

Arm's length transactions

Parliament has recently introduced new tax laws that make it more important than ever for SMSFs to make sure they transact on commercial terms. In this article, we discuss these new laws, which are:

1. New limits on claiming deductions for the costs of holding vacant land from 1 July 2019; and
2. A tax rate of 45% to apply where SMSFs incur expenses at discounted rates from 1 July 2018.

INFO—These changes are additional to the investment rule that requires fund transactions to be conducted at arm's length.

First new law – limiting of deductions that can be claimed for holding vacant land

Some taxpayers (including SMSFs) hold vacant land – for example, an SMSF may own farming land that it leases to a farming business. Alternatively, the fund may own vacant land that it is building new premises on to rent out.

SMSFs with vacant land incur holding costs such as rates, land tax, maintenance costs and interest (i.e., if the fund has a limited recourse borrowing arrangement in place). Traditionally, SMSFs have been able to deduct holding costs if the land was income-earning (unless the asset supports a 'retirement phase' pension).

However, the Government was concerned that some taxpayers were claiming holding costs for vacant land that was not income-producing (e.g., the land was not rented). The Government also wanted to reduce the tax incentives for 'land banking', which delays land from being developed.

To deal with these concerns, the tax laws were changed from 1 July 2019 to restrict deductions for holding costs on vacant land (including for SMSFs). However, a concession in the new law allows holding costs to be claimed if the land is leased out at market rates for use in the lessee's business (but not if the asset supports a 'retirement phase' pension).

Land is taken to be 'vacant' under the new rules if either:

- The land has no 'substantial and permanent structure' (e.g., a shearing shed, grain silo or a home – but not a residential garage on its own as this exists to support a house); and
- The fund is constructing or substantially renovating a residential property on the land which cannot be lawfully occupied. In this case, the SMSF cannot claim any holding costs until the building works are complete, and leased out or made available for rent.

HIGHLIGHTS

ARM'S LENGTH TRANSACTIONS

Two major law changes now in force that affect SMSFs

ATO UPDATE

The ATO to send SMS messages to trustees...but not just yet

TRUSTEE Q & A

I am turning 65 in March 2020 and wish to contribute under the bring-forward rule – Can I do this?

INFO—Any deductions denied under the new rules can be added to the cost base of the land to calculate any capital gain or loss when the land is sold by the SMSF.

EXAMPLE—Isaac is a member of an SMSF which owns a block of land in Brisbane on which it intends to construct a rental property. The fund has engaged an architect to develop plans, and the land has temporary fencing erected on it. As the land does not yet contain a substantial and permanent structure, Isaac's SMSF cannot claim deductions for the cost of holding the land from 1 July 2019.

Exemption – exceptional circumstances apply

A carve-out in the new tax laws ensures that the changes do not adversely impact on SMSFs (and other taxpayers) affected by a natural disaster.

Specifically, an exemption can apply if exceptional circumstances outside of the trustee's control (such as a natural disaster) result in the building or other substantial and permanent structure being destroyed.



“These internal duties are not intended to be caught by the new rules.”

Arm’s length transactions – continued

Exceptional circumstances can include the following:

- A natural disaster (such as a bushfire or flood); or
- A major building fire.

For residential premises, the following additional factors must be present just before they were destroyed:

- The residence must have been capable of occupation; and
- It must have been rented out, or available for rent

INFO–Deductions can be claimed on the basis of the exceptional circumstances above for three years after the event. The Tax Office can extend this time frame further.

Second new law – SMSFs that incur non-arm’s length expenses

Under this change, new rules have been legislated to apply a 45% tax rate to income from arrangements involving SMSFs that incur expenses or buy assets below market rates. The changes apply from 1 July 2018.

By way of background, ‘non-arm’s length income’ is income earned by an SMSF that is **higher** (i.e., inflated) than normal market rates.

This income is taxed at 45% instead of the normal tax rate of 15%, or nil if the fund is in ‘retirement phase’. The higher tax rate is intended to deter trustees from injecting income into their SMSF to shelter it from higher tax rates that apply outside of the super environment.

EXAMPLE–Jim’s SMSF leases a building it owns to his family company to carry on business from. Jim’s fund charges his related company rent of \$50,000 – which is \$20,000 above the market rental of \$30,000. The rental income of \$50,000 is taxed at 45%, instead of 15% (or nil if the fund is in ‘retirement phase’) because it is non-arm’s length income.

When are ‘non-arm’s length expenses’ incurred by SMSFs?

To explain, the Government was concerned that SMSFs could circumvent

the penalty tax rate of 45% on non-arm’s length income by incurring expenses or buying assets at discounted rates (including for free).

