Go-To Guide

Limited Recourse Borrowing Arrangement (LRBA)

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Table of Contents

Introduction

Traditionally, self-managed superannuation funds (SMSFs) have not been able to borrow unless under very limited circumstances. However, since 24 September 2007, SMSFs have been able to borrow to purchase an asset, using a limited recourse loan borrowing arrangement (LRBA).

An LRBA is a special type of loan structure designed for SMSFs that involves establishing a holding trust where the trustee of this trust (commonly referred to as the custodian) legally holds the asset on behalf of the SMSF trustee. Essentially, the borrowing must be on a limited recourse basis for the purpose of acquiring an asset that is held on trust until the borrowing has been repaid. The asset that is held on trust for the SMSF must be an asset that the SMSF would be permitted to invest in directly.

Gearing has always been a popular wealth accumulation strategy so it is not surprising that LRBAs have proven to be equally attractive to SMSFs as a mechanism to invest more capital in the concessionally taxed superannuation environment. Since 2007, the growth in LRBAs within SMSFs has been steady with ATO annual statistics confirming that in 2019/2020, 11.3% of SMSFs reported an LRBA which is slightly down from the 11.6% reported the year before. Total assets owned through LRBAs grew to $50.3 billion. Of the assets held under LRBAs, 96% ($48.2 billion) is related to real property, split evenly between residential ($26.2 billion or 52%) and non-residential real property ($22.1 billion or 44%).

The uptake of LRBAs has resulted in close Government scrutiny starting with the Financial System Inquiry (FSI) in 2014 which recommended removing the ability for SMSFs to borrow directly using an LRBA. Although government disagreed with the FSI's recommendation to prohibit LRBAs, they did commission the Council of Financial Regulators and ATO to monitor any risk. Their findings released in February 2019, confirmed that assets held by SMSFs under LRBAs were unlikely to pose a systemic risk to the financial system. Monitoring was set to continue with another report due three years thereafter. As at the date of this publication, the ATO and the Council of Financial Regulators have yet to provide their updated, three-year report on leverage and risk in the super system.

For a detailed chronology of the evolution of borrowing arrangements for SMSFs, refer to Appendix 1.

The latest ATO annual statistics[1] confirm that of the $50.3 billion of SMSF assets owned through an LRBA, they continue to represent a relatively low proportion of overall SMSF assets. Although LRBAs account for only 6.8% of the total value of all SMSF assets, LRBAs continue to present an opportunity for some members, to accelerate their retirement wealth for several reasons:

- Superannuation remains a very tax effective investment vehicle to accumulate wealth for the long term
- With new reduced contribution caps, personal and employer contributions are subject to annual limits and LRBAs may offer an alternative way to increase a member's superannuation balance
- LRBA loan repayment obligations can be met by the steady cash flow of members directing their regular employer & personal contributions to their SMSF.

The SMSF trustee is required to understand the risks associated with entering into an LRBA, which should be documented in the fund's investment strategy prior to purchasing the asset. There are also a number of other considerations that the trustee of an SMSF wishing to enter into an LRBA should consider. Those that are covered in

[1] Self-managed super funds: A statistical overview 2019-20

this guide, include:

- what assets can be acquired
- what can and cannot be done with assets subject to an LRBA after the fund has acquired the asset
- the ability of the fund to make loan repayments and meet other continuing liabilities of the fund
- liquidity issues which may arise in respect of benefit payments (e.g. death benefits, rollovers, pensions)
- the impact of LRBA repayments where an asset subject to lending supports both accumulation and pension interests, and
- the terms of the borrowing arrangement, particularly when the LRBA is established with a related party.

Background

Generally, SMSFs are prohibited from borrowing monies[2]. There are only limited circumstances in which SMSF's can borrow money under the Superannuation Industry (Supervision) Act 1993 (the SIS Act) and the Superannuation Industry (Supervision) Regulations 1994 (the SIS Regs). These include:

- borrowing to make a payment to a beneficiary which the trustee is required to make by law or by the governing rules and which apart from the borrowing, the trustee would not be able to make (and the borrowing is for less than 90 days and less than 10% of the value of the fund's assets);
- borrowing to pay superannuation surcharge payments (where the borrowing is for less than 90 days and less than 10% of the value of the fund's assets);
- borrowing to settle securities/investment transactions if at the time the relevant investment decision was made, it was likely that the borrowing would not be needed (and the borrowing is for less than 7 days and less than 10% of the value of the fund's assets); and
- borrowing in accordance with the new LRBA[3] provisions

The SIS rules were originally changed on 24 September 2007 with the introduction of section 67(4A) of the SIS Act (the old law) to enable SMSF trustees to borrow direct by entering into an LRBA transaction. Effective from 7 July 2010, s67(4A) was repealed and replaced with sections 67A and 67B of the SIS Act (the new law).

The new law allows an SMSF trustee to borrow money using an LRBA, provided the following conditions are satisfied:

- The borrowing is used to acquire a single acquirable asset that is held on trust so that the fund trustee receives a beneficial interest and a right (but not an obligation) to acquire the legal ownership of the asset (or any replacement) through the payment of instalments.

- The lender's or any other party's recourse against the fund trustee, in the event of default on the borrowing and related fees, is limited to rights relating to the asset at the time of the action. These rights may include taking possession of, or disposing of, the asset.

- The asset (or any replacement) must be one which the fund trustee is permitted to acquire and hold directly.

This guide is targeted at discussing in detail the new LRBA rules as amended in July 2010 which apply to:

- any borrowing arrangements put in place on or after 7 July 2010; and

[2] Section 67 SIS Act
[3] Section 67A & 67B SIS Act

- any pre-existing LRBAs that have been substantially changed or refinanced on or after 7 July 2010.
    - The view of the ATO is that the refinancing of an old LRBA is permitted, whereas refinancing a new LRBA is expressly permitted under the new law. (Refer to refinancing for more detail)

For a more detailed comparison of the 'old' and 'new' LRBA laws, please refer to Appendix 2.

Acquisition of an Asset

Acquisition of a new asset

Ordinarily, an 'asset'[4] is defined to include 'any form of property and, to avoid doubt, includes money (whether Australian currency or currency of another country)'. However, the LRBA provisions refer to an 'acquirable asset'[5] which specifically excludes money. Furthermore, the ATO has confirmed in SMSFR 2012/1[6] that the term 'property' has a very broad meaning, and can include any type of right, interest or thing of value which is legally capable of ownership.

In accordance with s67A, an asset is 'acquirable' to the extent that it is not money and acquiring it is not prohibited under SIS or other relevant laws. For example, a trustee would not be permitted to borrow to acquire an asset if the acquisition would otherwise cause a breach of the sole purpose test, the non arm's length rules or is limited by the acquisition from related party rules.

Even with restrictions on what SMSFs can invest in, particularly when dealing with related parties, an LRBA could still be used to make any of the following investments:

- acquire certain assets from related parties (includes listed shares, managed funds, business real property)
- lease some assets to related parties (includes business real property and other in-house assets provided it is within the 5% limit)
- own assets through other entities (such as related companies or unit trusts)

Despite the related party restrictions, an LRBA can also be used by an SMSF to own property with a related party as tenants in common. Provided the property is not subject to a lease between the trustee and a related party it will not be an in-house asset and the trustees of an SMSF can acquire the property under a tenants-in-common arrangement. Furthermore, where the property is business real property, the restriction on leasing the property back to a related party does not apply as the asset is exempt from the in-house asset rules.

To acquire in this context means using the borrowed monies to pay the purchase price which can also include associated acquisition expenses. From a practical perspective, it means that the borrowing needs to be arranged at the time the asset is purchased and not at some later date.

It also means that the money borrowed must be used to acquire a new asset (or replacement asset). Basically, an SMSF trustee is not allowed to put an existing fund asset into an LRBA. This is to ensure that there is no contravention of the superannuation laws which do not allow a charge[7] to be given over an existing asset of the fund, as would generally occur under an LRBA.

