

SMSFs & borrowing - new ATO guidelines

By Lilian Leong, Lawyer & Anthony Dao & Eric Cheng, Law Graduates

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Released on 6 April 2016, the ATO's new *Practical Compliance Guidelines* PCG 2016/5 (guidelines) set out 'safe harbour' rules for SMSF trustees to follow, to ensure that superannuation funds borrow on arm's length terms under limited recourse borrowing arrangements (LRBAs). However, the new guidelines apply to both existing and future LRBAs. This means that many SMSF trustees may need to make changes to their existing LRBAs by 30 June 2016, to ensure that they are following superannuation law.

In this article, we outline the new safe harbour rules, the implications of the new rules for SMSFs and what you should do, if you believe that your existing LRBA is not on arm's length terms.

Safe harbour rules

The safe harbour rules are what the ATO believes to be arm's length terms on which superannuation funds can borrow. If the terms of an LRBA are the same as the safe harbour terms, then the ATO will assume that the LRBA is on arm's length terms.

The safe harbour rules are as follows:

Term	Real property	Units/shares listed on stock exchange
Interest rate	RBA indicator lending rate for variable housing loans (i.e. for 2015/16, 5.75% per annum)	RBA indicator lending rate for variable housing loans + 2% (i.e. for 2015/16, 7.75% per annum)
Maximum term for fixed interest rate	5 years	3 years
Maximum term	15 years	7 years

Leverage	70% of property's value	50% of value of shares/units
Security	Registered mortgage required	Registered charge/mortgage required
Personal guarantee	Not required	Not required
Repayments	Monthly repayments of both principal & interest	Monthly repayments of both principal & interest
Loan agreement	Written loan agreement needed	Written loan agreement needed

If the terms of an LRBA are different to the above safe harbour terms, then this does not necessarily mean that the LRBA will not be on arm's length terms. Instead, you will need to explain why you believe that the terms of your LRBA are still consistent with what independent parties entering into a commercial agreement would agree to in the same circumstances (see *The Trustee for the Estate of the late AW Furse No 5 Will Trust v FC of T* 91 ATC 4007). If the ATO agrees with your reasoning, then your LRBA may still be on arm's length terms. However, if the ATO does not agree with you, then you may not be following superannuation law.

Implications of new guidelines

If you do not have an LRBA yet, but are thinking of entering into one in the future, it is important that you ensure that the terms of your LRBA follow the safe harbour rules. If you are planning to have different terms, then you will need to be able to explain why the different terms are still at arm's length.

If you have an existing LRBA with terms that are different to the safe harbour rules in the guidelines and you cannot justify why your terms are still arm's length terms, then you should:

- change the terms of your LRBA so that it is consistent with the safe harbour rules;
- refinance your loan with a bank or other external lender; or
- wind-up the LRBA.

If you undertake one of the above 3 options by 30 June 2016 and ensure that all payments made under the LRBA in 2015/16 are on arm's length terms, then the ATO will not penalise you for any non-arm's length terms that applied to your LRBA in 2014/15 or previous financial years (see PCG 2016/5, paragraphs 13 and 14).

If your existing LRBA does not meet the rules in the guidelines by 30 June 2016 or if your future LRBAs are not on arm's length terms, then the SMSF may be taxed at the highest marginal tax rate, under the non-arm's length income rules in ITAA 1997 s 295-550, and not the usual concessional tax rate that applies to SMSFs (*Interpretative Decisions* ID 2015/27 and 2015/28).

Other penalties may also be imposed such as fines, enforceable undertakings, education directives or rectification directions.

Extra compliance costs

One of the more significant requirements of the safe harbour terms is the requirement that loans to an SMSF be secured by a registered mortgage. Unfortunately, this will result in extra compliance costs for SMSFs, who will now need to pay extra fees for the preparation of mortgage documents, registration fees and mortgage stamp duty.

However, for SMSFs planning to buy New South Wales property, mortgage duty will be abolished from 1 July 2016 (*Duties Act 1997* (NSW) s 203A(1)). This will reduce some of the additional compliance costs. On the other hand, SMSFs with existing LRBAs will need to pay mortgage duty, since the ATO has asked for all existing LRBAs to be made compliant just one day before mortgage duty is abolished.

Conclusion

While the new safe harbour rules in the ATO's guidelines will result in some extra compliance costs, the guidelines provide some much needed guidance from the ATO on how LRBAs should be structured to ensure that they are on arm's length. SMSF trustees should familiarise themselves with the new safe harbour rules to ensure that they are not unnecessarily penalised. As 30 June 2016 is fast approaching, we would recommend that SMSFs with existing LRBAs seek legal advice on what actions they need to take, if any, to comply with the guidelines before the deadline.