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ConnectionPoint

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ATO issues further guidance on SMSF related party LRBAs

In this edition of Connection Point, we discuss two recent ATO Interpretative Decisions and the implications for related party lending to fund limited recourse borrowing arrangements (LRBAs). Where the terms of the loan (taken together) and the ongoing operation of the loan are not consistent with an arm's length lender, the ATO is likely to determine that the arrangement gives rise to non-arm's length income (NALI). NALI is taxed at the highest marginal tax rate (45% for 2013/14 financial year and 47% for the 2014/15 financial year).

To determine if the arrangement is arm's length, the ATO is likely to consider the:

- nature of the acquirable asset
- amount borrowed
- term of the loan
- loan-to-value ratio
- interest rate charged, or the other means by which the lender is compensated for the opportunity cost in lending the principal
- regularity and frequency of principal repayments required
- security taken for the borrower's performance under the loan, given the limited recourse nature of the loan – for example, mortgages and personal guarantees by self-managed superannuation fund (SMSF) members
- extent to which the loan has operated in accordance with its terms.

Not all related party borrowing will give rise to NALI. If an SMSF is considering such an arrangement:

- consider applying for a private binding ruling
- obtain and keep documentation to evidence that the terms of the loan and the ongoing operation of the loan are consistent with an arm's length lender.

Implications for your clients

- Your clients should be aware that related party borrowing on less than commercial interest rates and/or terms may result in non-arm's length income subject to penalty tax. A private binding ruling should be sought.
- LRBA related party borrowing at commercial rates and terms is unlikely to generate non-arm's length income.

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- Review existing related party borrowing arrangements to determine if they are impacted.

Grandfathering – a blessing and a curse

When legislation changes, existing arrangements may be quarantined or protected (known as grandfathering). Grandfathering allows a client to benefit from rules that applied before the legislation changed.
The problem with grandfathering is that it adds a layer of complexity when providing advice. Often certain actions will result in the loss of grandfathering.

Recent legislation changes that have incorporated grandfathering are:

- Deeming of superannuation account based income streams for income support payments, effective 1 January 2015
- Deeming of superannuation account based income streams for the Commonwealth Seniors Health Card (CSHC), effective 1 January 2015
- Restricting the type of insurance that can be held within superannuation, effective 1 July 2014.

Identify grandfathered income streams before rolling over

Deeming of superannuation account based income streams for income support payments and the CSHC is effective from 1 January 2015. Before rolling over a client's superannuation account based income stream it is important to identify if the income stream is grandfathered (protected) from deeming for an income support payment or for the CSHC.

What are the implications?

Rolling over a grandfathered income stream results in the new income stream being deemed and could reduce a client's income support payments, or loss of the CSHC and any associated benefits, over the life of the client. The impact on income support payments or entitlement to the CSHC must be considered prior to rolling over a grandfathered income stream.

Example – Income support recipient
Ted and Wilma are homeowners, each currently receiving a part Age pension subject to the income test. Ted currently has a grandfathered account based pension for income support payments. The following table illustrates the impact on their Age pension if grandfathering is lost on the account based pension.

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Asset	Grandfathered	Loss of grandfathering
Account based pension	$300,000 Nil income assessment (pension payment below deductible amount)	$300,000 (Subject to deeming)
Personal effects	$10,000	$10,000
Deemed investments	$60,000 Deemed income = $1,200	$60,000 + $300,000 Deemed income = $11,406
Defined benefit pension	Income = $15,000 Asset = nil	Income = $15,000 Asset = nil
Age Pension Assets Test	$15,116 each	$15,116 each
Age Pension Income test	**$14,540 each**	**$11,989 each**

If Ted loses the grandfathering on his account based income stream, Ted and Wilma's Age pension will be reduced by $2,551 each ($5,102 combined) in year 1. Their Age pension entitlements may also be impacted each subsequent year.

What if Ted and Wilma didn't have the defined benefit pension?

If Ted and Wilma didn't have the defined benefit pension they would remain asset tested before and after the loss of grandfathering, hence there would be no immediate change to their Age Pension entitlements.

Based on current Centrelink rates and thresholds:

Means test	Grandfathered	Loss of grandfathering
Assets test	**$15,116 each**	**$15,116 each**
Income test	$16,744 each	$15,739 each

However, if deeming rates increased, their entitlements could be impacted. Assuming deeming rates were 2% higher (4% and 5.5%).

Means test	Grandfathered	Loss of grandfathering
Assets test	**$15,116 each**	$15,116 each
Income test	**$16,744 each**	**$13,939 each**

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Before rolling over an account based income stream on the basis that there will be no impact on the client's Centrelink entitlements, consider what impact increasing deeming rates may have on their future Centrelink entitlements.

Where there is an impact on entitlements, determine that the benefits gained will exceed the costs of permanently losing grandfathering.

Example – CSHC holder

Holly is single and a self-funded retiree. She currently has a grandfathered account based income stream for the CSHC, with a balance of $400,000. As this is a grandfathered income stream, nil income is assessed for the CSHC. Total other income assessed for the CSHC totals $48,000. Her income must be less than $51,500 to be eligible for the CSHC.

If Holly loses grandfathering on her account based income stream it will be deemed to earn $13,280 when determining entitlement to the CSHC and she would fail the income test.

The new deeming rules could favour some clients

Clients receiving account based pension payments significantly exceeding the Centrelink deductible amount could be advantaged by the new deeming rules. In this case, consider commuting and commencing a new account based pension on or after 1 January 2015. However, if deeming rates increase, the benefits of this strategy could be negated or possibly yield a worse outcome. You also need to consider if significantly exceeding the Centrelink deductible amount is a one-off or regular occurrence (is the benefit gained short term or long term?).

