

27 October 2023

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Canberra ACT 2600

Via email: [economics.sen@aph.gov.au](mailto:economics.sen@aph.gov.au)

Dear Mr Raine,

**Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023 [Provisions]**

Chartered Accountants Australia and New Zealand, CPA Australia, Institute of Public Accountants, SMSF Association and The Tax Institute (together, the **Joint Bodies**) welcome the opportunity to provide feedback on the Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023 (**the Bill**) which was introduced into Parliament on 13 September 2023. Our comments relate solely to the proposed non-arm's length expenses (**NALE**) rules for superannuation funds contained in Schedule 7 to the Bill. We do not comment on the other parts of the Bill in this submission.

The Joint Bodies do not endorse the measures contained in Schedule 7 to and recommend its removal from the Bill.

The policy proposed to be implemented by Schedule 7 to the Bill aims to alter, rather than eliminate, measures that were put in place to address concerns that are now outdated. This will result in a 'two-tiered' superannuation system. Additionally, the Bill fails to address issues arising from the interplay between the non-arm's length income (**NALI**) provisions and the NALE framework for superannuation funds and specific expenses. **Attachment 1** to this submission which has been previously provided to Treasury and the Australian Taxation Office (**ATO**) on a number of occasions outlines several outstanding issues that require clarification<sup>1</sup>.

On 21 February 2023, the Joint Bodies, together with other professional associations, wrote to the Assistant Treasurer and Minister for Financial Services, the Hon Stephen Jones MP, in response to the Consultation Paper on Non-arm's length expense rules for superannuation funds released in January 2023 (**Consultation Paper**). In our submission, the Joint Bodies suggest a simpler, more effective long-term solution than what is proposed by the Bill, and which would eliminate continuing concerns. A copy of that submission, incorporating our letter to the Minister, is attached at **Attachment 2**.

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<sup>1</sup> These issues are retained for completeness, however some parts have been affected by the ATO's consultation on Draft Taxation Determination TD 2023/D1.

The current provisions concerning NALI/E in section 295-550 of the *Income Tax Assessment Act 1997 (ITAA97)* were amended in 2019, taking effect from 1 July 2018. These changes extended the NALI provisions to specifically address NALE incurred by a superannuation fund.

Initially, the NALI policy aimed to impose income tax penalties on superannuation funds involved in non-arm's length transactions. It was not intended to by-pass contribution caps, as implied in the Consultation Paper released in January this year. Likewise, it was not designed to permit superannuation fund members to exceed their transfer balance cap.

It is crucial to prioritise efficiency, equity, and simplicity when formulating tax laws and policy. The Joint Bodies recognise that there is often a trade-off among these principles. For instance, dealing with an integrity issue may necessitate complex rules, and a judgment must be made on whether the benefits of including an integrity rule outweigh the costs of increased complexity in administering that rule. Above all, equity should not be compromised when implementing integrity measures.

Since the legislative changes were made in 2019, the current NALI/E regime has raised considerable concerns across the superannuation industry, as recognised in the media release from the Assistant Treasurer issued 24 January 2023.

For the past three years, the superannuation sector, tax professional associations and industry, have strongly advocated for these concerns to be addressed, recognising that these rules are potentially detrimental to the retirement savings of Australians.

Our feedback on the proposed measures outlined in the Bill is detailed below. We continue to advocate for a resolution that upholds the principles of sound policy and law design, ensuring that adequate safeguards are in place and appropriate penalties can be enforced.

### **Introduction of a 'two-tiered' superannuation sector**

The amendments in the Bill propose to introduce a differentiation between key sectors of the superannuation industry with respect to taxation. Exempting large APRA-regulated superannuation funds in relation to general and specific expenses within the NALI/E regime creates a dual tax regime, thereby entirely separating the treatment of different types of superannuation funds. This differential treatment raises concerns, particularly since the trustees of all superannuation funds are held to the same standard regarding legal obligations, such as the statutory best financial interests duty, common law fiduciary duties, and the sole purpose test, making the inconsistency in treatment questionable. We do not endorse the unnecessary, disparate treatment of superannuation funds.

In our submission in response to the Consultation Paper,<sup>2</sup> we suggested a solution that eliminates the need for such divergence. Specifically, we proposed the repeal of the 2019 amendments to section 295-550 of the ITAA97 and a return to the previous legislative provisions. Any remaining concerns about non-arm's length arrangements in any superannuation fund can be handled by the Australian Taxation Office (ATO) and the

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<sup>2</sup> See our submission to Treasury as cited in the previous footnote, available at <https://tinyurl.com/wtvvfzd9>

superannuation sector in accordance with the current version of ATO Taxation Ruling [TR 2010/1](#), which uses the contributions framework to address such breaches.

If the Government deems it necessary, amendments to section 109 of the *Superannuation Industry (Supervision) Act 1993 (SISA)*, which already prohibits trustees from engaging in transactions with any party unless they are conducted on arm's length terms, could offer additional safeguards. We suggest that any amendment to section 109 of the SISA should apply only to self-managed superannuation funds (**SMSFs**) and small APRA-regulated superannuation funds (**SAFs**).

We firmly consider that our proposed solution is the fairest, most practical and least disruptive among all the solutions put forth thus far. It represents a superior approach compared to establishing a differentiated tax treatment for various types of superannuation funds.

### **Treatment of general expenses**

We consider that the suggested modification to how general expenses are handled in SMSFs and SAFs is an improvement compared to the previous rules legislated in 2019, as well as the proposed 'five times multiple' approach considered in the Consultation Paper. However, the proposed alteration in the rules regarding general expenses should be considered with caution. This change would cap any potential NALI at a maximum of a 'two times multiple' and limit the NALI to the taxable income of the fund. It is our view that this cap has the potential to result in unfair outcomes.

We consider that TR 2010/1 takes a sensible approach by treating minor breaches of the NALE rules as contributions. This approach ensures simplicity and efficiency, as the treatment of contributions serves as a self-correcting mechanism. It also subjects the relevant NALE amount to the existing rigorous regime of excess contributions tax in cases where the contributions caps are exceeded.

We recommend that the response to breaches involving general expenses should return to the approach currently described in TR 2010/1.

### **Treatment of specific expenses**

The handling of specific expenses for SMSFs and SAFs remains unaltered in the Bill. We are deeply concerned that the Bill has not taken into account the many issues we have raised throughout the various stages of consultation regarding the treatment of specific expenses under the NALI/E framework. As a united group of professional associations and individually, we have raised these concerns with Treasury and the ATO on numerous occasions. Attachment 1, which accompanies this submission, outlines several unresolved issues where the current treatment of specific expenses has not been satisfactorily resolved. It is our view that these problems will continue to create uncertainty if the legislation is passed in its present form.

We strongly recommend the prompt rectification of the issues concerning specific expenses in the best financial interests of superannuation fund members.