[4] Section 10(1) SIS Act
[5] Section 67A(2) SIS Act
[6] SMSFR 2012/1: Limited recourse borrowing arrangements - application of key concepts
[7] SIS Reg 13.14

From a practical perspective, the sale contract should be signed by the Custodian, particularly to limit the risk of double stamp duty in some jurisdictions in relation to property transfers. Only too often, a member of the SMSF signs the sale contract in their personal capacity and then attempts to nominate the trustee of the holding trust as the custodian. On strict interpretation of the law, the contractual rights the member enjoys under the sale contract constitute 'property' for the purposes of the SIS Act and as it would be an acquisition from a related party, it would not be permitted under s66 of the SIS Act.

It is also important to ensure and document that the deposit for the investment is paid from the SMSF's bank account. Payment of the deposit is evidence that the SMSF is the real owner of the underlying asset and will help with the SMSF's eligibility for any stamp duty concessions or exemptions when the underlying asset transfers from the holding trust to the SMSF trustee. For more, go to stamp duty.

Single acquirable asset

Once a trustee has ascertained that a particular asset can be purchased under an LRBA, it is then necessary to ensure that it meets the 'single acquirable asset' test prescribed by s67A. This test will determine whether the asset may be purchased under a single borrowing arrangement or whether multiple borrowing arrangements are required.

Although the term 'single acquirable asset' is not defined in the SIS Act, subsection 67A(3) does confirm that it can include a collection of identical assets with the same market value. For example, a parcel of shares in the same company or units in a managed fund or gold bars, all which are identical and have the same market value at any one time.

For more interpretative guidance on what is a 'single acquirable asset' refer to ATO Ruling SMSFR 2012/1. Essentially, when determining an 'acquirable asset' and 'single acquirable asset', both proprietary rights (legal form) and the substance of the asset acquired need to be taken into account. If the asset can be dealt with separately on different titles, then it will be more than one asset. Alternatively, an asset with a single legal and undivided right to ownership, which must be dealt with as one asset, would be a single acquirable asset.

In the context of shares, a collection of shares of the same type in the same company would be a 'single acquirable asset', provided they did not have different rights. Once a collection of shares is treated as a 'single acquirable asset', it must continue to be dealt with as a collection. This means that the SMSF could not sell just some of the shares, instead the trustee would have to sell all or none of the shares. It also means that any dividends received by the SMSF can be reinvested in the company but the additional shares cannot be added to the collection of shares subject to the LRBA as they are not a permitted replacement asset[8]. The dividends would need to pass through to the SMSF for the SMSF to reinvest directly.

In the context of exchange traded options over shares, an LRBA could be used to buy a collection of options. However, the conversion of an option to another asset, either shares or cash, would not be a permitted replacement asset within an LRBA. Instead, the LRBA would need to be wound up at or before the time the options were replaced by another asset.

[8] Section 67B SIS Act

In the context of real property, an SMSF is able to hold multiple properties under separate borrowing arrangements. Otherwise, the general principle is that only one property on a single title, can be held under one LRBA. Exceptions to this general principle which would allow multiple real estate titles to be treated as a single acquirable asset are outlined in SMSFR 2012/1 and include:

- where there is a unifying physical object, such as a fixture attached to the land which is permanent in nature and not easily removed and is significant in value relative to the value of the asset; and
- where there is a law that requires the assets to be sold together.

For more examples of particular assets that may or may not be single acquirable assets, refer to Appendix 3 which sets out the ATO's view as expressed in SMSFR 2012/1.

Getting the structure right – type of trust

Under an LRBA, there is a requirement that the asset is held on trust so the trustee of the SMSF acquires a beneficial interest in the asset while the trustee of the holding trust acquires legal title to the asset. The trust is effectively ignored for income tax purposes and there is no need to register the trust for a TFN or an ABN or even open a bank account for the trust.

The SMSF retains all rights to income and all income derived from the asset should be received by the SMSF trustee directly. The SMSF has the right to dispose of the asset and on payment of the loan balance has the right to legal ownership of the asset.

The SMSF is responsible for meeting all expenses relating to the maintenance, upkeep and running costs of the single acquirable asset. The SMSF trustee should also make all of the loan repayments to the lender. Normal rules around deductibility of these expenses apply.

The holding trust is a special trust established specifically for the purpose of the gearing arrangement. Although the SIS Act does not specify who can be the trustee of the holding trust, to ensure that a trust exists, the trustee (i.e. the custodian) cannot be the same as the trustee(s) of the SMSF. It is also the ATO's view that an existing family or unit trust should not be used as the holding trust.

There is also no need for a separate trustee where there are multiple assets which need to be purchased as single acquirable assets under separate borrowing arrangements.

The SIS Act is silent as to what documentation needs to be put in place to support an LRBA, particularly to ensure that a trust relationship has been established. However, should the arrangement come under ATO scrutiny, it is best practice to ensure that the appropriate evidence is in place to record the fact that a custodian holds the asset on trust for the superannuation fund. It is also vital that the custodian have clear records to differentiate between assets it holds on trust for the SMSF versus any other assets owned in the trust. This clearly identifies asset ownership and satisfies the SIS requirements that fund assets must be kept separate from other assets at all times.

In accordance with normal trust law rules, and provided it is done in accordance with the underlying trust deed, the following can generally be changed during the term of the LRBA without breaching the SIS provisions:

- Change the trustee of the holding trust
- Change the terms and conditions of the holding trust

In-house asset exemption

As the holding trust is a related trust of the SMSF, the in-house asset rules have a special exemption in subsections in 71(8) and 71(9) of the SIS Act to ensure that it is not an in-house asset.

All of the following conditions must be met for this exemption to apply:

- the holding trust is part of an arrangement that meets all of the requirements of the super law in connection with a borrowing by the SMSF; and
- the only property of the trust under the arrangement is the acquirable asset (referred to as the original asset) or its replacement under the old rules; and
- the asset held by the holding trust would not be an in-house asset of the SMSF if the SMSF owned the asset directly.

On strict application of subsection 71(8), a related trust is only exempt from the in-house asset limit, whilst the loan is in place. This created some practical issues where the holding trust was established before the loan was fully drawn down or where the asset was retained in the trust once the loan was repaid.

As a result, on 10 April 2014, the ATO registered a legislative instrument[9] to provide an exception to the in-house asset definition under paragraph 71(1)(f) of the SIS Act. In essence, a holding trust established under an LRBA will not be an in-house asset of an SMSF during the following times:

- at the beginning of an LRBA where a borrowing has not yet begun, or the related holding trust does not yet hold the acquirable asset; and
- where the asset continues to be held in the related holding trust after the borrowing has been repaid.

This is important as it allows a trustee to borrow to fund the payment of a deposit under a contract for the acquisition of the acquirable asset, even though there may be a delay in the related trust holding the asset such as where a strata-titled unit is being acquired 'off the plan'. The Commissioner has warned that the exemption provided by this legislative instrument is not intended to provide indefinite relief from the in-house asset rules and that SMSF trustees should not unreasonably delay the start of the borrowing or the acquisition of the asset by the custodian.

This legislative instrument also allows a trustee to retain the asset in the holding trust once the loan has been repaid and overcome any stamp duty issues that may arise on the transfer of the property from the custodian to the SMSF trustee (provided the property asset will not be an in-house asset if it were held directly by the SMSF).

ATO determination – intermediary LRBA

Ordinarily, the trustee of the SMSF directly undertakes the borrowing, maintains the borrowing and provides the total purchase price of the acquirable asset out of its own funds and borrowed funds. Alternatively, where the custodian (i.e. the intermediary) borrows the money as principal from a lender to acquire a single acquirable asset but the SMSF maintains the borrowing, this is referred to as an intermediary LRBA.

[9] Legislative Instrument: SMSF (Limited Recourse Borrowing Arrangements – In-house Asset Exclusion) Determination 2014

An SMSF with an intermediary LRBA that complies with s67A of the SISA must rely on a recently issued Determination made by the ATO under para 71(1)(f) of the SIS Act, to exempt the investment in the related holding trust from the definition of an in-house asset[10]. The Determination prescribes all the requirements which must be met. In particular, the rights of the Custodian or any guarantors against the trustee of the fund in connection with a default on the borrowing must be limited and the arrangement must be disclosed to the lender.

