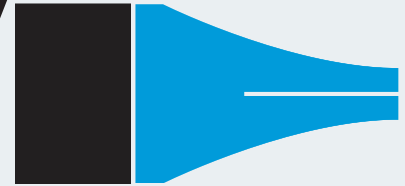
# SMSFs, trusts and property development: part 2



*by Phil Broderick, CTA, Sladen Legal*

**The second part of this article examines various structures (including trust structures) that can be used by SMSFs to conduct property development.**

In the first part of this article, I examined whether a self-managed superannuation fund (SMSF)[1] can carry on property development activities and a property development business, and what superannuation and tax laws must be considered when an SMSF carries on property development activities. In the second part of this article, I examine various structures under which an SMSF can undertake property development, or invest in an entity which undertakes property development activities.

Legislative references are to the *Superannuation Industry (Supervision) Act 1993* (SISA) or the *Superannuation Industry (Supervision) Regulations 1994* (SISR).

## SMSFs

Property development activities can be undertaken directly by the SMSF trustee provided the SISA and the SISR are not breached (see Diagram 1). Advantages of using this structure include:

- there is no need for other entities to be involved, and therefore costs and administration can be reduced;
- the SMSF's cash can be used directly in the development;
- existing SMSF assets can be developed (although not with borrowing);
- income and capital are taxed at SMSF rates; and
- the SMSF can undertake a property development business.

Disadvantages of using this structure include:

- SISA and SISR restrictions can make property development activities difficult;
- there is no asset protection — SMSF assets are subject to claims from the development activities;
- it is difficult to use borrowings when making improvements to properties;
- SMSFs cannot use borrowings to improve existing assets;
- it is difficult to bring other parties into the development (for example, it is generally preferable not to bring in third parties as members of the SMSF); and
- the difficulties of using related party developers/builders.

## Pre-99 unit trusts

Where an SMSF acquired units in a unit trust[2] prior to 12 August 1999, or under the transitional period operating from that date to 30 June 2009, such units will never be in-house assets.[3] In comparison, any units acquired from 12 August 1999 (other than those acquired under the transitional rules) will be in-house assets (see Diagram 2).

This means that such unit trusts (commonly known as "pre-99 unit trusts") can undertake activities that an SMSF cannot do directly without causing the SMSF to breach the in-house asset rules. These activities can include borrowing and dealing with related parties. This can make a pre-99 unit trust valuable for the purpose of property development.

It is important to note that, although the units in a pre-99 unit trust may not be in-house assets, other SISA and SISR rules, and taxation legislation, will continue to apply to the holding of the units. This includes the sole purpose test, s 109 SISA, the non-arm's length income rules and the public trading trust provisions. Therefore, it is particularly important that the activities of the pre-99 unit trust be undertaken on an arm's length basis.

In addition, this structure may present cash-flow issues. Any further units will be in-house assets, and the distributions cannot be left unpaid without, in the ATO's view,[4] becoming an in-house asset (as financial accommodation). This is especially problematic where the pre-99 unit trust has low levels of cash, a principal and interest loan and the obligation to pay distributions. This issue can often be fixed (in the short to medium term) by interest-only loans, and possibly with the capitalisation of interest.

## Regulation 13.22C unit trusts

Regulation 13.22C SISR unit trusts are sometimes referred to as non-geared unit trusts due to the specific prohibition against the trustee of such trusts borrowing