## Capital gains tax issues

A significant factor contributing to the issues surrounding the tax treatment of specific expenses is the interaction between the NALI/E rules and the capital gains tax (CGT) provisions in the ITAA97. Notably, examples 7.1 to 7.6 at paragraph 7.47 of the Explanatory Memorandum to the Bill, which explain how the new law will function, do not contain any instances illustrating the CGT impact. There continues to be substantial unease within the superannuation sector since the release of ATO Law Companion Ruling [LCR 2021/2](#). This ruling presents examples where specific NALE can affect the tax treatment of CGT assets in the future, including the income generated from these assets, as well as future capital gains upon their disposal.

From our perspective, the conclusions drawn in several examples in LCR 2021/2 extend well beyond what might be considered a reasonable connection with the initial expense for tax purposes. The conclusions reached in the ruling also extend beyond what the eventual reduction in intrinsic value resulting from the expense (for accounting and/or valuation purposes) would indicate.

The ATO's existing and proposed rulings and guidance appear to consistently indicate that the outcomes arise as a result of the current operation of the law. We consider that labelling the entire amount of a later capital gain as a result of a minor amount of specific NALE, as well as subjecting arm's length capital gains to the NALI/E provisions, leads to a disproportionate and inappropriate outcome. We recommend that this should be addressed through legislative change to ensure a fairer result.

We consider the outcomes contained in Draft Taxation Determination [TD 2023/1](#) (Draft TD) are inconsistent with community expectations, particularly the inability to choose which capital gains are offset by capital losses.

This Draft TD provides outcomes that arise because of section 102-5 of the ITAA97, which produces a single amount of statutory income, being the net capital gain. This provision works effectively for individual and corporate taxpayers who need to calculate a single amount of statutory income to include in their assessable income and which is taxed at either marginal tax rates (in the case of an individual) or a flat corporate tax rate (in the case of a company). However, superannuation funds face three possible tax rates – 0% for exempt current pension assets, 15% for non-pension assets and 45% for any NALI/E income.

The inability to disaggregate the net capital gain calculated under the method statement in section 102-5 of the ITAA97 interacts awkwardly with the operation of subsection 295-550(1) of the ITAA97 which is designed to identify NALI amounts and subject them to a higher rate of tax. The effect of statutory income being used for the purposes of section 295-550 is that arm's length capital gains are aggregated with non-arm's length capital gains in calculating the net capital gain under section 102-5 of the ITAA97. This results in arm's-length capital gains forming part of the non-arm's length component. This is a disproportionate outcome and unfairly taxes arm's length capital gains at a penal rate.

Section 102-5 of the ITAA97 appropriately applies to segregated and proportional pension assets because of the operation of Subdivision 295-F of the ITAA97. A similar approach needs to apply to NALI/E capital gains.

If Parliament proceeds with amendments to section 295-550 of the ITAA97, then changes must also be concurrently made to the CGT provisions.

## Remediation

It is important to note that the Bill does not contain provisions to enable funds that are deemed to have NALI due to honest mistakes or similar reasons to correct the situation. This is in sharp contrast to the corrective options available to manage loans made by private companies in Division 7A of Part III of the *Income Tax Assessment Act 1936 (ITAA36)*, as well as under various provisions in the SISA (particularly those addressing the in-house assets restrictions). In our view, the current NALI tax rate is excessively harsh and does not offer a fair avenue for trustees genuinely seeking to rectify their unintentional mistakes or inadvertent errors.

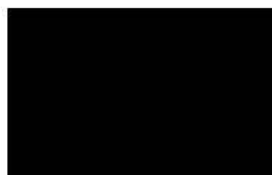
We recommend that the proposed legislative measures should contain a mechanism to enable remediation of honest mistakes and inadvertent errors that may otherwise attract the NALI/E provisions.

We would be pleased to discuss with Treasury any matter raised in this submission, or in the attachments. For any questions in relation to our submission, please contact Richard Webb, Senior Manager, Financial Planning and Superannuation Policy at CPA Australia on [REDACTED] or at [REDACTED]

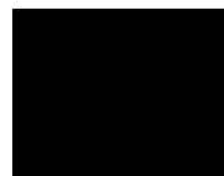
Yours sincerely,



**Elinor Kasapidis**  
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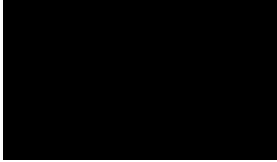


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Schedule of attachments:

1. Attachment 1: NALI/NALE Industry Issues Requiring Clarification
2. Attachment 2: Copy of Submission to Treasury made 22 February 2023 in response to “Non-arm’s length income provisions applying to superannuation funds” Consultation Paper (incorporating letter to Minister for Financial Services, the Hon Stephen Jones MP dated 21 February 2023)

## NALI/NALE Industry Issues Requiring Clarification

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## 1. Delineation of Roles Issue

### (a) Delineation between various roles and requirements to seek advice

At law, a trustee or director is required to undertake the activities of the trust or company. While the trustee or director may delegate those tasks or engage others to do such tasks, the ultimate responsibility for undertaking those tasks rests with the trustee/director.

With respect, the position of the ATO in LCR 2021/2, that actions by a trustee/director must be examined as to whether they are actions of trustee/director capacity or a non-trustee/director capacity, creates a false dichotomy. All actions of the trustee/director are in the role of the trustee/director unless expressly agreed otherwise. This is effectively codified in sections 17A and 17B of the SIS Act which prevents a trustee/director from charging for their services unless section 17B applies.

While it could be said that this creates an advantage to certain super funds that have trustee(s)/director(s) who have particular skill sets, that will always be the case as each trustee/director will have different skills and abilities. Additionally, some may have more time and others may be happy to delegate and pay for certain services.

In addition, by the trustee/director personally performing super fund services, the trustee undertaking work is not dealing with a non-arm's length party as it one cannot contract with oneself and/or in the alternative one that an arm's length party would be expected to incur. Given a trustee/director, at law, is expected to act as a volunteer (unless expressly authorised to be remunerated), then the arm's length position for someone at a trustee/director role is not to charge.

#### *Industry technical analysis:*

Industry accepts that the ATO has come to a different view to industry. Nevertheless, we wish to point out that the delineation between trustee/director roles and non-trustee/director roles will in many cases be difficult to ascertain without incurring red tape and cost.

In example 10 of the LCR, what if Jean was retired but still maintained an electrician's licence? On the ATO's other reasoning it would seem to follow that because he is able to undertake the work without charging a fee and the work can only be done by a qualified person it must be NALE to the fund. However, that should not be the outcome as Jean is prevented from charging a fee by Sec 17A of SIS Act and the effort can be said to be in Jean's capacity as trustee.

### (b) Uncertainty around acting in individual and personal capacity

**Uncertainty in determining if an individual is acting in their capacity as a trustee, or director of a corporate trustee with respect to the provision of accounting and tax services to a SMSF.**

Assume the following facts:

- Kate is a trustee of a SMSF of which she is the sole member. She is a chartered accountant who is employed in an accounting and tax agent business.
- At home, in her own time, Kate uses the computer supplied by, and paid for, by her employer to prepare the accounts for her SMSF.
- Kate does not charge the SMSF for her accounting work.



