Current issues with LRBAs – COVID, Safe harbour, Div 7A and more

SPEAKER
Phil Broderick

TITLE
Principal

ORGANISATION
Sladen Legal

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This paper examines a number of current and topical issues in relation to limited recourse borrowing arrangements (**LRBAs**), including:

- The LRBA COVID-19 relief measures
- Can you still qualify for the Australian Tax Office's (**ATO**) safe harbour if you apply the COVID-19 relief?
- The interaction of the safe harbour rules, COVID-19 LRBA relief, Division 7A and COVID-19 Division 7A relief
- Intermediary LRBAs – are they worth it?
- Refinancing LRBAs – how can it be done?
- Non-arm's length income (**NALI**)/non-arm's length expenditure (**NALE**) and LRBAs – where are we at?

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1. LRBA COVID RELIEF MEASURES

As a result of COVID-19, some SMSFs have sought relief from their LRBA loans.

This could be because:

- Rent relief has been offered to the SMSF's tenant(s)
- Reduced income generally
- Reduced contributions

LRBA relief could include:

- A refinance to better terms
- A freeze in principal and/or interest payments
- Reduction or waiver of interest
- Capitalisation of interest
- Extension of the term of the loan
- Writing off the loan in part or full

In 'normal times', any modification to related party LRBA loan terms (such as those listed above) could potentially cause issues for self managed superannuation fund (**SMSF**) trustees.

As part of the ATO administrative concessions introduced in response to COVID-19, the ATO has stated that temporary repayment relief may be offered for related party LRBAs. The repayment relief must reflect similar terms to what commercial banks are currently offering for real estate investment loans as a result of COVID-19.

What relief can be offered?

The ATO has stated the following in relation to what relief can be offered under this measure:

> *If the repayment relief reflects similar terms to what commercial banks are currently offering for real estate investment loans as a result of COVID-19, we will accept the parties are dealing at arm's length and the NALI provisions do not apply. For example, these terms currently include temporary repayment deferrals for most businesses of up to 6 months, with unpaid interest being capitalised on the loan.*

The ATO refers to the Australian Banking Association's (**ABA**) website for current information on COVID-19 bank relief.

The ATO also states that:

- It is also expected that there is evidence that interest continues to accrue on the loan and that the SMSF trustee will catch up any outstanding principal and interest repayments as soon as possible.

- Any further repayment relief needed due to the continued effects of COVID-19 should be reviewed at the end of the agreed deferral period and remain in line with what the commercial banks are offering at that time.

- Where the terms of the loan contract are varied to require interest to be capitalised on the loan and repayments to be made over an extended loan term as described above, the ATO will accept that these variations to the loan contract do not amount to a rescission or replacement of the original contract, or that there are fundamental changes to the character of the loan such that a new borrowing arises.

Issues with LRBA relief

LRBA relief could potentially raise a number of issues, including:

- A breach of the non-arm's length income requirements contained in section 109 of the SIS Act
- Sole purpose test contained in section 62 of the SIS Act

- Non-arm's length income (**NALI**) rules, including non-arm's length expenses (**NALE**)

NALI/NALE is the main issue. In identifying whether NALI/NALE concerns arise, look at:

- Has there been non-arm's length dealing? and
- Either:
  - The SMSF received more income than it should have had the parties been dealing at arm's length; or
  - In gaining the income, the SMSF incurred an expense that is less than an arm's length amount.

LRBA relief granted to a borrower by an unrelated lender will typically not trigger NALI, because the parties are at arm's length and are dealing at arm's length. However, as noted in the Explanatory Material to the NALE amendments, 'parties do not have to be related to deal with each other on non-arm's length terms. Benefits they or others receive due to the transaction are considered relevant in determining whether a transaction is on arm's length, unrelated party terms.'

On the other hand, LRBA relief from a related party can readily trigger NALI. That is, there is almost an assumption that the loan modifications are not at arm's length and the burden is on the SMSF to prove otherwise.

