[Insert DD Month YYYY]

|  |
| --- |
|  |

[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Company Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re: Limited recourse borrowing arrangements**

Self-managed superannuation funds (**SMSFs**) are generally prohibited from borrowing long-term funds to finance the acquisition of an investment under section 67 of the *Superannuation Industry (Supervision) Act 1993* (***SIS Act***). However, a fund may be able to obtain such long-term funding if the borrowing satisfies all the requirements of being a Limited Recourse Borrowing Arrangement (**LRBA**) under section 67A of the *SIS Act*. The rules relating to an LRBA are quite complex and have been subject to a range of guidance products issued by the Australian Taxation Office (**ATO**) which clarify the requirements which an LRBA must satisfy in order to be effective.

**Executive Summary**

The purpose of this correspondence is to provide you with a broad overview of:

1. The general rules which a borrowing must satisfy to be regarded as an LRBA.
2. ATO guidance on the application of those rules.
3. Implications for a member’s transfer balance account.

**General LRBA rules**

SMSFs are generally prohibited from borrowing money by section 67 of the *SIS Act*. This prohibition is designed to ensure SMSFs do not take on undue levels of risk. However, section 67A of the *SIS Act* allows SMSFs to borrow using an LRBA.

These rules, outlined below, essentially require that all the borrowed funds under the LRBA be used to finance the acquisition of a single asset or a collection of identical assets of the same market value. In addition, the funds obtained under an LRBA can be used to perform basic repairs or maintain the asset and cannot be used to improve the asset.

The requirements that must be satisfied in relation to the use of an LRBA are quite strict and include the following.

* Borrowed funds must be used to purchase either a single asset (e.g. real estate) or a collection of identical assets of the same market value (e.g. a collection of shares in the same company, each with identical rights). For example, an SMSF cannot borrow to purchase a collection of buildings each under separate strata title, even if the buildings are substantially the same, as the buildings will not be identical. However, as confirmed in Self-Managed Superannuation Funds Ruling SMSFR 2012/1, two separate proprietary rights (e.g. two separate titles) will be a single asset if they cannot be dealt with separately. For example, an apartment and a separate car park on a different title will be a single asset if they cannot be dealt with separately.
* Borrowed funds can be used to repair or maintain an asset but not to improve an asset. This prohibition on improvements is likely to create issues for SMSFs investing in real estate as it will place limits on any renovations they may wish to undertake. An improvement resulting in the fundamental change of the character of the asset will generally not be permissible.
* The rules place restrictions on the types of guarantees that SMSF members (and other parties) may give in relation to the borrowings. A guarantor of the SMSF’s borrowing would normally be entitled to reimbursement from the SMSF if the lender enforces the guarantee, meaning they could have rights against other SMSF property. However, in relation to SMSFs, all guarantee documentation must explicitly exclude this right in order to satisfy the requirements of section 67A as the guarantor’s right to reimbursement is limited to the single acquirable asset subject to the LRBA.

In addition, section 67A(1) of the *SIS Act* only allows a trustee of an SMSF to enter into a limited recourse borrowing where all the following conditions are met:

* The borrowings made by the trustee of the SMSF are applied to acquire a single acquirable asset, including expenses incurred in connection with the borrowing or the acquisition of the asset, or costs incurred in maintaining or repairing the acquirable asset.
* The acquirable asset is held on trust by a holding trust under which the trustee of the SMSF acquires a beneficial interest in the acquirable asset.
* The trustee of the SMSF has a right to acquire legal ownership of the acquirable asset by making at least one payment after acquiring the beneficial interest.
* The rights of the lender (or any other person) on any default is limited to the acquirable asset held by the trustee of the holding trust.
* If the trustee of the SMSF has a right relating to the acquirable asset (other than the right to acquire the legal ownership) the rights of the lender (or any other person) in connection with the trustee’s exercise of those rights are limited to rights relating to the acquirable asset.
* The acquirable asset is not subject to any charge other than the charge specifically with respect to the acquirable asset under the LRBA.

When setting up an LRBA it is important that you review all documentation to ensure that these requirements are satisfied.

**ATO guidance on related party LRBAs**

The ATO has released various guidance products outlining its views in relation to key aspects of LRBAs as discussed below.

*LRBA where borrowing is from related party – Practical Compliance Guideline PCG 2016/5*

The ATO released Practical Compliance Guideline PCG 2016/5 to assist trustees of SMSFs to structure effective LRBAs where the borrowing is provided by a related party.

Where an LRBA with a related party lender is established and the loan is not on commercial terms, the ATO may classify the income from the arrangement as non-arm’s length income (**NALI**) under section 295-550 of the *Income Tax Assessment Act* 1997, which is subject to tax at 45%.

However, if an LRBA is structured in accordance with the terms of certain safe harbours for assets comprising real estate or listed securities set out in PCG 2016/5, the ATO accepts that the terms of the LRBA will be consistent with an arm’s length dealing as effectively required in Taxation Determination TD 2016/16.

