

TD 2016/16 - Income tax: will the ordinary or statutory income of a self-managed superannuation fund be non-arm's length income under subsection 295-550(1) of the Income Tax Assessment Act 1997 (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?

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Taxation Determination

Income tax: will the ordinary or statutory income of a self-managed superannuation fund be non-arm's length income under subsection 295-550(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?

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Ruling

1. When parties to a scheme, that include a trustee of a self-managed superannuation fund (SMSF), have entered into a limited recourse borrowing arrangement (LRBA) on terms which are not at arm's length, it is necessary to consider whether 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.¹ Non-arm's length income (NALI) will only arise in those cases where the answer to this question is affirmative.

¹ Paragraph 295-550(1)(b) of the ITAA 1997.

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2. In answering the question above, it is necessary to identify both the steps of the relevant scheme and the parties that deal with each other under those steps of the scheme. Having identified the steps and parties to the scheme, paragraph 295-550(1)(b) of the ITAA 1997 requires a determination of the amount of ordinary or statutory income that the SMSF might have been expected to derive if the same parties to the scheme had been dealing with each other on an arm's length basis under each identified step of the scheme.

3. It is therefore necessary to identify what the terms of the borrowing arrangement may have been if the parties were dealing with each other at arms' length ('the hypothetical borrowing arrangement').

4. Having identified a hypothetical borrowing arrangement between the SMSF and the lender the terms of which are on an arm's length basis, it is then necessary to establish whether it is reasonable to conclude that the SMSF could have and would have entered into the hypothetical borrowing arrangement.

5. 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.

Example: SMSF acquired a commercial real property financed by an LRBA for rental income

6. *Relevant facts:*

- *an SMSF acquired a commercial real 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 SMSF financed the purchase under an LRBA on terms consistent with section 67A of the SISA;*
- *a Holding Trust was established, and the trustee of the Holding Trust is the legal owner of the commercial real property until the borrowing is repaid;*
- *the lender is a related entity to the SMSF (the Lender);*
- *the SMSF had an amount of \$25,000 cash at bank at the time of the purchase;*
- *the SMSF had no other property at the time of purchase; and*
- *the SMSF's investment strategy specifies a diversified asset portfolio between cash, listed shares and property.*

7. The following table outlines the terms of the LRBA under the scheme where the parties were not acting at arm's length (the 'Current LRBA') compared with the terms under the hypothetical borrowing arrangement (for the purposes of this example, the terms adopted are consistent with PCG 2016/5) to acquire the commercial real property:

	Current LRBA	Hypothetical borrowing arrangement
<i>Amount borrowed</i>	\$1,000,000	\$700,000
<i>Amount sourced from fund capital</i>	0	\$300,000
<i>Interest rate</i>	0%	Variable, 5.75% p.a. for the 2015-2016 year ²
<i>Term of the loan</i>	25 years	15 years
<i>Loan to Market Value ratio (LVR)</i>	100%	70%
<i>Security</i>	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
<i>Personal guarantee</i>	No personal guarantees or other security are given to the lenders in relation to repayment of the loan	Not required
<i>Nature and frequency of repayments</i>	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

8. For the hypothetical borrowing arrangement:

- a loan to value ratio (LVR) of 70% under the hypothetical borrowing arrangement required the SMSF to source \$300,000 of its own funding to make the purchase;
- the weekly rental of \$1,000 per week is not sufficient to meet the monthly repayments of both principal and interest calculated to be approximately \$5,800 per month at 5.75% p.a. for the 2015-16 year (repayments will change depending on the rate in later income years); and
- under the hypothetical borrowing arrangement, it is assumed that the SMSF would not be in breach of any of its legislative and regulatory requirements.

² The variable rate will differ for the 2016-17 and later income years.

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9. *Based upon the facts above, it is clear that the SMSF could not and would not have entered into the arm's length hypothetical borrowing arrangement. This conclusion is based upon the fact that:*

- *the SMSF did not have sufficient funds available to reduce the level of borrowings to finance the purchase to a level that satisfies the 70% LVR requirement; and*
- *the hypothetical borrowing arrangement, taking into account the weekly rental and any future capital gains, would not be earnings accretive.*

10. *Because the SMSF could not have and would not have acquired the commercial real 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. If the parties were dealing with each other at arm's length in relation to the scheme the investment in the commercial real property would not occur, as no arm's length LRBA could have been entered into.*

11. *Therefore, the \$1,000 per week rental income the SMSF receives is NALI.³*

Date of effect

12. This Determination applies to income years commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

28 September 2016

³ Refer to Practical Compliance Guideline PCG 2016/5 for the ATO's compliance approach for LRBAs established before 30 June 2016.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

13. When an SMSF acquires an asset under a LRBA, subsection 295-550(1) of the ITAA 1997 may apply to ordinary or statutory income generated from the asset if the terms of the LRBA are not consistent with an arm's length dealing.

