

SMSFs leasing commercial property to related parties

When the tenant experiences financial distress due to Covid-19.

Trustees of SMSFs that own a commercial property which is leased to a related party (such as the business of one or all of the members), may be concerned about the ability of the tenant to continue paying rent through the Covid-19 economic downturn.

Normally when a related party tenant is struggling to pay their rent, the SMSF trustees must follow the terms of the lease or risk breaching the superannuation laws or being subject to extra tax.

This can be an onerous process, requiring trustees to consider if they should enforce the terms of the lease arrangement to recover any shortfall. Often a landlord will agree to a payment plan such as a rent reduction or rent-free period as an alternative to eviction, especially when it's unlikely that a new tenant would be there to step in.

Trustees then need to prove that the approach they take is commercial and able to be substantiated. To this end, we usually recommend that trustees contact a local real estate for a written opinion on the current market conditions and the approaches taken by other landlords.

Trustees should then document what relief they consider is appropriate and why, taking into account a raft of factors ranging from the circumstances of the fund (for example, is it using the rental income to pay pension liabilities?) to the circumstances of the tenant, the terms of the existing lease, the location and type of property and comparative rent relief being offered by arm's length landlords for a similar property in a similar location.

Has the ATO offered any concession from obtaining this level of information?

The ATO have provided some relief for those SMSFs and businesses affected by Covid-19, but it is vital that both trustees and tenants ensure that they apply the relief correctly and document their decisions thoroughly.

The ATO have recently stated that for 2019/20 and 2020/21, they will not take action where an SMSF gives a tenant – who is also a related party – a temporary rent reduction during this period.

Whilst the ATO comment appears quite broad, this does not mean that the ATO suddenly views commercial behaviour between SMSFs and related parties as unimportant, nor is it an open invitation to put in place arrangements that are clearly not warranted.

In our view what the ATO is signalling is that they will rely on the obvious evidence at a national level that some form of rent relaxation is normal, commercial and expected between any landlord and a tenant affected by Covid-19.

Under what circumstances could an SMSF trustee offer a related party rent relief without following the usual substantiation process?

Essentially where the relief:

- ✓ is offered as a direct consequence of the adverse economic effects of Covid-19,
- ✓ is necessary, and
- ✓ is temporary.

How should SMSF trustees determine what rent relief is “necessary”?

In early April, the Federal Government released the National Cabinet's Mandatory Code of Conduct Commercial Leasing Principles (“the Code”) aiming to impose a set of leasing principles for commercial tenancies between landlords and tenants. SMSF landlords and tenants should first determine if the Code applies to their situation.

The Code provides a good guide for determining the how much relief is necessary and the form that relief should take, and provides that:

- ✓ The amount of relief should be proportionate to the tenant's loss in turnover.
- ✓ Rent relief can take the form of:
 - a rent waiver which must be at least 50% of the total rent relief and cannot be recouped by the landlord over the lease term and/or
 - a rent deferral for the remaining rent relief, with this amount amortised over the remaining lease term or at least 24 months (whichever is greater).

How might this look in practice?

Sally's SMSF owns business real property which is leased to Sally's company. Sally's company has sought rent relief from the SMSF because the turnover of the company has fallen 60% as a result of the economic effects of Covid-19. The SMSF is willing to offer rent relief but, given the tenant is a related party of the fund, the trustee wants to ensure the amount/type of relief offered is commercial.

Using the National Cabinet's Mandatory Code of Conduct – Commercial Leasing Principles, the following relief would generally be considered commercial and therefore "necessary":

- ✓ 60% rent relief made up of:
 - at least 50% rent waiver, and
 - the balance as a rent deferral amortised over the remaining term of the lease or at least 24 months (whichever is greater)

Under the Code, the landlord and their tenant could negotiate an alternative but, in the case of SMSFs and related party tenants, the SMSF trustee would need to establish that the arrangement was commercial. If an arrangement was considered non-commercial, then the fund may breach the superannuation laws and/or extra tax could apply.

SMSF landlords that are not subject to the Code could (and arguably should) still use the Code of Conduct as a guide for assessing the rent relief to be offered to a tenant (related party or otherwise). However, if the tenant is a related party, it will be important to ensure the relief was necessary (eg the tenant was suffering financial stress or hardship as a result of Covid-19).

Should the SMSF trustee document the new rental arrangement?

Yes, we would still recommend:

- ✓ the tenant makes written request to the SMSF trustee for a variation of the lease terms due to the adverse economic effects of Covid-19, and
- ✓ the SMSF trustee minutes the relief to be provided and why.

However, the ATO concession means SMSF trustees do not need to seek further external evidence of the commerciality of the rental relief provided, especially when following the Code.