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Dear Steve and Thomas

SELF MANAGED SUPERANNUATION FUND INVESTMENT IN USA PROPERTY

We refer to your request for advice concerning a proposal that involves self managed superannuation funds investing in property in the United States of America.

Your request raises issues concerning superannuation investments and the sole purpose test.

INVESTMENT

There is no prescription in the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) as to what specific assets a superannuation fund may or may not invest in other than the requirements mentioned below that any investment should be consistent with the fund's investment strategy and not contravene the investment standards set out in the SIS Act.

The general guiding principles that trustees should apply to superannuation fund investments are:

1. Establish and implement an Investment Strategy

The SIS Act requires that all funds must have an investment strategy.

Regulation 4.09(2) of the *Superannuation Industry (Supervision) Regulations 1994* (the SIS Regulations) provides:

> *(2) The trustee of the entity must formulate and give effect to an investment strategy that has regard to all the circumstances of the entity, including in particular:*
> *(a) the risk involved in making, holding and realising, and the likely return from, the entity's investments, having regard to its objectives and expected cash flow requirements;*
> *(b) the composition of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification;*
> *(c) the liquidity of the entity's investments, having regard to its expected cash flow requirements;*
> *(d) the ability of the entity to discharge its existing and prospective liabilities.*

The issues therefore to be considered when formulating an investment strategy are:

- The fund's overall Position;
- Risk as well as return on investment;
- Adequate diversification of investments; and
- Maintaining sufficient liquidity to meet cash flow requirements.

2. Invest in assets that are permitted by the trust deed

The Trust Deed may place some restriction of the type and class of asset in which the Fund may invest. Trustees must ensure that the Trust Deed gives the Trustee power to make any investment that may be proposed.

3. Avoid prohibited investments

The SIS Act prohibits certain investments. Restrictions are placed upon

- The acquisition of assets from related entities;
- Investing in, giving loans to and entering leases and lease arrangements with related parties (in house assets);
- Borrowing except as allowed by section 67A of the SIS Act; and
- Lending to members.

In addition all investment activities must be on an arm's length basis and the superannuation fund's purpose must be solely to provide retirement benefits.

Trustees must ensure that all investments do not cause the trustee to contravene the requirements of the SIS Act.

4. Avoid investments that are totally speculative

While any investment may be regarded as speculative, as Trustees are expected to act prudently, the acquisition of assets that are totally speculative should be avoided as they may so speculative so as not to be regarded as an investment.

Superannuation fund investments must also be consistent with the sole purpose test of section 62 of SIS.

SOLE PURPOSE

The sole purpose requirements are contained in section 62 of the SIS Act and limit the provision of superannuation benefits by funds to a range of prescribed or approved retirement or retirement related circumstances.

The sole purpose test provides that a fund must be maintained solely for at least one of the legislated core purposes or for at least one of those core purposes and for one or more of the prescribed or approved ancillary purposes. Essentially the "core purposes" are the provision of benefits on or after the member's retirement, reaching age 65 or earlier death.

APRA has issued Superannuation Circular III.A.4 "The Sole Purpose Test" in which is set out APRA's interpretation of section 62. It is understood that the ATO accepts APRA's interpretation where it has issued Superannuation Circulars.

At paragraphs 31 and 32, of Superannuation Circular III.A.4, the following appears in relation to superannuation fund investments:

31. Contravention of the sole purpose test may arise where there is no retirement purpose behind an investment. It is not the type of investment which must be considered for the purposes of the sole purpose test but rather it is the purpose(s) for which the investment is made and maintained that is relevant to the test.

32. An investment which is undertaken as part of a properly considered and formulated strategy, and which complies with the arm's length rule and other SIS investment restrictions, is unlikely to cause the fund to fail the sole purpose test unless exceptional circumstances exist.

Conclusion

It is our conclusion that provided that the guiding principles set out in this advice are followed by the trustees of a self managed superannuation fund, the fund may invest in property in the United States of America.

METHOD OF INVESTMENT

You have advised that your preferred methods by which a self managed superannuation fund may gain exposure to real estate in the United States of America is either through acquiring tax liens or through direct ownership of property.

You have also advised that in relation to direct ownership of property your recommendation is that the interest in property be gained through a limited liability company established in the United States of America. This company would acquire the property and the self managed superannuation fund would acquire shares in that company.

In Australian jurisdictions as a trust is not a legal person and as a superannuation fund is a trust property must be purchased in the name of the trustee of superannuation funds. The trustees are then required to make a declaration of trust that acknowledges that they hold the asset for the benefit of a beneficiary, namely the superannuation fund of which they are trustee. This may also be the case in jurisdictions in the United States of America and would need to be checked with the authorities of the relevant States.

