**BY USING THIS LETTER, YOU ARE NOT ENTERING INTO A CLIENT RELATIONSHIP WITH DBA LAWYERS. YOU AGREE THAT YOU TAKE FULL RESPONSIBILITY FOR THIS LETTER’S ACCURACY AND YOU WILL TAILOR IT AS APPROPRIATE TO SUIT YOUR CLIENTS**

18 April 2016

Our ref: xxxxxxxx

Name of client

Address of client

Dear client

**Re: Non-arm’s length income and related party SMSF limited recourse borrowing arrangements**

We refer to your SMSF limited recourse borrowing arrangement (‘LRBA’) where the lender might not be at arm’s length. Urgent action is required. Please contact our office immediately to discuss the following information.

1. Executive summary

Action might be required before 1 July 2016 and failure to do so might cause a significant tax bill. As soon as possible you should:

* contact our office to discuss this letter;
* review the existing terms of your SMSF LRBA;
* determine if the existing terms are within the new ATO safe harbours discussed below; and
* if the existing terms are not in the safe harbours, select one of the following options:
* **OPTION 1:** alter the existing terms before 1 July 2016 so that they are in the safe harbours;
* **OPTION 2:** terminate the LRBA before 1 July 2016;
* **OPTION 4:** document and retain evidence so that you can demonstrate that the LRBA was entered into and maintained on terms consistent with an arm’s length dealing;
* **OPTION 3:** re-finance with a bank or other arm’s length lender before 1 July 2016; or
* **OPTION 5:** instruct us to approach the ATO on your behalf as soon as possible.

1. Background information

In December 2015, the ATO released certain relevant commentary on their website, which we extract as follows ([https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/News/Non-arm-s-length-limited-recourse-borrowing-arrangements/#](https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/News/Non-arm-s-length-limited-recourse-borrowing-arrangements/)):

*NON ARM'S LENGTH LIMITED RECOURSE BORROWING ARRANGEMENTS*

… the non arm’s length income (NALI) provisions can apply when an SMSF trustee undertakes .. LRBAs … established or maintained on terms that are not consistent with an arm’s length dealing … NALI is currently taxed at 47%.

…

*What you should do by 30 June 2016*

SMSF trustees should review any LRBA you have to determine whether it was established and maintained on terms that are consistent with an arm’s length dealing. If this is not the case, we strongly encourage you to take steps to ensure that it is on terms consistent with an arm’s length dealing by 30 June 2016 or to bring the LRBA to an end by that date. You may wish to seek professional advice if you are unsure.

*What we will do*

… we will not be selecting an SMSF for review for the 2014–15 year or earlier years purely because the fund has entered into an LRBA.

The Commissioner may allocate compliance resources to review an LRBA of an SMSF for the 2015–16 year or later years.

We strongly encourage all SMSF trustees to take the actions suggested above in relation to your existing LRBAs before 30 June 2016. You should ensure that any new LRBAs you enter into are established and maintained on terms consistent with an arm’s length dealing.

1. safe harbours

In April 2016, the ATO released a guideline that sets out the 'safe harbour' terms. If those terms are used, the ATO says it will accept that the LRBA is consistent with an arm's length dealing and that the NALI provisions do not apply purely because of the terms of the borrowing arrangement.

You should read the full text of the safe harbours it in its entirety. The full text is available at <https://www.ato.gov.au/law/view.htm?DocID=COG/PCG20165/NAT/ATO/00001> However, as an introduction, we provide the following summary table:

| **TYPE OF ASSET BEING ACQUIRED** | **REAL PROPERTY (ANY KIND)** | **STOCK EXCHANGE LISTED SHARES OR UNITS** |
| --- | --- | --- |
| **INTEREST RATE** | Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors. Applicable rates:   * For the 2015–16 year, the rate is 5.75% * For the 2016–17 and later years, the rate published for May (the rate for the month of May immediately prior to the start of the relevant financial year) | Same as real property + 2% |
| **TERM OF LOAN** | 15 years for original loan (any refinancing will be reduced by duration of the previous loan(s)) | 7 years for original loan (any refinancing will be reduced by duration of the previous loan(s)) |
| **MAXIMUM LOAN-TO-VALUE RATIO** | 70% (an LRBA in existence on publication of these guidelines, the trustees may use the market value of the asset at 1 July 2015) | 50% (an LRBA in existence on publication of these guidelines, the trustees may use the market value of the asset at 1 July 2015) |
| **SECURITY** | A registered mortgage | A registered charge/mortgage or similar security (that provides security for loans for such assets) |
| **PERSONAL GUARANTEE** | Not required | Not required |
| **Nature and frequency of repayments** | Monthly repayments on a 'principal and interest' basis | Same as real property |
| **Loan agreements** | Written and executed | Written and executed |

1. Your options

As set out at the start of the letter, if the existing terms of the LRBAs are not in the safe harbours, you have the following options:

* **OPTION 1:** alter the existing terms before 1 July 2016 so that they are in the safe harbours. If pursuing this option we note that the ATO state in the guideline:

Given this, we will not select an SMSF for an income tax review for the 2014-15 year or earlier years purely because the SMSF has entered into an LRBA. However, this is conditional on the SMSF trustee ensuring that any LRBAs that their fund has is on terms consistent with an arm's length dealing by 30 June 2016 or, alternatively, is brought to an end by 30 June 2016.

In addition, *payments of principal and interest for the year ended 30 June 2016 must be made under LRBA terms consistent with an arm's length dealing* … [Emphasis added]

* **OPTION 2:** terminate the LRBA before 1 July 2016;
* **OPTION 3:** document and retain evidence so that you can demonstrate that the LRBA was entered into and maintained on terms consistent with an arms' length dealing. If pursuing this option we note that the ATO state in the guideline:

If SMSF trustees have entered into an arrangement which does not meet all of the 'Safe Harbour' terms set out in this Guideline, whilst the trustees are unable to be assured that the Commissioner will accept the arrangement to be consistent with an arms' length dealing, it does not mean that the arrangement is deemed not to be on arms' length terms. It merely means that there is no certainty provided under this Guideline. The trustees will need to be able to otherwise demonstrate that the arrangement was entered into and maintained on terms consistent with an arms' length dealing. One example of how a trustee may demonstrate this is by maintaining evidence that shows their particular arrangement is established and maintained on terms that replicate the terms of a commercial loan that is available in the same circumstances

* **OPTION 4:** re-finance with a bank or other arm’s length lender before 1 July 2016; or
* **OPTION 5:** instruct us to approach the ATO on your behalf as soon as possible as a tailored submission needs to be made if the 30 June deadline can’t be satisfied.

Accordingly, urgent action might be required. Please contact our office accordingly.

[Insert any appropriate disclaimers, eg, whether you provide financial product advice, etc]

Yours sincerely