**Diagram 1: SMSF**

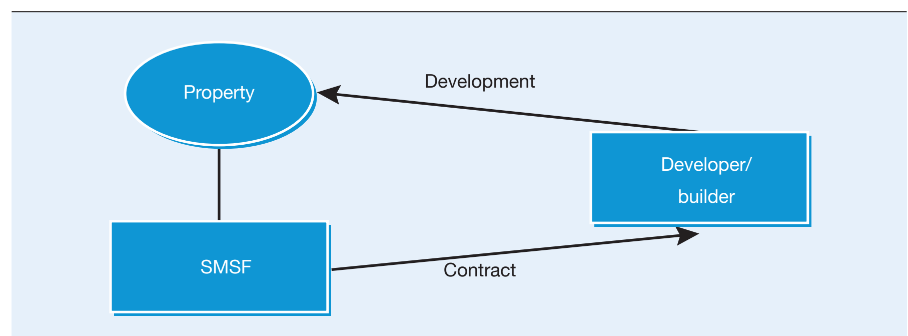
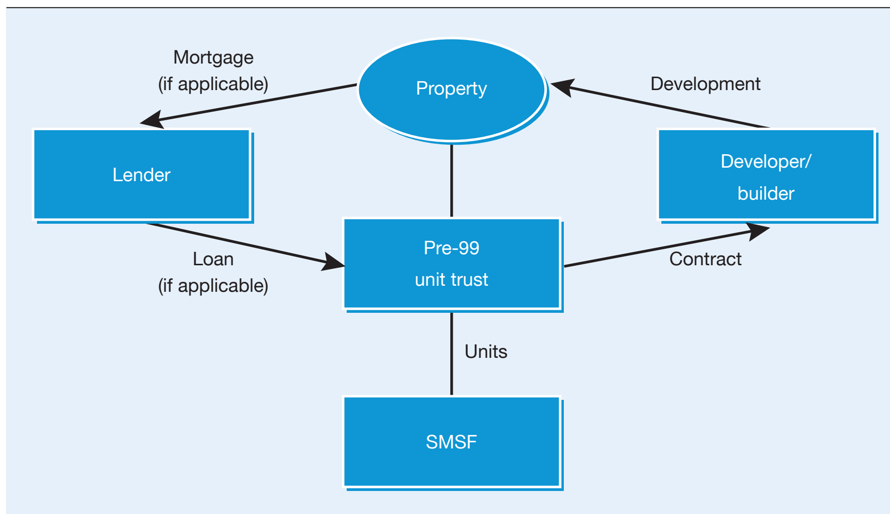


Diagram 2: Pre-99 unit trust

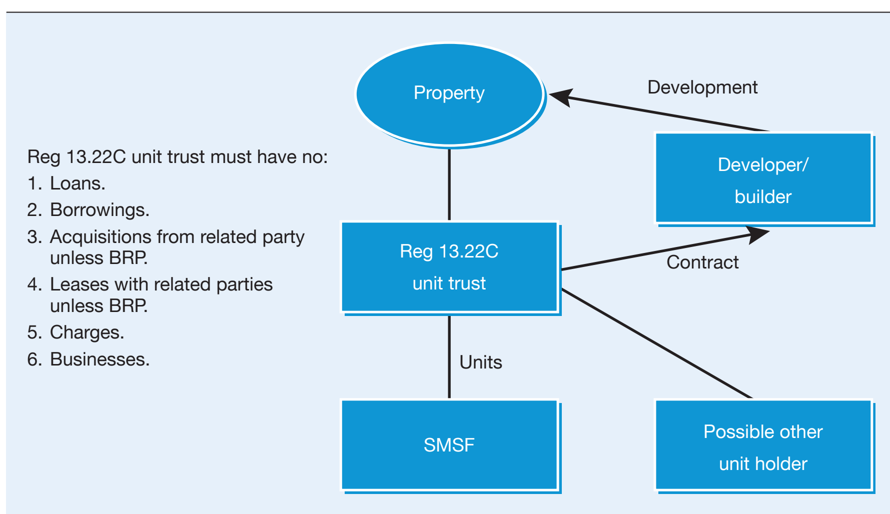



funds (see Diagram 3). However, the restrictions imposed on these trusts are much wider than a restriction on borrowing. For an SMSF to invest in such a unit trust, that trust must satisfy the requirements of reg 13.22C (or reg 13.22B) SISR, and must not breach reg 13.22D SISR.

