ALL THINGS LRBAS

William Fettes, Senior Associate, DBA Lawyers

#NC2020

William Fettes

Senior Associate, DBA Lawyers

William is a Senior Associate at DBA Lawyers where his work focuses on superannuation law compliance, succession planning and taxation in an SMSF context.

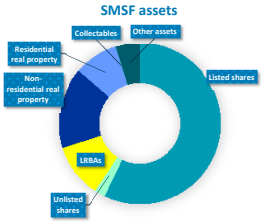
William presents regularly on SMSF and related tax issues across Australia, including for CPA Australia and DBA Network. William has also been published in numerous top SMSF publications, including CCH, Taxation in Australia, SMSF Adviser, and LexisNexis publications.

William holds a Bachelor of Laws and Bachelor of Arts from Monash University. William is currently completing his Master of Laws at the University of Melbourne.

Disclaimer

LRBAs — A popular investment structure

- Despite first tier lenders exiting the LRBA lending space, LRBAs remain a popular investment choice for SMSFs
- **SMSF statistical report — September 2019**
  - The total number of SMSFs: 598,582
  - Total value of SMSF assets: $746 billion
    - LRBAs: over $43 billion
    - Non-residential property: $64.6 billion
    - Residential real property: $35 billion

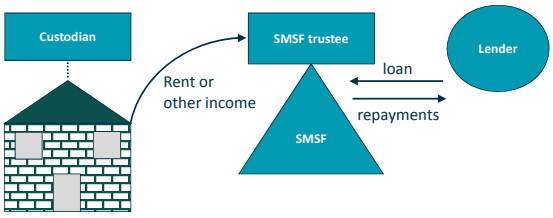


Current issues and themes

- The new lending environment
- Traps and pitfalls in practice
- New(ish) legislation impacting LRBAs

The basic structure

Legal title to asset held on trust by bare trustee/custodian



Questions

- Should the bare trust used to establish an LRBA custodial arrangement be named?
- Can an existing bare trustee be re-used for a second LRBA?
- When do the restrictive LRBA asset replacement rules fall away?
- Can more than one loan be used for an LRBA acquisition?
- Is there cause for concern in relation to enlivening the LRBA transfer balance cap rules?
- What is the impact of the LRBA total superannuation balance measures?
- How do the new non-arm's length income rules apply?

Bare trusts

- A holding trust is a fundamental part of the borrowing rules in s 67A of the SISA
- Few substantive requirements for LRBA bare trusts in SISA/SISR
  - Asset must be held on trust so that the SMSF trustee acquires a beneficial interest
  - Right to acquire legal ownership of the asset by making one or more payments

Note that it does not say 'express trust'

- Therefore, non-SISA/SISR reasons often have the most salience in relation to the content and naming conventions for LRBA bare trusts
- For example, property law concerns can be important, eg, for Queensland-based real estate, registering the bare trust on title is a common practice

Bare trusts

- Historically there has been a tension between the desire for the trust to be as transparent as possible for tax purposes and the requirements of LRBA lenders
  - Naming the bare trust could give rise to a question regarding whether the bare trustee should be lodging tax returns separately and in addition to the SMSF trustee
- The introduction of ss 235-820(2) and 235-840 of the ITAA 1997 in 2015 (with retroactive effect from 24 September 2007) helped address income tax transparency concerns with LRBA trusts

  An act done in relation to an instalment trust asset of an instalment trust by the trustee of the trust is treated as if the act has been done by the investor (instead of the trustee).
- Income tax transparency concerns over naming an LRBA bare trust are now less meaningful
- Lender requirements are an important driver and many second/third-tier lenders now require the bare trust to be named

