

RELATED PARTY LIMITED RECOURSE BORROWING ARRANGEMENTS – THE IMPORTANCE OF COMMERCIAL TERMS

The release by the ATO of a Private Binding Ruling has reignited discussion amongst SMSF trustees and advisers in regards to how commercial the terms of a related party loan should be.

The ATO has issued a number of Private Binding Rulings in response to a range questions concerning SMSF borrowing arrangements in general and nil interest loans in particular. In this article we examine a recent Private Binding ruling which has created much debate amongst SMSF Trustees and advisers alike.

Private Binding Ruling # 1012582301006

Despite most ATO rulings and other releases on the topic of nil interest loans appearing to be 'favourable', one recent ruling in particular was not favourable and, as such, has received a good deal of attention from advisers and trustees.

Of the 4 questions asked of the ATO in Private Binding Ruling (PBR) # 1012582301006, 3 of those related to contributions issues. The ATO's response to each question was that the arrangement would not give rise to the deeming of contributions.

Question 2 of the 4 questions, however, did not result in such positive news.

That question resulted in the ATO stating that income derived by the SMSF from an investment

using money borrowed at nil interest, in the particular circumstances, would be non-arm's length income.

The consequence of that, for the fund in question (which was stated to be fully in pension mode), is that all of the income from that particular investment would be taxed at 45% - the top marginal tax rate.

What has changed?

The conservative view has always been that related party loans, in relation to limited recourse borrowing arrangements, should be made on a commercial basis due to the fact that the borrower and the lender are related entities.

However, with release of ATO Interpretative Decision ID 2010/162 and subsequent discussions at NTLG meetings, in which the ATO seemed to state that a nil interest rate is acceptable for related limited recourse borrowing arrangements, many advisers took this to mean the terms of the loan did not have to be commercial – that is, the terms of the loan did not need to be similar to terms that a external lender would provide in a similar transaction.

So has the ATO's view changed on nil interest rate loans?

Without clear guidance it is hard to determine, but it is possible that the cumulative circumstances of this particular PBR are sufficiently different to those previously issued which has resulted in a different view for this particular transaction by the ATO.

The welcome news is that the ATO is understood to be planning to release an Interpretative Decision on the topic of nil interest loans and resulting non-arm's length income issues, which will provide some clarity around the acceptance of related party loans, and the appropriate commerciality.

In the meantime, we suggest that trustees and advisers considering related party loans to SMSFs do so on terms that would be considered consistent with commercial transactions, or alternatively, apply to the ATO for a Private Binding Ruling.

Circumstances of PBR # 1012582301006

The circumstances put to the ATO which resulted in the PBR included:

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- the proposed lender to the SMSF was the family trust;
- the corporate trustee of the family trust was also the corporate trustee of the SMSF;
- the directors of that company were the members of the SMSF;
- the same members of the SMSF were also the directors and shareholders of a new company established to act as trustee of the bare trust;
- 2 or more separate loans, limited in recourse, were to be made by the family trust to the SMSF;
- the loan agreement set the applicable interest rate at '0% or such other rate as agreed ...';
- the terms of the loans were that they would be repaid by way of a single lump sum payment at the end of the (unspecified, but suggested to be several decades hence) term of the loan;
- the LVR of each loan would be 100%;
- personal guarantees from related parties would not be obtained;
- the lender was to be granted a first ranking mortgage or charge over the respective asset being acquired;

- 1 or more of the loans would be to fund the purchase of listed ASX shares (1 loan per holding); and
- 1 loan would be applied to purchase units in a related unit trust which, in turn, would invest in cash and interest-bearing securities.

Familiar Structure?

The structure of the proposed arrangement, as put to the ATO, contains similarities to many other limited recourse borrowing arrangements in existence between SMSFs and related parties.

Therefore, the questions arising from the PBR include:

- has the ATO decided that nil interest loans should cease? or
- is it the combined structure, as outlined in PBR, that caused the negative reaction? and, if so
- which components?

The PBR did not specifically answer those questions, although some indication can be gleaned from the ATO's explanation.

Specific Aspects

Income shelter

If we consider the apparent purpose of one of the loans, being:

- the transfer of money from the taxed environment of the family trust;

- to be invested by the trustee of the SMSF, via a unit trust, in cash and interest bearing deposits in a tax free environment (i.e. - SMSF in pension mode);

the structure of the arrangement could be considered to be contrary to what is normally permitted under related party transactions.

The ATO applied the tests under subsection 295-550(5) of the ITAA 1997, to arrive at its conclusion in this PBR.

Subsections 295-550(4) & (5) of the 1997 Tax Act succeeded subsections 273(6) & (7) of the 1936 ITAA, which were added in 1999.

In the Explanatory Memorandum to the 1999 amendments, it was stated:

"Section 273 is designed to prevent income being unduly diverted into superannuation ... as a means of sheltering that income from the normal rates of tax applying to other entities ...".

So, the apparent 'picking up' of funds in one entity, with the intention of investing that money (in relatively secure investments) in a 'no tax' entity, would appear to be one reason why the specific aspects as outlined in PBR # 1012582301006 achieved the reaction it did.

As an aside, we wonder, if the ultimate investment under that loan had been 'at risk', rather than

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in bank deposits, whether the result may have been different.

Other matters

The main focus of the ATO in the PBR was consideration of the existence of a scheme, and further to this, if a scheme existed, if the terms of the LRBA constituted non-arms length income.

The following characteristics of the transaction are important to consider in this respect:

- a lack of personal guarantees;
- the LVR set at 100%; and
- the loan repayment terms.

Scheme

The application of subsection 295-550(5) enabled the ATO to determine that the income derived from the investment would be 'non-arm's length income', by virtue of the fact that a scheme existed.

As 'scheme' is very broadly defined, it seems it can be applied in almost any transaction, arm's length or not.

Non-Arm's Length Income

Basically, income is deemed to be non-arm's length if an entity, when not dealing at arm's length:

- acquired an entitlement under a scheme; or
- received income derived under a scheme;

when the income is greater than what it would be if dealing at arm's length.

In the PBR, the ATO appears to determine that the interest of the SMSF in the bare trust is the acquisition of an entitlement and further that the circumstances of the LRBA did not constitute an arms length transaction.

Is the ATO correct

Unfortunately the PBR does not indicate which components of the LRBA are not acceptable and which would be accepted as being at arm's length.

Hopefully, a forthcoming Interpretative Decision or SMSF Ruling will provide details which will provide clear guidance to trustees and their advisers.

Conclusion

A literal reading of the PBR would appear to indicate the ATO position is that every related party loan gives rise to a scheme. Therefore, what must be clarified by the ATO is the exact terms of the arrangement that constituted the transaction as non-arm's length.

The lesson which should be applied to the PBR is that related party loans should be arranged on a commercial basis.

Consideration should be given, when investing using a limited recourse borrowing from a related party, to applying for a PBR, particularly when any components of the transaction will be different to normal arrangements.

More information

Should you have any queries, or require more information, please contact the team at Topdocs on 1300 659 242.

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