These requirements include:

- the trustee of the unit trust is not a party to a lease with a related party of the superannuation fund, unless the lease relates to business real property (BRP);
- the trustee of the unit trust is not a party to a lease arrangement with a related party of the superannuation fund, unless the lease arrangement:
  - is legally binding; and
  - relates to BRP;
- the trustee of the unit trust is not a party to a lease, or lease arrangement, with another party in relation to an asset that is the subject of another lease or lease arrangement between any party and a related party of the superannuation fund (unless the asset is BRP);
- the trustee of the unit trust does not have outstanding borrowings;
- the assets of the unit trust do not include:
  - an interest in another entity;
  - a loan to another entity, unless the loan is a deposit with an authorised deposit-taking institution within the meaning of the *Banking Act 1959* (Cth);
  - an asset over, or in relation to which, there is a charge;
  - an asset that was acquired from a related party of the superannuation fund after 11 August 1999, unless the asset was BRP acquired at market value; or
  - an asset that had been, at any time (unless it was BRP acquired by the trustee of the unit trust, at market value) in the period from the end of 11 August 1999 to the commencement of Div 13.3A SISR, an asset of a related party of the superannuation fund; and
- the trustee of the unit trust does not conduct a business.

Diagram 3: Regulation 13.22C unit trust




Although restrictive, the reg 13.22C unit trust has significant advantages: units held by an SMSF in such a trust will not be an in-house asset, and the SMSF can acquire units in such a trust from related parties without breaching s 66 SISA.[5] A reg 13.22C unit trust also has the advantage that related parties can hold units in such a unit trust, even where the SMSF's "group" controls the unit trust.

In a property development context, the trustee of a reg 13.22C unit trust can acquire property and develop it, but it must do so without borrowing money, charging the asset, acquiring assets from a related party (including materials from a related party builder) or operating a business. Therefore, any property development would need to be fully funded from capital contributions by the unit holders and carefully managed.

## Unrelated trusts

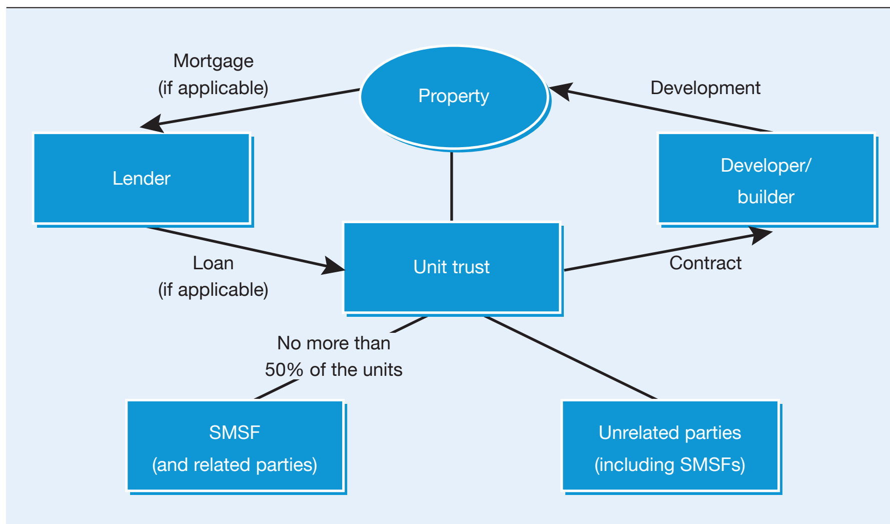
An unrelated trust is a unit trust which does not fall within the definition of a "related trust" under section 10(1) SISA (see Diagram 4). As noted in part 1 of this article in the discussion of the in-house asset rules, to determine whether a trust is a related trust is a complicated task.

However, as a simple rule of thumb, if the SMSF and its "group":

- hold no more than 50% of the units in the trust;
- hold no more than 50% of the shares in the corporate trustee;
- hold no more than 50% of the director roles in the corporate trustee; and
- do not have the unilateral power to remove the unit trust's trustee,

then the unit trust will not be a related trust.

**Diagram 4: Unrelated trust**




An example of an unrelated trust is where two unrelated SMSFs each hold 50% of the units in the unit trust, and their respective related parties hold no more than 50% of the shares in the corporate trustee and 50% of the director roles in the corporate trustee.

Unrelated trusts have significant advantages, as, like pre-99 unit trusts, the units held by the SMSF will not be treated as in-house assets regardless of what activities the unrelated trust does. Therefore, the unrelated trust can borrow, charge its assets, deal with related parties and carry on a business without causing the units held by the SMSF to be in-house assets.

As noted above for the pre-99 unit trusts, units in an unrelated trust can still cause an SMSF to breach the SISA (for example, the sole purpose test or s 109), or trigger adverse tax consequences under the non-arm's length income rules or the public trading trust rules. Therefore, it is important that an unrelated trust deals on an arm's length basis to avoid the potential application of these rules.