If a limited liability company is used to acquire the property and the self managed superannuation fund owned greater than 50% of the issued shares in that company, section 71 of the SIS Act would apply to provide that the shares would be an in-house asset of the self managed superannuation fund.

An in-house asset is defined in section 71(1) to include *an asset of the fund that is a loan to, or an investment in, a related party of the fund.*

Section 10(1) defines "related Party":

> ***related party**, of a superannuation fund, means any of the following:*
> *(a) a member of the fund;*
> *(b) a standard employer-sponsor of the fund;*
> *(c) a Part 8 associate of an entity referred to in paragraph (a) or (b).*

Section 70B defines who is a Part 8 associate of an individual:

> *For the purposes of this Part, each of the following is a **Part 8 associate** of an individual (the **primary entity**), whether or not the primary entity is in the capacity of trustee:*
> *(a) a relative of the primary entity;*
> *(b) if the primary entity is a member of a superannuation fund with fewer than 5 members:*
> *(i) each other member of the fund; and*

(ii) if the fund is a single member self managed superannuation fund whose trustee is a company—each director of that company; and
(iii) if the fund is a single member self managed superannuation fund whose trustees are individuals— those individuals;
(c) a partner of the primary entity or a partnership in which the primary entity is a partner;
(d) if a partner of the primary entity is an individual—the spouse or a child of that individual;
(e) a trustee of a trust (in the capacity of trustee of that trust), where the primary entity controls the trust;
(f) a company that is sufficiently influenced by, or in which a majority voting interest is held by:
(i) the primary entity; or
(ii) another entity that is a Part 8 associate of the primary entity because of another paragraph of this section or because of another application of this paragraph; or
(iii) 2 or more entities covered by the preceding subparagraphs.

As the members of the self managed superannuation fund would control that fund, if the fund owned greater than 50% of the shares of the limited liability company that is used to acquire the property, the shares would be an in-house asset of the fund. Similarly, if the fund and its related parties collectively owned greater than 50% of the shares of the limited liability company, the shares owned by the fund would be an in-house asset of the fund.

Sections 82, 83 and 84 of the SIS Act apply where a superannuation fund's in-house assets are greater than 5% of the value of the fund's assets.

Section 82 requires that if the value of the in-house assets exceeds 5% at the end of a financial year the trustees of the superannuation fund must prepare a written plan setting out the steps for reducing the value of the in-house assets to 5% by the end of the next following financial year.

Section 83(2) and (3) of the SIS Act provide:

(2) If the market value ratio of the fund's in-house assets exceeds 5%, a trustee of the fund must not acquire an in-house asset.
(3) If the market value ratio of the fund's in-house assets does not exceed 5%, a trustee of the fund must not acquire an in-house asset if the acquisition would result in the market value ratio of the fund's in-house assets exceeding 5%.

Finally, section 84 requires trustees of superannuation funds that have contravened section 82 or 83 to take all reasonable steps to reduce the value of the in-house assets to 5% or below.

However, regulation 13.22C of the SIS Regulations prescribes that shares in a company may be acquired and not be an in-house asset of a superannuation fund, if when the shares were acquired:

(a) *the superannuation fund has fewer than 5 members; and*
(b) *the company, or a trustee of the unit trust, is not a party to a lease with a related party of the superannuation fund, unless the lease relates to business real property; and*
(c) *the company, or a trustee of the unit trust, is not a party to a lease arrangement with a related party of the superannuation fund, unless the lease arrangement:*
(i) is legally binding; and
(ii) relates to business real property; and
(d) *the company, or a trustee of the unit trust, is not a party to a lease, or lease arrangement, with another party in relation to an asset that is the subject of another lease or lease arrangement between any party and a related party of the superannuation fund (unless the asset is business real property); and*
(e) *the company, or a trustee of the unit trust, does not have outstanding borrowings; and*
(f) *the assets of the company or unit trust do not include:*
(i) an interest in another entity; or
(ii) a loan to another entity, unless the loan is a deposit with an authorised deposit-taking institution within the meaning of the Banking Act 1959; or

(iii) an asset over, or in relation to, which there is a charge; or
(iv) an asset that was acquired from a related party of the superannuation fund after 11 August 1999, unless the asset was business real property acquired at market value; or
(v) an asset that had been at any time (unless it was business real property acquired by the company, or a trustee of the unit trust, at market value) an asset of a related party of the superannuation fund since the later of:
(A) the end of 11 August 1999; and
(B) the day 3 years before the day on which the fund first acquired an interest in the company or unit trust.

