Limited recourse borrowing arrangements - related party loans

**Issues raised**

If a related party lender offers a discounted rate of interest to an SMSF under a section 67A borrowing arrangement, would the discount be considered a contribution received by the SMSF?

Can an SMSF enter into a borrowing arrangement under section 67A of the *Superannuation Industry (Supervision) Act 1993* (SISA) with a related party if a zero rate of interest is charged by the related party lender and only principal repayments, with no imputed interest, are made throughout the loan term in accordance with the loan agreement?

**Background information provided by member**

Section 67A of the SISA does not prohibit an SMSF from entering into a borrowing arrangement with a related party lender. ATO ID 2010/162 states that an SMSF trustee does not contravene section 109 of the SISA if it borrows money from a related party of the SMSF under a limited recourse borrowing arrangement (LRBA) on terms more favourable to the SMSF.

In the example used in ATO ID 2010/162, the interest rate imposed under the LRBA is lower than the rate that would be available to the SMSF from an arm's length lender for an otherwise similar loan.

In this example, the ATO concluded that the borrowing entered into by the SMSF trustee entails no contravention of paragraph 109(1)(b) of the SISA because the terms and conditions of the borrowing are not more favourable to the other party than would be reasonably expected if the parties were dealing with each other at arm's length.

Similarly subsection 109(1A) of the SISA applies to dealings with parties that are not at arm's length, during the term of the investment. Subsection 109(1A) of the SISA applies after an investment to which paragraph 109(1)(b) applies has commenced and is interpreted in that context. As a result provided the dealing is not more favourable to the other party than would be expected had the parties been at arms length then the provision will not be contravened.

However, it is not clear in ATO ID 2010/162, whether the discount offered in the example, would constitute a contribution received by the fund.

As a discounted rate of interest, compared to an interest rate that could have reasonably been expected to have been charged if the parties were dealing at arms length, has the effect of increasing the capital value of the fund, it has been suggested by some industry practitioners that a contribution has been made to the fund in these circumstances.

This argument is supported by paragraph 9 of TR 2010/1, which states:

'…an objective determination of a person's purpose may in some cases lead to the conclusion that the person's purpose is to benefit one or more particular members of the fund or all of the members in general. This may occur when a transaction or arrangement is entered into because of a connection or relationship between the person and the superannuation provider or cannot be explained by reference to commercial or arm's length dealings.'

Arguably, the value of the contribution would be the value of the discount offered by the related party lender in these circumstances.

It is also not clear in ATO ID 2010/162, whether 'terms more favourable to the SMSF' would extend to situations where a zero rate of interest is charged by the related party lender and only principal repayments, with no imputed interest, are made throughout the loan term in accordance with the loan agreement.

**Industry view / suggested treatment provided by member**

Paragraph 35 of SMSFR 2009/2, defines a 'loan' of money under a contract as a:

'…contract whereby one person lends or agrees to lend a sum of money to another, in consideration of a promise express or implied to repay that sum on demand, or at a fixed or determinable future time, or conditionally upon an event which is bound to happen, with or without interest.'

This is explained further in paragraph 39 of SMSFR 2009/2 which states that the necessary features of a 'borrowing' or a 'loan' are that:

* + there is a temporary transfer of an asset from a lender to a borrower, and
	+ there is an obligation or intention to return the temporarily transferred asset to the lender.

Paragraph 48 of SMSFR 2009/2 states that an obligation to pay interest that recognises that the lender is being compensated for the borrower's temporary use of funds, is a common but not a necessary feature of a borrowing.

Paragraph 172 of TR 2010/1 states that a contribution arises in situations when a liability incurred by the superannuation provider is forgiven by the person to whom the liability is owed. In these situations the capital of the fund has been increased by extinguishing the liability of the superannuation provider, and therefore a contribution has been made.

Similarly, paragraph 175 of TR 2010/1 states that a question arises as to whether a contribution would be made if a lender were to forgive the debt of a trustee particularly in relation to a LRBA.

However, given there is no requirement under section 67 of the SISA for interest to be charged, the borrower only has an obligation to pay the rate of interest stipulated in the loan agreement. No other obligation to pay interest (including an obligation to pay an arm's length rate of interest) can be said to exist.

