# Checklist: LRBAs

**We get it.**

The ATO has signalled a hard line when it comes to related party loans to SMSFs and when Fund income will be treated as non-arms length income – see Interpretative Decisions ID 2015/27 and 2015/28.

These Interpretative Decisions were followed by Practical Compliance Guidelines PCG 2016/5 ("PCG") to provide some guidance and safe harbours for related party loans. The PCG contains safe harbours for loans to acquire real estate or listed securities only. It does not provide safe harbours or deal with loans to finance other asset classes. The PCG will apply to an initial loan or a re-finance of an existing loan.

Where a related party intends on making such a loan, care is required to avoid the terms of the loan resulting in the SMSF deriving non-arms length income ("NALI") under section 295-550 of ITAA 1997. NALI will be taxed at the highest marginal rate rather than the SMSF's concessional rate of 15%.

The question that needs to be asked is: "Can the super fund get the same deal in the open market?".

In all cases, the proposed terms of a related party loan must be compared to a typical loan that a commercial lender might make in the same circumstances.

The ATO has advised that SMSF trustees should review any limited recourse borrowing arrangements to determine whether they have been established and maintained on terms that are consistent with an arm's length dealing. If this is not the case, trustees are strongly encouraged to take steps to ensure that related party loans are consistent with an arm's length dealing, or otherwise bring the arrangement to an end.

We have developed the Acis LRBA checklist to enable you to:

- Quickly identify any related party LRBAs that may contain terms that fail the arm's length test; and
- Take steps to amend terms and put related party LRBAs on arm's length terms.

**Please call us on 1800 773 477 if you have questions or identify any changes required to existing LRBAs upon completing this checklist.**

# LRBA Checklist

**Please refer to the FAQs attached for a more detailed explanation of these issues.**

## 1. Loan terms FAQ 1

| | | |
|---|---|---|
| What is the principal amount of the loan? | $ ................................ | |
| Is the trustee satisfied a bank would lend this amount to the SMSF? | ☐ Yes | ☐ No/Unsure |
| What is the applicable interest rate? | ................ % pa | |
| Is the trustee satisfied a bank would lend at this rate to the SMSF? | ☐ Yes | ☐ No/Unsure |
| Does the loan have a default rate of interest? | ☐ Yes | ☐ No/Unsure |
| What is the applicable default interest rate? | ................ % pa | |
| What is the term of the loan? | ................ Yrs/Mnths | |
| Is the trustee satisfied a bank would lend for this term to the SMSF? | ☐ Yes | ☐ No/Unsure |

## 2. Repayments FAQ 2

What are the repayment terms of the loan?

| | | |
|---|---|---|
| Interest Only? | ☐ Yes | ☐ No/Unsure |
| Principal and Interest? | ☐ Yes | ☐ No/Unsure |
| Interest Only converting to Principal and Interest? | ☐ Yes | ☐ No/Unsure |
| Other? | ☐ Yes | ☐ No/Unsure |

Describe:

## 3. The asset FAQ 3

What is the acquirable asset? ☐ Property ☐ Shares/Units ☐ Other

Describe:

## 4. Valuation FAQ 4

| | | |
|---|---|---|
| What is the contract price for the asset? | $ ................................ | |
| What is the valuation of the asset? | $ ................................ | |
| Does the trustee hold a formal independent valuation for the asset? | ☐ Yes | ☐ No |
| What is the loan/value ratio of the loan? | ................................ % | |
| Is the trustee satisfied a bank would lend to SMSF on this LVR? | ☐ Yes | ☐ No/Unsure |
| How is the balance of the price provided? | ................................ | |

# LRBA Checklist

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## 5. Security FAQ 5

| | | |
|---|---|---|
| Has security been given for the loan? | ☐ Yes | ☐ No |
| If yes, what security has been given for the loan? | | |
| Mortgage/charge? | ☐ Yes | ☐ No |
| Personal guarantees? | ☐ Yes | ☐ No |
| Additional mortgage/charge over other assets? | ☐ Yes | ☐ No |
| Other? | ☐ Yes | ☐ No |

Describe:

## Notes:

As LRBA loans are limited recourse, often the terms of these loans must be different to full recourse loans due to the inability of the lender to have recourse to all assets of the SMSF.

It is strongly recommended that the trustees hold/obtain a written statement of indicative terms including all of the above considerations from the SMSFs usual bank/finance company.

Where the related party loan is not on arm's length terms or deficiencies are identified in this review, the trustees may:

1. Amend the existing terms of the loan to ensue they are arm's length terms; and/or
2. Repay all or part of the principal amount of the loan.

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# FAQ 1 – Loan terms

### 1.1 Principal sum

The principal is the amount actually borrowed by the SMSF. Commercial lenders will use a number of criteria to determine the maximum amount they will lend in a given circumstance. One element in determining the maximum amount of the loan to a SMSF will be the ability of the SMSF to service the loan, taking into account all of the other terms. The SMSF must be able to demonstrate an ability to make the regular payments required under the loan terms. Payments must be made out of the SMSF's resources and not made using resources outside of the SMSF.

Where the amount of the principal of the loan exceeds the SMSF's ability to make the repayments (taking into account the timing and amount of payments, including interest) a commercial lender will usually decline a loan.