The commencement date of this Determination is 24 September 2007 and applies to all intermediary LRBAs established from that date. The Determination will not apply where the investment would be an in-house asset if it was held directly by the SMSF.

Setting up & maintaining the loan correctly

Limited Liability

The LRBA provisions specifically require that the loan be limited recourse[11]. That is, where an SMSF defaults on the loan, the rights of the lender against the SMSF trustee are limited to the underlying asset subject to the borrowing – not any other asset owned by the SMSF.

The new LRBA rules also allow for a guarantee to be put in place, provided the rights of any guarantor, against the SMSF trustee, are also limited to the asset acquired under the borrowing. (A third-party guarantee was also possible under the old rules[12]). Refer to guarantees section below for more information.

Under the new laws, provided it is a complying LRBA, granting the lender a right of recourse to the underlying asset of an LRBA will also not contravene the existing prohibition in SIS Reg 13.14 which does not allow an SMSF trustee to give a charge over a fund asset[13]. However, care must be taken to ensure that no charge is granted in favour of anyone not a party to the LRBA – for example a breach will occur where a member of the SMSF borrows money from a bank to on lend to the SMSF and the charge over the asset is granted in favour of the bank (ATOID 2010/185).

Given the limited recourse nature of LRBAs, it means the following:

- SMSFs can purchase property as tenants in common where they each use a separate LRBA to fund the purchase of their fractional interest. Each loan could only be secured against the respective SMSF's interest.
- Two parties can borrow separately to purchase a joint asset, provided there is no cross securitisation of interests in the single acquirable asset.
- Money applied to acquire a single acquirable asset may be borrowed under an LRBA from two lenders[14]
- It is not permissible for multiple SMSFs to jointly borrow to buy a single acquirable asset[15].

Guarantees

Depending on the circumstances, some lenders may require additional security. For example, the lender may require

[10] SPR 2020/1: Superannuation Industry (Supervision) In-house Asset Determination - Intermediary LRBA Determination 2020.
[11] Section 67A(1)(d) SIS Act
[12] Section 67A(1)(d) SIS Act. See also ATO ID 2010/170 SMSF: limited recourse borrowing arrangement – third party guarantee.
[13] Section 67(1)(f) SIS Act
[14] NTLG Superannuation Technical Sub-group meeting minutes, June 2012
[15] ATOID 2010/172: Self-managed superannuation fund: limited recourse borrowing arrangement - joint investors

the trustees in their personal capacity to provide additional security using their personal assets.

The example in s67A expressly permits guarantees[16] provided the guarantor's rights of indemnity against the SMSF trustee, are limited to the single acquirable asset which is the subject of the arrangement. Given that the SIS Act does not prescribe who can provide a personal guarantee, it can be a member, another related party or an unrelated third party.

In the event that a guarantee is called on and the guarantor pays the SMSF trustee's debt to the lender the guarantor should seek to recover its loss from the SMSF trustee, provided it is limited to the SMSF's rights in the underlying LRBA asset.

Where the SMSF holds onto the asset and the guarantor forgoes their right of indemnity against the SMSF trustee, it is the ATO's view that this will result in a deemed contribution to the SMSF. Essentially, TR 2010/1[17] confirms that by extinguishing the SMSF's liability to a third party, the capital of the SMSF will increase, resulting in a contribution. TR 2010/1 confirms that there will be no contribution if the guarantor exercises its rights of indemnity or where the value of the single acquirable asset is insufficient to meet the debt to the lender or the guarantor.

Personal guarantees provided by a member may also give rise to non-arm's length income, particularly where an SMSF, or entities that the SMSF invests in, is involved in property development. Although property development is beyond the scope of this guide, the ATO's view is that non arm's length income can apply unless a member is remunerated on an arm's length basis for providing the guarantee[18].

Arm's length loan agreement/terms

A risk associated with related party lending is not only a potential breach of s109 of the SIS Act but also that any income derived by the SMSF from the borrowed funds may be classified as non-arm's length income with the result that it is subject to tax at the highest marginal rate (taxed at 45%).

Despite any ATO views expressed in earlier ATOIDs on the application of the NALI provisions, the ATO's current view in TD 2016/16 confirms that, for tax purposes, the income derived by an SMSF from an asset acquired under an LRBA where some or all of the terms of the arrangement were not established on purely commercial terms, and the terms are more or less favourable to the SMSF, will be non-arm's length income.

To provide guidance to SMSF trustees the ATO released PCG 2016/5 which sets out 'safe harbour' terms on how an LRBA may be structured to ensure it is consistent with an arm's length dealing. The PCG outlines safe harbour terms for both loans over real property, listed shares and listed units and is discussed below.

From 1 July 2018, NALI of an SMSF now also comprises the original NALI i.e. inflated income derived directly as a result of a non-arm's length scheme and the new NALE (non arm's length expense). NALI includes both ordinary and statutory income of the scheme.

Essentially the latest amendments to section 295-550 ITAA 97 add further situations which cause income derived to be treated as non-arm's length income of the SMSF. These apply to income derived on or after 1 July 2018, regardless of when the transaction giving rise to the income was entered into. An amount of ordinary or statutory

[16] Section 67A(1)(d) SIS Act

[17] TR 2010/1 Income Tax: superannuation contributions, paras 175 - 180

[18] SMSFR 2020/1 - SMSF Regulators Bulletin: Self-managed superannuation funds and property development

income will also be non-arm's length income of a complying superannuation fund where:

- there is a scheme in which the parties were not dealing with each other at arm's length
- the fund incurs a loss, outgoing or expenditure of an amount in gaining or producing the income, and
- the amount of the loss, outgoing or expenditure (including nil expenditure) is less than the amount that the fund might have been expected to incur had those parties been dealing with each other at arm's length in relation to the scheme.

LCR 2021/2 confirms that where an SMSF incurs NALE under an LRBA to acquire an asset, any income derived from that asset will be tainted forever as NALI, regardless of whether the LRBA is subsequently refinanced on arm's length terms. The NALE incurred under the LRBA will also result in any capital gain that might arise on the disposal of the asset, also being NALI.

A primary example of NALE is where a related party charges a nil or below market rate of interest to the SMSF under an LRBA. Based on the ATO's view, the NALE will effectively "taint" the single acquirable asset permanently so that any income derived from that asset (including the capital gain on its eventual sale) will also be NALI. This view aligns with the EM for the Treasury Laws Amendment (2018 Superannuation Measures No 1) Bill 2019, which contains the NALI provisions, which states that a "non-arm's length interest on borrowings to acquire an asset will result in any eventual capital gain on disposal of the rental property being treated as non-arm's length income".

Another example could be where a related party offers an SMSF trustee a deferral on any loan repayments and instead the SMSF capitalises the amount. Ordinarily this is likely to be at risk of NALI. However, during the COVID-19 pandemic, an exception applied provided any repayment relief offered to the SMSF by a related party lender was temporary and on similar terms to loan repayment deferrals offered by commercial third-party lenders[19].

Please note that the ATO has also released practical compliance guideline PCG 2020/5 containing a transitional compliance approach specifically in relation to general expenses of the fund that have a nexus to all of the income of the fund. However, this PCG does not apply where the fund incurs NALE directly related to the fund deriving particular ordinary or statutory income. For example, PCG 2020/5 would not apply in the situation where an SMSF gets a lower than arm's length interest rate that relates directly to an LRBA as the expenditure can be directly related to the income generate by that particular asset.

For more on s109 of the SIS Act, refer to arm's length arrangements.

Safe harbour

As stated above, the ATO's view is that the non-arm's length income (NALI) provisions in ITAA 1997 can apply when an SMSF trustee undertakes LRBAs that are not financed through a bank or financial institution.

