SMSFR 2009/3EC - Compendium

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Ruling Compendium – SMSFR 2009/3

This is a compendium of responses to the issues raised by external parties to draft SMSFR 2008/D1 – Self Managed Superannuation Funds: application of the *Superannuation Industry (Supervision) Act 1993* to unpaid trust distributions payable to a Self Managed Superannuation Fund

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	Tax Office Response/Action taken
1	As there is no 'tax mischief' associated with unpaid present entitlement amounts between related parties, I think that this draft ruling is unnecessarily prescriptive and could even be interpreted as the manufacturing of a compliance issue.	The existence of substantial unpaid trust distributions effectively increases the level of the SMSFs assets tied up within a related trust. Tax Office compliance activity has identified some SMSFs in which nearly all of the assets of an SMSF are held in related trusts either in the form of direct investment or unpaid entitlements. The Tax Office considers that the view contained in the ruling is defensible and consistent with the policy intention contained in Part 8 of the *Superannuation Industry (Supervision) Act 1993* (SISA). *No action required.*
2	UPP's[1] are 'at call' and therefore the superfund should be in a position to call in the cash distribution at any stage.	Although the unpaid trust entitlement is available on demand, this does not preclude the existence of an arrangement whereby the 'calling in' of these amounts is deferred. *No action required.*

[1] We take this to mean unpaid present entitlements

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3	By stating that the superfund should negotiate an interest payment on the UPP (this) will change the character to that of a loan which is a clear compliance breach.	The payment of interest or otherwise is not critical to the characterisation of an arrangement as a loan for the purposes of Part 8 of the SISA. The reference to interest is part of the general comments on the potential application of section 109 when entitlements are allowed to remain unpaid for no compensation. *No action required.*
4	The draft ruling seems to assume that the superfund would use the cash proceeds in an income generating activity that would be more beneficial than having the amount held in the trust.	In respect of the question of whether the unpaid trust amount is a loan for the purposes of the in-house asset rules, the question of whether the unpaid amount could be better employed by the SMSF is not relevant. The in-house asset rules are concerned with keeping the level of assets in related parties or trusts to a specified level. In respect of potential breaches of the arm's length rules in subsection 109(1A) and the sole purpose test in section 62, no assumptions are intended to be inferred about alternative investment opportunities. All of the facts and circumstances need to be taken into account in any assessment of whether the maintenance of an SMSF satisfies the sole purpose test. However, circumstances where fund entitlements are deferred and this provides benefits to a related party are relevant to such an assessment. *No action required.*
5	In order to constitute a loan, there needs to be a clear, demonstrable intention by the parties that the UPE be a loan to the related trust. The term 'loan' is defined broadly in section 10 of the SISA. However, this does not alter the view that there must actually be an intention for a UPE to be treated as a loan, credit or other form of 'financial accommodation' as described in that definition.	The Tax Office agrees that, to have formed agreement, the parties must have intended that a loan, provision of credit or financial accommodation would be provided. However, the Tax Office believes that such an intention can be demonstrated not just from formal documentation created, but also by an objective examination of the facts of each case.