Instructions to auditors

The ATO has told SMSF auditors that loan relief matching the ABA requirements and/or similar to what the commercial banks are offering will be treated as being on arm's length terms (ie, no contravention arises).

If auditors identify LRBA relief which is not on arm's length terms, then they should lodge an ACR.

Will modifications to LRBA loans lose the safe harbour protection?

The ATO has not specifically addressed the question of whether LRBA modifications will result in the loss of the safe harbour protections as set out in PCG 2016/5. However, the ATO website material states that if the LRBA modifications comply with the requirements set out in the ATO FAQs document, the ATO will accept the parties are dealing at arm's length and the NALI provisions will not apply.

Accordingly, it appears implied that the LRBA modifications (provided they meet the relevant requirements) will not result in the loss of the safe harbour protections.

Where an SMSF has chosen to apply the ATO's safe harbour provisions, the SMSF trustee should ensure that the capitalised interest during any loan repayment deferral period reflects the correct interest rate from that time.

The rate used by the ATO is the Reserve Bank of Australia Indicator Lending Rate for banks providing standard variable housing loans for investors, based on the published rate in May each year (5.10% p.a. from 1 July 2020).

Can other relief be offered?

The ATO confines its relief to those set out in the ABA's website. However, in my view, the relief could extend beyond that. Although, if that were to occur it would be prudent to have some benchmarking material to support the relief offered.

ATO material

ATO FAQs

Eligibility

Again, the ATO website material is silent as to precisely what relief can be offered and whether it can be offered to all borrowers, however it does state that 'temporary repayment relief may be offered in relation to an existing LRBA between an SMSF and a related party due to the financial effects of COVID-19'.

Currently, the ABA provides that lenders will provide a deferral of loan repayments for up to six months on the following basis:

- The Borrower must be able to show they have been financially impacted by COVID-19; and

- The Borrower must not terminate a lease or evict a tenant for rent arrears during the loan deferral period.

The ABA announced on 8 July 2020 that customers with reduced incomes and ongoing financial difficulty due to COVID-19 are eligible to apply for an extension of their deferral for up to four months. This deferral extension was not automatic, and was provided only to those who genuinely needed the extra time.

According to the ABA website, other options at the end of the six-month deferral are:

- You can pay in full
    - You must restart repayments of the loan as per the loan terms
- You can partially repay
    - You may have your loan restructured or varied
- You cannot pay
    - 'You will be assisted through your bank's financial hardship process to determine your best long-term solution'

Documentary requirements

The relief should be appropriately documented including:

- The parties to the arrangement must document the change in terms to the loan agreement for example by way of deed or exchange of letters.
- Parties should also demonstrate and document the financial impact on the SMSF caused by COVID-19.
- Appropriate benchmarking material should be sought and retained. Beware of changing website material – print out or take screen shots of material being relied upon.

At the core of the relief is that an SMSF trustee needs to be able to show that they are unable to meet loan repayments due to the financial impact of COVID-19. That is, the relief can't be accessed unless it is actually required.

This is an ATO administrative concession so that while the ATO has stated that it won't apply compliance to such actions, it is not strictly bound by this measure.

2. THE INTERACTION OF THE SAFE HARBOUR RULES, COVID-19 LRBA RELIEF, DIVISION 7A AND COVID DIVISION 7A RELIEF

Where the lender under an LRBA is:
- a related company; or
- a related trust that has an unpaid present entitlement owing to a company (directly or through a chain of trusts)

the operation of Division 7A of Part III of the *Income Tax Assessment Act 1936* must also be considered.

Where Division 7A is triggered, the loan will be treated as an unfranked dividend to the SMSF, and potentially deemed to be a contribution.

A related party LRBA to which Division 7A applies should ideally meet both the Division 7A criteria and the PCG 2016/5 safe harbour to ensure the loan is not deemed a dividend under Division 7A, and not deemed to be on non-arm's length terms.