Therefore, without a liability to pay an arm's length rate of interest, it is difficult to see how paragraphs 172 or 175 of TR 2010/1, have relevance in situations where a discounted rate of the interest, is offered by a related party lender in accordance with the loan agreement.

For the same reasons, it is difficult to see how a zero rate of interest, offered in accordance with the loan agreement would cause the arrangement to fail the requirements of section 67A, or any other sections, of the SISA. Section 67A of the SISA refers to the term 'borrowing' which takes on the meaning given in SMSFR 2009/2.

**Technical reference**

Sections 67A and 109 of the SISA

ATO ID 2010/162

TR 2010/1

SMSFR 2009/2

**Impact on clients suggested by member**

Possible breaches of section 66 of the SISA and the impost of excess contributions tax.

**Priority of issue where ATO view is required suggested by member**

Low

**ATO initial response**

**If a related party lender offers a discounted rate of interest to an SMSF under a section 67A borrowing arrangement, would the discount be considered a contribution received by the SMSF?**

No. The absence of a requirement to pay interest on money loaned to the trustee does not increase the capital of the fund. A saving on an expense of an SMSF in the circumstances described is analogous to the circumstances outlined in examples 2 and 5 in Taxation Ruling TR 2010/1 Income tax: superannuation contributions. The purpose of a person in offering a low interest loan to an SMSF does not fall for consideration if there has been no increase in the capital of the fund.

The outcome is different if, for example, interest incurred by the fund is paid by a third party, forgiven or reimbursed. In all of those circumstances the capital of the fund is increased as the interest liability has been met by a third party or forgiven or an amount has been reimbursed to the SMSF.

**Can an SMSF enter into a borrowing arrangement under s67A of the *Superannuation Industry (Supervision) Act 1993* (SISA) with a related party if a zero rate of interest is charged by the related party lender and only principal repayments, with no imputed interest, are made throughout the loan term in accordance with the loan agreement?**

Yes. A lower than market interest rate or the absence of a requirement to pay interest on money loaned to the trustee by a related party will not prevent the arrangement from being a borrowing for the purposes of section 67A of the SISA. The ATO recognises that while the obligation to pay interest may evidence the existence of a borrowing of money, it is not a necessary feature of such a borrowing (see paragraph 48 of SMSFR 2009/2).

If such a borrowing is entered into between an SMSF trustee and a lender that is a related party of the fund, a fact that the borrowing is interest free does not cause a contravention of paragraph 109(1)(b) of the SISA as that fact does not make the terms and conditions of the borrowing more favourable to the related party lender than would be reasonably expected if the parties were dealing with each other at arm's length in the same circumstances.

Further, as noted in ATO Interpretative Decision ATO ID 2010/162, subsection 109(1A) of the SISA applies after an investment to which paragraph 109(1)(b) applies has commenced and is interpreted in that context. As a result, if such a borrowing is entered into between an SMSF trustee and a lender that is a related party of the fund, for example by refinancing the original loan, a fact that the borrowing is interest free does not cause a contravention of subsection 109(1A) for the same reasons as stated above in relation to paragraph 109(1)(b) of the SISA.

**Note: The ATO initial response has been prepared on the basis that the arrangement is, in fact, a borrowing for the purposes of section 67A of the SISA**

A borrowing, for the purposes of section 67A of the SISA, is an arrangement for the payment of an amount of money from one party to another where the parties intend that it will subsequently be repaid to the lender. Although a borrowing arrangement will commonly involve an interest charge, the absence of interest will not, of itself, preclude an arrangement from being a borrowing. To determine whether a related party transaction does, in fact, amount to a borrowing, the ATO will consider any documentary evidence that is available together with any other evidence, for example whether any repayments of the amount borrowed are made. Further information is available in SMSFR 2009/2 on the ATO's view of the meaning of a borrowing in the relevant context. It should also be noted that Taxation Ruling TR 2010/1 Income tax: superannuation contributions explains the circumstances in which the forgiveness of a loan may constitute a contribution by the lender to a superannuation fund.

**Meeting discussion**

Members were satisfied with the ATO initial response but suggested that a disclaimer should be added to the response emphasising that there must be a genuine loan in place. That is, the arrangement must include a genuine intent that the amount is to be repaid to the lender. (A note has been inserted to explain that the ATO initial response has been prepared on the basis that the arrangement is, in fact, a borrowing.)

* Last modified: 26 Jul 2012QC 26298