Examples of these situations include:

- SMSFs borrowing money from a family structure at discounted interest rates;
- SMSFs buying permitted assets (such as listed shares) from related parties for a cost that is below their true market value; and
- SMSF who outsource activities (such as looking after their rental property) at discounted (or nil) rates to a trustee who has the skills and knowledge in that area (e.g., a real estate agent).

EXAMPLE–Nadia owns business real property worth \$600,000. Her fund buys the property off her for \$400,000. This transaction will be caught by the changes, with any rent and future capital gains taxed at 45%.

What if I do work for the fund as trustee (e.g., do the books or collect the rent)?

These internal duties are not intended to be caught by the new rules. In fact, an SMSF trustee is generally prevented from charging for services or functions carried out as trustee.

This means that the non-arm’s length expense rules will not typically capture situations in which the trustee undertakes bookkeeping services or collects the rent for the fund for no charge.

However, if the trustee’s skill-set (e.g., a real estate agent or an accountant) enables them to perform certain tasks for the fund that would otherwise be outsourced, this could be caught by the new rules if below market rates (or nil) is charged.

TIP–The ATO is consulting on some aspects of these new laws. Google ‘LCR 2019/D3’ and ‘PCG 2019/D6’ to read about the ATO’s initial views and compliance approach.

ATO UPDATE

The ATO is currently checking on the top 100 auditors who audit 33% of all SMSFs. Google ‘QC 60943’ to see more.

Also, the ATO has released a checklist of issues it works through when reviewing the files of an SMSF auditor. Google ‘QC 60044’ to see what the ATO checks.

Recently, the ATO contacted some SMSFs with limited recourse borrowing arrangements to make sure their 2019 tax return was correct. Google ‘60878’.

The ATO has been testing a new security system to send text messages (SMS) to SMSF trustees advising them of any changes to the fund (e.g., contact details). The ATO is still tweaking the system and advises that no alerts have been sent to trustees at this stage. Google ‘QC 60861’.

SMSF trustee Q & A

Question

I turn 65 in March 2020, and I currently work full-time. I am hoping to make a non-concessional contribution of \$300,000 in June 2020 under the bring-forward rule (I had \$700,000 in super at 30 June 2019). Can I do this even though I will be 65 at the time I contribute?

Answer

Yes, you can make a non-concessional contribution in June 2020 even though you will be 65 when you contribute.

You qualify for the three-year bring-forward rule if you meet the following:

- You haven't triggered the bring-forward rule more recently than the 2017 income year.
- You are under 65 on 1 July 2019 – **you meet this condition;**
- Your total superannuation balance

on 30 June 2019 was below \$1.4 million – **you meet this requirement.**

Although you meet the bring-forward rule, you also need to check that the fund can accept the contribution (i.e., you will be subject to work test as you will be 65 at the time of contributing).

In this regard, you meet the work test if you work at least 40 hours in 30 consecutive days in the 2020 income year. Based on the facts above, you meet this test.

You also need to be mindful that the contribution generally counts towards your cap in the income year that the fund receives it. Contribute well in advance of 30 June 2020 to allow enough time for the contribution to clear the fund's bank account.

INFO—Additional super law issues apply if you were to contribute by transferring an asset into the fund.

Question

My fund owns shares on the ASX that I wish to sell to myself, rather than on the open market. I am 40 years of age, is it possible to do this?

Answer

Yes, your SMSF can sell the shares to you – provided the transaction is properly documented and the shares are sold to you at market value.

Unlike contributing to a fund, the super laws don't generally prohibit the transfer of an asset to a related party of the fund, such as yourself as member.

However, your fund is required by law to ensure that all transactions occur on arm's length terms. This means that the fund should not provide you with a discount or extended payment terms.

Any tax issues (e.g., capital gains tax) should also be addressed.

Key dates and reminders

28 Feb 2020

Tax return and payment due date for new SMSFs lodged via a tax agent, unless the ATO advised the fund upon its initial registration of a due date of 31 October 2019.

28 April 2020

Quarterly TBAR due for affected SMSFs with a reportable event occurring during the quarter ended 31 March 2020. Quarterly reporting applies to SMSFs with a member over the \$1m threshold with a reportable event.

28 April 2020

Due date for SMSFs where a tax return is not required at an earlier date and the SMSF is not eligible for the 5 June concessional lodgement date.

Auditing your fund – reminder for trustees

We remind trustees that all SMSFs are (by law) required to be audited annually – with no exceptions. This means that your SMSF must still be audited if the fund was 'dormant' (e.g., no contributions were made to the fund).

Crucial dates to bear in mind regarding the audit of your fund are as follows:

- An SMSF auditor must be appointed no later than 45 days before your SMSF return is due to be lodged.
- Any additional information requested in writing by your SMSF auditor must be given to them within 14 days.

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