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	Moreover, the definition of the word 'loan' in section 10 of SISA cannot be read in isolation but must be read in conjunction with relevant sections of SISA (for example section 65) so that it is interpreted in the proper context. Under section 65 of SISA, a trustee or investment manager 'must not … lend money of the fund… or give any other financial assistance using the resources of the fund' to a member or a relative. The wording requires an act on behalf of the trustee or investment manager. It must 'lend' or 'give'. Failing to claim a UPE is not an action. It is purely passive. Moreover, it does not involve 'money of the fund' or 'resources of the fund'. Until the UPE is called up, the money or resources belong to the trust which has conferred the UPE on the SMSF. That trust retains title to its money and resources pending payment of the UPE.	The Tax Office agrees that the word 'loan' in section 10 should not be read in isolation and should be interpreted in its proper context. This is specifically noted in paragraphs 91 to 98 of the final ruling (paragraphs 65 to 72 of SMSF 2008/D1). However, the Tax Office believes that little contextual benefit can be gained from consideration of section 65. Section 65 was included in the original 1993 enactment and has always co-existed with in-house asset rules in Part 8. Section 65 is concerned with actions of the trustee of the fund and is therefore triggered by a specific activity. The in-house asset rules are primarily concerned with limiting the level of in-house assets held by the fund. To this end, it concentrates primarily on the identification of the level of in-house assets held by the fund, not on the specific actions which bring about the existence of those in-house assets. *No action required.*
6	Documentation such as a loan agreement would be clear evidence of an intention to make a loan. However, there is concern that the draft Ruling goes too far in inferring this intention from the circumstances surrounding an UPE. In particular, the ATO appears to draw this inference from factors which are incidental and not determinative of whether there is a 'loan'. In example 1, it is stated at paragraph 26 that a loan arrangement can be inferred from the two trusts having the same trustee, the substantial amounts of distributions and the time frame of deferral. This should not lead to the conclusion that there is a loan: the mere identity of the parties, amount of money involved and duration of the UPE are not, on their own, evidence of any intention for there to be a loan at law.	The Tax Office is of the view that the circumstances surrounding the failure of the SMSF to obtain payment of present entitlements from a trust fund in which it holds an investment may enable it to be concluded that a financial accommodation is being provided by the SMSF. In addition, the Tax Office believes that the factors listed in paragraph 101 (paragraph 73 of SMSFR 2008/D1) are relevant to determining whether such an arrangement between the trustee of the SMSF and the trustee of the trust exists. The final ruling does not state that any one factor will be determinative. Rather it states at paragraph 103 (paragraph 75 of SMSFR 2008/D1) that it is consideration of all of the circumstances which may allow such a conclusion to be reached. *No action required.*

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	It is submitted that the duration of the UPE is not determinative of whether there is actually any intention of a loan. There is no time limit on claiming UPE.	
7	Even having regard in isolation to the definition of 'loan' in section 10 of the SISA is not convincing of a UPE being a loan. It refers to the 'provision of credit or any other form of financial accommodation'. The word 'provision' is important and cannot be overlooked. To 'provide' requires a positive act. However, a UPE is an indefeasible claim that arises by operation of law pursuant to the trust deed without the SMSF having to do anything. The SMSF is completely passive/inactive. It is not providing anything. The UPE arises without it doing anything. Simply because it is a unit holder, it is entitled. Moreover, it is unpaid for the very reason that the SMSF is doing nothing at all to claim the UPE.	The basis of the Tax Office view explained in paragraphs 88 to 95 of the final ruling (paragraphs 62 to 77 of SMSFR 2008/D1) is that an arrangement between the trustee of the SMSF and the trustee of the unit trust for forbearance from demanding payment of the trust distribution will exist in certain circumstances. The Tax Office is of the view that this arrangement would constitute a sufficient act of providing the financial accommodation if this was required by the definition. *No action required.*
8	In practice, the failure of an SMSF trustee to seek payment of a UPE is not because there is an intention to financially assist the trust. It is because the UPE is vested and indefeasible and, therefore, cannot be taken away. This rock solid equitable entitlement (which is much stronger than the rights of a lender) will leave many SMSF trustees comfortable and relaxed about not calling it up until the money is needed by the SMSF. The trustee of the trust has a fiduciary duty to pay the UPE. Repayment of a loan or other financial assistance is not a fiduciary obligation of the borrower.	The Tax Office believes that the intention or purpose of the SMSF trustee in leaving the present entitlements unpaid for extended periods of time is not directly relevant to determining whether the outstanding amount is a 'loan' for the in-house asset rules. However, the affect of allowing this amount to remain available for the use of the trust fund may amount to a financial accommodation. Relevantly, notwithstanding the preferred status which the unpaid trust entitlement has over unsecured creditors of the trust, this unpaid entitlement still represents an amount of the assets of the SMSF which are in a related party or related trust. This is in direct conflict with the stated policy objects referred to in paragraphs 96 and 97 of the final ruling (paragraphs 70 and 71 of SMSFR 2008/D1). *No action required.*