The current PCG 2016/5 safe harbour loan terms are more restrictive than the current Division 7A loan terms (maximum term for Div 7A where loan is secured by a mortgage over real property is 25 years vs 15 years for safe harbour; interest rate of 4.52% vs 5.10%). Accordingly, the safest course is to follow the PCG 2016/5 safe harbour terms to ensure the loan satisfies both criteria.

Note: targeted amendments to Division 7A originally scheduled to commence on 1 July 2020 have been deferred (due in part to the reprioritisation of legislative amendments in response to COVID-19).

COVID Division 7A relief

One of the requirements for a Division 7A loan is that the borrower must make a minimum yearly repayment (**MYR**) by the end of the private company's income year. This avoids the borrower being considered to have received an unfranked dividend, generally equal to the amount of any MYR shortfall.

In response to the financial impact of COVID-19, the ATO have allowed an extension of the repayment period for those borrowers who are unable to make their MYR by the end of the lender's 2019-20 income year.

Once the application for an extension has been approved by the ATO, the ATO will confirm the borrower will not be considered to have received an unfranked dividend. This is subject to the shortfall being paid by 30 June 2021.

Interaction between COVID-19 Division 7A relief and COVID-19 LRBA relief

The Division 7A requirements are the minimum requirements – ie, can charge a higher interest rate and have a shorter loan term.

The safe harbour loan terms are generally more onerous. For example, for real estate as they require:

- Shorter loan term (eg 15 vs 25 years);
- higher interest rate (eg for 2021, 5.10% vs 4.52%); and
- lower loan to value ratio (70% vs 90%).

Accordingly, if the loan terms fall within the safe harbour, they will generally not trigger Division 7A.

In terms of the COVID relief offered for LRBAs and Division 7A, both allow for deferral of principal payments:

- LRBA COVID relief allows deferral for 6-10 months;
- Division 7A allows a deferral for 2019/2020 payments until 30 June 2021 upon application.

The major difference is between the type of interest relief offered:

- LRBA COVID relief allows for interest deferral for 6-10 months, with the interest being capitalized on the loan.
- The ATO website material in relation to Division 7A relief appears to not allow for interest to be deferred. That is, the interest must continue to be paid, albeit at the lower Division 7A rate. This means the balance of the interest could potentially be deferred.

POSTSCRIPT - Division 7A loans can capitalise interest

The author has recently had discussions with the ATO in relation to the problems associated with the non-capitalisation of interest under the Division 7A COVID relief. The ATO has confirmed that interest can be capitalised and that the ATO:

- won't take compliance action for 2019/20 year;
- will release clarification for the 2020/21 year.

3. INTERMEDIARY LRBAS – ARE THEY WORTH IT?

What is an intermediary LRBA?

Under a 'standard' LRBA, the bare trustee under the LRBA will hold the legal title to the asset, while the SMSF trustee is the principal borrower and beneficial owner of the asset.

Under an intermediary LRBA, the bare trustee holds the legal title to the asset and also acts as principal borrower rather than the SMSF trustee.

In their explanatory statement to SPR 2020/1(discussed further below), the ATO define an intermediary LRBA as an arrangement, entered into by the parties, which meets the following requirements:

1. *a holding trust is established with members of a fund being the only trustees or shareholders and directors of the corporate trustee (**Holding Trustee**);*
2. *the trustee of the fund is a beneficiary of the holding trust;*
3. *the Holding Trustee holds an acquirable asset (**Asset**) on trust for the trustee of the fund, who is beneficially entitled to the Asset;*
4. *the Asset is a single acquirable asset (as referred to in subsection 67A(1)) that the trustee of the fund is allowed to acquire under the Superannuation Industry (Supervision) Act 1993 (**SIS Act**);*
5. *the Holding Trustee enters into a borrowing as principal with a lender with the borrowing secured by a mortgage over the Asset;*
6. *the contract or deed of borrowing, referred to in paragraph (5), between the Holding Trustee and the lender may not limit the lender's right of recourse, under the contract or deed, to only the Asset in the event of default;*
7. *the lender may require that personal guarantees are given as part of the intermediary LRBA;*
8. *the arrangement is established by a legally binding deed(s) under which the trustee of the fund and the Holding Trustee agree for:*