To provide more certainty for SMSF trustees and their advisers when dealing with related party loans, the ATO issued ATO PCG 2016/5[20], which specifies the arm's length terms for these types of LRBAs. The guide outlines the 'Safe Harbour' terms on which SMSF trustees can structure their LRBAs consistent with an arm's length dealing, so that the NALI provisions will not apply.

[19] ATO COVID-19 FAQ

[20] PCG 2016/5: Practical Compliance Guidelines Income tax - arm's length terms for LRBAs established by SMSFs

LRBA arrangements that are not within the safe harbour guidelines do not automatically give rise to non-arm's length income. However, the burden of proof will be on the trustees of the SMSF to be able to show that an arrangement is commercial and has been established on an arm's length basis. The guidelines do not prevent the terms of a particular arrangement from being benchmarked against actual commercial arrangements.

The guidelines only relate to LRBAs where the acquired asset is real estate or listed shares/units. The guidelines do not address LRBAs where the acquired asset is of a different class of asset that is permitted to be acquired e.g. personal & collectible assets, units in an unlisted trust or gold bullion.

Refer to Appendix 4 for summary of the Safe Harbour provisions.

For SMSFs with LRBAs that pre-dated the release of the ATO's view on the application of NALI, PCG 2016/5 also confirmed that the ATO would not select an SMSF for any further compliance action for the 2014/15 year (and prior) purely because the SMSF had entered into an LRBA. This concession was conditional on SMSF trustees ensuring that all existing LRBAs were on terms consistent with the new "Safe Harbour" terms by 31 January 2017 or, alternatively, they were brought to an end by that date. Most importantly, payments of principal and interest for the year ended 30 June 2016 and up to 31 January 2017, had to be brought in line with the new requirements. Where it is considered that the NALI provisions apply to a particular LRBA and no reasonable attempt has been made to bring the arrangement in line with an arm's length dealing by this deadline, the ATO will apply the NALI provisions from the commencement of the arrangement.

In March 2022, the ATO updated PCG 2016/5 to confirm that it will not apply compliance resources to review LRBAs established in the 2014-2015 financial year (or before) that are impacted by the NALI expense provisions, where a SMSF trustee had taken steps to place the LRBA on terms that were consistent with an arm's length dealing, by 31 January 2017.

For more information refer to the ATO's FAQ https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/SMSF-resources/SMSF-technical/PCG-2016/5-frequently-asked-questions/

Source of funds

There is no limitation with respect to the lender in a gearing arrangement. The lender may be a financial institution, unrelated third party or a related party including a member of the SMSF, provided it is on commercial terms.

Provided the requirements in subsection 67A(1) are satisfied, the ATO's view is that it is possible that money applied to acquire a single acquirable asset can be borrowed under an LRBA from two lenders[21] and that each lender can have a charge over the asset.[22] Documentation from the arrangement should be clear that all monies borrowed are being applied as part of the one arrangement for the acquisition of a single acquirable asset and that the rights of each lender are limited to the single acquirable asset.

Where the loan is from a financial institution or unrelated third party, normally, the SMSF trustee will need to have the holding trust prepared and approved by the lender before the loan can proceed. The lender typically must also approve the SMSF trust deed for the purpose of the borrowing.

[21] See the NTLG Superannuation Technical Sub-group meeting minutes, June 2012
[22] See the NTLG Superannuation Technical Sub-group meeting minutes, September 2013

Refer to Division 7A issues which can also arise when dealing with related company lenders.

Permitted use of borrowings

Under the LRBA provisions, a trustee is permitted to use borrowings to acquire a single acquirable asset as well as to pay for borrowing and transaction costs. The ATO has confirmed that this also includes the capitalisation of interest if the interest relates to the borrowing for the purchase of the single acquirable asset[23].

A trustee is also permitted to use borrowings to fund any repairs and maintenance to the asset acquired with the borrowings. However, the provisions specifically prohibit the borrowings from being used to improve the asset. (Drawdowns for capital improvements are allowed for arrangements entered into between 24 September 2007 and 7 July 2010.)

The distinction between what is maintenance/repairs and what is an improvement is extremely important where borrowings will be used to fund the work and is discussed in greater detail below.

Provided the loan agreement permits multiple drawdowns and the single acquirable asset requirements are met, then multiple drawdowns are also allowed. However, a redraw facility cannot be added afterwards and must be included in the initial loan from the offset.

The ATO considers each new drawdown of funds is a separate borrowing[24]. Although it is not necessary to enter into a new borrowing arrangement upon each redraw there still needs to be a nexus between each drawdown and the acquirable asset to determine if an exception in s67A applies. This nexus will be met as long as the funds on the redraw are applied towards the original acquirable asset or relate solely to the original borrowing. For example, each drawdown can only be used for expenses incurred in maintenance or repairs as it relates to the acquirable asset. It is not possible to simply borrow money to maintain or repair an existing asset of the fund.

Refinancing

Section 67A explicitly allows refinancing of a borrowing (including any accrued interest) under an arrangement if the new borrowing arrangement is over the acquirable asset from the first arrangement (including an asset from the first arrangement that is a replacement asset under section 67B of the SIS Act).

Even where the application of the new borrowing is solely to extinguish the previous borrowing and meet associated costs, it will satisfy the requirement that borrowed funds are applied for the acquisition of the relevant asset.

Where a refinancing takes place, a new LRBA is entered into at that time. All refinanced arrangements must meet the requirements of s67A and 67(B), even where the original LRBA was entered into prior to 7 July 2010. Any grandfathered provisions under former s64(A) will no longer apply, including:

- The ability to gear into a portfolio of shares instead of a single collection of shares as required by s67A
- The ability to apply borrowed money towards capital property improvements

[23] ATO website QC 20439, SMSFR 2009/2 and ATOID 2010/184 for pre 7 July 2010 LRBAs

[24] SMSFR 2009/2: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of s67 SIS Act

- The ability of any personal guarantor, to have recourse over the assets of the SMSF
- More flexible replacement assets rules

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This raises the question of what constitutes a refinancing. According to the ATO[25], if something happens that alters the character of the LRBA in a significant way (either directly or indirectly), this will be considered a new LRBA and it will be subject to the new rules. The ATO will take into consideration the nature and extent of the variation as well as the intention of the parties to determine whether a refinancing has taken place. For example:

- Whether the original loan agreement provided for the parties to agree to extend the term
- The period of extension in relation to the period of the original loan
- Whether other terms of the loan were changed by the later agreement
- Whether there is a drawdown that is inconsistent with the earlier arrangement
- Whether there has been a change to the ultimate beneficiaries of the arrangement

What can be done with the asset?

Even though the single acquirable asset is held by the custodian of the holding trust for the SMSF, it is the SMSF trustee that should account for all transactions relating to the asset. However, as the legal owner of the asset, the custodian will be the party that enters into any lease arrangement for the asset.

Repair/Maintenance v improvements

SMSFR 2012/1 is the primary source of guidance as to the meaning of 'repair', 'maintenance' and 'improvements' for the purposes of the LRBA provisions.

As mentioned earlier, money borrowed under an LRBA may be applied not only to acquire a single acquirable asset but also to carry out repairs and maintenance to that asset whether necessary at the time of its acquisition or at a later time. Essentially, there is no need to distinguish between 'maintaining' and 'repairing', as both are allowed to be funded from borrowed moneys under section 67A of the SIS Act.

Maintaining means work done to prevent or in anticipation of future defects, damage or deterioration of an asset to ensure the functional efficiency of the asset is maintained in its present state. Repairs refer to restoring the functional efficiency of the asset without changing its character and may include restoration to its former appearance, form, state or condition. The ATO's ruling further clarifies that a repair is usually occasional and partial and involves replacing a part of something that is already there that has become worn out, dilapidated or damaged. A repair would not involve anything that replaced the asset entirely or that changed the character of the asset.

Improvement refers to when the functional efficiency of the asset or the value of the asset is substantially increased. To determine whether the asset has been improved, the qualities and characteristics of the asset must be reviewed from the time the asset was acquired. The rules governing superannuation borrowing allow some improvements to be made while the loan is in place but not if they fundamentally change the character of the asset.