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9	The fact that it is intended that a UPE be paid at some later time does not give it the quality of a loan 'repayment'. If it has not been paid by the SMSF to the trust, it cannot be repaid. To suggest that it is a repayment distorts what is actually happening and is a fiction.	The Tax Office acknowledges that the ordinary meaning of the term 'loan' involves arrangements for the payment and repayment of an amount. This is discussed in paragraphs 77 to 87 of the final ruling (paragraphs 51 to 61 of SMSFR 2008/D1). However, the Tax Office is of the view that the definition of 'loan' in subsection 10(1) expands the types of arrangements which fall within this extended definition and consequently the elements of payment and repayment are not essential. This is explained in paragraphs 88 to 105 of the final ruling (paragraphs 62 to 77 of SMSFR 2008/D1). *No action required.*
10	Disagree that a pattern of deferring payments over several years is evidence that a particular deferral is a loan. If anything, this is evidence that this is the usual course of conduct by the SMSF trustee and that it is normal in practice to have some period of deferral before the trustee seeks payment.	The Tax Office agrees that a pattern of deferring payment of trust entitlements may point towards the normal course of conduct of the SMSF trustee in respect of distributions from the trust. However, the Tax Office does not agree that this detracts from the conclusion that arrangements for financial accommodation exist in respect of those unpaid amounts. Rather, the Tax Office believes that this may assist in concluding that the delay in obtaining payment each year is due to a conscious, deliberate and re-occurring arrangement that those entitlements not be paid for an extended period of time – see Example 1. *No action required.*

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11	Example 2 in the draft Ruling indicates that the ATO would not be concerned about a payment of an UPE within a 30 day period. This is concerning as, normally, at least 12 months is required after year end for the amount to be communicated to the SMSF trustee and acted upon. It is suggested that a period of, say, 24 months after the end of a particular financial year is more appropriate for Example 2. However, as discussed above, it is not of any consequence if a longer period applies. Trust Law imposes no time limit on claiming a UPE. The ATO's proposal for a time period invents a time constraint that is unknown to trust law and is not a statutory requirement.	The Tax Office agrees that often the amount of the trust distribution will not be ascertained until some time after the end of the financial year when the accounts of the trust are finalised. However, the amount of the trust distribution must be known at the time when the relevant income tax returns are lodged and therefore it would be expected that payment of that amount would normally occur within a reasonable time afterwards. The Tax Office therefore does not accept that a period of 24 months after the end of the financial year is appropriate. The Tax Office does not agree that time is irrelevant. It is the exercise of the choice to obtain payment, or rather the failure to exercise this choice within a reasonable time, which leads to the conclusion that an arrangement for the provision of a financial accommodation exists. The extent of the delay in exercising the right to demand payment of the distribution therefore is highly relevant to reaching this conclusion. *Example 2 has been revised to allow for the ascertainment of the actual trust distribution payable prior to payment.*
12	It is considered that the recording of a UPE as a 'loan' in the SMSF and trust accounts should not be given any significance as this is an incorrect accounting practice that arises from imperfect knowledge about equitable entitlements. If a UPE is incorrectly described as a loan in the accounts this will not change its essential character as a trust entitlement: *Eurasian Holdings Pty Ltd v Ron Diamond Plumbing Pty Ltd* (1996) 14 ACLC 502, at 504; *CIR (NZ) v Ward* 69 ATC 6050, at 6071.	The Tax Office agrees with this point at paragraphs 6 and 67 of the final ruling (paragraphs 5 and 41 of SMSFR 2008/D1). *No action required.*

