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TIPS AND TRAPS FOR SMSFS INVESTING IN A PRIVATE COMPANY

Stuart Sheary

Gaining greater control and investment flexibility are often significant motivators for people setting up a self-managed superannuation fund (SMSF). SMSFs provide the ability to invest in a wide range of investments, including direct property, unlisted investments and private company shares. These types of investments may not be as accessible via a public offer fund. While SMSFs provide an opportunity to invest in alternative investments such as private company shares, trustees should be careful not to breach any Superannuation Industry (Supervision) Act 1993 (SISA) investment rules.

Investing in private company shares may present SMSF trustees with an opportunity to diversify the fund's portfolio and potentially achieve higher risk-adjusted returns. The ability of the trustee to be able to invest in private company shares using their SMSF will depend on whom the trustee is acquiring the shares from and whether the shares are in a related company.

What are the rules surrounding the purchase by the SMSF trustee?

An SMSF trustee cannot ordinarily acquire an asset from a related party. One exception to this rule is listed shares, which an SMSF trustee may acquire from a related party. It is not uncommon for an SMSF trustee to acquire listed shares from a related party via an in-specie contribution or a direct purchase at market value. Tax Ruling TR 2010/1 confirms that the acquisition of a listed share (or any asset) below market value would be considered a contribution. A purchase of listed shares from a member or relative of a member above market value would likely breach SIS restrictions relating to providing financial assistance to a member or relative. It would also contravene trustee requirements to transact on terms no more favourable to the other party than would be expected on an arm's length basis.

Deliberately acquiring private shares below market value and not recording the discount as a contribution can present more complications. Dividend income derived by the SMSF under such an arrangement might be considered 'non-arm's length income' (NALI) and subject to a higher rate of tax (45%) indefinitely. In addition,



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any capital gain made on the sale of the shares acquired below market value may also be subject to NALI. SMSFs are subject to NALI whenever they deal with another party on a non-arm's length basis as part of a scheme to earn more income than what would have been expected had they been acting on an arm's length basis. In Tax Ruling TR 2006/7 the ATO confirm that, 'dividends are only derived on an arm's length basis when the shares are acquired, the investment is maintained, and the dividends are paid on an arm's length basis.', see also Darrelen Pty Ltd v Commissioner of Taxation [2010] FCAFC 35.

In the event there is insufficient money in the fund to purchase the desired number of shares at market value or the trustees simply do not wish to use available funds to purchase all the shares then the trustees can adopt a combination of share purchase and in-specie contribution. The trustees may decide not to purchase any shares at all and treat the entire transfer as a contribution. Self-managed superannuation ruling SMSFR 2010/1 paragraph 39 confirms that if the SMSF gives no consideration or consideration less than the market value then the market value requirement is satisfied 'if the asset is wholly or partly a contribution and is treated by the SMSF as a contribution equal to the asset's market value to the extent that consideration was not given for it.' This means all or part of the in-specie transfer can be treated as a contribution depending on how much, if any, the trustee wishes to purchase at market value.

Two factors that influence whether an SMSF trustee may acquire private company shares will be whether or not the company is a related party and whether the entity the SMSF is acquiring the private shares from is a related party. This is summarised in the table below.

Table 1. When private shares can be acquired by an SMSF

	Related company	Unrelated company
Acquisition from related party	<ul style="list-style-type: none"> • Acquirable • Limited to 5% of total fund assets 	<ul style="list-style-type: none"> • May not be acquired
Acquisition from unrelated party	<ul style="list-style-type: none"> • Acquirable • Limited to 5% of total fund assets 	<ul style="list-style-type: none"> • Acquirable • No investment limit*

*Subject to the SMSF's investment strategy

Subject to the SMSF's trust deed, investment strategy and other SIS investment rules such as the sole purpose test an SMSF trustee may purchase shares in an unrelated private company from an unrelated party.

Where related parties are involved, trustees need to be more careful. Before looking at these issues let's review who a related party includes.

A related party of the fund includes:

- All members of the fund
- Standard employer sponsors
- Part 8 associates of fund members or the fund's standard employer sponsors.