   a. *the trustee of the fund to maintain all borrowing obligations entered into by the Holding Trustee in respect of the borrowing arrangement referred to in paragraph (5);*

   b. *the trustee of the fund is absolutely entitled to any income derived from the Asset, less fees, costs, charges and expenses incidental to the acquisition, holding or management of the Asset;*

   c. *the trustee of the fund has the right to acquire the legal title of the Asset on completion of the borrowing referred to in paragraph (5);*

   d. *the rights of the Holding Trustee or any guarantors against the trustee of the fund following the default on the borrowing referred to in paragraph (5) is limited to the Asset.*

9. *the documentation referred to in paragraph (8) in connection to the borrowing referred to in paragraph (5) is disclosed to the lender at the time of borrowing.*

Why use an intermediary LRBA?

- Increased borrowing options as some lenders will only lend where the borrowing entity also holds title of the property that will be used as security under the loan;

- Unlike a typical LRBA, an intermediary LRBA does not have to be limited in its recourse;

- May enable SMSFs to access a wider range of lenders and possibly borrow at more attractive investor rates compared to existing higher SMSF loan products;

- Simplicity of having the asset and loan in the one entity;

- Potentially no liability in the SMSF financial statements; and

- Potential asset protection advantages.

Any downsides?

- The bare trustee is a look through entity for taxation purposes, and is not a reporting entity. Accordingly, where the borrowing is undertaken by the bare trustee and maintained by the SMSF trustee under an intermediary LRBA, this may involve the flow of funds through the bare trustee (and therefore extra administration with the trust required to register for an ABN, GST and to lodge tax returns).

- Intermediary LRBAs are not well known or well understood in the market.

- Cannot be used to hide the involvement of an SMSF from the lender (as bare trust deed must be disclosed to the lender as per SPR 2020/1).

In-house asset issues

Under a standard LRBA, because the SMSF trustee controls the bare trustee, the bare trust is a related trust of the SMSF, and so the interest of the SMSF in the bare trust would typically be classed as an in-house asset of the SMSF. However section 71(8) of the SIS Act specifically excludes from the definition of 'in-house asset' a fund's investment in a related trust that is connected to a borrowing, by the SMSF trustee that is covered by section 67A of the SIS Act (i.e. a complying LRBA).

The exclusion under section 71(8) of the SIS Act only covers circumstances where the borrowing, covered by section 67A of the SIS Act, is undertaken by the SMSF trustee. That is, to be excluded from being an in-house asset, the fund must borrow the amount directly.

To address this, the ATO issued *Superannuation Industry (Supervision) In-house Asset Determination — Intermediary Limited Recourse Borrowing Arrangement Determination 2020* (**Determination**). The Determination was made under section 71(1)(f) of the SIS Act, which gives the ATO power to exclude an asset from the definition of in-house assets.

Relying on this power, the Determination now ensures that an investment by an SMSF in a related trust that is in connection with an intermediary LRBA, and that complies with section 67A of the SIS Act, is excluded from being an in-house asset of the SMSF in the circumstances described in the Determination.

The Determination has retrospective effect from 24 September 2007.

The Determination now provides SMSF trustees with an additional borrowing option, however it is vital that the SMSF trustee, and bare trustee structure, comply with the relevant prescriptive requirements set out in the Determination. In particular, the SMSF and bare trustee must disclose the arrangement to the lender.

Importantly, the Determination will not apply where the investment would be an in-house asset if it was held directly by the SMSF.