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13	The UPE issue has also been addressed in relation to Division 7A (particularly the former section 109UB of *Income Tax Assessment Act 1936*). It is an accepted position that a UPE is not a loan for Division 7A purposes within the definition of 'loan' in Section 109D(3) of the ITAA 1936. Division 7A has been shaped on this foundation stone and it is fundamental to the operation of former Section 109UB and current Subdivision EA of Division 7A.	The Tax Office believes that the definition of 'loan' in subsection 10(1) of the SISA, read in the context of Part 8 and the Act as a whole, does include unpaid trust distributions in the circumstances set out in the draft ruling. This ruling does not consider the interpretation of similar definitions in other Legislation administered by the Commissioner of Taxation. The explanation of the circumstances where the Commissioner is of the view that an unpaid trust distribution amounts to a loan for the purposes of Part 8 of the SISA has been amended to further clarify the reasons for this view. This revised explanation is contained in paragraphs 88 to 103 of the ruling. The views expressed in this ruling do not affect the Tax Office view of the operation of Division 7A of the *Income Tax Assessment Act 1936*. *A new paragraph 3 has been included to emphasise that the views expressed in the ruling are only in the context of the SISA.*
14	While the essence of a loan is payment of money on condition that it will be repaid at a future point in time, the circumstances of the payment and conditions of repayment must be considered before it can be determined that it was a loan. The draft ruling does not provide sufficient guidance for the circumstances in which a loan will or will not arise where there is an unpaid trust distribution.	The ruling discusses the characteristics of a 'loan' using its general meaning and concludes that the trustee of a superannuation fund could enter into a formal agreement for a loan with the trustee of the distributing trust. Although general contract law requires many factors to be considered when construing any agreement, it is believed that to attempt to discuss these considerations within this ruling would add too much complexity to this part of the ruling. Rather, in the circumstances where a formal loan agreement is entered into it would be expected that the intended rights and obligations of the parties involved would be evidenced in written documents.

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	The draft ruling simply says at paragraphs 5 to 7 that it is possible that an unpaid trust distribution may be a loan and cites an example of an execution of a loan agreement and it is agreed that an execution of a loan agreement is very strong evidence that a loan exists. However, the draft ruling should set out a range of circumstances to give greater guidance to Trustees as to when it is more likely that a loan would exist and more likely that it would not. The factors that should be taken into account would include the following: (a) evidence of intention in relation to the reason for non payment of the Trust Distribution; (b) the manner of reporting of the unpaid trust distribution; (c) whether a loan agreement is in existence; (d) any other documents executed by the parties evidencing the circumstances of the unpaid trust distribution.	We believe that the factors mentioned are adequately covered in the ruling. Specifically, paragraphs 101 to 103 of the final ruling (paragraphs 73 to 75 of SMSFR 2008/D1) discuss the factors from which it might be concluded that an arrangement for financial accommodation exists. These paragraphs have been revised in the final ruling to add further clarity. It is believed that in the majority of cases it will be unusual for any documentary evidence to exist which might explain the reasons for the delay in making payments. However, an additional dot point has been added to paragraph 101 of the final ruling (paragraph 73 of SMSFR 2008/D1). As discussed in paragraphs 6 and 67 of the final ruling (paragraphs 5 and 41 of SMSFR 2008/D1), the manner of reporting of the trust distribution will generally not assist in determining the character of the unpaid amount. *No action required.*
15	The draft ruling too readily concludes that an unpaid trust distribution will be a loan.	Paragraphs 101 to 104 of the final ruling (paragraphs 73 to 76 of SMSFR 2008/D1) have been re-written to further clarify the Tax Office view of when an unpaid trust distribution will be a ‘loan’. However, the Tax Office view has not been altered.