Bare trusts

- **Warning:** The look-through provisions do not mean that the bare trust instrument does not require careful legal drafting, with some appropriate regard for minimalism
- Consider *MD Commercial Pty Ltd & AJ Commercial Pty Ltd v Commissioner of State Revenue* [2018] VSC 560 where a duty exemption under the s 35 of the *Duties Act 2001* (Vic) was denied because the purported bare trust instrument provided powers to:
  - '…hold, use, purchase, construct, demolish, maintain, repair, renovate, reconstruct, develop, improve, sell, transfer, convey, surrender, let, lease, exchange, take and grant options or rights in, alienate, mortgage, charge, pledge, reconvey, release or discharge or otherwise deal with any real or personal property'
  - '…partition or agree to the partition of, or to subdivide or agree to the subdivision of any land or other property which may for the time being be subject to the trusts hereof'

Can an existing bare trustee be re-used for a second LRBA?

- Starting point: must be a separate bare trust and loan for each new LRBA acquisition
- Borrowing rules do not preclude re-using an existing bare trustee entity for a new LRBA
- Must be a different entity to the SMSF trustee and there are many sound reasons to avoid using a company that acts in other capacities (eg, as a trading entity)
- However, it is critical to thoroughly review the lender's documentation including any guarantee documentation! Watch out for clauses such as the following:

  If you are the trustee of any trust, you are liable under this guarantee in your own right and as trustee of the trust. Accordingly, the lender can recover against the trust assets as well as from you to satisfy your liabilities under this guarantee.
- Thus, best practice is to establish a separate company to act as bare trustee for each LRBA

When do the restrictive LRBA asset replacement rules fall away?

- Many people would say the answer is when the LRBA loan has been fully repaid *But not so fast!*
- Section 71(8) of the SISA and regulatory instrument SPR 2014/1 must be considered
- Section 71(8) broadly carves out LRBA bare trusts from the in-house asset rules
- Under this provision, an LRBA bare trust that would otherwise be considered an investment in a 'related trust' is excluded from the definition of an in-house asset where it is a trust as described in s 67A(1)(b) **in connection with a borrowing** and **covered by s 67A(1)**
- This means the absence of borrowing (on establishment of the trust or after the loan has been fully repaid) technically precludes s 71(8) from applying

When do the restrictive LRBA asset replacement rules fall away?

- SPR 2014/1 overcomes the technical issue of s 71(8) not applying where there is no borrowing
- The explanatory statement to SPR 2014/1 states: 'In many cases, the holding trust will be a 'related trust' of the SMSF as defined in subsection 10(1)'
- SPR 2014/1 clarifies that a LRBA bare trust will not be considered a related trust for the purposes of the in-house asset rules subject to certain provisos
- In the context of an LRBA loan that has been fully repaid one key requirement is that:
  - The SMSF trustee can demonstrate s 71(8) applied at all relevant times but for the fact that the borrowing has been repaid
- Recall that s71(8) requires the arrangement be '…covered by subsection 67A(1)'

Is this really true?

When do the restrictive LRBA asset replacement rules fall away?

- Therefore, the most conservative approach is to treat the restrictive rules that apply to LRBA assets as continuing to apply until:
  - The LRBA loan has been fully repaid; AND
  - The asset has been transferred from the bare trustee back to the SMSF trustee
- Only at that time is there no question that the fund does not need to rely on s 71(8) and SPR 2014/1 in relation to the investment in the bare trust potentially being an in-house asset
- In particular, this means the LRBA asset must continue to be the same asset (see SMSFR 2012/1):
  - Cannot fundamentally change the physical or legal character of the asset (eg, subdivision or development that is not an allowable improvement)
  - Subject to asset replacement covered by s 67B of the SISA

Watch out for stamp duty

Can more than one loan be used for an LRBA acquisition?

- This scenario typically only arises where a main loan from a commercial lender with top up funds from a related party loan or where there are multiple related party lenders
- To comply with PCG 2016/5, the overall LVR across both loans would need to fall within 70%
- PCG 2016/5 also requires registered mortgage
- Many commercial lenders may be reluctant to accept a second loan and second mortgage
- If the lender accepts this arrangement, they would generally require a deed of priority in place to protect the bank's interest

Is there cause for concern in relation to enlivening the LRBA transfer balance cap rules?