*(a) Has Kate provided her accounting services in her capacity as trustee of the SMSF?*

It is argued that, based on paragraphs 54 and 57 of LCR 2021/2, Kate has provided her accounting services as trustee of the SMSF, rather than on an individual basis or as part of an arrangement in which the parties are dealing on a non-arm's length (NAL) basis. Kate's use of her work computer is minor and incidental in nature. As such, the non-arm's length income (NALI) rules should not apply with respect to Kate's provision of accounting services.

*Industry technical analysis:*

S.17A of the SIS Act is satisfied as no remuneration was paid to Kate in this scenario.

S.17B of the SIS Act is not relevant as it requires remuneration to have been paid.

S.295-550 of the ITAA 1997 does not apply as there is no arrangement with a NAL party, rather, this occurs as an internal fund dealing.

*Further assume the above example continues as follows:*

- Sometime later, after Kate has had her accounts audited, she sends the accounts to her firm and a colleague at her work who uses the financial information as a basis to prepare and lodge the return using the firm's tax agent registration (i.e., the registration of Kate's employer). The colleague checks the reasonableness and veracity of the numbers and obtains any other information necessary to prepare, check and lodge the return. This satisfies the firm's professional obligations in relation to preparing and lodging a tax/statutory return.
- The SMSF is not charged any amount by Kate's employer (or Kate), with respect to the lodgement of the SMSF annual return.
- Kate's employer does not have a discount pricing policy within the meaning of paragraph 51 of LCR 2021/2.

In this case, Kate's employer has provided a NAL tax-related service to the SMSF.

*(b) Does the provision of the tax-related services to the SMSF trigger the NALI rules?*

One reading of LCR 2021/2 (namely paragraph 19 and 20, as well as the phrasing of Example 2 at paragraph 24) is that non-arm's length expenditure (NALE) incurred in complying with, or managing, the fund's income tax affairs and obligations (for example, Subdivision 295-F), which are deductible under S.25-5, do not result in the application of the NALI rules because these expenses lack the necessary nexus to all the ordinary and statutory income of the fund.

Based on this interpretation there is insufficient nexus between the provision of tax-related services and all the income of the fund and, as such, the NALI rules do not apply with respect to the provision of these tax-related services.

An alternate view is that NALE with respect to 'tax-related matters' (that would be deductible under S.25-5) do have a sufficient nexus to all income of a SMSF (and therefore can potentially cause all of the fund's income to be NALI).

*Industry technical analysis:*

It is as arguable as not that S.295-550 of the ITAA 1997 could be a problem in this situation, which highlights the need for ATO clarification and/or legislative reform. The question is, in gaining or

producing the fund's income, did the fund incur an amount that is less than it would have incurred had the parties been dealing at arm's length with respect to the arrangement? It is possible to put forward compelling arguments that support both views.

*(c) Has Kate provided her accounting services in her capacity as trustee of the SMSF?*

If the ATO does accept that the provision of NAL tax-related services lack the requisite nexus to all of the income of the SMSF (such that the NALI rules are not triggered with respect to the provision of NAL tax-related services by Kate's employer), this then raises the issue of whether the provision of these tax-related services may taint the capacity in which Kate provided her accounting services to her SMSF. In other words, does the provision of the tax-related services provided by the employer change the outcome at (a), above?

It is argued that the provision of lodgement services by Kate's employer should not taint the capacity in which Kate provided her accounting services to the fund. The accounting services are separate to those provided with respect to the provision of tax services (lodging the SMSF return) and were provided to the SMSF at different times.

*Industry technical analysis:*

Regardless of the NAL arrangement with respect to the preparation of the annual return, the accounting work remains an internal fund dealing and, as such, S.295-550 of the ITAA 1997 does not apply to the accounting services provided by Kate to the fund at no cost.

*Does the ATO agree with this analysis?*

If however the better view is considered to be that the accounting services are tainted, such that Kate is no longer taken to provide the accounting services in her capacity as trustee, then she will invoke the NALI rules if she does not charge market value (MV) for the accounting work she performs for the SMSF. If, however, she does charge the fund for this work she will breach S.17A of the SIS Act (in this scenario she cannot satisfy S.17B of the SIS Act as she is an employee and does not otherwise provide services to the public as a sole trader).

It is industry's view that where a SMSF trustee is precluded from being able to charge for a trustee service, that S.295-550 does not apply.

*Industry technical analysis:*

It could be argued that, if the SIS Act precludes a charge for a trustee service, this may indicate that the arrangement is an internal fund dealing rather than a scheme to which S.295-550 of the ITAA 1997 would apply.

*Costs that are ordinarily deductible under S.25-5 of the ITAA 1997*

If the ATO accepts that NAL incurred in complying with, or managing, the fund's income tax affairs and obligations, that is ordinarily deductible under S.25-5 of the ITAA 1997, does not have a nexus to all the income of a fund, this raises the issue of when a NAL cost is considered to be ordinarily deductible under S.25-5 of the ITAA 1997. For example, in the following scenarios, would the NAL costs be ordinarily deductible under S.25-5 of the ITAA 1997?

(a) XYZ Accounting P/L provides services on a NAL basis to a SMSF that consists of the preparation of financial accounts and preparation and lodgement of the SMSF annual return.

It is industry's view that the NALE in this case would be ordinarily deductible under S.25-5 of the ITAA 1997. However, this would only apply if the financial accounts were used to prepare the SMSF annual return but would not apply if the accounts were prepared to obtain finance for a limited recourse borrowing arrangement (LRBA).

(b) ABC Accounting P/L provides services on a NAL basis to a SMSF that consists of the preparation of financial accounts and preparation and lodgement of the SMSF annual return. The firm also provides bookkeeping services on a NAL basis to the SMSF throughout the year, which is used to prepare the financial accounts.

It is industry's view that the NALE, including that related to bookkeeping, would be ordinarily deductible under S.25-5 of the ITAA 1997 for the purposes of the NALI rules

#### *Discount policy for smaller firms*

Based on paragraphs 51 and 8 of LCR 2021/2, an arrangement entered into by a SMSF will not be considered NAL where a trustee/director, acting in their capacity as trustee of the fund, is entitled to a discount under a discount policy where the same discounts are provided to all employees, partners, shareholders, or office holders provided the trustee/director is not able to influence the formulation of the policy.

Assume the following facts:

- ABC Accounting P/L ('ABC') operates an accounting practice. The company is controlled 50/50 by two unrelated principals. The principals are employees of the company, and the company has one other employee.
- ABC Accounting P/L has established a 'discount policy' for shareholders, directors, and employees.
- One of the unrelated principals, in their capacity as trustee of their SMSF, engaged ABC to provide services to their SMSF, which are provided at a discount rate pursuant to the firm's discount policy.

It is industry's view that in this case the principals of this firm were able to influence its discount policy and s 295-550 would apply to the discounted fee.

#### *Discount policy for large entities*

Does a senior executive of a large entity involved in the decision-making concerning total employee remuneration have sufficient influence on discounts offered to all employees? It is industry's view that the answer to this issue is fact dependent and we believe this needs to be explored in greater detail with the ATO.

