

TAX TALKS

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Property development within an SMSF is ok. But play it safe.

Property Development Within an SMSF

Doing property development within an SMSF you just have to watch out for a lot more potholes than usual.

In this episode Bryce Figot of [DBA Lawyers](#) in Melbourne will walk you through those potholes.

Here is what we learned but please listen in as Bryce explains all this much better than we ever could.

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Property Development Within an SMSF

SMSFs can do property development. There are just five questions:

- 1 – Would the SMSF be running a business and is not an issue?
- 2 – Would a unit trust be the solution?
- 3 – What if the SMSF doesn't have the cash?
- 4 – Can the SMSF do a 'Cost-plus' contract?
- 5 – Can a builder provide his services for free?

Let's go through these one by one.

1 – Running a business and is that an issue?

Doing property development within an SMSF might constitute running a business but that is not an issue.

Sometimes the cases *Scott v Federal Commissioner of Taxation (no. 2) (1966) 16 ATD 333* or *Miller v FCT [2016] FCAFC 94* get quoted as a warning against running a business within an SMSF.

However, the [ATO](#) confirms that an SMSF is allowed to carry on a business as long as:

- 1 – The trust deed allows it and,
- 2 – The fund operates the business for the **sole purpose** of providing retirement benefits for fund members.

Just expect a lot more scrutiny from the ATO looking for breaches of the sole purpose test.

The main hurdle for an SMSF to do property development is that the SMSF can't borrow to fund the development. That puts the SMSF into a very tight cash flow position, especially given current contribution caps.

A unit trust is often suggested as a possible solution. But is it?

2 – Would a Unit Trust Be The Solution?

To avoid the restrictions an SMSF faces, a popular solution is to have the SMSF invest into a unit trust and the unit trust then does the property development and borrowings.

The main issue is that the unit trust runs a high risk of being an in-house asset per s71 (1) SIS Act. Unit holders of the trust are often related parties so the only possible way out is for the trust to be a Div 13.3A unit trust.

But a trust can only be a Div 13.3A trust (also called a Reg 13.22D trust) if the trust does NOT run a business.

But it is notoriously difficult to know where a business starts and stops. The ATO has listed some factors in TR 97/11 [13], but then there are various court cases like *JR Walker (1985) 16 ATR 331* and *WWXY [2015] AAT 130*, and appeal (*Rosgoe [2015] FCA 1231*) that throw doubt on the issue.

So even if you think the trust is not running a business, the AAT might find that it is.

The only time you can have confidence that the unit trust is not carrying on a business is if the ATO gives you a private ruling. But unlikely that they would.

So a unit trust is not the safe solution that some accountants make it to be. That takes us back to the start. An SMSF can do property development but can't borrow.

3 – What if the SMSF doesn't have the cash?

Bad luck. The SMSF can't borrow to finance property development. A unit trust is not a safe solution either. So if the SMSF doesn't have the cash, then you can't use your super for property development.

4 – Cost plus Contract?

So let's assume that the SMSF has the cash to finance property development without borrowing. The next issue is the purchase of materials.

'Cost-plus' contracts are very common. Meaning the builder buys the material and oncharges it plus a margin for his building services. That is an issue because of s66 SIS Act. An SMSF can't buy assets from a related party (unless ASX listed or commercial property).

There are three possible solutions.

1 – The SMSF buys the material directly from unrelated parties (Bunnings, Reece etc) and the builder charges their building services separately to the SMSF. But a lot of builders resent that because it means the loss of trade discounts.

2 – The builder could act as the SMSF's agent, but you need to document that accordingly and pay straight away.

3 – You open a Bare trust in the builder's name. The SMSF deposits money into this bank account and the builder uses this bank account exclusively to buy physical materials

5 – Can The Builder Work For Free?

Of course they can. The question is whether they should. The problem are the new NALI provisions in s 295-550(1)(c) ITAA 1997. The issue is whether too much money is pumped into the SMSF, avoiding tax outside the SMSF.

From a NALI point of view, it all depends on whether the builder is performing their activities in their:

- personal capacity or
- capacity as a trustee

How can you tell in which capacity someone acts? LCR 2019/D3 tries to answer that question. A member performs services in their personal capacity if they

- 1 – charge for their services,
- 2 – use business equipment,
- 3 – act under their business licence,
- 4 – use their business or professional expertise and
- 5 – are covered by their business or professional insurance policy.

The risk of non-arm's length expenses is that the SMSF might:

- 1 – Fail the definition of an SMSF (s17A SIS Act);
- 2 – Contravene s65 SIS Act (no financial assistance) ;
- 3 – Fail the sole purpose test in s62 SIS Act.

So avoiding all this, have the SMSF pay the builder at arm's length for their services.

Conclusion

So you can do property development within an SMSF, but to play it safe, have the SMSF,

- 1 – Buy real estate from an unrelated party,
- 2 – Buy material from an unrelated party,
- 3 – Retain evidence that all services/labour are at arm's length,
- 4 – Sell the developed real estate,
- 5 – Do no borrowings,
- 6 – Avoid unit trusts,
- & – Avoid joint ventures,
- 9 – Avoid free work from related parties,
- 10 – Have a thorough investment strategy.

That's all.

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