- Broadly, a credit to a member's transfer balance account occurs if:
  - (a) [An SMSF trustee] makes a payment in respect of a borrowing under an arrangement that is covered by the [s 67A(1) LRBA] exception …; and
  - (b) as a result, there is an increase in the *value of a *superannuation interest that supports a *superannuation income stream of which you are the *retirement phase recipient …
- Can only apply to LRBAs where the loan contract was entered into from 1 July 2017 onward (excluding qualifying refinances of pre-1 July 2017 LRBAs)
- Can only apply where the loan payment occasions a shift in value from another interest to a retirement phase pension interest as a result of the LRBA liability being reduced

Is there cause for concern in relation to enlivening the LRBA transfer balance cap rules?

- How would such a shift in value actually arise?
- The LRBA asset and debt would need to be segregated (for investment/accounting purposes) to the pension interest, and the repayment would need to be debited from an accumulation account or assets that are not part of the same segregated pension pool as the LRBA asset
- This kind of accounting approach is very far from being commonplace and it is likely contrary to the fair and reasonable standard in reg 5.02(3) of the SISR
- Thus, it is unlikely many funds would be affected by this integrity measure

What is the impact of the LRBA total superannuation balance measures?

- Under ss 307-230(1) and 307-231 of the ITAA 1997, an individual member's TSB may be increased by the share of an outstanding balance of a LRBA, commenced after 1 July 2018, related to the assets that support their superannuation interests
- An increased TSB only applies to members:
  - who have satisfied a relevant condition of release with a nil cashing restriction; or
  - whose superannuation interests are supported by assets that are subject to an LRBA between the SMSF and its 'associates'
- This measure may result in significant hurdles and limits being imposed on the member and their fund

What is the impact of the LRBA total superannuation balance measures?

Recall that a member's TSB is relevant for various superannuation rights and entitlements, eg:

- $500k — Eligibility for the 5-year carry forward rules for CCs
- $1m — Annual or quarterly TBAR reporting frequency
- < $1.4m to $1.5m —Eligibility to bring forward NCCs
- $1.6m — Eligibility to make an annual NCC without an excess
- $1.6m — Eligibility to use the segregated ECPI method
- $1.6m — Eligibility for spousal contribution tax offset
- $1.6m — Eligibility for government co-contribution

What is the impact of the LRBA total superannuation balance measures?

- SMSF trustees and advisers need to be mindful about the potential impact of the measure:
  - Cash flow constraints on servicing the loan (eg, due to more restrictions on contributions)
  - Denial of other TSB-tested superannuation concessions or entitlements
- Worthwhile considering possible options to mitigate how/when the measure applies
  - Eg, deferring retirement or refinancing the LRBA to a non-associate
- Careful planning and cash flow forecasting should be undertaken prior to entering into an LRBA after 1 July 2018

How do the new NALI rules apply?

- Key NALI provisions rewritten by *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019* (Cth)
  - Royal Assent on 2 October 2019
  - Effective from 1 July 2018 onwards
- Re-writing of s 295-550(1) does not impact income previously captured as NALI
- Amendments target 'technical deficiency' in the prior provisions in relation to income derived where the superannuation entity has non-arm's length expenditure or nil expenditure
- **Expansive application** including in respect of LRBAs

How do the new NALI rules apply?

- Recall in the minutes of the December 2012 National Tax Liaison Group, it was stated:

  > The ATO position on low rate loan arrangements and LRBA [sic] is that that they do not generally invoke a contravention of the SISA, **do not give rise to non-arm's length income** under section 295-550 of the Income Tax Assessment Act 1997 (ITAA), do not invoke Part IVA of the ITAA 1936 and are not considered to give rise to contributions to the SMSF just from that one fact alone

- The re-written provisions address certain technical arguments against NALI, eg:
  - Where the amount of ordinary income or statutory income from the scheme is the same as might be expected had the dealings been at arm's length
  - Where the market value substitution rule operates in calculating a net capital gain
- These arguments were not in any event accepted by the ATO under current ATO practice

How do the new NALI rules apply?