ATO material

SPR 2020/1
SPR 2020/1 – Explanatory Statement

4. REFINANCING LRBAS – HOW CAN IT BE DONE?

Section 67A(1)(a)(ii) of the SIS Act specifically permits the refinancing of an LRBA as follows:

> (1) Subsection 67(1) does not prohibit a trustee of a regulated superannuation fund from borrowing money, or maintaining a borrowing of money, under an arrangement under which:

(a) the money is or has been applied for the acquisition of a single acquirable asset, including:

(i) expenses incurred in connection with the borrowing or acquisition, or in maintaining or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset); and

Example: Conveyancing fees, stamp duty, brokerage or loan establishment costs.

(ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset)…

Accordingly, the SIS Act allows for an LRBA to be refinanced, provided the refinanced arrangement meets the requirements of section 67A of the SIS Act.

ATO view

The ATO confirmed in ATO ID 2010/169 that where:

- the money borrowed under the refinance arrangement is applied solely for the purpose of replacing the financing arrangement for the earlier arrangement; and
- the refinanced LRBA meets the requirements of section 67A of the SIS Act (if the refinancing occurred on or after 7 July 2010); and
- legal ownership of the asset is not temporarily acquired by the SMSF trustee when changing to the new arrangement;

the refinancing will not contravene the general borrowing prohibition in subsection 67(1) of the SIS Act.

Where a new trust is created to hold the asset as part of the refinancing, the SMSF trustee must ensure that the asset is transferred directly to the new trustee and that the SMSF does not temporarily obtain title to the asset at that time, otherwise a contravention of the SIS Act will occur.

Can a refinancing be used to borrow more?

The short answer is no, it can't. The application of the new borrowing must be solely to extinguish the previous borrowing and meet the associated costs of establishing the new borrowing.

In particular:

- The refinancing must not increase the amount borrowed against the property. That is, the refinancing arrangement must be solely used to replace an earlier arrangement; and
- The LRBA cannot be refinanced for a higher amount with the additional funds used to purchase an additional income producing asset, as the money is not being applied for the acquisition of a single acquirable asset.

Interaction with the safe harbour provisions

The ATO confirmed in their PCG 2016/5 FAQs that an existing LRBA can be refinanced with a related party lender:

> *There is no prohibition on the refinancing of an existing loan with a related party lender. However, to ensure that the NALI provisions do not apply, SMSF trustees will need to provide evidence that the refinanced loan is established and maintained on terms consistent with an arm's length dealing; for example, by applying the safe harbour guidelines in PCG 2016/5 if applicable.*

PCG 2016/5 sets out the safe harbour loan terms to refinance a borrowing used to acquire real property, or to refinance a borrowing used to acquire a collection of shares in a stock exchange listed company or units in a listed unit trust.

Where the refinancing is on the terms set out in PCG 2016/5, the ATO will accept that these terms are consistent with an arm's length dealing.

If the refinancing of an existing loan with a related party lender does not meet the terms of PCG 2016/5, it does not mean that the arrangement is deemed not to be on arm's length terms. Meeting the terms of PCG 2016/5 simply means that the SMSF trustee can be assured that the Commissioner will accept that the arrangement is consistent with an arm's length dealing.

If the refinanced related party LRBA does not meet the safe harbour terms, the trustee must be able to otherwise demonstrate that the arrangement was entered into and maintained on terms consistent with an arm's length dealing. This could include, for example, providing evidence of a loan offer to the SMSF in relation to the particular asset from a financial institution and benchmarking to the terms of that offer.

ATO material

ATO ID 2010/169
PCG 2016/5
PCG 2016/5 FAQs

5. NALI/NALE AND LRBAS – WHERE ARE WE AT?

Under Division 295 of the *Income Tax Assessment Act 1997* (**ITAA97**), the taxable income of a complying super fund is split into two components: a low tax component (taxed at 15%), and a NALI component (taxed at the highest marginal tax rate).

Section 295-550 of the ITAA97 provides that an amount of ordinary or statutory income will be NALI of a superannuation entity if, as a result of a scheme where the parties were not dealing with each other at arm's length in relation to that scheme, one or more of the following applies:

a) The amount of the income is more than the amount the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;

b) In gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme (known as 'non-arm's length expenditure, or NALE); or

c) In gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme (also NALE).