Regulation 13.22D provides that regulation 13.22C will cease to apply if any of the following events happens:

(a) *the number of members of the superannuation fund increases to 5 or more;*
(b) *either of the following becomes an asset of the company or unit trust:*
(i) an interest in another entity;
(ii) a loan to another entity, unless the loan is a deposit with an authorised deposit-taking institution within the meaning of the Banking Act 1959;
(c) *the company, or a trustee of the unit trust:*
(i) borrows money; or
(ii) gives, or allows to be given, a charge over, or in relation to, an asset of the company or unit trust;
(d) *the company, or a trustee of the unit trust, conducts a business;*
(e) *the company, or a trustee of the unit trust, becomes a party to a lease with a related party of the superannuation fund, unless the lease relates to business real property;*
(f) *the company, or a trustee of the unit trust, becomes a party to a lease arrangement with a related party of the superannuation fund, unless the lease arrangement:*
(i) is legally binding; and
(ii) relates to business real property;
(g) *if the company, or a trustee of the unit trust, is a party to a lease, or legally binding lease arrangement, with a related party of the superannuation fund in relation to business real property, the property ceases to be business real property;*
(h) *if the company, or a trustee of the unit trust, is a party to a lease arrangement with a related party of the superannuation fund in relation to business real property, the lease arrangement ceases to be legally binding;*
(i) *the company, or a trustee of the unit trust, becomes a party to a lease, or lease arrangement, with another party in relation to an asset (unless it is business real property) that is the subject of another lease or lease arrangement between any party and a related party of the superannuation fund;*
(j) *a related party of the superannuation fund becomes a party to a lease, or lease arrangement, with another party in relation to an asset (other than business real property) that is the subject of another lease or lease arrangement between any party and:*
(i) the company; or
(ii) a trustee of the unit trust;
(k) *if the company, or a trustee of the unit trust, is a party to a lease, or lease arrangement, with another party in relation to business real property that is the subject of another lease or lease arrangement between any party and a related party of the superannuation fund, the property ceases to be business real property;*
(l) *the company, or a trustee of the unit trust, conducts a transaction otherwise than on an arm's length basis;*
(m) *the company, or a trustee of the unit trust, acquires an asset of a related party of the superannuation fund, unless the asset is business real property acquired at market value;*
(n) *the company, or a trustee of the unit trust, acquires from any party an asset (unless it is business real property acquired by the company, or trustee of the unit trust, at market value) that had been an asset of a related party of the superannuation fund at any time since the later of:*
(i) the end of 11 August 1999; and
(ii) the day 3 years before the day on which the asset was acquired by the company or the trustee of the unit trust.

The Australian Taxation Office has issued a Determination, SMSFD 2008/1 in which the Commissioner sets out his view concerning the application of regulation 13.22D. In SMSFD 2008/1 the Commissioner states that if one of the events listed in regulation 13.22D happens:

> *From the time when the event happens, investments held by the SMSF in that particular related company or unit trust are not excluded from being in-house assets of the SMSF under subparagraph 71(1)(j)(ii) of the SISA. Therefore, from that time those investments are in-house assets of the SMSF. Further, the existing investments and any future investments in that particular related company or unit trust can never again be excluded from being in-house assets*

The effect of these provisions on a superannuation fund's ownership of shares in a company that is a related party is:

1. The company must not own an interest in another entity;
2. The company must not borrow or give a charge over its assets;
3. The company must not lend money other than to an authorised deposit-taking institution;
4. The company must not conduct a business;
5. The trust not enter a lease arrangement with a related party other than for business real property;
6. The company must conduct all transactions on an arm's length basis; and
7. The company must not acquire an asset from a related party unless it is business real property acquired at market value.

Business real property is defined in section 66(5) of the SIS Act:

> ***business real property**, in relation to an entity, means:*
> *(a) any freehold or leasehold interest of the entity in real property; or*
> *(b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer; or*
> *(c) if another class of interest in relation to real property is prescribed by the regulations for the purposes of this paragraph—any interest belonging to that class that is held by the entity;*
> *where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not), but does not include any interest held in the capacity of beneficiary of a trust estate.*

If the trust did not comply with any these requirements of regulation 13.22C and 13.22D, all of the superannuation fund's shares in the limited liability company would become in-house assets and any future investment by the superannuation fund in the company would also be an in-house asset. The exemption provided by regulation 13.22C would never again be available in respect of shares in that limited liability company.