### **(c) Trustee of unit trust performing work on unit trust assets**

There are a considerable number of SMSFs that invest in private unit trusts. These unit trusts may include pre-99 unit trusts, unrelated unit trusts and non-g geared unit trusts (under div 13.3A of the SISR).

Unit trusts are also used extensively by APRA regulated super entities and many of the issues mentioned here about SMSFs using unit trusts also apply to large super funds (see below).

LCR 2021/2 provides limited guidance in relation to how paragraphs 295-550(2)(b) and (c) apply to unit trusts. It provides only one example (Example 12 of LCR 2021/2 involves Scott's SMSF acquiring \$50,000 of units in a stock exchange listed unit trust).

One important point which is not dealt with in LCR 2021/2 is what is the status if a trustee/director of the trustee of the unit trust provides services to a unit trust (often the trustees/directors of the unit trust are the same as the trustees/directors of the SMSF). For example, consider a SMSF that is invested in a non-g geared unit trust that owned a factory and the unit trust trustees/directors (who are also the SMSF trustees/directors) oversaw the collection of rent and dealings with the tenant (which may be a related party where the property constitutes business real property), attended to bookkeeping and instructed the accountant regarding the unit trust's annual financial statements.

The position relating to remuneration for a trustee/director of a unit trust that a SMSF invests in depends on a range of factors including the unit trust's governing rules (eg, the unit trust deed and the constitution of the corporate trustee of the unit trust). Typically, no remuneration applies unless the governing rules expressly allow for same.

The ATO acknowledges, and industry agrees that, in relation to a trustee or director of a corporate trustee of a SMSF that:

- A trustee or a director of a corporate trustee of a SMSF will be required to perform particular actions in order to satisfy a range of obligations imposed on them, eg, any conditions imposed by statute as well as fiduciary duties and obligations (see paragraph 44 of LCR 2021/2).
- The trust deed may also provide a trustee or director of a corporate trustee the power to perform certain actions (see paragraph 45 of LCR 2021/2).
- An individual's business, profession, life experiences or employment may result in the individual having skills and knowledge that can assist the individual to perform their duties in their capacity as trustee, or as a director of a corporate trustee, of a SMSF. Utilising such skills and knowledge of itself does not indicate that the individual is not acting in their capacity as trustee or as a director of a corporate trustee (see paragraph 46 of LCR 2021/2).

While the three points referred to above relate to the trustee or director of a corporate trustee of a SMSF, these same principles also apply to a trustee of a unit trust, eg, a director of a corporate trustee of a unit trust is required to perform a range of obligations both at law and under the trust deed. Such a director may also possess special skills and knowledge.

Item 23 of the Compendium issued with LCR 2021/2 states that:

*We [ATO] consider the Ruling provides sufficient guidance on the key principles to assist trustees to determine how the provisions apply.*

*Trustees may seek certainty on their specific circumstances through the private ruling process.*

We believe the same principles as outlined in pars 44 to 46 of LCR 2021/2 applies to unit trust investments where a super fund invests in that unit trust.

Industry does not believe it is appropriate for taxpayers to have to seek private rulings on such matters. Applying for private rulings ties up considerable ATO and taxpayer resources. This is a popular query for both large and small funds and as a result much time and cost can be saved if clear guidance were provided to industry.

## 2. Capital Gains Tax Issues

### *Background*

At paragraph 17, LCR 2021/2 states that a super fund will incur NALI if there is a sufficient nexus between the NALE and the relevant ordinary or statutory income. That is, the expenditure (or lack thereof) must have been incurred in gaining or producing the relevant income (or acquiring the relevant entitlement).

Although the LCR provides examples of how a nexus can exist between the NALE and the gaining/producing of ordinary income, it is not clear how/why a sufficient nexus can exist between the NALE and any future capital gains on disposal of an asset.

For example, does the nature of the expense and work provided (ie. capital or revenue expenditure) play a role in determining whether NALI will include both ordinary income and future capital gains? In many cases, the capital gain is solely a factor of capital appreciation due to market conditions and to taint the entirety of all future capital appreciation lacks any real nexus.

We are aware that paragraph 2.38 of the explanatory memorandum to the law<sup>3</sup> indicates that the nexus includes instances where revenue expenditure is deductible (under s.8.1 of ITAA97), or capital expenditure is included in the fund's cost base for capital gain or loss assessment. LCR 2021/2 also clarifies that NALE can be both revenue and/or capital in nature. However, the examples provided in the LCR do not provide sufficient guidance around why the NALE can taint all income and capital gains indefinitely.

Paragraph 21 of the LCR introduces the concept of expenditure of a 'recurrent nature' that only has a nexus with the fund deriving ordinary or statutory income during a particular income year, and subsequently ceases to incur that NALE in a later income year. The 'recurrent expenditure' concept is not used in s 295-550 and could arguably be contrary to legislative interpretation.

Paragraph 75 of the LCR acknowledges that there will be cases where there will not be a sufficient nexus between NALE and any future capital gains. As such, it is important that industry has clear guidance on the types of expenditure which, if incurred on a non-arm's length basis (often inadvertently and of minor monetary value), will give rise to NALI and any future capital gains on disposal of an asset.

### *LCR 2021/2 – example 9*

In this example Trang undertakes a complete renovation of the bathroom and kitchen of her second SMSF rental property. Trang's use of the tools of her trade is not considered minor, infrequent, or irregular in nature and by not charging her SMSF for the services provided, it constitutes a non-arm's length dealing between the SMSF and Trang. In this situation, there is a sufficient nexus between the NALE and the rental income derived from the second SMSF rental property and therefore the

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<sup>3</sup> Treasury Laws Amendment (2018 Superannuation Measures No.1) Act 2019

rental income will be NALI. The NALE will also result in any capital gain that might arise from the subsequent disposal of the second SMSF rental property being NALI.

#### *LCR 2021/2 – example 10*

In this example, Jean undertakes electrical work on his SMSF rental property that can only be done by a licensed electrician. As the work done by Jean is not as trustee of his SMSF but in his individual capacity, and he charges his SMSF the commercial rate for the work undertaken on the rental property, the NALE provisions will not apply.

#### *LCR 2021/2 – example 11*

In this example, Sharon the licensed real estate agent, provides property management services in her individual capacity to her SMSF with respect to her SMSF residential property. She charges her SMSF 50% of the price for her services that she would otherwise charge a non-related party. As a result, the rental income will be NALI for each financial year the NAL dealing remains in place. The example then concludes that due to the nature of the NALE, there will not be a sufficient nexus between the NALE and any future capital gain made by the SMSF on the disposal of the residential property.

#### *Questions and industry technical analysis*

1. In example 9, why does the NALE result in the future capital gain being taxed as NALI? Are we correct to assume that NALE applies to future capital gains is because the work performed by Trang was capital in nature and hence ordinarily deductible under the capital works deduction ie, 2.5% per annum over 40 years?