What income streams are impacted?

Income streams impacted by the new superannuation account based income stream deeming rules are:

- Account based pensions
- Allocated pensions
- Allocated annuities

Including transition to retirement income streams.

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Deeming account based pensions for the low income health care card (LIHCC)

From 1 January 2015, superannuation account based income streams are deemed under the income test for the LIHCC. There are no grandfathering arrangements for the LIHCC. As a result, some of your clients may lose entitlement to this concession card.

Deeming for income support payments, the CSHC and the LIHCC are different measures

Deeming of superannuation account based income streams for income support payments, the CSHC and the LIHCC are different measures. The assessment across each one of these entitlements is determined independently of each other.

Effect of 1 January 2015 changes to assessment of account based income streams

Client situation	Effect of changes on or after 1 January 2015
Low Income Health Care Card holder	Deemed income from account based income streams is used to assess entitlement to card. Deeming applies to account based pensions when calculating aged care fees.
Income support recipient immediately before 1 January 2015	Account based income streams held before 1 January 2015 will continue to be assessed using deductible amount ('grandfathered') rules. Loss of grandfathering will occur if income support payments cease or there is a change in account based income stream providers. Deeming applies to new account based income streams commenced from 1 January 2015 are deemed. Same rules apply when calculating aged care fees.
CSHC holder immediately before 1 January 2015	Account based income streams held before 1 January 2015 will continue to be exempt from CSHC adjusted taxable income test. Loss of grandfathering will occur if lose eligibility for CSHC or change in account based income stream providers. Deeming applies to new account based income streams commenced from 1 January 2015. Deeming applies to account based income streams when calculating aged care fees.

Deeming for income support payments and implications for partners

Income support recipients may have partners who are not in receipt of income support (eg a younger partner who doesn't qualify for Age Pension because of their age). If the income support recipient owns a grandfathered account based income stream and the partner subsequently qualifies for income support, the income used to determine the partner's entitlement includes:

- Gross annual pension payment less deductible amount in respect of the income support recipient's grandfathered account based income stream.

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- Deemed income from account based income streams held by the partner who is claiming income support.
- Deemed income from account based income streams held by the income support recipient commenced after 1 January 2015.

Example

John, age 66, receives Age Pension (immediately before 1 January 2015 and thereafter) and commenced an account based pension before 1 January 2015. The gross payment less deductible amount is $5,000. His wife Rita, who is not in receipt of income support, applies for Age Pension when she reaches qualifying age on 5 February 2015. Rita's account based pension commenced before 1 January 2015 and is deemed to earn $4,056. The couple's combined income used to determine each of their Age Pension entitlements is $5,000 + $4,056 = $9,056.

Deeming for CSHC and implications for partners

Similarly, CSHC holders may have partners who don't hold the CSHC card. A grandfathered account based income stream owned by the CSHC holder will not be included in the couple's combined income assessment if the partner applies for the CSHC card after 1 January 2015. Deemed income from account based income streams held by the partner applying for the CSHC and those commenced after 1 January 2015 by the CSHC holder will be included in the couple's combined adjusted taxable income test.

Example

Erica is 65, and holds a CSHC card (immediately before 1 January 2015 and thereafter) and commenced an account based pension before 1 January 2015. No income from her account based pension counts under the CSHC adjusted taxable income test. Her partner, Baptiste, applies for the CSHC card on 4 April 2015 when he reaches qualifying age. Baptiste commenced an account based pension before 1 January 2015, which is deemed to earn $9,306. Eligibility for the CSHC is determined on the couple's combined adjusted taxable income which includes $0 from Erica's grandfathered account based pension and $9,306 deemed income from Baptiste's account based pension.

Moving back to accumulation phase

Moving a deemed superannuation account based income stream back to accumulation phase could reduce a client's deemed income. But this depends on the type of benefit and the client's age.

Type of benefit	Client's age
CSHC	Any age
Income support payment	Whilst the super fund member remains less than age/service pension age

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LIHCC	Whilst the super fund member remains less than age/service pension age

A cost benefit analysis needs to be performed if considering moving a deemed superannuation account based income stream back to accumulation ie compare the benefits of being in an income stream against the benefits gained by returning to accumulation phase.

Implications for your clients

- As a financial adviser, we identify grandfathered income streams before rolling over or cashing out an existing account based pension, allocated pension or allocated annuity.
- We educate our clients on grandfathering of their superannuation account based income stream and the implications should grandfathering be lost.
- If considering rolling over or cashing out a grandfathered income stream, clients should consider what impact increasing deeming rates may have on their entitlements.
- Grandfathering does not apply to low income health care card holders. Some clients may lose entitlement because of this change.
- If a client is considering moving back to accumulation phase, we perform a full cost benefit analysis.

Pre 1 July 2014 insurance via superannuation arrangements

We identify any grandfathered superannuation insurance arrangements before we suggest we roll a client over.

From 1 July 2014, new insurance policies commenced through super must align with the superannuation conditions of release. An insurance contract for TPD and income replacement policy inside super commenced from 1 July 2014 could be quite different from those offered before this date. Generally, these differences will reduce the likelihood of a payout. In addition, new trauma policies cannot be offered within super.

Policies that are held inside super prior to 1 July 2014 are grandfathered (the insurance contract is not required to align itself with the super conditions of release).

As part of our best interests duty and reasonable investigation obligations, we take care when providing super switching advice.

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