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FARMLAND IN A SMSF: IS IT TOO “GNARLY”

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A Self-Managed Superannuation Fund (SMSF) has the ability to purchase farmland and lease it back to the member or a related party. The key benefits of owning farmland within an SMSF include favourable tax rates on lease income and reduced capital gains tax (CGT) when the land is sold or vested out. In the accumulation phase, superannuation earnings are taxed at 15%, and in the pension phase, they are taxed at 0%. If an asset is held for more than 12 months, a 1/3rd discount on CGT applies, resulting in an effective tax rate of 10% in the accumulation phase.

A related party in an SMSF includes the member(s) or a Part 8 associate, such as a spouse, children, parents, uncles, aunts, grandparents, or entities controlled by the member. When leasing farmland to a related party, it's crucial to ensure that the income and expenses are consistent with arm's length terms. This means the lease must reflect market rates, and an independent valuation from a qualified expert can be used to verify the lease income.

Non-Arms Length Income (NALI), pronounced “gnarly”, occurs when the income from an investment with a related party deviates from what would be expected in an arm's length transaction.

For example, if the farm lease terms differ from those that would be agreed upon by independent parties, the lease income could be classified as NALI. The Australian Taxation Office (ATO) recently issued TD 2024/5, which clarifies how NALI impacts CGT provisions. If NALI is identified, both ordinary income (such as lease income) and statutory income (like CGT) are taxed at a higher rate of 45%.

Recent amendments to section 295-550 of the Income Tax Assessment Act 1997 have provided greater clarity regarding how NALI/E (non-arm's length income and expenditure) affects SMSFs. A "specific expense" refers to costs directly associated with generating income from a specific asset, like farm property expenses. If a shortfall occurs in a specific expense, the entire income from that asset, as well as any potential CGT on its sale in the future, could be subject to NALI taxation at 45%. NALI on a specific expense is capped at taxable income of the fund excluding assessable contributions and any deductions against them. For instance, if farm lease income is $200,000 with eligible deductions of $50,000, NALI would apply to the remaining $150,000.

To mitigate the risks of NALI/E, SMSF trustees should ensure they engage third-party contractors and suppliers for property-related expenses. Regular independent market valuations should be conducted, and all lease agreements should be well-documented for audit purposes. Trustees should also consult professional advisors with expertise in superannuation law to ensure transactions are structured appropriately and comply with regulations.

In November 2024, the ATO updated draft rulings LCR 2021/2DC and TR 2010/2DC regarding NALI/E and requested submissions by January 2025. These updates may allow some shortfalls in "specific expenses" to be addressed by recording a contribution within the fund. We are awaiting further guidance from the ATO following this submission period.

In conclusion, SMSF trustees need to be mindful of NALI/E risks, as they could lead to a 45% tax rate. **At Byfields, our dedicated and specialist SMSF team will help you navigate the complexities of Superannuation, particularly in owning farmland within an SMSF.**

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