However, no amount borrowed under an LRBA can be applied to improve the single acquirable asset. Where an SMSF borrows money to improve a single acquirable asset, the exception under section 67A will not apply and there

[25] ATO website QC 20439

will be a breach of s67 of the SIS Act. In essence, any improvements allowed under s67A must be completed with other existing fund assets or contributions made to the fund[26].

Even where money already held by the SMSF is used to improve the asset, care needs to be taken, to ensure that the asset doesn't become a new or replacement asset as defined in s67B of the SIS Act. Consideration of both the proprietary rights and the physical object is required to determine if the character of the asset as a whole has fundamentally changed.

Examples of possible improvements which do not change the fundamental nature of the property include the renovation of the kitchen/bathrooms, converting a carport to a garage, building a pool. The ATO also accepts that an improvement, even if not broadly comparable to an asset that was destroyed, if funded from insurance proceeds, will not affect the LRBA.

Where there is a very substantial change, it will be deemed to have effectively resulted in one asset (the original property) being replaced by another asset (the improved property). These 'replacement" assets are not permitted while the LRBA is in place and these changes can only be made to the asset once the loan has been extinguished. The ATO has stated that its interpretation of the definition of a replacement asset requires one borrowing structure to end and a new one to be commenced as there is a different underlying asset. The ATO does not consider that it is open to SMSF trustees to undertake any form of substantive property development while the fund's property is subject to a borrowing as this will result in a new asset.

Section 67B does allow for some very limited circumstances where one asset can be replaced with another. This generally only applies to shares or units in unit trusts where there is a merger, takeover or restructure. Even if an SMSF trustee wanted to sell one collection of shares and replace them with a new collection, this could not be done under a single borrowing arrangement. Instead, the SMSF would be required to sell its original collection of shares, repay any outstanding loan and then enter into a new LRBA to invest in a different collection of shares.

For more guidance on what changes in an asset are permitted and what changes will result in a new replacement asset, refer SMSFR 2012/1 and Appendix 5.

Winding up the LRBA

Ending the borrowing

Where the asset is sold, the sale proceeds will be used to discharge the loan and any remainder will be paid to the SMSF. All borrowed monies under the LRBA must be repaid. The loan cannot be retained and used to acquire another asset.

When the loan is fully repaid, the SMSF has the right to obtain legal ownership of the asset from the custodian of the holding trust. The ATO has confirmed that when the single acquirable asset is transferred from the holding trust to the SMSF once the loan has been repaid, the transfer will not contravene s66 of the SIS Act, even though the holding trust is a related party. However, stamp duty may be triggered when legal ownership is transferred from the Custodian to the SMSF trustee and the LRBA was not correctly structured. For more refer to stamp duty content

[26] Section 67A(1)(a)(i) SIS Act

below.

Additionally, once the asset is transferred, related documents such as leases may have to be updated to reflect the new legal owner of the property (the SMSF trustee). It is also important to ensure that any mortgage over the underlying property is removed otherwise the SMSF may effectively provide a charge over the assets of the fund and breach SIS Reg 13.14.

It is not compulsory for ownership to be immediately transferred to the SMSF. A delay in the transfer of ownership will not be a breach of the lending provisions and the asset can remain within the holding trust even after the loan has been repaid without breaching the in-house asset provisions[27]. In addition, a conservative view of the law is that while the asset remains owned by the custodian, the asset should not be changed or improved such that it becomes a fundamentally different asset (i.e. the restrictions which apply to improving or fundamentally changing the single acquirable asset continue to apply whilst the asset remains in the holding trust). Furthermore, the ongoing costs of maintaining the holding trust need to be considered.

Planning for the unexpected

Winding up an LRBA may also be an outcome of unforeseen events. Below we discuss some of the more common events, outside of the trustees' control, which may result in the forced sale by the lender and/or the winding up of an LRBA.

To avoid having to unexpectantly wind-up an LRBA, trustees may need to consider alternative funding arrangements for both the loan repayments and member benefit payments. These can include, albeit not limited to, arranging to have additional concessional or non-concessional contributions made to the fund and maybe even look to introduce new members to increase contributions capacity, alternatively if possible, consider refinancing the loan.

Loan default

A safeguard with LRBAs is that, should the value of the asset be less than the value of the debt and a sale be forced, the lender does not have recourse to other assets of the fund. However, depending on the loan-to-value ratio, it is possible with significant falls in the price of the underlying asset, that the SMSF may lose any amounts initially contributed to the acquisition of the asset. For example, following the COVID-19 global pandemic, despite any loan relief available to the SMSF trustee, there is still the possibility that some trustees may be forced to sell the asset due to the loss of rental income and fall in value.

Divorce

In the event of a divorce it is most likely that one of the members of the SMSF is going to want to leave the fund. This raises liquidity concerns for the SMSF to fund the rollover of a member's benefit, particularly for SMSFs where the LRBA asset is the major asset. This may force the SMSF to sell the asset and unwind the LRBA.

[27] SPR 2014/1: SMSF (Limited Recourse Borrowing Arrangements – In-house Asset Exclusion) Determination 2014

Death or disability of a member

The forced sale of an LRBA asset may also eventuate where an LRBA is the main asset of the SMSF and the SMSF trustee requires liquid funds to pay either a death benefit or a disability benefit. This risk may be mitigated through the use of insurance but even if there is an insurance claim paid, all insurance proceeds received on behalf of a member must be added to that member's account.

Although this may provide the SMSF with liquid funds to repay any debt, where the major or only asset of the fund is then an unencumbered property, the trustees may still be faced with a liquidity challenge of paying a member a death or disability benefit. The use of cross-member insurance policies or the use of insurance reserves as a strategy to provide sufficient liquidity to pay out member benefits, as well as extinguish any LRBA without having to dispose of any assets, is no longer permitted from 1 July 2014[28].

Members entering retirement/pension phase

The retirement of a member and the need for the SMSF trustee to meet ongoing pension liabilities may also result in the need to sell the LRBA asset to ensure the fund has the necessary liquid funds to pay pensions to members.

General compliance issues

Section 67(1) is a 'civil penalty provision'[29] and any person 'involved in a contravention'[30] is taken to have contravened that provision. Civil penalties of up to 2,400 penalty units[31] can be imposed[32].

If the breach is done dishonestly with an intention to gain an advantage, or is done with an intention to deceive or defraud someone, then the breach is a criminal offence also punishable by up to 5 years imprisonment[33].

From 1 July 2014, under Part 20 of the SIS Act, the ATO has the ability to direct the trustee to rectify the breach and/or direct the trustee(s) to undertake further education. In addition, the ATO can impose administrative penalties on SMSF trustees and directors of corporate trustees of 60 penalty units[34].

SMSF trustees need to ensure that the fund has not only complied with s67A of the SIS Act but that additional steps have been undertaken to make certain the fund does not breach any other provisions under the SIS Act. The most relevant ones are discussed below.

Sole purpose test (s62)

An SMSF should be created for the retirement benefits of the members and for ancillary purposes like payment to dependants on death etc. Any investment or borrowing must be consistent with this overarching requirement and should not provide a current day benefit to members.

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[28] SIS Regulation 4.07D
[29] Section 193 SIS Act
[30] Section 194 SIS Act
[31] Value of penalty unit amount is $222 on or after 1 July 2020 (s4AA of the Crimes Act 1914)
[32] Section 196 SIS Act
[33] Section 202 SIS Act
[34] Section 166 SIS Act

Investment strategy (s52B and SIS Reg 4.09(2))

SMSF trustees must make sure that all investment decisions are made according to the fund's investment strategy. Therefore, prior to entering into an LRBA, the fund's investment strategy should be reviewed to ensure it allows both the borrowing and the proposed investment.

Some of the key considerations for an SMSF's investment strategy include:

- the potential risk and returns from investments
- the benefits of diversification
- the fund's liquidity and cash flow needs
- the fund's ability to discharge its existing and prospective liabilities
- the insurance need of members

Although these matters must be considered they do not prevent a trustee from proceeding with an LRBA. For example, when entering into an LRBA to acquire an asset, the need to consider the benefits of diversification does not prevent an SMSF from investing all (or most) of the fund's money in a single property. However, the investment strategy needs to acknowledge the lack of diversification and the risks associated with this and address how the trustees plan to do to deal with the lack of asset diversity.