It does not seem reasonable to assume that Trang's bathroom fit-out forever taints the potential capital gain on the whole of the asset especially if the asset is held for a lengthy period after the improvement is made. Industry's view is that NALE of a revenue nature taints revenue gains and NALE of a capital nature can taint a capital gain. However, we argue that after a period of time, say at least 5 years, that it becomes difficult to argue that any improvement taints the whole of the capital gain as the capital expenditure would no longer be reflected in the value of the property and any increase in value is attributable to normal capital appreciation.

In any case there may be mitigating circumstances as to why a super fund asset is sold within a short timeframe after such improvements have been completed. For example, a member benefit may have to be paid out because a transfer request by a member of the fund or because a member has died or become permanently disabled. In other words not all asset disposals in this case should taint a capital gain. In other words the super fund's trustees actions may not be an indication of its motivation.

2. What if the work done by Trang on her second property had instead been ad-hoc repairs and maintenance (ie. revenue/deductible in nature) rather than a complete renovation of the bathroom and kitchen, and Trang did not charge her fund a commercial fee in respect of this repair/maintenance work?

We are of the view that in this case NALE would apply to all the rental income (irrespective of the value of the repairs) but not to any future capital gains.

3. In example 10, what if Jean did not charge his fund a commercial fee, what would be NALI?

Assuming the work performed by Jean is not a capital improvement – it is not clear from the example the nature of the work performed – then we believe that only the rental income is subject to NALI. That is, NALI does not apply to any capital gains.

4. In example 11, we assume that NALI only applies to the net rental income because the work performed by Sharon was not capital in nature. However, another interpretation is that it is a recurrent expense not related to the acquisition of the asset.

We would argue that it is the former interpretation that has created this result. There is long established case law principles on the distinction between revenue versus capital. The recurrent expense theory appears to have been created by the ATO as without this theory, the ATO view that a general fund expense taints everything would logically result in every asset then held by that fund being tainted with NALI on both ordinary and statutory income – which is an absurd outcome which would be unlikely to succeed in a court of law.

#### *An alternative to the recurrent expenditure concept*

In LCR 2021/2, the concept of recurrent expenditure appears central to a determination as to whether NALI could apply to any future capital gain on disposal of an asset. As mentioned, the concept of expenditure of a recurrent nature is not used in Sec 295-550, and there does not appear to be any legal basis or case law judgements that supports this concept. Therefore, it is difficult to provide a detailed legal analysis, and it could be years before a tribunal, or the courts can confirm the true meaning and correct application of the concept in the context of Sec 295-550. Indeed, it may be 15 to 25 years before industry obtains any clarity on the ATO's 'recurrent expense' theory.

An alternative approach, which would provide far more certainty, and would preserve what we understand is the rationale behind the recurrent expenditure concept, would be to adopt the well established revenue versus capital distinction. Most taxpayers for instance understand the improvement versus repair/maintenance concept. The distinction between what is an improvement, and what is a repair, is well established in law, and can be relied on by the industry. It can also be used to align to the general principal that NALE that permanently improves or adds to the state or function of an asset, or which significantly alters the asset for the better, would give rise to NALI on any future capital gain. In clear contrast, expenditure which merely ensures the continued functioning of the asset in its present state (i.e. maintaining or repairing the asset), would only give rise to NALI in the income year in which the NALE was incurred (assuming the exceptions which apply to trustees acting in their individual capacity do not apply).

In the context of LRBAs, and for the purpose of determining whether borrowed funds have been used to improve an acquirable asset in contravention of Sec 67 of the SIS Act, SMSFR 2012/1 provides the following practical definition of 'maintaining', 'repairing' and 'improving' an acquirable asset.

#### Maintaining the acquirable asset

*19. The term 'maintaining' ordinarily means work done to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration, provided that the work merely ensures the continued functioning of the asset in its present state.*

#### Repairing the acquirable asset

20. The term 'repairing' ordinarily means remedying or making good defects in, damage to, or deterioration of an asset and contemplates the continued existence of the asset.

21. A repair is usually occasional and partial. A repair restores the function of the asset without changing its character and may include restoration to its former appearance, form, state or condition. A repair merely replaces a part of something or corrects something that is already there and has become worn out or dilapidated through ordinary wear and tear, or is damaged whether accidentally or deliberately or by natural causes.

22. As to whether the repair is partial and restorative it is the entire asset that is held under an LRBA that is relevant. For example, if it is a house and land held under the LRBA, then in determining if the asset is maintained, repaired or restored, or whether it has been improved, it is necessary to consider the overall effect of the work (or expenditure) on both the house and the land and the qualities and characteristics<sup>[15]</sup> of the asset at the time it was acquired under the LRBA. If work on the asset restores the function of the asset to what it was at the time it was acquired, and uses similar or modern equivalent materials, it is a repair.

Improving the acquirable asset

23. In contrast to repair, an asset is improved if the state or function of the asset is significantly altered for the better, through substantial alterations, or the addition of further substantial features or rights, to the asset.<sup>[16]</sup>

24. Determining if an acquirable asset is merely restored, or whether its state or function is significantly altered for the better, is a question of fact and degree. In each case it is necessary to consider the qualities and characteristics of the acquirable asset that is subject to the LRBA at the time the LRBA was entered into. Whether the state or function of the acquirable asset has altered significantly for the better is determined objectively and without reference to the actual use to which the acquirable asset is put. Alterations will not amount to an improvement if the state or function of the acquirable asset is only bettered to a minor or trifling extent as compared to the asset as a whole.

We see no reason why these concepts cannot be used instead of the recurrent expenditure concept when distinguishing between NALE which gives rise to NALI on any future capital gain (i.e. NALE which improves the asset), and NALE which only gives rise to NALI on the statutory income derived from the asset and only for the income year in which the NALE was incurred (i.e. expenditure which merely maintains or repairs the asset). This approach also recognises NALE can be both revenue and/or capital in nature.

### 3. Contribution Issues

#### (a) NALI and proposed changes to TR 2010/1

Broadly, LCR 2021/2 provides:



- An asset purchased under a contract at less than market value (MV) invokes NALI.
- However, an in specie contribution recorded for less than MV is a contribution (and not NALI).
- Where a part asset is purchased, the contract must specify the part of the asset being acquired, otherwise there can be no contribution. If the asset is transferred at less than MV, NALI would apply to the entire asset.

We will examine an example to illustrate some issues that we have with the above analysis.

*Facts -- Jon's SMSF -- part purchase and part in specie contribution:*

- Jon has business real property with a MV of \$500,000 that he leases to a third party which uses the property to carry on a business
- Jon enters into a contract of sale to sell a ½ tenant in common (T-i-C) interest for \$200,000 to his SMSF (undervalued by \$50,000)
- John also makes an in specie contribution of a ½ T-i-C interest, and his SMSF records this as a \$200,000 non-concessional contribution (NCC) to his SMSF (undervalued by \$50,000).
- The ATO subsequently determine the property was undervalued.

It appears that there is a 'double jeopardy' applying the ATO's view on the part contributed, ie, NALI applies to all of the asset even though the in specie contribution is adjusted to reflect MV. Also, s 108-5 ITAA 1997 recognises that part of an asset is an asset for CGT purposes. Moreover, the ATO has also provided its view on how separate acquired parts of an asset are to be treated separately for tax purposes in TD 2000/31.