Where the SMSF uses the LRBA to acquire real property it must be made on the following terms:

* interest rate must be 8.85% for the year ended 30 June 2024 and may be variable or fixed depending on loan term
* loan term cannot exceed 15 years
* loan-to-value ratio is capped to 70%
* repayments of interest and principal must be made monthly
* registered mortgage over the property is required
* loan agreement must be in writing and properly executed.

By contrast, where the SMSF uses the LRBA to acquire listed securities it must be made on the following basis:

* interest rate must be 10.85% for the year ended 30 June 2024 and may be variable or fixed depending on certain factors
* loan term cannot exceed seven years
* loan-to-value ratio is capped to 50%
* repayments of interest and principal must be made monthly
* registered mortgage or similar security is required
* loan agreement must be in writing and properly executed.

*Practical Compliance Guideline PCG 2020/5*

To be read in conjunction with *Law Companion Ruling LCR 2021/2*, PCG 2020/5 provides guidance on amounts the ATO will consider NALI where LRBAs are not entered into on complying terms, or within the relevant safe harbours identified by PCG 2016/5. As mentioned above, to the extent an amount of income is NALI, this income will be taxed at the top marginal tax rate rather than the SMSF concessional rate of 15%.

In accordance with the draft Ruling, NALI may also be identified by reference to non-arm’s length expenditure (**NALE**), particularly where the SMSF accepts discounted services. To the extent that the expenditure results in the SMSF incurring a loss, outgoing or expenditure (or the absence of such things in certain circumstances), the related income may also be assessed as NALI at the punitive marginal tax rate.

The ATO has announced that the transitional compliance approach in PCG 2020/5 will be available for the income years from 2018-19 to 2022-23.

*SMSF Regulator’s Bulletin SMSFRB 2020/1*

The ATO has outlined its concerns for SMSFs entering into certain arrangements involving the purchase and development of real property for subsequent disposal or leasing. While the Bulletin considers a variety of issues, in this context, the ATO requests that SMSF trustees regularly review arrangements to ensure that there are no breaches of various *SIS Act* provisions, including whether the arrangement satisfies the LRBA borrowing requirement conditions as set out above.

*Refinancing - ATO ID 2010/169*

Arrangements entered into by SMSF trustees before 7 July 2010 can be refinanced as an LRBA after this date without contravening the general borrowing prohibition rules under section 67 of the *SIS Act* provided that:

* the money borrowed under the refinanced arrangement is applied solely for the purpose of replacing the initial financing arrangement
* the refinanced arrangement meets the requirements of section 67A of the *SIS Act*
* when changing to the new arrangement, the SMSF trustee does not temporarily acquire the legal ownership of the asset.

*In-house assets exemption – Self Managed Superannuation Funds (Limited Recourse Borrowing Arrangements – In-house Asset Exclusion) Determination 2014*

This Determination ensures that an SMSF investment in a holding trust in an LRBA will not be an in-house asset of the SMSF. The release of this Determination was to address the concern that an asset held by an LRBA trust would be considered an in-house asset and potentially breach the 5% in-house asset limit if it was not immediately transferred from the trust to the SMSF upon final repayment of the loan.

This means that SMSF trustees are now able to keep the asset in the LRBA trust, even after the loan is repaid, without breaching the in-house asset rules. However, we recommend that you consider whether this will necessarily provide the best tax outcome.

*Risk of non-compliance*

In order for a SMSF to be able to borrow funds using an LRBA, it is important to ensure the conditions of drawing down or additional borrowings are appropriately addressed in the terms and conditions under the loan.

Where the terms of the original loan are silent on additional drawings, but additional borrowings are in practice made available sometime after the establishment of the arrangement, it is likely that the arrangement will not meet the conditions of section 67A. This consequence is likely to arise because the additional borrowings were not provided for the acquisition, maintenance or repair of a single acquirable asset under the terms of the arrangement entered into.

By way of further explanation, where a trustee of the SMSF maintains an existing loan with the original lender and is able to obtain a separate loan for repairs which is unsecured, the requirements of section 67A to limit the rights of the lender or any other person on default to the acquirable asset will not be satisfied as the loan is unsecured.

**Transfer balance credit for LRBA repayments – Asset Segregation**

Individuals receive a credit to their transfer balance account where a superannuation provider makes a payment in respect of an LRBA that increases the value of a superannuation interest supporting a retirement income stream. This only applies to LRBAs entered into on or after 1 July 2017 and for SMSF utilising asset segregation within a Fund. LCG 2016/9 was introduced as an integrity measure aimed at SMSF’s attempting to shift value between assets supporting a retirement interest under a borrowing whilst utilising assets from accumulation interests to repay the borrowing.

Should you wish to discuss any of the above matters please contact our licensed financial planning adviser who can resolve any queries you may have concerning LRBAs. [insert telephone number of adviser]

Yours faithfully

**[Insert name of Partner]**