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16	The discussion in paragraphs 83 - 88 of the draft ruling too readily concludes that an unpaid trust distribution can be an investment. The meaning of investment has been considered at the AAT level in *Qx95b and Qx95c v the Insurance Superannuation Commissioner* [1996] AATA 81 (1 March 1996). While this was a case considering the meaning of investment and the in-house assets under the Occupational Superannuation Standards Regulations, it conveniently collects the authorities in relation to the meaning of the term investment. At paragraph 78 it was concluded that investment can have a broader and narrower meaning. The meaning adopted will depend on the context.	The Tax Office has considered the case referred to in addition to other cases discussing the concept of 'investment'. However, as noted, the case considers previous legislation which significantly, did not include a definition of 'invest'. *The Tax Office has reviewed the explanation of when an unpaid trust distribution will become an investment in a related trust in paragraphs 112 to 118 of the final ruling. The ATO is of the view that the final ruling correctly applies the relevant legislation and reflects the intended operation of these provisions.*
17	Paragraph 9 states that failure to enforce the equitable right to payment does not amount to an investment. The concept of an equitable right to payment is introduced early in the draft ruling but it is not a concept that lends itself to being readily understood. An equitable right stands in contrast to a legal right and will arise in circumstances where the parties have conducted themselves to lead to the belief that an investment has been made.	*A footnote has been added to paragraph 11 of the final ruling to refer the reader to the explanation of the nature of trust distributions contained in paragraphs 64 to 70 of the final ruling (paragraphs 38 to 44 of SMSFR 2008/D1).*

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18	Paragraph 10 states that an acceptance of payment in the form of additional units will amount to an investment. The draft ruling too readily concludes that an investment will have occurred in the circumstances of payment of additional units. Whether there is an investment will depend on all the circumstances of the case. The draft ruling should provide greater guidance to trustees to guide them in circumstances where there is an unpaid distribution to avoid contravening the investment rules under the SISA.	The term 'invest' is defined in subsection 10(1) to mean: (a) apply assets in any way; or (b) make a contract; for the purpose of gaining interest, income, profit or gain. In light of this, the Tax Office is of the view that the discharging of an unpaid trust distribution through the issue of new units in the trust is the application of an asset of the SMSF for the purpose of gaining interest, income, profit or gain. *No action required.*
19	At paragraph 14, the Commissioner's view is that an arm's length beneficiary would not allow substantial amounts of distribution entitlements to remain unpaid. While this is certainly indicative that the arrangement is not an arm's length arrangement, there are other factors that should be taken into account to determine whether the circumstances of the unpaid trust distribution have contravened section 109. Greater guidance should be provided to Trustees to determine whether the arrangement is an arm's length arrangement or not.	Paragraphs 27 and 28 of the final ruling (paragraph 14 of SMSFR 2008/D1) discuss the failure to seek payment of trust distributions in greater detail than this comment indicates. In addition, they should not be read in isolation but should be read together with paragraph 26 (paragraph 13 of SMSFR 2008/D1) and the explanation contained in paragraphs 144 to 155 (paragraphs 93 to 106 of SMSFR 2008/D1). Finally, section 109 does not provide a detailed prescription of any factors to be considered, but rather sets a broad requirement that dealings with non-arm's length parties are conducted on the same basis that they would be with arm's length parties. The explanation in the ruling has been further expanded and the Tax Office believes that it provides an appropriate discussion of factors that it will consider when determining if this subsection has been contravened. *Further clarification added.*

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20	The sole purpose test is a test that, in the past, has been productive of much confusion. This arises because it is a discretionary test having regard to all circumstances of the case. It is a difficult subject and the draft ruling does not do justice to this complex area of superannuation law.	The ruling emphasises that compliance with the sole purpose test is determined having regard to the overall conduct of the SMSF and refers the reader to SMSFR 2008/2 which specifically addresses application of this test. The ruling therefore only seeks to highlight that the maintenance of substantial amounts of unpaid trust distributions would be a factor which would be in favour of concluding that the fund may not be carried on for the requisite purposes. *No action required.*