

SMSF: property development?

The question of whether an SMSF can carry on a business of property development is one that many would like clear guidance on; especially as the ATO has recently flagged that an SMSF carrying on a business may be in contravention of certain rules.

The good news here is that the ATO has confirmed that there is nothing expressly prohibiting SMSFs from conducting a business.

Property development may indeed constitute a business where there is a substantial pattern of buying and selling that is more than the mere realisation of an asset.

For example, where an existing property is subdivided by an SMSF into four apartments and sold, that may not constitute a business.

However, where an SMSF has a large parcel of outer urban land and goes about subdividing and developing many homes and then selling them off quickly, this may constitute a business.

There are certainly many grey areas in between these two examples. If an SMSF is found to be conducting a business, the ATO will closely scrutinise its activities for compliance with each and every rule (ie, that SMSF will be under the microscope).

Even if an SMSF is not conducting a business in relation to its property investments, it should carefully review this article.

The main super tests

The sole purpose test

Basically, the sole purpose test provides that trustees must ensure the fund is maintained solely for certain purposes (eg, retirement benefits to members).

An SMSF should therefore not become an extension of a property developer's business activities. The SMSF must therefore make prudential investments associated with providing retirement benefits. The SMSF should not be undertaking activities that merely enhance the members' or related parties' interests.

Arm's length requirements

An SMSF must broadly deal with other parties on arm's length terms. This rule requires parties that are not at arm's length, to make sure their dealings are.

When related parties are dealing with an SMSF, this rule is easily overlooked, eg, intra-group transactions may arise that contravene this rule.

Thus, SMSFs must avoid any contraventions and document transactions with related parties that evidence arm's length terms, eg, obtain quotes from third parties and gather suitable evidence.

Failure to keep related party transactions at arm's length can give rise not just to superannuation legislation compliance issues, but also to tax issues (eg, excess contributions and non-arm's length income).

Charges over assets

An SMSF must generally not give a charge over a fund asset. Many building contracts however provide a charge over the land and property being worked on.

SMSFs must therefore carefully inspect each relevant document, especially standard building contracts, and exclude any mortgage, lien or other encumbrance.

Trustee remuneration

If an SMSF trustee is undertaking work by managing an SMSF property development that would usually be paid for, this may not be at arm's length.

On the other hand, an SMSF trustee must not receive remuneration for services performed in their role as trustee. This gives rise to the question of: where should a trustee's services cease?

Practical considerations

There are a number of practical hurdles that need to be satisfied before an SMSF undertakes property development (even if it is not a business).

Documents

Naturally, all documents such as contracts, specifications, resolutions, etc, should be reviewed to ensure there is no contravention of any superannuation law. The SMSF's documents may also need to be updated to authorise the SMSF to undertake a property development especially if it is likely to constitute a business, eg, the SMSF deed and investment strategy may need to be revised.

Commercial Risks

Property development involves considerable legal and financial risks. Substantial cost overruns are common place. Thus, the cash flow and the liquidity of an SMSF must be capable of managing these risks, eg, will the SMSF withstand a cost increase of say 25%–50%.

DBA Lawyers are aware of one recent case where unforeseen environmental clean up costs exceeded the purchase price of the property.

SMSFs are prohibited from borrowing money to finance improvements. The new borrowing law only allows borrowing for an acquisition and certain repairs (summarised below).

Property development can also give rise to other 'general' legal risks. For example, in one recent case, substantial damages were awarded against the property owner in respect of a tradesman electrocuted while fixing a roof.

The exposure from these risks is minimised by a corporate trustee. DBA Lawyers recommend all SMSFs have a sole purpose corporate trustee especially those undertaking a property investment.

New borrowing laws

The new super borrowing provisions bring with them several key changes from 7 July 2010.

Key changes

Only a 'single' asset can be acquired with a borrowing. The conservative view is that a separate borrowing is needed for each title being acquired. However, a collection of assets that are identical and have the same

market value is deemed a single asset (eg, a parcel of ordinary shares in a company).

Refinancing is now allowed. SMSFs can now shop around for a better finance deal. While the new law only applies to arrangements after 6 July 2010 refinancing an old arrangement will subject it to the new law.

Money borrowed for repairs and maintenance of an asset are now allowed. See our July 2010 Borrowing Newsletter for further details: <http://dbalawyers.com.au/index.php?p=NLR>. Certain repairs that improve the form or function of the asset however constitute an improvement and are prohibited.

Guarantees and indemnities can be allowable, subject to certain criteria being met. Accordingly, it's important that the borrowing documentation has been closely checked.

An asset cannot generally be replaced. However, shares, stapled securities and units in a unit trust can be replaced in certain cases.

Main issues with the new law

Properties that come with more than one title may need several borrowing arrangements put in place. This is common with apartments and commercial premises sharing common property or that come with a separate car park as well as farms (as they are often spread over multiple titles).

Check that the documents being used reflect the new law as older templates pose a compliance risk and many are yet to be updated.

Online borrowing seminar

Following the success of DBA's recent borrowing seminars, an invitation will soon issue for our online seminar on SMSF borrowing on 30 September 2010.

SMSF BORROWING MEMO UPDATE

DBA Lawyers' SMSF Borrowing Memo has been updated for the new rules introduced with effect from 7 July 2010. The memo covers the latest positions from the ATO, as well as strategies, tips, traps, tax implications, frequently asked questions and much more.

SMSF FY 2011 Kit

DBA Lawyers have recently updated their SMSF Kit for FY 2011. Updates to the kit include ATO rates and limits for FY 2011 as well as updates in line with the new SMSF borrowing rules. The kit is a useful tool, which flags many issues that should be considered by SMSFs leading for FY 2011.

The above can be ordered online at http://dbalawyers.com.au/download/smsf_documentation_brochure.pdf or by contacting Katrina on 03 9092 9400.

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