Standard employer sponsor

A standard employer sponsor is an employer who contributes to the SMSF as part of an arrangement between the fund and the employer. This is ordinarily stipulated in the fund's deed. These arrangements are not typical, as employers usually contribute to an SMSF as part of an arrangement between themselves (employer) and the employee, rather than with the SMSF. Caution is needed as some old deeds define a standard employer sponsor as any employer who contributes to the fund.

A **Part 8 associate** of a member includes:

- The relatives of each member
- Other members of the SMSF
- All partners in a partnership
- Any spouse or child of those business partners
- Any company the member or their associates control or influence
- Any trust the member or their associate controls.

When is a company related?

A company can be a related party by being a standard employer sponsor of the fund, a Part 8 associate of the member, or a Part 8 associate of the standard employer sponsor (if applicable).

A Part 8 associate of a member includes any company the member or their associates control or influence. SISA sect 70E states that an entity controls a company if:

- The majority of its directors, are accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts)
- An entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

What are the issues if the company is related?

If an SMSF trustee invests in a related company the investment will be an in-house asset. An SMSF trustee may invest in an in-house asset if the acquisition does not result in the market value of total in-house asset investments exceeding 5% of the market value of the fund. If the SMSF trustee acquires an in-house asset and the value of the in-house assets grows relative to other investments this may result in exceeding the 5% in-house asset limit. The fund will then need to prepare a written plan to reduce its investment to 5% or less before the end of the next financial year.

An exception to the restrictions on acquisition from related party rules is the ability to acquire an asset from a related party if it immediately becomes an in-house asset and is within the 5% in-house asset limit. This effectively

allows an SMSF trustee to acquire shares in a related private company as long as the acquisition does not result in the fund exceeding the 5% in-house asset limit. The SMSF trustee may acquire related party shares from a related party or from the company itself via newly issued shares. If the company were not a related party the acquisition would be prohibited. This means the SMSF trustee would not be able to acquire the unlisted shares from the related party. In this case the SMSF trustee would have to acquire the shares from an unrelated party or from the company itself as newly issued shares.

Non-arm's length income – dividend income

Any dividend received by an SMSF from a private company that was not paid on an arm's length basis can be treated as NALI. This means if the dividends paid to the SMSF were more generous than what would be expected on an arm's length basis then NALI can apply. This may extend to any dealings within the company that are not on an arm's length basis which as part of the scheme result in greater company profits and subsequent dividends. For example, employees with SMSFs holding shares in their employer company may accept a below market salary in expectation of larger dividends. These dividends may get caught as non-arm's length income to the SMSF.

Investing in assets used by the private company

An alternative to investing in the private company shares might be for the SMSF trustee to invest in the assets used in the company. If the company is a related party these assets would ordinarily become in-house assets with certain exceptions, meaning that the SMSF would be limited to the 5% in-house asset limit.

Such an investment might include a loan by the SMSF trustee to the private company. A commercial rate of interest together with other terms on the loan would need to be at arm's length.

If the company is related, then the SMSF trustee will need to take care to ensure that it does not exceed the 5% in-house asset limit. In addition, the SMSF trustee must not enter an arrangement to lend money to a member, be it directly or indirectly or provide financial assistance to a member or relative of a member. An example of an SMSF trustee indirectly giving financial assistance to a member is provided in example No 20 of SMSFR 2008/1 in which the SMSF trustee lends money to a family company to facilitate a loan from that company to members of the SMSF. The ruling confirms this would breach SIS prohibitions relating to providing financial assistance to a member or relative of a member.

Investing in business real property used 'wholly and exclusively' by the company is another way for the SMSF trustee to obtain, albeit indirect, exposure to the company. If the trustees have confidence in the longer-term viability of the company then leasing an asset to the company may present less risk than leasing the asset to

another entity. Trustees who are confident of securing a long-term stable lease with a trusted tenant may find investing in business real property attractive. Please note that an SMSF trustee is ineligible to claim any small business CGT concessions on property used in the business. This means if the property is an active asset used in the business it may be more appealing to hold it outside of the SMSF where it may benefit from the small business CGT concessions.

Final considerations

To satisfy the sole purpose test any investment in private company shares should be motivated by the intention of providing benefits for retirement. Any benefits derived from any investment before a member's retirement or death, i.e. receiving 'current day benefits', may raise sole purpose test issues.

In addition, all investments should be considered prudent by the trustees and allowable under the SMSF's deed and investment strategy. **FS**



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