The NALE provisions were added recently, to ensure that SMSFs can't increase their income through the use of non-arm's length expenditure.

In an LRBA context, the NALE provisions would capture, for example, an LRBA using a non-arm's length interest rate, as the SMSF would incur an expenditure that is less than the expenditure it would have incurred with an arm's length interest rate.

Explanatory Memorandum to NALE amending act made the following comments in relation to what is arm's length:

It can be difficult to determine an exact price that is 'non-arm's length'. An 'arm's length' price may be accepted to fall within a range of commercial prices. For example, loans may be available at different interest rates based on a range of factors. Accordingly, an SMSF may be able to apply an acceptable commercial rate of interest to a loan within a band of rates available to it on an arm's length basis.

ATO's position on NALI as it applies to LRBAs

Timeline

As noted below, the ATO's view on the application of NALI to low/nil interest LRBA loans has changed over the years:

- ATO ID 2010/162 – low interest LRBA loans don't breach section 109
- June 2012 NTLG minutes – interest free loans don't breach section 109
- December 2012 NTLG minutes – interest free loans don't breach SIS Act, don't trigger NALI and don't invoke Part IVA
- Private rulings – nil/low interest loans don't trigger NALI
- ATO ID 2014/39 and 40 – nil/low interest loans trigger NALI (under fixed trust provisions)
- ATO ID 2015/27 and 28 – nil/low interest loans trigger NALI (under SMSF provisions via look through approach)

TD 2016/16

The ATO's current position on when NALI might arise in an LRBA context is set out in ATO TD 2016/16.

TD 2016/16 provides that when parties to a scheme, that include a trustee of an SMSF, have entered into a LRBA on terms which are not at arm's length, and where the SMSF has derived more ordinary or statutory income under the scheme than it might have been expected to derive if the parties had been dealing with each other at arm's length in relation to the scheme, then that income will be NALI.

TD 2016/16 sets out the process to be followed in determining whether there is NALI:

- Identify the steps of the relevant scheme and the parties that deal with each other under those steps of the scheme;

- Identify what the terms of the LRBA might have been if the parties were dealing with each other at arm's length (**hypothetical borrowing arrangement**);

- Establish whether it is reasonable to conclude that the SMSF could have and would have entered into the hypothetical borrowing arrangement; and

- 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. In this instance, the ordinary or statutory income derived under the scheme is NALI.

The ATO give the following example of terms used in a related party LRBA (**Current LRBA**) as compared to a hypothetical borrowing arrangement (using the safe harbour loan terms from PCG 2016/5 at the time TD 2016/16 was issued):

Background facts:

- An SMSF acquired a commercial property from a third party at market value of $1,000,000 on 1 July 2015;

- The SMSF receives rental income of $1,000 per week;
- The lender is a related entity to the SMSF;
- The SMSF had an amount of $25,000 cash at bank at the time of the purchase; and
- The SMSF had no other property at the time of purchase.

	Current LRBA	***Hypothetical borrowing arrangement***
Amount borrowed	*$1,000,000*	*$700,000*
Amount sourced from fund capital	*0*	*$300,000*
Interest rate	*0%*	*Variable, 5.75% p.a. for the 2015-2016 year*
Term of the loan	*25 years*	*15 years*
*Loan to market value ratio (**LVR**)*	*100%*	*70%*
Security	*Mortgage in favour of the Lenders is registered in respect of the asset*	*Mortgage in favour of the Lenders is registered in respect of the asset*
Personal guarantee	*No personal guarantees or other security are given to the lenders in relation to repayment of the loan*	*Not required*
Nature and frequency of repayments	*No repayment is required until the end of the term of the loan – $0 monthly repayments*	*Monthly repayments of both principal and interest – approximately $5,800 per month at 5.75% p.a. for the 2015-16 year*

For the hypothetical borrowing arrangement:

- the LVR required the SMSF to source $300,000 of its own funding to make the purchase; and
- the weekly rental of $1,000 per week would not cover the monthly repayments of both principal and interest (approx. $5,800 per month for the 2015-16 year).