If we now assume that John's SMSF paid the correct MV for the 50% T-i-C interest purchased and undervalued the 50% T-i-C in specie contribution, then it would appear that NALI would not apply as the ATO would merely treat John as having an additional \$50,000 contribution as an NCC (which may give rise to excess contribution issues).

In our view, a super fund trustee can agree to treat any undervalued asset or undercharged service as a contribution. This is particularly so, where the member agrees to such a treatment. That is, if the super fund records the undervalue sale of an asset or the undercharging or failure to charge for an asset as a contribution, then there is no NALI or NALE to trigger. This is because the super fund will effectively have received full consideration for the asset or service.

- How are expense payments now treated?

An expense payment on behalf of a super fund has been treated as a contribution since TR 2010/1 was originally issued. However, since a fund would not be paying such an expense (either in full or part) an expense payment on behalf of a fund would also appear to be NALE.

- How are super fund establishment costs treated?

Also, when a super fund is set up, often the costs of the SMSF deed and corporate trustee are not paid by the fund. Industry believes there may be NALE and contribution risks with this practice.

There are likely to be many other similar queries that arise, and taxpayers need clear and concise guidance of the division between what is a contribution and what is NALI. These items should be

mutually exclusive and appropriate guidance and ‘tie breaker’ pointers are required where a particular item may fall into the grey zone.

Industry has decided to defer any substantive feedback on TR 2010/1 DC pending finalisation of the outcome on LCR 2021/2 with the ATO.

### **(b) Employee Share Schemes (ESS)**

Acquiring shares under an ESS via a super fund – SMSFs and APRA regulated super funds – is subject to great uncertainty.

Where the shares are nominated to a SMSF, the ATO has also treated any discount as a contribution. This is confirmed on the [ATO webpage QC 26221](#).

Our interpretation of paragraph 18 of LCR 2021/2 together with proposed par 25C of TR 2010/1 is that the purchase of ESS shares at a discount will result in all future dividends and net capital gain being NALI.

A super fund typically purchases ESS shares by paying the company directly. The company provides the discount to the super fund as part of the ESS provisions. These provisions form part of the contractual terms and conditions relating to the super fund acquiring the ESS shares as the nominated purchaser.

That is discounts offered to super funds on ESS shares are no longer contributions.

This appears to be a major change to the long-established practice based on the current TR 2010/1 which has been a binding public ruling that has been relied on for the past 11+ years. The ATO’s latest draft view also differs from the ATO’s current view reflected on its website at QC 26221 (noted above).

Let’s examine a typical ESS example:

- Jon is offered \$10,000 worth of shares in his employer’s company via an ESS for \$9,000.
- Jon nominates his SMSF as the purchaser.
- Jon’s SMSF pays \$9,000 to the company for the shares.
- Subject to any tax concession, Jon accounts for the \$1,000 discount in his personal tax return.
- Jon’s SMSF records \$1,000 as a NCC
- Jon’s SMSF has a cost base of the shares of \$10,000 reflecting the \$9,000 payment and Jon’s \$1,000 NCC.

NALI should not apply to this case as the correct amount has been provided (ie, payment of \$9,000 under the ESS contract and a contribution of \$1,000).

We see no reason why s 295-550 causes the current accepted interpretation, which has worked well in practice, to cease.

We note that paragraph 51 of LCR 2021/2 allows discounts offered to say all staff to not give rise to NALI. However, many ESSs are only offered to a particular class of employee, eg, senior managers

and executives rather than to all employees and, in certain cases, shares may be offered to greater than say 75% of permanent employees who have completed at least 3 years of service (for example, as required by s 83A-105 of the ITAA 1997). Thus, unless ESS discounts are offered to all employees or all office holders or all shareholders, as relevant, a super fund is unlikely to be able to rely on the discount concession in paragraph 51.

It is unlikely that a super fund would be in a position to have the contractual terms varied to specify the part being purchased under most ESSs.

And in any event the full MV of the shares is accounted for as Jon's SMSF has recorded \$1,000 as an NCC.

However, the ATO's latest view expressed in TR 2010/1-DC appears to preclude this argument as the sale contract does not specify the part of the shares that are acquired under the sale contract and the part that is being made by way of in specie contribution as required pursuant to paragraphs 28 and 29 of LCR 2021/2.).

We see no reason as to why the ESS discounts should be recognised as a contribution (i.e., the \$1,000 discount recognised as an NCC). As we noted above this has been the position for many years.

We believe that the better view is that if an employee fails to disclose the correct amount or nil amount of contribution, then the contribution rules should apply and not NALI given the ATO's long standing view expressed in the current wording of TR 2010/1

#### 4. Guarantees and 50–50 unit trust

Previously the ATO has acknowledged the possibility of two unrelated SMSFs investing 50–50 in a unit trust and the trustee of the unit trust is then able to borrow from, say, a bank.<sup>4</sup>

Presumably in this situation:

- The unit trust will have a corporate trustee.
- The corporate trustee will have two directors: a member of SMSF1 and a member of SMSF2.
- The lender will want (in addition to a mortgage over the real estate that the trustee of unit trust acquires with its loan) a personal guarantee from the directors of the trustee of the unit trust.
- The lender will not lend without such personal guarantees.
- The trustee of the unit trust uses the borrowings to passively acquire real estate. The trustee then passively rents out real estate.

We refer to this as the '**usual 50–50 unit trust situation.**'

In SMSF Regulator's Bulletin SMSFRB 2020/1 the ATO allude to personal guarantees. Example 3 in that Bulletin involves personal guarantees as well as many other very unusual and aggressive facts in respect of a 50–50 company. Example 3 concludes with the ATO warning that, among other things,

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<sup>4</sup> See the discussion under the heading '1.7.10 Control of a unit trust' in the [Superannuation Technical minutes, March 2013](#)

‘the dividends from [the 50–50 company] may be NALI for the two SMSFs’. The ATO’s reasoning includes that ‘the risk was born by [the directors] personally’ due to the guarantee.

However, example 3 is a very unusual and aggressive set of facts. Example 3 is far less common than the usual 50–50 unit trust situation. Nevertheless, example 3 suggests that the usual 50–50 unit trust situation causes NALI unless say the directors charge the unit trust a fee consistent with an arm’s length dealing.

When banks lend to SMSFs under LRBA’s they also insist upon personal guarantees.

For the reasons outlined below we would argue that personal guarantees should not cause NALI and similarly LRBA’s with guarantees from banks also do not cause NALI.

### *Analysis of NALI to guarantees*

Personal guarantees are required in many transactions especially where a company is involved. A lawyer would be negligent if they did not insist on a guarantee by the directors of a company; otherwise, a \$2.00 company could ‘walk away’ from many transactions without much risk.

Most lenders require a guarantee as a term of extending finance without necessarily differentiating the price between the provision of a loan with a guarantee, versus one without a guarantee.

