

Loans under Division 7A and the ATO's Safe Harbour guidelines

A limited recourse loan by a member's family trust to their SMSF might be a Division 7A loan. Can the loan comply with all the rules if it is in fact both types of loan?

A recent enquiry has allowed Townsends Law to visit the question of when will a loan be deemed as a payment of dividends rather than a complying loan in the scenario below.

John and Mary have a corporate trustee and are the only two members of their fund. They have recently acquired commercial property in NSW under a limited recourse borrowing arrangement ('LRBA') through their SMSF. The property was financed by J & M Pty Ltd (a private company acting in its capacity as the corporate trustee of their family trust). As John and Mary are members of their fund and also shareholders of J & M Pty Ltd they are concerned that the loan may not be a complying loan.

This is because when an SMSF trustee or a member of a fund is a shareholder of the lender, which is a private company, it raises the issue of whether the loan falls under Division 7A of the Income Tax Assessment Act 1936 and is deemed as a payment of dividends rather than as a complying loan.

Section 109N of the Income Tax Assessment Act 1936 sets out the criterion for a loan to be explicitly exempted from being deemed to be a dividend. These include:

- the loan being made under a written agreement.
- the loan has a minimum interest rate.
- the loan has a maximum loan term.

In this case, John and Mary's loan is to be treated as a complying loan rather than as a dividend because the loan was made under a written agreement, the interest rate for each year after the year in which the loan was made is greater than or equal to the benchmark interest rate (i.e. the Division 7A benchmark interest rate that is published annually by the ATO) for each year, the loan term is 15 years, the loan was secured by a mortgage over real property and the market value of the property is 110% of the amount of the loan.

Further, as John and Mary have acquired the property under an LRBA the loan must be on arm's length terms (i.e. a loan that is commercial). The Australian Taxation Office ('ATO') had provided its 'Safe Harbour Guidelines' that trustees can adhere to in order to ensure their loan is on arm's length terms as required under the Superannuation Industry (Supervision) Act 1993 ('SIS Act').

The ATO accepts that an LRBA used to acquire real property or to refinance a borrowing used to acquire real property is consistent with an arm's length dealing provided that:

- the interest rate used is the Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loan for investors.
- either a variable rate is used for each year of the LRBA or the interest rate is fixed up to a maximum of 5 years.
- the maximum term of the loan is 15 years.

- the maximum loan to market value ratio is 70% for commercial and residential properties acquired.
- a registered mortgage is used as security over the property.
- repayments are made monthly.
- each repayment is of both principal and interest.
- the loan is made under a written agreement.

An LRBA with a potential issue of Division 7A should meet both Division 7A criteria and the ATO's LRBA Safe Harbour Guidelines to ensure the loan is not deemed a payment of dividend under Division 7A and also is on arm's length terms as required under the SIS Act.

Current Safe Harbour Guidelines are more restrictive than the current Division 7A criteria (i.e. higher interest rate, shorter maximum term, lower maximum LVR and a mortgage has to be registered). For this reason, it is recommended that John and Mary follow the Safe Harbour Guidelines to ensure the loan satisfies both criteria.

If John and Mary decide not to follow the Safe Harbour Guidelines, they will need to be able to demonstrate otherwise that the loan is on arm's length terms (i.e. benchmarked to commercial LRBA).

Finally, please note that the Federal Government has announced changes to the Division 7A rules which will now come into effect on 1 July 2020, though the Government has also flagged 'further consultation' so the final outcome is still uncertain.

For more information on any aspect covered in this article, please call SUPERCentral on 02 8296 6266 or email info@supercentral.com.au.