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**Summary**

In certain circumstances, a SMSF may find that its income is taxable at a rate of 45%. Non-arms length income generally arises where a SMSF and other parties are not dealing on an arms-length basis, or where dividends are received from a private company. Bryce Figot and Daniel Butler have generously provided the following article for distribution to our network.

## SMSFs Non Arm's Length (Special) Income

### The Key 'Must Know Elements'

By Bryce Figot ([bfigot@dbalawyers.com.au](mailto:bfigot@dbalawyers.com.au)) and Daniel Butler ([dbutler@dbalawyers.com.au](mailto:dbutler@dbalawyers.com.au))

### Introduction

A recent AAT decision reminds us that there are several elements of non-arm's length income that all practitioners must be aware of. This is especially relevant where superannuation fund trustees have invested in related unit trusts. (Note that prior to 1 July 2007, 'non-arm's length income' was called 'special income'.)

### Background information

Superannuation fund income which is non-arm's length income is subject to income tax at 45% (not the usual 15%). Income is non-arm's length income if:

- it is derived from a scheme where the parties were not dealing at arm's length and the amount of the income is more than the amount that would have received if they were dealing at arm's length; or
- it is a private company dividend (unless the Commissioner deems the dividend not be non-arm's length income).

### Facts of the AAT decision

In 1995 a superannuation fund trustee acquired 4% of the shares in a private company from Mrs C. There was a 'relationship' between the director of the superannuation fund trustee and Mrs C's husband who controlled the private company. The acquisition price was only 10% of the shares' market value. The superannuation fund trustee conceded that the price at which it acquired the shares was not an arm's length price. The private company was a passive holding company that held shares in a listed public company. Over the years, the listed public company paid dividends to its shareholders, including the private company. The private company then paid these dividends to its shareholders, including the superannuation fund trustee. All of the dividends paid by the public listed company and the private company were proportional to the shares held. Specifically, the superannuation fund trustee paid \$51,218 for the shares in 1995, which had a market value of around \$594,136. The dividends from the shares were as follows:

- year ending 30 June 1996 — the amount of \$26,400;
- year ending 30 June 1997 — the amount of \$208,136;
- year ending 30 June 1998 — the amount of \$140,000;
- year ending 30 June 1999 — the amount of \$125,200
- year ending 30 June 2000 — the amount of \$143,720;
- year ending 30 June 2001 — the amount of \$143,720;
- year ending 30 June 2002 — the amount of \$86,320; and
- year ending 30 June 2003 — the amount of \$76,640.

The superannuation fund's investment in the private company was recouped in a short time frame and as can be seen above, substantial dividends flowed. As these facts arose prior to 1 July 2007, the relevant legislation referred to special income. If the facts arose today, the relevant legislation would refer to non-arm's length income.

As the dividends were from a private company, the dividends received by the superannuation fund trustee constituted special income. However, the Commissioner of Taxation may determine otherwise, having regard to certain factors. Those factors include:

- factor (a): the value of the shares; and
- factor (f): any other matters that the Commissioner considers relevant.

The Commissioner declined to exclude the dividends from being special income. The superannuation fund trustee objected to the AAT.

The Commissioner had stated in a taxation ruling that 'value' in factor (a) means 'market value'. A major argument by the superannuation fund trustee was that the Commissioner was wrong to state in his tax ruling that 'value' in factor (a) means 'market value'. The superannuation fund trustee won on this point, with the AAT stating 'the Ruling is in this particular regard incorrect'. However, market value was still relevant for factor (f).

The superannuation fund trustee argued that if the AAT decided the matter in favour of the Commissioner, the 'tainting effect' arising from the acquisition of assets for less than market value would endure indefinitely, and that this consequence could not have been intended. However, the AAT rejected this argument. They found that the underlying transaction that gave rise to the relevant income could not be divorced from the income itself.

Accordingly, the AAT affirmed the Commissioner's decision and the dividends constituted special income.

For the full text of this decision, email the author at [bfigot@dbalawyers.com.au](mailto:bfigot@dbalawyers.com.au).

### **Implications of the decision: the tainting effect**

The decision suggests that if an asset is ever acquired on other than arm's length's length terms that will taint all associated income forever. Also, this principle applies to other investments that can result in non-arm's length income being derived from investments in trusts.

For example, consider a situation where an SMSF trustee purchases 500,000 units in a brand new unit trust for \$500,000 and an SMSF member also personally purchases 500,000 units for \$500,000. The unit trust trustee uses this money to acquire a \$1 million property. The property increases in value to \$1.5 million. The unit trust trustee needs further cash for repairs. The SMSF trustee wants to invest a further \$50,000 to fund the repairs. The unit trust trustee issues the SMSF trustee 50,000 units for \$50,000 each (ie, \$1 per unit). Because the real estate increased in value, \$1 per unit is no longer an arm's price for a unit. The arm's length price is now \$1.5 per unit.

Because of this, at least some of the income that the SMSF trustee now receives from the unit trust trustee (and arguably all of the income) is non-arm's length income and will be subject to income tax at 45%. This situation could have been avoided if the SMSF trustee had acquired 33,333 units instead of 50,000 in exchange for its \$50,000.

### **What does 'arm's length' actually mean?**

There are two different definitions of 'arm's length'. One is applied for the superannuation prudential rules (eg, the arm's length requirements in s 109 of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA')). The other is applied for income tax legislation purposes (eg, to determine whether income is special income).

For superannuation prudential rules, case law has defined arm's length as follows:  
... it plainly implies a dealing that is carried out on commercial terms ... a useful test to apply is whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment.

For income tax law, case law has defined arm's length as follows:

the term 'at arm's length' means, at least, that the parties to a transaction have acted severally and independently in forming their bargain ... That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.

### **The pension exemption**

When a superannuation fund trustee commences paying a pension, typically, income derived by the assets supporting the pension become income tax free. This is referred to as the 'pension exemption'. Some have asked whether the pension exemption can be used to overcome the effects of non-arm's length income. The short answer is no because the pension exemption expressly does not apply to non-arm's length income.

### **Practical implications**

In light of the AAT decision, practitioners should:

- Ensure that all future SMSF transactions are at arm's length.
- Check that any previous SMSF transactions that are still giving rise to income today were at arm's length.
- Ensure that sufficient evidence is retained to prove the above.
- Remember that a transaction can still not be at arm's length even if the other party is not related.

Bryce Figot is a senior associate and Daniel Butler is a director at leading SMSF law firm DBA Lawyers ([www.dbalawyers.com.au](http://www.dbalawyers.com.au)). This article is general information only and should not be relied upon without first seeking advice from an appropriately qualified professional.

Note: DBA Lawyers will be presenting at an SMSF seminar at venues all around Australia in November 2009. For more details or to register, visit [www.dbabutler.com.au/index.php?p=DNW](http://www.dbabutler.com.au/index.php?p=DNW) or call Marie on 03 9092 9400.

Regards

#### **Peter Kelly**

National Technical Services Manager

**Professional Investment Services Pty Ltd**

Level 14

Corporate Centre

Cnr Bundall Rd & Slatyer Ave

Bundall QLD 4217

Phone: 07 5574 0244

Fax: 07 5574 1846

Mobile: 0408 703 964

Email: [PeterK@profinvest.com.au](mailto:PeterK@profinvest.com.au)

Web: [www.profinvest.com.au](http://www.profinvest.com.au)

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