



A holistic approach to SMSF property compliance

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Property investment within SMSFs remains a popular strategy for building retirement wealth. Compliance in this area, however, requires a holistic approach to ensure that SMSFs operate within the legal framework administered by the Australian Taxation Office (ATO) and the Australian Securities and Investments Commission (ASIC).

One of the problems is that SMSF trustees investing in property do not appreciate how the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and *Superannuation Industry (Supervision) Regulations 1994* (SISR) interact.

Areas that can cause the most concern are the sole purpose test, the non-arm's length income (NALI) provisions, market value implications and property development.

The sole purpose test

The sole purpose test lies at the heart of a complying SMSF as outlined in section 62 of the SIS Act. It mandates that an SMSF must be maintained solely to provide retirement benefits to its members or their dependents in the event of a member's death.

Until then, SMSF assets must not be misused for personal or business purposes unrelated to retirement benefits. Breaches of the sole purpose test can have severe repercussions because an SMSF can risk losing its complying status and be subject to higher taxation rates.

Non-compliance may arise from various scenarios, such as:

- occupying residential property by a related party for personal purposes
- undertaking property development activities where transactions are not at arm's length
- leasing business real property at market rates if used by related parties.

Where the trustees of an SMSF are involved in property development ventures in various capacities, they must demonstrate that their decision-making is solely pursuing the retirement purpose of the SMSF and is not influenced by other goals or objectives concerning those business or other entities.

Non-arm's length income (NALI)

NALI is another critical area of compliance for SMSFs. The NALI provisions, detailed in section 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997), target income derived from arrangements not conducted on commercial terms.

NALI acts as a powerful deterrent against arrangements that could unfairly increase member entitlements. Where income is classified as NALI, it is taxed at the highest marginal rate instead of the concessional superannuation tax rate of 15%.

Identifying NALI involves examining transactions to ensure they are conducted on arm's length terms. For example, if an SMSF acquires an asset for less than its market value or receives income

under non-commercial terms, such arrangements may be deemed non-arm's length triggering the NALI provisions.

Implications for property development projects

NALI provisions are particularly relevant in the context of property development projects.

The ATO has flagged concerns about property development arrangements where income gets diverted to SMSFs through non-arm's length dealings in:

- SMSFRB 2020/1: *Self-managed superannuation funds and property development*
- Taxpayer Alert TA 2023/2: *Diverting profits of a property development project to a self-managed superannuation fund, through use of a special purpose vehicle, involving non-arm's length arrangements.*

For instance, SMSFs may hold direct or indirect interests in entities that invest in property development projects that engage in non-arm's length transactions, such as entering into loans with related parties at a 0% interest rate, to maximise profits.

Market value and its role

Market value is central in determining compliance with the sole purpose test and NALI provisions.

Regulation 8.02B SISR requires SMSF trustees to value all assets at market value when preparing financial statements every year. The ATO says a valuation will be fair and reasonable if it takes into account all the relevant factors and considerations that are likely to affect the value of an asset.

Accordingly, not only should the valuation be undertaken in good faith, but it should also be a rational and reasoned process. SMSF trustees must be able to explain the valuation in terms of the methodology and evidence to an independent third party.

It means that trustees are obliged to document what value has been adopted and how that value has been determined.

It would be difficult to perceive a situation where a vendor would sell a property to an unrelated party based on an outdated market valuation. The test is whether a prudent person, acting with due regard to their own commercial interests, would have agreed to the terms.

The NALI provisions are triggered when a property transfer or sale is made at less or more than market value because the parties are not dealing with each other at arm's length.

What does the ATO want?

The ATO will accept a trustee valuation if:

- it does not conflict with its valuation guidelines or market valuation for tax purposes guide
- SMSF trustees do not use different valuations for different purposes, such as a low one for a CGT event and a higher one for the financials, because the fund has in-house assets
- it is based on objective and supportable data.

The ATO also advises that SMSF trustees should

consider an independent qualified formal valuation if the asset value is a significant portion of the fund's value, the valuation could be complex or difficult, or a significant event has occurred.

A significant event includes a natural disaster, market volatility, a macroeconomic event, such as a major hike in interest rates, or substantial changes to the character of property because of renovation or repair.

Most importantly, where the ATO disagrees with a valuation, it will apply the appropriate method to an amended value, which can affect non-arm's length income, transfer balance caps and total super balances. Penalties may apply as a result.

Consistency and objectivity in market valuations are paramount to avoid disputes with the ATO.

Market valuation options

Property owned within an SMSF does not require an annual independent market valuation.

SMSF trustees, however, must undertake research and produce evidence in the form of supportable and objective data each year to show how they arrived at the property's market value.

For example, trustees could source the market value of the property through a property report, comparable sales or other evidence. The cost of property purchased during the audit year at arm's length may be acceptable audit evidence depending on when it was purchased.