Guarantees in this sense are an everyday arm’s length term in commercial and business dealing, ie, they are reflective of arm’s length terms. A further example is when the directors of a corporate trustee of an SMSF purchasing property are required to provide a guarantee to the vendor in the event the SMSF as purchaser defaults. If such guarantees gave rise to NALI, then most investments purchased would be subject to NALI where a corporate trustee was used. Thus, there would, among other things, be a huge disincentive for having a corporate trustee which would give rise to yet another absurd outcome from construing the NALI legislation too broadly.

Moreover, from a practical perspective, there is no simple method of valuing a guarantee fee and there does not appear to be any professional body or recognised skill set that offers such a service especially given the many and varied guarantees that arise in day-to-day commerce.

We do note, however, that banks do provide certain guarantees for which they charge a commercial fee for. Naturally, banks are selective in respect of who and when they will offer these type of bank guarantee facilities, e.g., rental guarantees for commercial tenants.

We also refer to paras 44 and 45 of LCR 2021/2 which, for convenience, are repeated as follows:

1. A trustee or director of a corporate trustee of a SMSF will be required to perform particular actions in order to satisfy obligations imposed on them, including:
  - any conditions imposed by statute (for example, the SISA and the *Corporations Act 2001*)
  - any fiduciary conditions imposed under the law, and
  - any duties or obligations imposed under the trust deed of the SMSF.
2. The trust deed of the SMSF may also provide the trustee or director of the corporate trustee the power to perform certain actions.

It is our view that the directors of the corporate trustee would typically be asked to guarantee many transactions entered into by that corporate trustee, eg, the purchase of real property or the engagement of a builder to build an improvement on land owned by that unit trust. As discussed above, third parties would typically not be prepared to transact with a corporate trustee unless they received a guarantee; otherwise, they would be at risk of a \$2.00 company walking away from a deal if it suited or was 'under water'.

Guarantees provided by directors of a corporate trustee should not be considered a service where NALI should be invoked as it is part and parcel of everyday commercial dealings and is a duty or obligation of a director under the constitution, the *Corporations Act 2001* (Cth), unit trust deed or via a transaction that either an SMSF or unit trust, etc, has entered into.

## 5. Confirming market value (MV)

The starting point is that the ATO does have some useful material on MV. However, this material has not been fine tuned for the introduction of NALE. In particular, the ATO's Valuation guidelines for SMSFs (QC 26343) does not expressly confirm the ATO's position that a valuation report or valuation evidence is acceptable where it may fall within an acceptable range of MV. This is despite various senior ATO officers being quoted at seminars and in the media having confirmed that this is the ATO's view.

Indeed, para 2.49 of the Explanatory Memorandum (EM) to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 provides:

### **Range of transactions may be on arm's length terms**

2.49 It can be difficult to determine an exact price that is 'non-arm's length'. An 'arm's length' price may be accepted to fall within a range of commercial prices. For example, loans may be available at different interest rates based on a range of factors. Accordingly, an SMSF may be able to apply an acceptable commercial rate of interest to a loan within a band of rates available to it on an arm's length basis.

While the above comments from the EM relate to interest rates, it applies equally to the MV of an asset.

LCR 2021/2 at [92] does note that:

92. For this reason, from 1 July 2022, where the ATO applies any compliance resources for such general fund expenses, they will only be directed:
- for an SMSF – toward ascertaining whether the parties have made a reasonable attempt to determine an arm's length expenditure amount for services provided to the fund, ...

The ATO do not expressly refer to this aspect of the EM in its materials which is a concern. In particular, the ATO has recently issued a draft consultation report referred to as 'Market value for tax purposes consultation Draft August 2021' where it states:

***Tax legislation requires the specific market value to be ascertained. Where your method leads to a range of possible values, you need to explain why you have adopted the specific market value that you finally nominated.***

This draft is concerning in the NALE/NALI context as often there will be a commercial range of acceptable values to choose from. Indeed, many valuers avoid providing a pinpoint value for obvious reasons (eg, fear of being sued and increased professional indemnity insurance premiums, etc).

We would therefore like to have confirmation that the ATO do accept that there can be considerable range in MVs and that this is especially the case where there is no mandatory requirement for a registered valuer to be engaged (refer, for example, to QC 26343). It is unreasonable to expect taxpayers to engage a professional valuer who only reports with a range of MV – between a lower and higher value range and then expect a taxpayer to gather evidence to establish and support their pinpoint value within that range, eg, do they go the mid, the low, the high or somewhere in between?

A member of one of our professional bodies contacted several independent registered valuers that regularly value real estate around Australia and confirmed that there is generally an acceptable market valuation range for a given property. This range typically takes into account what a willing but not overly anxious vendor and a willing but not overly anxious purchaser would be willing to agree upon. These valuers also confirmed that this valuation range could invariably provide up to a 10% range either side of a specified value as falling within an acceptable valuation range for a given property. For example:

- A valuation of \$1 million could produce an acceptable valuation range of \$900,000 to \$1.1 million providing a \$200,000 potential differential in valuation.

It should be noted that s 273 of the *Duties Act 2000* (Vic) and s 100A of the *Taxation Administration Act 1997* (Vic) implicitly accept a range of + or – 15% of a MV of value of property.

We therefore request that the ATO take into account paragraph [2.49] of the EM and provide further guidance on when a valuation or valuation evidence falls within an acceptable valuation range that NALI will not be invoked unless there are other factors justifying its application.

We request that the ATO confirm that it will accept a MV that falls within an acceptable range of values. We would also be willing to accept the qualification here that if there is any dispute as to a value, the ATO will accept the taxpayer's position if they have relied on reasonable valuation evidence.

**Attachment 2**

**Copy of Submission to Treasury made 22 February 2023 in response to “Non-arm’s length income provisions applying to superannuation funds”  
Consultation Paper (incorporating letter to Minister for Financial Services,  
the Hon Stephen Jones MP dated 21 February 2023)**

Wednesday, 22 February 2023

Retirement, Advice and Investment Division  
Treasury  
Langton Cres  
Parkes ACT 2600

Dear Sir/Madam

**Non-arm’s length expense rules for superannuation**

We thank you for the opportunity to comment on the Consultation Paper on Non-arm’s length expense rules for superannuation funds.

Chartered Accountants Australia and New Zealand, CPA Australia, Institute of Financial Professionals Australia, Institute of Public Accountants, National Tax & Accountants Association, SMSF Association and the Tax Institute do not support the policy outlined in the Consultation Paper.

Our submission does not directly comment on the recommendations contained in the Consultation Paper.

We believe that poor law design can lead to inequitable outcomes. In our opinion it is an over-reach and seeks to solve problems that no longer exist. The Government has other legislation in place to identify potential offenders who may unintentionally or intentionally breach the regulations in place. Suitable existing penalties will discourage future bad behaviour.

In the enclosed document we propose a better long-term solution.

We would be happy to discuss with Treasury any aspect of our submission.

