

SMSF Borrowing and Non-Arm's Length Income - The Inadequate IDs

Inadequate may seem harsh but, in releasing 2 Interpretative Decisions, the ATO has missed the opportunity to provide positive guidance to SMSF trustees and their advisers.

On 12 December 2014, the ATO released 2 Interpretative Decisions concerning limited recourse borrowing arrangements and non-arm's length income. This paper explains what could have been improved.

ATO IDs 2014/39 & 40

The two Interpretative Decisions (IDs) are quite similar in a number of ways, with a few variations:

- [ATO ID 2014/39](#), deals with an example of an acquisition of listed shares;
- Whilst [ATO ID 2014/40](#) deals with an example of an acquisition of real property.

We have been waiting

From the time the ATO released Private Binding Ruling (PBR) # 1012582301006, the industry has been awaiting the release of the promised IDs so that it could obtain guidance as to what the ATO would (and would not) consider to be an acceptable arrangement between non-arm's-length parties to a limited recourse borrowing arrangement (LRBA).

Positive Guidance

The inadequacy referred to above, which will be explained in some detail below, stems from the absence in the IDs of any commentary which would assist

SMSF trustees and their advisers in ensuring any related party limited recourse borrowing arrangements (LRBAs) are acceptable to the ATO.

What can be determined from the IDs is that, as we already knew from the PBR, 0% interest rates are not acceptable and will lead to a non-arm's length income (NALI) assessment.

A comparison of the facts set down in each of the 2 IDs, as examples of transactions that would trigger NALI, indicates little difference between the IDs. Comments on the facts presented are covered in the table below.

Facts of the LRBAs set out in the IDs

Detail of the Transaction	ID 2014/39	ID 2014/40	Our Notes
The Fund is a complying superannuation fund	Yes	Yes	
The Fund has a corporate trustee	Yes	Yes	Assume not of significant relevance
What asset is being acquired	A number of parcels of ASX listed shares	Commercial property	As banks are generally reluctant to lend on the security of shares, the investment under ID 2014/39 would, in most cases, require related party finance
Composition of the LRBA	1 per parcel of shares	1 only	Complies with Single Acquirable Asset rules

Current as at 17 December 2014

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Facts of the LRBAs set out in the IDs			
Detail of the Transaction	ID 2014/39	ID 2014/40	Our Notes
Who is the borrower	SMSF Corporate Trustee	SMSF Corporate Trustee	Correct as per previous ATO directions
Who is the lender	SMSF trustee, in the capacity as trustee of family trust	Individual fund members	No indication whether SMSF trustee (in a different capacity) as lender is a concern
Who is the trustee of holding trust	Separate company	Separate company	No indication it is a concern
Who are the directors of the holding trust trustee	Same as SMSF trustee	Same as SMSF trustee	No indication of a concern
SMSF entitlement in the Asset	<ul style="list-style-type: none"> ■ Vested and indefeasible interest; ■ absolutely entitled; ■ fixed entitlement 	<ul style="list-style-type: none"> ■ Absolute benefit and an entitlement; ■ beneficial interest vested in possession 	In assets of the holding trust and against the holding trust trustee
Terms of the loans	<ul style="list-style-type: none"> ■ Several \$million across all loans ■ 20 year terms ■ single lump sum repayment; ■ 0% interest rate; ■ 100% LVR ■ 1st ranking mortgage and charge; ■ no personal guarantees or other security 	<ul style="list-style-type: none"> ■ \$500,000 ■ 15 year term; ■ monthly principal repayments; ■ 0% interest rate; ■ 80% LVR ■ 1st ranking mortgage; ■ no personal guarantees or other security 	<ul style="list-style-type: none"> ■ single lump sum repayment - presumably not commercial ■ 0% interest rate - we know it is a problem ■ 100% LVR – some banks will lend to 110% to certain customers, but would they to <u>that</u> borrower? No mention whether 80% is acceptable ■ 1st ranking mortgage and charge – must be a positive ■ no personal guarantees or other security – mere statement or actual concern? Incidentally, it was a concern of the Financial System Inquiry that personal guarantees <u>existed</u>!

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What hasn't helped?

The general problem with the facts as set out in the two IDs is that they clearly contain at least one component which is likely to result in the income the SMSF derives from the investment being treated as NALI. However, what has not helped here is that the IDs contain no indication of which of those facts would be acceptable - in other words, would not trigger a NALI assessment.

For example, both IDs refer to the fact that no personal guarantees or other security is given to the lender, without stating whether the ATO:

- takes a positive or negative reaction to that; or
- is indifferent to that aspect and is merely stating facts.

How is a NALI assessment arrived at?

NALI is covered under section 295-550 of the ITAA 1997. Under subsection 295-550(5), NALI will apply where a scheme exists under which the Fund derives its income from a trust where:

- the parties were not dealing at arm's length; and
- the income is greater than it would have been had the parties been dealing at arm's length.

In the PBR and the IDs, the ATO has arrived at its decision that NALI applied based on the argument that, rather than the bare trustee

merely holding the asset as custodian for the SMSF, the SMSF is actually a beneficiary of a trust and derives income from that trust.

Particularly as a result of the 0% interest applicable, which would be most unlikely to be available if the parties had been dealing at arm's length, the SMSF income from the investment is then deemed greater than would otherwise have been available.

However, as mentioned previously, the other facts included in the IDs do not come with any indication as to whether they are considered not to be dealing at arm's length.

How should the SMSF financial statements be prepared?

Until clear guidance is provided from the ATO, financial statements and the SMSF annual return, for an SMSF with a related party loan under a LRBA, will need to be prepared on a case by case basis.

Application may need to be made for a Private Binding Ruling on the specific facts, to be fully certain that NALI does not apply.

Consider the position of an SMSF auditor who needs to provide an opinion as to whether the financial report '... presents fairly, in all material respects' i.e., accurately reflects the financial position, when they cannot be certain that the tax position is accurate when there is a possibility of NALI.

How could we have been better informed?

As ATO IDs in general tend to deal with a specific question, it may be somewhat unreasonable to expect them to contain examples of what would be acceptable in the circumstances of a related party borrowing under an LRBA, so as not to trigger a NALI assessment.

What would have been of assistance is more detailed guidance, such as in the form of an SMSF Ruling, which tends to include examples showing both positive and negative results.

Conclusion

Clearly, 0% loans will be considered by the ATO to represent NALI, so SMSF trustees and their advisers will need to consider how they record income from the investment in the annual return of the SMSF.

Additionally, trustees and advisers should review other terms of the arrangements, such as the length of the loan, payment requirements and intervals and the security provided to the lender.

When documenting a related party limited recourse borrowing arrangement, our conservative recommendation, as always, is to make the terms of the loan noted above as comparable as possible to those the Fund could have obtained from an arms-length lender.

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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