While the value could remain the same in the subsequent year, the trustees must be able to provide evidence and objectively demonstrate precisely how and why they have continued to rely on that valuation.

Other valuation methodologies can include:

- the value of similar properties with recent comparable sales results
- the amount that was paid for the property in an arm's length market – if the purchase was recent and no events have materially affected its value since the time of purchase
- an independent appraisal from a real estate agent (kerbside)
- whether the property has undergone improvements since it was last valued
- rates notice—if consistent with other valuation evidence
- for commercial properties, net income yields—not sufficient evidence on their own and only appropriate where tenants are unrelated.

While not a requirement of the SISA, SISR or the auditing standards, the ATO considers a valuation insufficient if it is based on only one item of evidence from the above list.

Where a valuation states the methodology used, such as comparable sales, the evidence must be attached.

Online valuations may be used for residential property only, with the data generated from an automated service as an estimated value. Under these circumstances, the sales history used in the valuation must include similar properties. The auditor will also check that the valuation range is not too broad; otherwise, the value could be meaningless.



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Shelley is head of Technical and an accredited SMSF specialist with 15+ years in superannuation and a renowned expert in SMSF compliance. She offers strategic advice, quality training, and education to private and public sectors. A frequent presenter at industry conferences, Shelley is a respected author and sought-after commentator.



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Impact of market value on NALI

The link between market value and NALI is critical. If an SMSF purchases an asset that is less than the market value, the difference is considered non-arm's length income in line with Law Companion Ruling 2021/2: *Non-arm's length income – expenditure incurred under a non-arm's length arrangement.*

For example, if a purchase contract states that the fund is the purchaser, but the fund physically pays less than the amount on the contract, this discrepancy triggers NALI provisions.

The ATO has clarified that such differences are not considered in-specie contributions but rather as paying less than market value, leading to NALI consequences.

Property development considerations

No specific prohibitions prevent an SMSF from investing directly or indirectly in property development. It can be a legitimate investment for SMSFs if the fund's property development activities comply with the superannuation legislation.

The ATO, however, is concerned about the structure of certain schemes and arrangements that divert income into superannuation, creating potential breaches of the sole purpose test and other SIS issues. Non-arm's length income and non-arm's length expense issues may also arise.

The ATO has provided guidance to SMSFs through its regulatory updates in SMSFRB 2020/1 and TA 2023/2, cautioning that care needs to be taken by SMSF trustees.

Joint ventures

The ATO has affirmed that a joint venture (JV) agreement involving related parties is an 'in-house asset' under section 71 SIS Act *Meaning of in-house asset* and confirmed it again in SMSFR 2009/4 and TA 2009/16.

As a result, the SMSF must hold a proprietary interest in any real property being developed so that the ATO is comfortable with the SMSF investment being 'in' that property and not an investment 'in' the related party.

One of the leading indicators that the investment may be an in-house asset is that the fund provides capital for the joint venture and has no other rights than receiving a return on the final investment. The ATO has flagged that this will depend on the terms of the JV.

Where outside influences affect the trustee's decision, such as ceasing to pay a pension to make a cash injection into a struggling property development venture, a contravention of the sole purpose test may occur.

The SMSF is not there to ensure the success of a property development joint venture at its peril.

Ungearred entities

Investing in ungearred entities is another area where compliance with the requirements of regulation 13.22C SISR is complex.

Ensuring the ungearred entity does not borrow, all

transactions are at arm's length, any related party acquisitions are at market value, and the entity does not operate a business can avoid the investment becoming an in-house asset.

The asset can never be returned to its former exempt status, even if the trustee fixes the issue/s that caused the assets to cease meeting the relevant conditions.

It can be difficult, therefore, for SMSFs to meet and maintain these conditions while undertaking property development investments.

Special purpose vehicle (SPV)

The ATO has now set a higher bar for property development schemes by focusing on a 'controlling mind'. It makes the decisions for one or more property development groups by selecting the project and establishing an SPV who are typically the members of the fund.

The ATO has adopted a broader approach and is less prescriptive about specific arrangements and structures that could potentially fail the SIS Act compliance with property development.

The ATO has acknowledged that non-arm's length dealings by any party, with respect to any step in relation to a scheme, can give rise to NALI as defined in ITAA 97.

It gives the ATO a much wider net to cast, which ensures that trustees cannot circumvent the rules and can try to get more money into an SMSF.

Conclusion

Navigating the regulatory landscape of SMSFs requires a holistic approach to SMSF property compliance. Understanding the connections between NALI, the sole purpose test, and market value, to name but a few, is crucial for an SMSF's successful and compliant operation.

SMSF trustees must ensure that their funds are maintained exclusively for retirement purposes and that all transactions are conducted on arm's length terms. Non-compliance with these requirements can lead to severe consequences, including significant tax penalties and potential disqualification. **FS**