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SMSFs and the in-house asset rules explained

A not-uncommon conundrum for many SMSF trustees is what to do when the fund is found to have breached the in-house asset rules. There are also some common misconceptions about these regulations that keep resurfacing.

What does the ATO say in relation to the in-house asset rules?

Recent ATO statistics on the SMSF sector show the proportion of reported breaches that relate to the in-house asset rules remains high. While it can be argued that the higher number is because the in-house asset provisions are by far the most complex and hard to understand SMSF investment rules, it is still critical for trustees to improve compliance to prevent the substantial penalties imposed for breaching these rules.

What's an in-house asset and how does the limit work?

Essentially, an in-house asset is a loan to, lease to, or an investment in, a *related party* of the fund.

The term "related party" is relevant for an SMSF for the purpose of ascertaining whether an investment constitutes an investment in an in-house asset.

Full discussion of the definition of a related party will take up more space than we have available here, but the key issue for our purposes is that a related party will include the fund's members, their relatives, and entities such as companies or trusts that are controlled or majority-owned by members and their associates (that is, relatives of members, partners in partnerships with those members, and companies or trusts that are controlled or majority-owned).

Whether or not a particular investment is an "in-house" asset of the fund is important because a trustee must not invest in assets that cause the value of the in-house assets of the fund to exceed 5% of the total market value of the fund's assets.

In-house assets are measured at market value, and the market value ratio of 5% (that is, market value of in-house assets expressed as a percentage of the market value of total fund assets) applies to all regulated superannuation funds. This low percentage was mainly designed to limit use of fund assets by related parties to protect the retirement benefits of members.

Perhaps one of the most important points to note is that the market value ratio must be tested at June 30 each year as well as during the course of the income year that a new in-house asset is acquired by the fund.

What if the limit is exceeded?

The relevant provision of the legislation requires the trustees of funds exceeding the 5% in-house asset limit at the end of an income year to prepare a written plan to rectify the situation before the end of the following income year.

The plan must specify the amount that is above the in-house asset limit and set out what steps will be undertaken to get the limit below 5% (generally by disposing or selling excess assets). Each trustee of the fund must ensure that the steps in the plan are carried out within the next year of income.

Another provision of the same legislation applies during the year when a new in-house asset is acquired, and prohibits the acquisition of an in-house asset if the market value ratio already exceeds 5%, or, if this level is not exceeded, applies when acquiring an in-house asset that would cause the ratio to exceed 5%. This means a trustee is only allowed to acquire an in-house asset provided the percentage of the total in-house assets involved does not exceed the 5% limit.

It is worth noting these provisions must be considered in their entirety, not relying on either one in isolation. Focusing solely on the level of in-house assets at June 30 each year (the first provision) and not taking into account the rules applicable to new in-house assets acquired during the course of an income year (set out in the second provision) may lead to the misconception that no breach of the in-house asset rules could occur as long as the fund's in-house assets at June 30 each year is under the 5% limit. This may not be the view taken by the ATO.

Another noteworthy point is that the trustee can only sell/dispose of an asset that meets the definition of an in-house asset if the level of 5% is exceeded at the end of a financial year. This is an important consideration that is quite often misunderstood.

Exceptions to the in-house asset rules

Like many rules governing SMSFs, there are a range of exclusions and transitional arrangements that specifically exclude certain investments in related parties from being considered an in-house asset, including, but not limited to:

- investments in business real property
- any investments in a related unit trust (or company) purchased before August 11, 1999 and certain new investments in these trusts/companies made before June 30, 2009
- investments in a non-geared related unit trust or company that meets certain requirements, and
- investments in a widely held unit trust (such as a public unlisted property fund).

Other considerations

As stated earlier, the definition of an in-house asset includes a loan to a related party of the fund. It is important to note however that while a related party of the fund can include a member and their relatives, SMSF loans and other financial assistance to members and/or relatives of members are expressly prohibited under a certain section of the legislation.

Consequently, an SMSF cannot lend money or provide any other financial assistance to members and/or their relatives even though the value of the loan may not contravene the in-house asset rules (that is, being less than 5% of the fund's value). This is because there is no allowable limit under the superannuation law when it comes to loans to members or relatives of members. In order to rectify this contravention, the loan must be repaid in full to the SMSF.

In addition to the above, an SMSF loan to a related trust/company would not be prohibited under superannuation laws (subject to 5% in-house asset rule) on the assumption that the loan is not made to indirectly facilitate loans/financial assistance from the trust/company to fund members and/or their relatives. Otherwise, the fund may be in breach.

This part of the legislation is black and white; it outright prohibits the lending of money directly or indirectly to a member or a relative of a member regardless of the terms.

If you have any concerns with the in-house asset rules please contact us.

In-house asset breach, or not — an example

Assume an SMSF lends $10,000 to the family company (a related party), which represents less than 5% of all fund assets. The SMSF loan is supported by a written loan agreement, at a commercial rate of interest, with the capital to be repaid in three years.

Shortly after that, the company provides financial assistance to members of the fund by lending them $10,000 at a commercial rate of interest. The fund members use the $10,000 to cover personal credit card debt.

At face value, the loan would be in accordance with the in-house asset rules. In this case, there is however a clear breach as the company uses the money of the fund to facilitate loans from the company to fund members. In other words, financial assistance using SMSF resources has been indirectly provided to members. The investment is not allowed, and thus the loan must be repaid in full to the fund.

If, on the other hand, the family company had used the $10,000 to acquire machinery or equipment for the business (instead of using the money to satisfy a personal debt of fund members), there would have been a completely different result. In these circumstances, the loan to the company would not cause a contravention and would therefore be allowed.