### 1.2 Interest rate

Many related party loans have very low or zero interest rates. Such rates will immediately attract the attention of the ATO.

Commercial rates of interest must be charged for related party loans. Rates that are available in the open market for similar loans will, usually, suffice. However, consideration must be given to the limited recourse nature of a LRBA. Under normal commercial conditions, commercial lenders will charge a higher rate of interest to take account of the higher risk attached to limited recourse loans.

Many lenders will also charge a higher "default" rate where payments are not made on time. Consideration needs to be given to whether a default rate should also be charged on a related party loan.

The PCG provides a safe harbour rule for loans to acquire real estate if the interest rate is the Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors.

The PCG provides a safe harbour rule for loans to acquire listed securities if the interest rate is the Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors plus 2% per annum. The interest rate may be fixed but only for a maximum period of 5 years.

The RBA rate is the rate published for May in each year (the rate for the month of May immediately prior to the start of the relevant financial year). The interest rate may be fixed but only for a maximum period of 3 years.

Trustees borrowing from related companies may also be subject to Division 7A of the ITAA 1936. If Div 7A applies this may have an impact on the interest rate which must be charged.

### 1.3 Term of the loan

Repayment of the loan must, usually, be made within a stipulated time. Usually, the maximum term of a residential loan, for example, will be 30 years. Commercial loans usually have shorter terms.

The PCG provides a safe harbour rule for loans to acquire residential or commercial real estate where the maximum term of the loan is 15 years.

The PCG provides a safe harbour rule for loans to acquire listed securities where the maximum term of the loan is 7 years.

Repayment terms which are excessive may be deemed non-arms length.

Trustees borrowing from related companies may also be subject to Division 7A of the ITAA 1936. If Div 7A applies this may have an impact on the maximum term of the loan.

## FAQ 2 – Repayment terms

The way in which the loan is repaid will have consequences for the other terms of the loan. For example, if a limited recourse loan is made on terms that it is interest only with a "balloon" payment at the end of the term, a commercial lender may impose a higher interest rate or a shorter maximum term.

Most limited recourse loans will impose a repayment regime that reduces the amount of the principal outstanding over time. This reduces the risk to the lender of non payment or loss of the loan amount.

The PCG provides a safe harbour rule if the repayment terms require monthly payments of principal and interest.

Trustees borrowing from related companies may also be subject to Division 7A of the ITAA 1936. If Div 7A applies this may have an impact on the amount and timing of payments.

## FAQ 3 – The asset

A SMSF may acquire a single acquirable asset using a LRBA, and can acquire any asset using complying borrowings, that it could otherwise acquire without borrowing.

Most commonly, real estate and listed shares or units are acquired using LRBAs.

The nature of the asset to be acquired must be considered when deciding the terms of a loan for the acquisition. Assets that are inherently more volatile in terms of value, will attract higher interest rates and/or shorter loan terms. Shares/units by nature involve higher risks than real estate.

## FAQ 4 – Valuation

Most commercial lenders will lend a percentage of the lesser of (a) the contract price of an asset or (b) the market value of the asset. A formal, and independent, valuation of the asset will be obtained by the lender to establish the maximum amount of the loan.

It is essential that related lenders undertake similar valuations to underpin the terms of the loan. This is particularly important where, for example, the SMSF acquires business real property from another related party.

The valuation of the asset being acquired will also be used to set the maximum loan to value ratio (LVR) available to the borrower. Limited recourse loans will usually have lower LVRs applied to them and so, where the LVR exceeds commercially available terms, the loan may be non-arms length. Higher LVRs will also have higher interest rates applied and/or attract a requirement for additional security to be provided.

Consideration needs to be given as to how the balance of the purchase price is to be funded. For example, where a bank lends 70% of the value of the asset, the remaining 30% needs to be funded from available equity in the SMSF. Often, the balance is itself funded by a second loan, meaning an effective LVR of 100% or greater. Without additional security, this loan would be unacceptable.

# FAQ continued

The PCG provides a safe harbour rule for loans to acquire residential or commercial real estate where the maximum LVR is 70%.

The PCG provides a safe harbour rule for loans to acquire listed securities where the maximum LVR is 50%.

## FAQ 5 – Security

The primary question in determining the need for security is "Can the SMSF obtain an unsecured loan for the relevant amount in the open market from a commercial lender?" If the answer to this is "No", then security must be taken to secure the related party loan.

The nature and extent of the security required, will be determined by the characteristics of the related party loan. A higher LVR will attract a demand for additional security. Additional security may also have an effect on the applicable interest rate, term of the loan and repayments. A low LVR may mean the only security required is a charge/mortgage over the relevant asset.

The form of security will primarily be a charge/mortgage over the relevant asset. Additional security could include personal guarantees and/or charges/mortgages over assets held outside of super.

It is also essential that where a charge/mortgage is taken to secure a related party loan, that the charge/mortgage is registered, where possible, to disclose the security on a public register. For example, a mortgage over real estate should be registered with the land titles authorities, regardless of the fact that the mortgagor and the mortgagee may be related parties.

The PCG provides a safe harbour rule if a written loan agreement and registered security is given to secure repayment.