14. Subsection 295-550(1) of the ITAA 1997 provides that an amount of ordinary or statutory income is NALI of a complying superannuation fund, a complying approved deposit fund or certain pooled superannuation trusts if:

- (a) it is derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme; and
- (b) that amount is more than the amount that 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.

15. If it is established that the parties are not dealing with each other at arm's length because the terms of an LRBA are not consistent with an arm's length dealing, then paragraph 295-550(1)(a) of the ITAA 1997 is satisfied.⁴ It is not required that all parties to the scheme be acting on a non-arm's length basis. Rather, where some of the parties are not acting at arm's length in respect of any step in the scheme, paragraph 295-550(1)(a) is satisfied.

16. To satisfy paragraph 295-550(1)(b) of the ITAA 1997, it is necessary to identify both the steps of the relevant scheme and the parties that deal with each other under those steps of the scheme. Having identified the steps and parties to the scheme, paragraph 295-550(1)(b) requires a determination of the amount of ordinary or statutory income that the SMSF might have been expected to derive if the same parties to the scheme had been dealing with each other on an arm's length basis under each identified step of the scheme.

17. Accordingly, it is necessary to identify what the terms of the borrowing arrangement would have been if those same parties had been acting on an arm's length basis under a hypothetical borrowing arrangement in respect of the same steps of the scheme, without introducing any new steps or parties to the scheme. The terms of the borrowing arrangement to be considered include (but are not limited to):

- the interest rate;
- whether the interest rate is fixed or variable;
- the term of the loan; and
- the loan to market value ratio (LVR).

⁴ See Practical Compliance Guideline PCG 2016/5 which sets out 'Safe Harbour' terms on which an SMSF trustee may structure their LRBA consistent with an arm's length dealing.

18. Once the terms of the hypothetical borrowing arrangement are identified⁵, consideration is then required as to whether or not it is objectively reasonable to expect that the SMSF trustee *could have* and *would have* entered into the hypothetical borrowing arrangement.

19. The following factors are relevant in considering whether an SMSF trustee '*could have*' acquired the asset under the relevant hypothetical borrowing arrangement:

- the terms of the trust deed and governing rules of the SMSF that is a party to the arrangement, and whether these rules pose any impediment to the SMSF acquiring the asset under the hypothetical borrowing arrangement;
- whether or not the SMSF has sufficient capital available, having regard to liquidity and cash flow requirements, to complete the purchase depending on the extent that an arm's length borrowing limits the amount that can be borrowed to acquire the asset;
- the ability of the SMSF to service the arm's length terms of the hypothetical borrowing arrangement; and
- any legislative or regulatory impediments that might prevent the SMSF from acquiring the asset under the hypothetical borrowing arrangement, including covenants under section 52B of the *Superannuation Industry (Supervision) Act 1993* (SISA) that are required to be included in an SMSF's governing rules.

20. The following factors are relevant in considering whether the SMSF trustee '*would have*' entered into the hypothetical borrowing arrangement:

- whether the hypothetical borrowing arrangement would be consistent with the SMSF's investment strategy at or immediately prior to the purchase and/or obtaining finance under the LRBA;
- whether the hypothetical borrowing arrangement would be an optimal use of their funds; and
- whether the hypothetical borrowing arrangement, taking into account the income including any future capital gains that the asset acquired is expected to generate, would be earnings accretive. For example, when the scheme is implemented on arm's length terms, the rate of interest may be so high that it results in the scheme making no real return or in fact a loss. This suggests that an SMSF would reasonably be expected to have not entered into the scheme on arm's length terms.

21. 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 necessarily have derived more ordinary or statutory income from the non-arm's length scheme than it might have been expected to derive from the scheme with the hypothetical borrowing arrangement. That income will therefore be NALI.

⁵ The 'Safe Harbour' guidelines in PCG 2016/5 may be applied to determine what the arm's length terms of the borrowing arrangement would be, but as explained at paragraph 4 of PCG 2016/5, it is not mandatory to use those safe harbours if the SMSF trustee can otherwise demonstrate what those arm's length terms would have been.

22. Where the SMSF can objectively establish with evidence that it *could have* and *would have* entered into the hypothetical borrowing arrangement, a comparison can then be made of the SMSF's ordinary or statutory income from the scheme (where the parties have not been dealing with each other at arm's length and have entered into an LRBA on terms which are not at arm's length) and the income under the hypothetical borrowing arrangement.

References

Previous draft:

Not previously issued as a draft

- ITAA 1997 295-550(1)
- ITAA 1997 295-550(1)(a)
- ITAA 1997 295-550(1)(b)

Related Rulings/Determinations:

TR 2006/10

- SISA
- SISA 52B

Legislative references:

- ITAA 1997

Other References

PCG 2016/5

ATO references

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