 June 2009.
- 31 *See above n 27 at 45 to 51.*
- 32 *[2009] AATA 657 (1 September 2009).*