- Application of the new provisions requires an analysis of the nexus between NALE and income
  - Was the expenditure incurred 'in' gaining or producing the relevant income?
- Nexus requirement elaborated on in LCR 2019/D3
- **Specific nexus:** NALE incurred to acquire an asset will have a sufficient nexus to any ordinary and statutory income derived by the fund in respect of that asset
  - Eg, If a property is acquired on non-arm's length terms, any rental returns and net capital gain on disposal of the property will be NALI
  - No comfort from the ATO that favourable LRBA loan terms would not result in the net capital gain arising on disposal of the LRBA asset being NALI even if the asset acquired for arm's length purchase price
- **General nexus:** NALE can have a sufficient nexus to all of a fund's ordinary/statutory income

How do the new NALI rules apply?

- No transitional compliance approach is available under PCG 2019/D6 for the asset specific nexus
- Accordingly, the new laws sharpen the scope for NALI to apply in respect of any ordinary and statutory income derived by an SMSF trustee in connection with an LRBA asset from 1 July 2018
- For real property and listed securities, best to stick within PCG 2016/5 safe harbour terms
- Otherwise, must be able to show that the terms are arm's length

> If SMSF trustees have entered into an arrangement which does not meet all of the 'Safe Harbour' terms set out in this Guideline … it does not mean that the arrangement is deemed not to be on arm's length terms. It merely means that there is no certainty provided under this Guideline. The trustees will need to be able to otherwise demonstrate that the arrangement was entered into and maintained on terms consistent with an arm's length dealing.
> One example of how a trustee may demonstrate this is by **maintaining evidence** that shows their particular arrangement is established and maintained on terms that replicate the terms of a commercial loan that is available **in the same circumstances**

How do the new NALI rules apply?

- Also need to consider previous ATO publications on NALI
- Eg, the hypothetical borrowing arrangement concept in TD 2016/16:

  > Where it is reasonable to conclude that the SMSF could not have, or would not have entered into the hypothetical borrowing arrangement, the SMSF will have derived more ordinary or statutory income under the scheme than it might have been expected to derive under the scheme with the hypothetical borrowing arrangement

- Can be very difficult to obtain appropriate benchmark evidence for different types of assets, such as units in a private unit trust

Conclusions

- The SISA/SISR provisions relevant to LRBAs are now relatively settled territory
- But there are still numerous pitfalls and traps
- The new lending landscape is introducing new challenges
  - Documentation being relied on by new lenders is not always appropriate
  - New conventions are emerging, such as requiring bare trustees to give a name to the bare trust
- New TSB laws demand careful planning and monitoring to ensure loans can be appropriately serviced and to avoid the denial of other super concessions
- NALI remains an area of active surveillance and ATO compliance resources bolstered by the re-written expansive provisions

Contact details

William Fettes, Senior Associate, DBA Lawyers

Ph: 03 9092 9400

E: wfettes@dbalawyers.com.au

Web: www.dbalawyers.com.au

Twitter: @DBALawyers

Disclaimer

This presentation is for general information only. Every effort has been made to ensure that it is accurate, however it is not intended to be a complete description of the matters described. The presentation has been prepared without taking into account any personal objectives, financial situation or needs It does not contain and is not to be taken as containing any securities advice or securities recommendation. Furthermore, it is not intended that it be relied on by recipients for the purpose of making investment decisions and is not a replacement of the requirement for individual research or professional advice. Actions, reactions and interpretations cannot be relied upon.

The presentation is purely the opinion of the presenter on the day and this presentation is record of that opinion.

This presentation was accompanied by an oral presentation, and is not a complete record of the discussion held.

No part of this presentation should be used elsewhere without prior consent from the author.

#NC2020