The awareness of the risks associated with LRBAs and lack of diversification has been a key focus of the ATO over the recent years. The recent COVID-19 global pandemic is a reminder of liquidity risk where the LRBA asset represents the main or only investment in the fund and cash flow problems arise. With COVID-19 forcing many companies to cut or suspend dividends and many properties either untenanted or taking advantage of rent relief, cash flow problems were experienced by some SMSF trustees. Considering that a trustee can't sell a portion of its LRBA shares or a portion of the property to fund a cash flow shortfall, funds will need to primarily rely on contributions to service the debt and meet other cash flow needs.

Arm's length arrangement (s109)

The trustee of an SMSF must ensure that all investments are made on an arms-length basis; that is, the investment must be on commercial and business-like terms. Parties must continue to deal with each other at arm's length or on an arms-length basis for the duration of the transaction.

This affects all investment decisions made by the trustee including an LRBA. For example, if the LRBA asset is a commercial property and a lease is entered into with a related party, s109 requires that the rent should be no more favorable to the tenant than if the landlord was an unrelated party. The related party must pay market rent to the SMSF.

The terms 'at arm's length' and 'arm's length basis' do not prevent trustees from dealing with related or associated parties. Rather, the rule is to ensure that all fund investments are made or maintained on true commercial terms. Whether a transaction is undertaken on an arm's-length basis is determined based on all the circumstances of the investment. The general test is whether a prudent person acting with due regard to their own commercial interests would have made such an investment. For more on the terms on which SMSF trustees may structure their LRBA's so they are consistent with an arm's length dealing, refer to the ATO's safe harbour.

Where a fund does not deal at arm's length then the fund may have non-arm's length income for tax purposes. Non-arm's length income is taxed at a flat rate of 45%, regardless of the overall tax liability of other taxable income of the SMSF. For more on ensuring that the terms of any LRBA are established and maintained at arm's length for income tax purposes go to Arm's length loan agreement/terms.

If the arms length provisions are breached, the validity of the transaction is not affected. The commercial reality of the transaction still stands.

Trust deed

The SMSF trust deed must specifically permit the SMSF trustee to borrow and to provide security. If it does not, the trust deed will need to be amended before the loan is drawn down.

Auditor requirements

SMSF auditors are required to ensure that the LRBA entered into by the fund complies with the exemption under s67A and s67B of the SIS Act. Listed below are some of the common documents generally requested at audit:

- Signed loan agreement – check conditions in contract meet the LRBA rules
- Signed personal guarantees – check limited to recourse of asset being purchased
- Signed fund trust deed – check borrowing allowed
- Signed holding trust deed - check executed correctly
- Loan statements – check account in debit balance or evidence of more drawdowns
- Purchase contract – check single acquirable asset
- Independent valuation – check if purchased from related party vendor
- Property title search – check mortgage exists to financier only and in holding trust name
- Insurance policy – check the correct property is insured at reasonable value
- Expenses invoices where material – check if improvements been made through drawdowns
- Signed lease agreements – check that rent is at market rates on an arm's length basis

Other considerations

Total Superannuation Balance (TSB)

For LRBAs established on or after 1 July 2018, a proportion of any outstanding balance needs to be included in the calculation of a member's TSB[35] where:

- a member has satisfied a condition of release with a nil cashing restriction (i.e. retirement, reaching age 65, terminal medical condition, permanent incapacity), or
- the loan is a related party LRBA.

[35] Section 307-231 ITAA 1997

These provisions are commonly referred to as the TSB 'add-back' provisions.

This measure does not apply to LRBAs entered into prior to 1 July 2018 or to the refinancing of the outstanding balance of an LRBA that commenced before 1 July 2018. In all other cases, where there is a related party LRBA, all members of the SMSF whose interest is supported by the asset purchased with the LRBA, must include their portion of the outstanding balance of the LRBA in their TSB calculation.

The impact on a member's TSB is tested not only at the time the loan is entered into but on an ongoing annual basis. The amount by which an impacted member's TSB is increased is a proportion of the LRBA balance based on the member's share of the total superannuation interests that are supported by the asset that is subject to the LRBA.

This increase in a member's TSB can create liquidity issues for the SMSF as member's may be potentially restricted from making further non concessional contributions (NCCs) and catch-up concessional contributions (CCs) to the SMSF to assist with the repayment of the LRBA.

It is important to highlight that the TSB 'add back' provisions apply where a superannuation provider in relation to the fund has a borrowing that is covered by the exception in subsection 67A(1) of the SIS Act. Importantly, section 995-1 ITAA97 defines a superannuation provider (for a superannuation fund) as the trustee of the fund. An intermediary LRBA covered by SPR 2020/1 differs from a standard LRBA in that the bare trustee, rather than the SMSF trustee, enters into an LRBA as principal with a lender. On a strict interpretation, an intermediary LRBA would not appear to be covered by the TSB 'add-back' provisions because it is the bare trustee rather than the SMSF trustee, which has the borrowing. The SMSFA continues to work closely with the ATO on this issue and until the ATO finalise their interpretative view, we strongly discourage exploitation of any perceived loophole with the TSB add-back provisions.

Transfer Balance Cap (TBC)

Generally, when a member commences a retirement phase pension, the value of the capital used to commence their pension will give rise to a credit[36] in their transfer balance account. This would generally be the net market value of the assets at that time where an LRBA is in place.

Where an SMSF trustee has an LRBA that was entered into on or after 1 July 2017, a TBC credit will also arise when a loan repayment is made under the LRBA and the payment results in an increase in the value of a member's interest supporting a retirement phase income stream. This does not apply to LRBAs entered into before 1 July 2017 or refinanced after that date.

The TBC credit will only arise where the LRBA repayments are sourced from assets not in retirement phase. For example, no credit will arise where an LRBA asset is part of a segregated asset pool supporting retirement phase income streams and the associated loan repayments are made using funds from that asset pool.

Where an asset subject to an LRBA is supporting both retirement phase income streams and other superannuation interests, any repayments should be apportionment on a fair and reasonable basis when calculating the TBC credit to those interests.

[36] Section 294-25 ITAA 1997

For more information refer to LCR 2016/9 Superannuation reform: transfer balance cap.

Income Tax implications, including capital gains tax

Essentially, the use of a holding trust as part of a complying LRBA provides 'look through' treatment for tax purposes[37]. This income tax look-through treatment continues to apply, provided all eligibility criteria of s67A and s67B continue to be satisfied, after the borrowing is fully repaid until the holding trust comes to an end. Therefore, any income tax consequences associated with an LRBA asset are generally attributable to the SMSF trustee as the beneficiary of the holding trust, instead of the trustee of the holding trust.

By treating the asset as being an asset of the SMSF and not an asset of the custodian, the amendments ensure the SMSF trustee stands in the shoes of the custodian for most purposes of the income tax law.

This means that if the single acquirable asset is a collection of shares, any dividends and franking credits on those shares will be taken to be received by the SMSF and not by the custodian for income tax purposes. This enables the dividend assessing provisions to be applied to the SMSF trustee and not the trustee of the holding trust.

By treating the SMSF as the owner of the underlying asset from the time that the SMSF acquires the interest in the holding trust, there is no CGT event, and therefore no CGT taxing point, once the loan is fully repaid for the custodian or the SMSF. The look-through treatment continues even after the SMSF discharges all its obligations relating to the borrowing.

Therefore, whether the asset continues to be held in the trust or is transferred to the SMSF trustee in order to collapse the holding trust, no CGT taxing point arises when the asset is legally transferred from the custodian to the SMSF trustee. It is worth noting that in certain circumstances CGT withholding obligations can arise for the custodian when transferring the asset to the SMSF trustee. This is beyond the scope of this guide and we recommend you seek specialist advice.

