

# SMSF BORROWING AND THE SAFE HARBOUR PROVISIONS

In September 2016, the ATO released a Taxation Determination TD 2016/16 which provided guidance to trustees who could not, or who decided not to, meet the Safe Harbour guidelines of the previously released ATO Practical Compliance Guidelines on related party limited recourse borrowing, PCG 2016/5.

With a rather lengthy title of “Income tax: will the ordinary or statutory income of a self-managed superannuation fund be non-arm’s length income under subsection 295-550(1) of the Income Tax Assessment Act 1997 (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm’s length?”, TD 2016/16 provides a workable alternative to the Safe Harbour guidelines.

In effect, as the title indicates, the TD looks at certain related party loan arrangements and provides guidance as to whether or not income derived from the investment would be deemed to be non-arm’s length income (NALI).

At the time of the release of TD 2016/16, the ATO:

- withdrew previous Interpretative Decisions ID 2015/27 and ID 2015/28 (which had replaced former IDs 2014/39 and 2014/40); and
- updated PCG 2016/5, to include reference to TD 2016/16 and to accommodate the removal of the IDs listed above.

Basically, the examples under TD 2016/16 look at the terms of the borrowing arrangement and compare those terms to a hypothetical borrowing arrangement which the trustee may be able to obtain in the marketplace. The interesting point here is that the trustee does not, for example, need to approach a bank and obtain agreement to provide finance, but the hypothetical arrangement must be able to be justified. In other words, there would need to be an indication of commerciality in the hypothetical arrangement.

That arrangement would need to consider the applicable interest rate, and whether the rate is fixed or variable, the term of the loan and the loan to value ratio (LVR).

If, under the hypothetical borrowing arrangement, it would not be possible for the trustee to borrow, the income from the investment would be NALI.

In TD 2016/16, the ATO reviews a number of components for consideration under the hypothetical borrowing arrangement, including:

- trust deed - whether the deed permits borrowing;

- capital - the amount the SMSF will be contributing to purchase the asset;
- cash flow - whether the SMSF will be receiving sufficient funds from the investment to service the loan;
- investment strategy - whether the fund investment strategy provides for:
  - the purchase of the particular asset; and
  - the use of borrowings to make that acquisition;
- whether the investment represents the optimal use of fund assets;
- whether the investment is earnings accretive, after considering potential income and future capital gains; and
- whether there are any legislative or regulatory impediments to the borrowing arrangement.

TD 2016/16 contains a scenario whereby an SMSF entered into a related party loan to purchase an asset which was providing rental income of \$1,000 per week. The table below sets out the details of the arrangement (‘Current LRBA’ column) and also provides details of an acceptable hypothetical borrowing arrangement which, incidentally, matches the safe harbour provisions under PCG 2016/5.

**Current as at 5 December 2016**

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TD 2016/16		
	Current LRBA (not at arm's length)	Hypothetical Borrowing Arrangement - (PCG 2016/5)
Amount Borrowed	\$1,000,000	\$700,000
Fund capital	\$0	\$300,000
Interest rate	0%	Variable, 5.75% p.a. for 2015/16 year
Term of loan	25 years	15 years
LVR	100%	70%
Security	Registered mortgage	Registered mortgage
Personal guarantee	Nil	Not required
Nature & frequency of payments	End of term	Monthly P & I - \$5,800 per month

From the table above, you will note, to avoid a NALI determination:

- the LVR is 70%, meaning that the SMSF will need to source \$300,000 to pay down the loan;
- the interest rate needs to increase;
- the term of the loan needs to be reduced; and
- the payment frequency needs to change.

Unfortunately, the fact that the ATO used the safe harbour provisions for their example means that there is still a lack of clarity for those that do not specifically meet the safe harbour terms, and wish to use the hypothetical loan option.

One of the most common related party borrowing scenarios occurs when members borrow from a bank, on a full recourse basis, using their home as security and on-lend to the SMSF (i.e. a back-to-back loan). The ATO did not answer the question surrounding the potential interest rate - for example, if the

members borrow from the bank at (say) 4.5%, must the loan from the members to the SMSF be set at the safe harbour rate of 5.75% (for 2015/16 as above or 5.65% for 2016/17)?

In other words, are the members forced to 'take a clip' on the way through? That appears to be the case, which runs contrary to a number of long held tenets under which superannuation has been operated, including:

- sole purpose test;
- provision of financial assistance; and
- early access to funds.

Back to the table above, the fact that the rental of \$1,000 per week is less than the monthly principal and interest requirement of \$5,800 appears to lead the ATO to the conclusion, in their example, that the SMSF would not have been able to borrow under those hypothetical terms and, as a result, the income from the investment will be NALI. If that is the case, the \$1,000 per

week rental would be taxed at the top marginal tax rate.

However, all may not be lost as the ATO appears to accept that cash flow considerations can be taken into account in determining the funding structure of the hypothetical loan arrangements - i.e. as arm's length lenders also do. Therefore, in deciding whether the loan arrangement meets a hypothetical commercial arrangement, (careful) consideration can be given to other income expected to be received by the fund, such as:

- income on other investments; and/or
- contributions to be made to the fund.

### Where to from here?

Trustees now have a choice to make in respect to their related party limited recourse borrowing arrangements, in that they can:

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- have the arrangement meet the safe harbour terms under PCG 2016/5, which provides a large degree of certainty but which applies only to real estate and listed shares and trusts; or
- construct a hypothetical loan arrangement, based on realistic factors, in accordance with TD 2016/16 and have the arrangement meet those hypothetical terms. That will apply not only to real estate and listed shares and trusts, but also to other investments such as managed investments, related trusts and a broader range of investments.
- determine whether they meet the safe harbour guidelines;
- if not, decide whether there is a possibility of meeting those guidelines;
- if so, decide whether they wish to meet the guidelines;
- if not, apply a hypothetical loan arrangement to determine whether or not the income from the investment will be NALI.

The matters which would need to be reviewed include:

- the interest rate, including the percentage, whether the rate is to be fixed or variable and whether payments from 1 July 2015 match that rate;
- the terms of the loan;
- the LVR;
- the security provided to the lender;
- compliance with the loan agreement, including principal payments; and
- whether effective documentation is in place in respect of the loan, including any varied arrangements to meet the safe harbour or hypothetical terms.

Following the review, the arrangements need to be implemented, including having payments brought up to date, prior to 31 January 2017. In other words, whilst it is not too late to change, the window of opportunity has almost closed.

The alternative to the above is to have the income from the investment (including realised gains) treated as NALI.

## It is not too late to change

The ATO has provided trustees with a timeframe up to 31 January 2017 in which to make amendments to the related party limited recourse borrowing arrangements. They have indicated that if any amendment is made before 31 January 2017, and any deficiencies from 1 July 2015 are rectified by that date, they will generally not review beyond 1 July 2015.

The window is closing, as the ATO has also indicated it does not foresee extending the 'Key Date' beyond 31 January 2017. Therefore, trustees and their advisers should urgently review the current related party limited recourse borrowing arrangements of their SMSF and:

## More information

Should you have any queries or require more information, please contact us

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