Accordingly, the SMSF could not and would not have been able to enter into the hypothetical borrowing arrangement because:

- it did not have sufficient funds available to satisfy the 70% LVR; and

- the borrowing arrangement, taking into account the weekly rental and any future capital gains, would not be earnings accretive.

Because the SMSF could not and would not have acquired the property under the hypothetical borrowing arrangement, the income that the SMSF would be expected to derive from the scheme if the parties were dealing with each other at arm's length is nil. Therefore, state the ATO, the $1,000 per week rental income the SMSF receives under the current LRBA is NALI.

The example provided by the ATO is of fairly limited practical guidance, given the extreme terms used (0% interest rate, 25 year loan term, no repayments required until the end of the term of the loan). Ideally, TD 2016/16 would have provided a range of examples illustrating how the 'hypothetical' test would apply to an LRBA in the grey area (e.g. 'almost but not quite' safe harbour terms).

LCR 2019/D3

More recently the ATO released Draft Law Companion Ruling 2019/D3 (**LCR 2019/D3**), which has been widely criticised by industry due to the ATO view that 'in some instances, the NALE will have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund' – i.e. that a general fund expense will have the ability to invoke NALI across a fund.

The related party LRBA NALI example contained in LCR 2019/D3 is also of limited practical guidance, using extreme loan terms similar to those contained in the TD 2016/16 example (100% LVR; interest rate of 1.5% p.a.; 25 year loan term).

Importantly, the LCR 2019/D3 example also notes that the NALE incurred under the non-arm's length LRBA will also result in any capital gain that might arise from a subsequent capital gains tax event (such as disposal of the property) being NALI.

As LCR 2019/D3 remains in draft form, it is not binding and represents the Commissioner's preliminary view only.

Pause on certain compliance action won't cover LRBAs

Since the amendments to the NALI provisions to add NALE, there has been some confusion as to how the ATO will interpret and apply the provisions. This was largely due to the somewhat contentious ATO view as set out in LCR 2019/D3.

In response, the ATO issued PCG 2020/5 which sets out the ATO's transitional compliance approach to the application of the NALE amendments to section 295-550 ITAA97. PCG 2020/5 states:

> *The ATO will not allocate compliance resources to determine whether the NALI provisions apply to a complying superannuation fund for the 2018-19; 2019-20 and 2020-21 income years where the fund incurred non-arm's length expenditure (as described in paragraphs 9 to 12 of LCR 2019/D3) of a general nature that has*

a sufficient nexus to all ordinary and/or statutory income derived by the fund in those respective income years (for example, non-arm's length expenditure on accounting services).

This transitional compliance approach does not apply where the fund incurred non-arm's length expenditure that directly related to the fund deriving particular ordinary or statutory income.

As this transitional compliance approach does not apply where the fund incurred NALE that directly related to the fund deriving particularly ordinary or statutory income (e.g. rent under an LRBA), it arguably does not apply to NALE in an LRBA context (such as a non-arm's length interest rate, or 0% interest rate).

How to ensure NALI does not arise in related party LRBAs

Based on the ATO view as set out in TD 2016/16 and LCR 2019/D3, SMSFs can ensure income from related party LRBAs is not classed as NALI by:

- using the safe harbour loan terms as set out in PCG 2016/5 (however these only apply where the assets being acquired are listed shares/units or real estate); or
- benchmarking the loan terms to an offer from a commercial lender (to demonstrate that the LRBA terms are consistent with an arm's length dealing in the same factual circumstances). Noting it can be difficult to obtain benchmarking evidence, especially for less common assets such as shares in a private company or units in an unlisted unit trust

ATO material
TD 2016/16
LCR 2019/D3
PCG 2020/5