Alternatively, at the end of an LRBA, the Custodian may dispose of the relevant asset directly to a third party. The CGT provisions will apply as though the asset were held by the SMSF trustee, even if the asset is sold while the legal ownership is with the Custodian. Therefore, any capital gain or loss made on the sale will be included directly in the assessable income of SMSF.[38]

GST

To ensure that amendments to subdivision 235-1, which affect the income tax provisions, interact appropriately with the GST Act, any consequence arising under the GST Act for the Custodian as a result of anything done in relation to the single acquirable asset is also taken to have instead arisen for the SMSF trustee. This is the case even where that consequence would not have arisen if the SMSF trustee had done that thing instead of the Custodian. Given that the SMSF trustee is taken to stand in the shoes of the Custodian, this rule is necessary to ensure that any entitlements or liabilities of the Custodian under the GST Act are appropriately taken into account by the SMSF trustee for income tax purposes[39].

[37] Sections 235-820 and 235 -840 of the ITAA 1997
[38] Subsection 235-820(2) ITAA 1997
[39] Subsection 235-820(5) ITAA 1997

The look through approach ensures that the SMSF trustee as beneficiary under the holding trust is liable to pay any GST and is entitled to input tax credits. Once the loan is repaid, there would ordinarily not be any GST payable on the transfer of property from the holding trust to the SMSF. As mentioned earlier, the trustee of the holding trust need not register separately for GST.

A more detailed look at the GST consequences associated with an LRBA is beyond the scope of this Guide. For further guidance on the GST treatment of a holding trust under an LRBA refer to GSTR 2008/3.

Div 7A

The complexity of any related party loan is compounded where the LRBA is financed by a related company who must also comply with Division 7A requirements of the ITAA 1936. Essentially, if the lender is a company (or even a trust in certain circumstances[40]), unless the loan meets strict criteria which includes the need to make a minimum annual repayment, it is at risk of being deemed a dividend in the hands of the SMSF trustee (i.e. the borrower). This may deem the entire loan to the SMSF to be a dividend subject to tax and potentially may even be taxed as non-arm's length income[41].

Traditionally, an LRBA with a potential Division 7A issue needs to meet both Division 7A criteria and the ATO's PCG 2016/5 to ensure the loan is not deemed a dividend under Division 7A and is on arm's length terms as required under the SIS and Tax Act.

When compared to the requirements under Division 7A, the PCG currently allows for a higher interest rate, allows a shorter maximum term, sets a lower maximum loan to value ratio, and requires a mortgage to be registered. Provided the ATO's safe harbour guidelines continue to be more restrictive, trustees that choose to follow the safe harbour guidelines, will ensure the loan satisfies both criteria.

However, even if an LRBA is put on a complying loan basis, Division 7A could still apply where the loan is forgiven or the SMSF trustee fails to make a payment of principal or interest by the due date.

Where loan repayment relief had been given in relation to a Division 7A loan due to the financial impacts of COVID-19, it was possible to access additional relief with respect to the capitalisation of interest and minimum yearly repayments. For SMSFs that were unable to make the minimum annual repayment required for Division 7A purposes, they were able to apply online, for an extension of time from the Commissioner, to pay any shortfall. Furthermore, where an SMSF trustee capitalised any interest on the loan, the ATO confirmed that there would be no Division 7A consequences.

At the time of writing this guide, the broader Division 7A reforms[42] first announced as part of the 2017 Budget, remain in limbo. It is unknown whether a start date of 1 July 2020 will still apply or whether there will be a deferral to allow for further consultation. The SMSF Association has already flagged with the ATO the potential need to review PCG 2016/5, once we see this draft law. In the meantime, it is important for industry to be aware that these Division 7A reforms have the potential to give rise to larger loan repayments than currently allowed under the PCG.

[40] Section 109XA ITAA 1936
[41] Section 295-550 ITAA 1997
[42] Treasury paper *Targeted amendments to Division 7A*

The operation of Div 7A provisions are complex and beyond the scope of this guide so we encourage specialist advice be sought if impacted.

Land tax

Where the underlying asset of an LRBA is land, land tax may apply. In some jurisdictions, it may be that the custodian as well as the SMSF trustee will be liable to land tax however to ensure that tax is not paid twice, the super fund will get a credit for any land tax paid by the custodian.

Stamp duty

Generally, where the asset acquired with borrowed funds is "dutiable property" then the SMSF trustee will be liable for stamp duty on the initial purchase of the property acquired via an LRBA. In addition, the transfer of the property from the custodian of the holding trust to the SMSF trustee once the loan is extinguished, can also attract stamp duty.

Subject to the various jurisdictions, different concessions and exemptions apply in an effort to apply only one round of duty to LRBAs. However, with any LRBA, if the documentation is not done correctly, the holding trust may be treated as a "separate trust" owning the property in its own right and not as trustee for the SMSF in which case there is a risk that double stamp duty may apply.

To avoid a double up of stamp duty, it is also important to have clear evidence to show that the SMSF trustee provided all of the purchase monies, including the deposit starting with the SMSF's bank statements showing the money leaving the bank account.

Alternatively, the single acquirable asset could be retained in the holding trust structure until such time as the asset is sold. This avoids any need to exempt from duty the transfer from the custodian to the SMSF trustee.

Interest & tax deductions

As a general rule, costs associated with the establishment of an LRBA are considered capital in nature, hence, not immediately deductible but added to the cost base of the asset[43]. This includes expenses that relate to the transfer or acquisition of the asset such as stamp duty and legal fees. It also includes upfront investment related expenses such as a financial plan, prepared by a financial adviser for an SMSF trustee seeking advice on an LRBA.

Expenses incurred in relation to borrowing for the purpose of producing assessable income are specifically deductible for SMSFs in accumulation phase[44]. Borrowing expenses which can generally be claimed under this specific provision include loan establishment fees, obtaining relevant valuations, costs of documenting guarantees required by the lender, lender's mortgage insurance, fees for property and title search fees, costs for preparing and filing mortgage documents, etc.

The costs in establishing a trust for an LRBA are not considered to be borrowing expenses because they are incurred for establishing the arrangement through which the borrowing occurs, not for the borrowing itself. Therefore, the SMSF cannot claim a deduction for its legal expenses in setting up the trust under section 25-25 of the ITAA 1997.

[43] TR 93/17 Income tax: income tax deductions available to superannuation funds
[44] Section 25-25 ITAA 1997

Also, the SMSF cannot claim these costs:

- as a deduction under the general deduction provision because they are capital in nature
- as 'black hole'[45] expenses, as an SMSF is generally not considered to be carrying on a business.

Where an amendment to the SMSF's trust deed is required to allow the SMSF to borrow, the ATO will generally accept that the cost will be tax deductible. However, there is a possibility that the ATO could argue that an SMSF that amends its trust deed for the sole purpose of allowing it to comply with the LRBA rules is a capital expense and not deductible[46,] unless the SMSF trustee is also able to demonstrate that the deed amendment is required for the fund to comply with the SIS Act.

Where an SMSF is in retirement phase and the LRBA asset is supporting the payment of a pension, then the SMSF will not be entitled to claim a deduction on any of the expenses relating to the LRBA.

Conclusion

Setting up an LRBA in an SMSF can allow members to grow their retirement benefits and to invest in asset classes, such as direct property and listed shares. However, the risks associated with gearing means that is not appropriate for every SMSF trustee. This guide outlines the primary issues that need to be considered to ensure that the arrangement is structured correctly. It covers the main issues that need to be understood to ensure that the LRBA is maintained in accordance with the super and tax law requirements.

The LRBA rules are complex. SMSF trustees require specialist advice to help them navigate these rules and to understand the risks involved.

[45] Section 40-880 ITAA 1997
[46] TR 93/17 Income tax: income tax deductions available to superannuation funds

Appendix 1 – LRBA Chronology

The following tracks the evolution of borrowing arrangements by an SMSF.