Leveraging using an unrelated trust has a particular advantage over limited recourse borrowing arrangements (LRBAs) (see Diagram 5), as considered in the next section, as the loan can be full recourse, and neither the single acquirable asset rule nor the replacement rules apply.

As a result of the advantages noted above, the unrelated trust is the best structure for SMSFs to have an interest in property development. The biggest downside, however, is that an SMSF and its "group" can only have a 50% interest in the unit trust. Therefore, this structure will not be appropriate where the SMSF and its "group" want to control more than 50% of a unit trust, or other investors cannot be found.

## LRBAs

The examination of the LRBA rules is a topic in itself. Therefore, in this article, I have confined the issues of using LRBAs to those relating to property development.[6]

### New law LRBAs

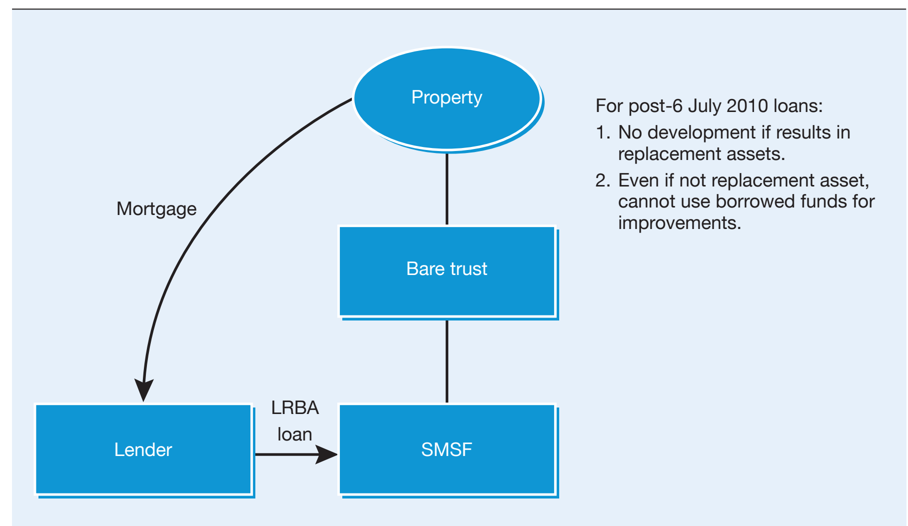
Limited recourse borrowing arrangements put in place after 7 July 2010 (new law LRBAs) are governed by ss 67A and 67B SISA. In a property development context, these new law LRBAs are very restrictive for the following reasons:

- they can only be used to acquire single acquirable assets;
- borrowed funds cannot be used to improve assets under a new law LRBA; and
- assets under an LRBA cannot be improved to the extent that it results in a "new asset".

Despite these restrictions, the development of a property held under a new law LRBA can occur where that improvement is funded from the SMSF's own funds (not borrowed funds) and the nature of the property does not change. The ATO gives the following examples of permitted improvements:

- Each (or all) of the following changes to a residential property would be treated as improvements but would not result in a different asset:
  - an extension to add two bedrooms;
  - the addition of a swimming pool;
  - an extension consisting of an outdoor entertainment area;
  - the addition of a garage shed and driveway;
  - the addition of a garden shed.[7]
- The trustees of an SMSF enter into an LRBA where the single acquirable asset is a property which has a car-washing facility on it. The property is leased to a tenant who operates a car-washing business. The trustees decide to expand the facility by extending the back of the building to double the

**Diagram 5: LRBA**



number of wash bays. The extension, which involves concreting, roofing and plumbing work, will be funded from accumulated funds held by the SMSF and will result in higher rent being received from the tenant. Although there is an improvement to the asset, that improvement does not result in the commercial property becoming a different asset. The fundamental character of the property remains a car-wash facility.[8]

### Old law LRBAs

Any LRBAs put in place between 24 September 2007 and 7 July 2010 (old law LRBAs) have the following significant advantages over new law LRBAs:

- they could be used over multiple assets;
- property could be improved and subdivided under old law LRBAs; and
- the borrowed funds could be used to make improvements.

