The perils of buying property for super

DIY super

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One of the special entitlements available to a do-it-yourself superannuation fund is investing in a property from which a related party of the fund is running a business.

A related party is a member of the fund, which also makes them an individual trustee or director of the trustee company, a relative of a member or trustee, or any entity – such as a company or trust that any of those parties control, individually or as a group.

The strategy is fine if it can be implemented in a fairly clean way by someone who is easily able to make contributions to super – with no age restriction, for instance – or has adequate fund resources to complete the transaction, if necessary. However it's a totally different story where layers of complexity are introduced. An example would be if the property is owned by someone who is ineligible for small business tax concessions, or has significant debt, or is held in a structure where acquisition by a super fund may not be possible or comes with major strings attached.

The strategy doesn't need the complications and challenges highlighted by a reader. He says the property contribution he'd like to make to his DIY fund comes in the form of a 45 per cent interest in a hybrid trust that owns a warehouse valued at $5.9 million, of which $1 million is a capital gain and $3.9 million is owed to the bank.

The warehouse is used in an $8 million family business in which he is a shareholder, although he has just turned 70 and considers himself retired. The other hybrid trust investors are his son, who has a 45 per cent interest, and an employee of the family business.

Can he roll his hybrid trust property investment into the DIY fund, he asks, and can it be tax-exempt?

The challenge with the reader's question, says Graeme Colley, national technical manager with the SMSF Professionals' Association, starts with the fact that the property is owned through a hybrid trust, a complicated structure used mainly for tax management, that has similarities to a family trust. These are arrangements where certain beneficiaries can have a fixed entitlement to the investment returns and others can receive their return on a discretionary basis.

"Discretionary" means they may or may not receive income every year, or profits when an investment is sold,

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and whether they do is up to the trustees running the hybrid trust.

As a general rule, a super fund can only acquire an interest in a trust where parties who are related control at least 50 per cent of the trust, with fixed entitlements to trust capital or income. If so, while a fund is allowed to acquire what is called a related party interest in the trust, this entitlement is restricted by a requirement that the investments must satisfy super's in-house asset rules. They stipulate that where the acquisition is from a related party trust, it can't be worth more than 5 per cent of the market value of all the fund's investments.

These rules, Colley says, are only part of the complexity of having a hybrid trust. If the fund happens to satisfy the related party rule and go ahead with the acquisition, the possibility that part of any income or profit could be linked to a discretionary distribution means the income will be taxed at 45 per cent as non-arm's length income of the super fund, under section 295-550 of the Income Tax Assessment Act 1997.

This provision would apply irrespective of whether the investment in the hybrid trust was held in the accumulation or pension phase of the super fund. Generally, income earned on super fund assets that are used to support a pension are tax-free, but if the income is non-arm's length, it will be taxed at 45 per cent in all cases, including tax on any capital gains realised when a property is sold for a profit. This treatment of hybrid trust income was confirmed in a 2012 Administrative Appeals Tribunal case (AATA 527, Ghali v the Commissioner of Taxation). It's a measure, Colley says, aimed at discouraging anyone with a hybrid or family trust who can pay discretionary distributions from combining this with a super fund.

To the question about whether the property interest can be rolled tax-exempt into the DIY fund, accountant Aaron Dunn of the SMSF Academy sees other problems with the reader's strategy. The debt with a charge by the lender over the property would likely prevent the units from being acquired by the fund. Being able to claim the generous small business tax concessions is also a potential problem, given there is a $2 million business turnover test and a $6 million net asset value test that must be satisfied to claim these attractive tax breaks.

Last, but not least, is the limited scope to make any major contribution to super, due to the $150,000 non-concessional contribution cap. There is also the requirement for anyone who is older than 65 to meet a work test to be able to contribute to super.