DATE	DETAILS
24 Sept 2007	New SIS Act s67(4A) is introduced to ensure that investments by super funds in instalment warrants did not breach the borrowing limitations under s67.
4 April 2008	ATO issued Taxpayer Alert TA 2008/5 - Certain borrowings by self-managed superannuation funds, expressing concern regarding a number of potential features of arrangements under which SMSF trustees enter into limited recourse borrowings.
8 April 2009	ATO released SMSF Ruling SMSFR 2009/2 - Self Managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of s67 of the SIS Act.
25 Feb 2010	ATO released TR 2010/1 - Income tax: super contributions. Confirmed non-recovery of a loss by a guarantor will generally be treated as a contribution, as will forgiveness of debt.
6 July 2010	Superannuation Industry (Supervision) Amendment Act 2010 received Royal Assent. Law revokes s67(4A) of SIS Act and introduce new sections 67A & 67B. Became effective 7 July 2010.
29 July 2010 (and updates)	ATO released updated document 'Limited recourse borrowing arrangements by self-managed super funds – questions and answers' (referred to throughout this document as the ATO Q&A).
17 Sept 2010 to 8 Oct 2010	ATO released 6 Interpretative Decisions in regards LRBA, these being 2010/162, 2010/169, 2010/170, 2010/172, 2010/184 and 2010/185.
23 May 2012	ATO released SMSFR 2012/1 - Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts
20 Nov 2012	Taxpayer Alert TA 2012/7 released detailing ATO's concerns with some borrowing practices
4 April 2014	ATO release legislative instrument to provide in-house exemption certainty to holding trust
7 Dec 2014	Financial System Inquiry (FSI) 2014 Final Report released: Recommended removal of direct borrowing for LRBAs by SMSFs.
20 Oct 2015	Government response to the FSI: Disagreed with the recommendation to prohibit LRBAs. The Council of Financial Regulators and ATO commissioned to monitor risk and

	report back in 2018.
6 April 2016	ATO release PCG 2016/5 - Practical compliance guidelines Income tax - arm's length terms for Limited Recourse Borrowing Arrangements established by self-managed superannuation funds
28 Sept 2016	ATO release TD 2016/16 –Treatment of income received by an SMSF that enters into an LRBA on non-arm's length terms
1 July 2017	Transfer Balance Cap introduced (includes LRBA integrity measures)
4 Feb 2019	The Council of Financial Regulators and ATO release their report: assets held by SMSFs under LRBAs unlikely to pose systemic risk to the financial system at this time. Continue to monitor LRBAs and report again in three years.
19 May 2020	ATO releases legislative instrument: In-house asset determination – Intermediary LRBA
21 Mar 2022	ATO release updated PCG 2016/5 — Practical compliance guidelines Income tax — arm's length terms for Limited Recourse Borrowing Arrangements established by self managed superannuation funds.

Appendix 2 - Pre and Post 7 July 2010 LRBA requirements

The SIS rules were originally changed on 24 September 2007 to enable SMSF trustees to enter into an LRBA transaction. Further changes were made on 7 July 2010 to clarify the nature of an LRBA. A comparison of the 'old' and the 'new' LRBA laws are set out below.

LRBA Features	24 Sept 2007 to 6 July 2010 ('Old' law)	From 7 July 2010 ('New' law)
Can a SMSF make capital improvements to an asset?	Yes (considered a replacement asset)	No, trustees cannot borrow to improve asset and there are specific limitations on replacement assets
Can a SMSF refinance an LRBA?	Yes – if solely done to replace a previous loan	Yes, but will be considered a new arrangement and post 7 July 2010 laws apply
Can more than 1 property be purchased?	Yes, more than 1 property can be acquired	No
What is the limit of the recourse to the lender?	Asset acquired, but other parties could provide guarantees	Asset acquired, including where other parties provide guarantees
Can an LRBA be used to purchase a diversified portfolio of direct shares?	Yes, more than 1 asset can be acquired	No, only a single asset or collection of identical assets
Can the asset be charged?	Yes, not limited to the loan subject to the borrowing	Only to the extent of the loan
Can the asset be replaced?	Yes, very few restrictions	Limited to shares or units on a like for like basis with identical shares

Appendix 3 – Single acquirable asset examples

Asset subject to borrowing [47]	Is the asset a single acquirable asset?	
House built on land already owned by the SMSF	✗	Where an SMSF already owns vacant land the fund cannot enter into an LRBA for the contract to build a house on the land because the house and land cannot be dealt with separately.
Apartment with a separate car park, both registered under the same strata plan (either on one title, or across two separate titles)	✓	Where the titles cannot be separated and must be dealt with together, the apartment and car park can be a single acquirable asset. (If the car park title could be sold separately, this would be a separate asset.)
Off-the-plan real property	✓	The completed apartment and title constitute a single asset. Both the deposit and the balance can be financed by the borrowed funds.
Serviced apartment with furnishings	✗	The apartment on its own is a single acquirable asset but the furnishings are separate assets and separate LRBAs would be required for each furnishing.
Two adjacent vacant blocks of land	✗	Unless there are physical or legal restrictions on the two blocks being sold separately, they are not considered to be a single acquirable asset. The blocks could be purchased under two separate LRBAs
Two adjacent blocks of land, with a structure straddling both	?	If the structure straddling the titles (i.e. a unifying physical object which is permanent in nature and not easily removed) is significant in terms of the value it adds to the land, it will be considered a single acquirable asset. E.g. an operational factory complex. If the unifying object is not of significant value, and is not permanent in nature, it will not be considered to be a single acquirable asset. E.g. a derelict factory or abandoned warehouse
House and land package	✓	The asset being acquired is a completed residential property and the land on the title. The two assets must be dealt with together from a legal and practical perspective. Therefore, the single acquirable asset requirement is met.

[47] See SMSFR 2012/1 for original examples

Appendix 4 – PCG 2016/5: an arm's length safe harbour for LRBAs

	Real Property	Listed Securities
Interest Rate[48]	RBA Indicator Lending Rates for banks providing standard variable housing loans for investors	RBA Indicator Lending Rates for banks providing standard variable housing loans for investors + margin of 2%
Interest	Fixed or variable	Fixed or variable
Term of Loan	Maximum 15 years (if refinancing, max. term is 15 years less duration of any previous loan(s) in relation to the asset)	7 years
LVR	Maximum Total LVR = 70%	Maximum Total LVR = 50%
Security	A registered mortgage	A registered charge/mortgage or similar security
Personal Guarantee	Not required	Not required
Nature & frequency of repayments	Principal & interest – at least monthly	principal & interest – at least monthly
Loan Agreement	A written and executed loan agreement is required.	A written and executed loan agreement is required

[48] The applicable rate is the rate for the month of May immediately prior to the start of the relevant financial year

Appendix 5 – Improvement versus Replacement asset

The table below has been extracted from SMSFR 2012/1 and illustrates whether a change to a single acquirable asset results in a different (i.e. replacement) asset.

Asset changes made	New Asset	Reasoning
The following changes to a residential property: **- an extension to add two bedrooms** **- addition of a pool** **- kitchen extension** **- construction of a granny flat** **- addition of garage and new driveway** **- convert a bedroom into a study**	NO	While each of the changes would be improvements each (or all) of the changes would not result in a different asset. The character of the asset has not fundamentally changed and remains residential property.
A vacant block is: **- subdivided into multiple titles** **- has a property built on it**	YES	One asset has been replaced by several different assets. The fundamental character of the asset has changed from vacant land to residential property.
A residential house is: **- demolished and replaced by a block of units** **- converted into a restaurant** **- Destroyed by fire and a new superior home is built (funded by insurance and member contributions)**	YES NO	The character of the premises and proprietary rights have fundamentally changed from one asset to several assets or from a residential property to a commercial property. The new residential house (whether of the same size or larger) does not fundamentally change the character of the asset.
Primary production property has the following additions (funded by SMSF monies): **- new cattle yards, tank, windmills, dam and fencing** **-construction of large shed to shelter cattle** **- construction of new residence for farmer to live in**	NO	The additions do not result in the property becoming a different asset as the character of the cattle property has not fundamentally changed. The new residence merely allows persons working on the property to live on site.