This gave a lot more flexibility to do property development under old law LRBAs. Old law LRBAs retain this flexibility post-7 July 2010, provided the terms of the arrangement permit such activities. If they do not, then in the ATO's view, changes to the arrangement may result in it being deemed to be refinanced into a new law LRBA.

### New law LRBAs and reg 13.22C unit trust combination

Due to the difficulties of undertaking property development activities under a new law LRBA, one alternative structure is for the property to be held by a reg 13.22C unit trust and for the SMSF to acquire the units in the unit trust using a new law LRBA (see Diagram 6). This allows the unit trust trustee to undertake development of the property and not be restricted by the LRBA rules. The units held by the SMSF in the reg 13.22C unit trust under the LRBA structure will not be affected by such activities, and therefore there will be no breach of the LRBA rules.

The major downside of this structure is that the activities of the reg 13.22C unit trust will be highly restricted (as discussed above). In particular, the property held by the reg 13.22C unit trust cannot be used as security for the LRBA loan. Therefore, any security given to the lender will have to be restricted to the units in the reg 13.22C trust or other assets provided by guarantors.

### Conclusion

As this two-part article has demonstrated, property development in an SMSF is possible, although such activities must be conducted carefully to ensure that no breaches of the superannuation laws occur and that no adverse tax consequences are triggered. The use of trust structures can assist in, or enhance, such activities but such structures can bring their own additional complexities.

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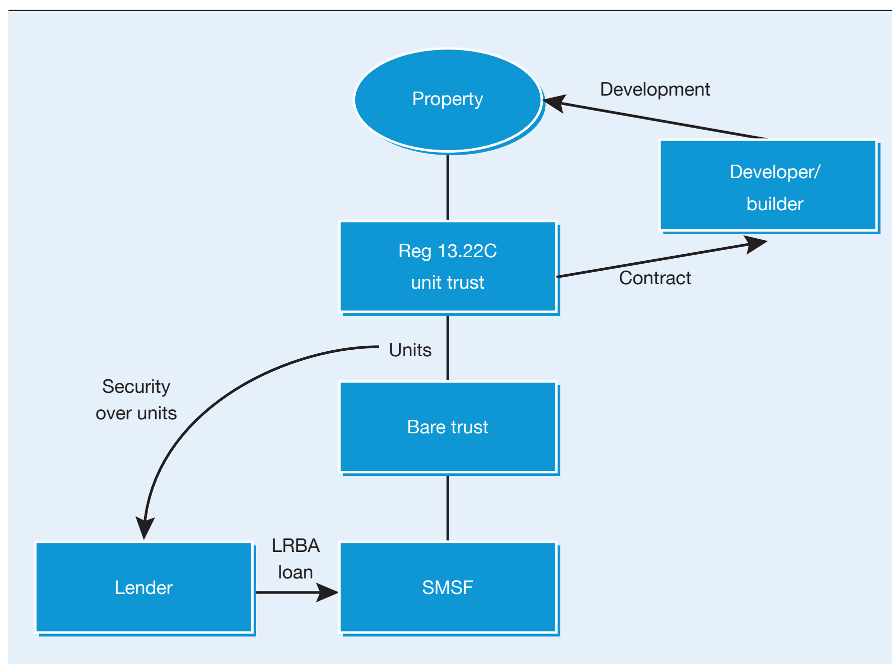
Diagram 6: LRBA with reg 13.22C unit trust




#### References

1. References in this article to self-managed superannuation funds, SMSFs include, where the context requires, a reference to the trustee of the SMSF in its trustee capacity. Similarly, references to trusts include a reference to the trustee of the trust in its trustee capacity.
2. An equivalent rule applies for acquiring shares in a "pre-99" company.
3. See Subdiv D of Pt 8 SISA.
4. SMSFR 2009/3.
5. S 66(2A)(a)(iv) SISA.
6. For a detailed explanation of the LRBA rules as they apply to new law LRBAs, see P Broderick, "An A to Z of limited recourse borrowing arrangements", at http://sladen.com.au/news/2014/3/31/an-a-to-z-of-limited-recourse-borrowing-arrangements.
7. SMSFR 2012/1, para 35, item 7.
8. SMSFR 2012/1, para 83