Once the shares became in-house assets, the fund would be compelled to dispose of its shares in the limited liability company. Otherwise the fund could be made non-complying and be subject to tax being imposed at the rate of 45% on the assets of the fund after deducting the amount of non-concessional contributions. It is therefore critical that the superannuation fund ensures that the limited liability company at all times complies with the requirements set out in this advice if the fund owned greater than 50% of the issued shares.

Conclusion

It is our conclusion that a self managed superannuation fund may invest in a limited liability company established in the United States of America if either:

1. The fund and its related parties do not own greater than 50% of the issued shares; or
2. The fund and its related parties own greater than 50% of the issued shares and the fund complies with the requirements of regulations 13.22C and 13.22D.

INVESTMENT RETURN

If a self managed superannuation fund proceeded to invest in a limited liability company established in the United States of America and that company invested in property in the United States of America, the fund would be entitled to receive dividends from that company. Australian law does not prevent dividends from being paid from the ordinary income of the company and from the proceeds of the sale of properties owned by the company.

TAXATION

We are not qualified to advise on the taxation provisions that would apply in the United States of America.

However, we are aware that the United States of America has recently enacted new legislation that imposes new information-reporting and withholding requirements on certain investors known in the USA as 'foreign financial institutions' (FFI).

The *Foreign Account Tax Compliance Act* (FATCA) seeks to prevent USA persons from using overseas investments to evade USA taxes. The basic requirement is that non-USA entities investing in the USA (either directly or indirectly) must meet certain requirements to avoid the imposition of a 30% FATCA withholding tax on their investment income and the proceeds from their direct/indirect USA related investments.

We understand that the USA Treasury and the Internal Revenue Service (IRS) have now released guidance on the operation of the FATCA provisions. They plan to exempt 'certain foreign retirement plans' from the FATCA provisions, but this exemption will only apply to foreign retirement plans that meet all of the criteria below:

1. Qualify as a retirement plan under the law of the country where the plan was established
2. Are sponsored by a foreign employer
3. Do not allow US participants and beneficiaries other than employees who worked for the foreign employer in the country where the plan was established during the time the benefits accrued.

Unless the above exception is expanded, we believe that most, if not all, Australian superannuation entities will be FFIs under the FATCA provisions.

Consequently, your proposal that self managed superannuation funds invest in limited liability companies established in the USA would appear to avoid the provisions of FATCA. However, funds investing in this manner should be aware that the compliance costs associated with a limited liability company would be a cost that would not apply to direct investments in property.

Under Australian tax law, any dividends from limited liability companies established in the USA that are received by individuals in their capacity as trustees of a self managed superannuation fund would not be treated as assessable income of the individuals. That income would be treated as income of the fund concerned and taxed at the income rates applying to superannuation funds taking account of tax paid in respect of the dividend in the USA. However imputation credits would not apply to tax paid by the company in the USA.

Conclusion

It is our opinion that you should seek professional advice from an expert on the taxation provisions that would apply in the United States of America.

MORROWS SERVICES

The Morrows Group is one of the few multidiscipline advisory practices in Australia. The Group consists of Morrows Accounting, Morrows Private Wealth, Morrows Superannuation, Morrows Legal and Morrows Family Office.

Morrows Superannuation Consulting is acknowledged as a leader in self managed superannuation funds. We have established an impressive performance record by providing a high level of technical expertise, skill, judgement and service.

Morrows Superannuation Consulting offers specialist advice on deed establishment and variation, fund administration, compliance, audit and pension calculations. Its experienced team of superannuation specialists are able to guide clients through the increasing complexity, to provide clients with an integrated solution and give them peace of mind based on advice they can trust.

Clients who wish to explore how Morrows Superannuation Consulting can assist them should contact Wendy Dickson on 03 9690 5700.

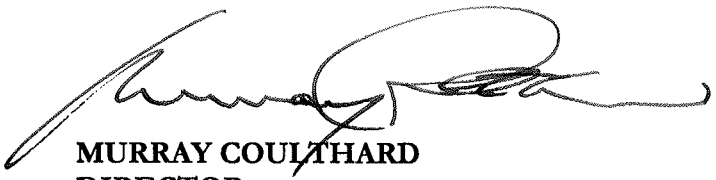
DISCLAIMER

The views expressed in this advice are based upon

1. the information set out in this advice;
2. an assumption (without independent verification) that all information considered is accurate and not misleading;
3. existing income tax and superannuation legislation, which legislation may be subject to change at any time, as may its interpretation by the Courts;
4. your understanding that this opinion should not be considered a representation, warranty or guarantee that the Australian Taxation Office or the courts will concur with the views expressed in this opinion.

Please contact me if you have any queries.

Yours faithfully
MORROWS LEGAL PTY LTD



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