Sincerely,



Tony Negline  
Superannuation and  
Financial Services  
Leader  
Chartered Accountants  
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Peter Burgess  
Deputy CEO/  
Director of Policy  
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Scott Treatt  
General Manager  
Tax Policy and  
Advocacy  
The Tax Institute



21 February 2023

Hon Stephen Jones MP  
Minister for Financial Services  
PO Box 6022  
House of Representatives  
Parliament House  
Canberra ACT 2600

Delivered by email: [REDACTED]

Dear Minister,

### **Non-arm's length income provisions applying to superannuation funds**

The current version of the non-arm's length income (NALI) provisions, found in Sec 295-550 of the *Income Tax Assessment Act 1997* (ITAA97), were amended in 2019 with a commencement date of 1 July 2018. The 2019 amendments extended the NALI provisions to specifically deal with non-arm's length expenditure incurred by a superannuation fund.

The original policy intent of NALI was to apply income tax penalties to superannuation funds involved in specific non-arm's length dealings.

Its purpose was not to circumvent contribution caps as detailed in the Treasury Consultation Paper<sup>5</sup> (Consultation Paper).

The principles of good law design are efficiency, equity and simplicity. As the Tax White Paper said, "There will more often than not be a tension between efficiency, equity and simplicity when developing tax policy. For example, sometimes to address an integrity issue very complex rules may be needed, and choices have to be made as to whether the integrity benefits are worth the complexity cost."<sup>6</sup> Equity is not a principle that should be compromised with regards to an integrity measure.

The 2019 amendments and the (Consultation Paper) proposals do not satisfy the original purpose, the new purpose and good law design.

We believe we have a solution, which we detail in this letter, that follows the principles of good law design yet also provides adequate safeguards and proportionate penalties.

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<sup>5</sup> <https://treasury.gov.au/consultation/c2023-323132>

<sup>6</sup> <https://treasury.gov.au/speech/tax-white-paper>

The current NALI provisions have been the source of considerable concern for the superannuation sector since their amendment in 2019, as acknowledged in your 24 January 2023 press release<sup>7</sup>. These concerns need to be addressed as a matter of urgency.

The NALI rules, as anti-avoidance provisions, have existed in some form in the income tax laws for over 60 years<sup>8</sup>. It is our view that given the tax concessions that attach to superannuation an anti-avoidance NALI provision remains necessary.

However, we believe the current (as amended) version of the NALI provisions is an unnecessary over-reach and seeks to solve a problem that no longer exists. The current version of NALI might apply with other tax laws so that a taxpayer could find themselves taxed more than twice for the same transaction. Furthermore, the present laws conflict directly with superannuation funds' best financial interest duty (BFID)<sup>9</sup>, as well as existing Government policy to reduce fees charged to members of all superannuation funds, but APRA-regulated superannuation funds in particular.

For the reasons outlined below, we request that the Government considers amending the non-arm's length provisions to reverse the 2019 amendments. This is our view notwithstanding the Government's proposed changes to the NALI provisions as set out in the Consultation Paper (the 'Consultation Paper').

#### **Current NALI rules an over-reach**

Under the NALI provisions (as amended), the NALI rules can be invoked by superannuation funds performing common activities, where they may not be provided on an arms-length basis, such as:

- in-house bookkeeping or auditing activities performed for low or no fees
- services being provided to funds with little or no mark-up by entities owned by the fund (common for many APRA regulated superannuation funds)
- trustees unable to indemnify basic costs (e.g., postage) due to evidential burden of proof requirements imposed by the BFID

Trustees are often required to act in the best financial interests of their members (a requirement of the superannuation laws for trustees as noted above) by choosing a lower cost option.

If the NALI provisions apply to the common actions noted above, a penalty tax rate of 45 per cent, or more, can apply to the income generated by the non-arm's length activity AND on all employer contributions (including compulsory minimum Superannuation Guarantee contributions) and future income of the fund. Depending upon circumstances, Division 293 tax, excess contribution tax and the general anti-avoidance provisions – often referred to as "Part IVA" – might also apply.

For example, it is possible that as well as the NALI provisions applying, the Australian Taxation Office's Tax Ruling TR 2010/1<sup>10</sup> might also deem the same amounts to be contributions. Anything caught by NALI rules can face penalty tax that attaches to that provision and also be deemed to be contributions

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<sup>7</sup> <https://ministers.treasury.gov.au/ministers/stephen-jones-2022/media-releases/consultation-open-non-arms-length-expense-rules>

<sup>8</sup> Over the years the ANLI rules have had different names such as "special income".

<sup>9</sup> Refer Part 6 of the *Superannuation Industry (Supervision) Act 1993*

<sup>10</sup> Income tax: superannuation contributions

and dealt with under the contribution cap rules in the ITAA97<sup>11</sup> including being classed as excess concessional and non-concessional contributions.

Clearly these impacts are beyond the scope of the intended policy and may have a disproportionate impact on taxpayers' superannuation balances.

For an average Australian with an [income of around \\$90,000](#) and [super balance of \\$135,000](#), the inadvertent triggering of the NALI provisions by the superannuation fund results in an effective tax increase of \$6,000 per year. This could significantly impact the ability for Australians to better support themselves during retirement.

Increased tax at penalty rates for all superannuation funds could result in lower growth of superannuation balances, with superannuation balances potentially cut by 30 per cent or more. Noting the broad scope of this issue, there is a significant risk of a large cumulative impact on the balance of Australians' superannuation balances.

Further to the above, the NALI provisions are disproportionate in a number of respects. Of note, any non-arm's length dealings will trigger a 45 per cent tax rate on all the net income (and potentially gains) attaching to a specific asset (if the dealings relate to an asset) or a 45 per cent tax rate on all the net income, concessional contributions and capital gains of the fund (if the dealings do not relate to specific assets). For example, a failure of an APRA-regulated fund to pay a market service fee to a related service provider could result in all of the of the income of that fund being taxed at 45 per cent (with the corresponding reduction of members' benefits).

### **Current NALI rules solving a problem that no longer exists**

The current version of the NALI provisions was introduced to ensure that superannuation funds could not enter into Limited Recourse Borrowing Arrangements (LRBAs), as permitted under Sec 67A and 67B of the *Superannuation Industry (Supervision) Act 1993* (SIS Act), with a related party lender on non-arm's length terms.

These arrangements were initially specifically permitted by the Australian Taxation Office (ATO).

That said, the ability to enter into these arrangements was a matter of obvious concern. They were effectively out-lawed before 1 July 2018 by the Australian Taxation Office when it issued Practical Compliance Guide PCG 2016/5<sup>12</sup> on 6 April 2016. This Practical Compliance Guide was reissued to take into account the publication of the ATO's Tax Determination TD 2016/16<sup>13</sup> on 28 September 2016. We note that the ATO's Tax Determination applies to income years before it was issued. In effect TD 2016/16 would apply to all non-arm's length LRBAs including those put into place before 28 September 2016 and any that were put into place after that date.

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<sup>11</sup> See Divisions 290, 291 292 and 293 of the ITAA97

<sup>12</sup> Income tax – arm's length terms for Limited Recourse Borrowing Arrangements established by Self-Managed Superannuation Funds

<sup>13</sup> Income tax: will the ordinary or statutory income of a Self-Managed Superannuation Fund be non-arm's length income under subsection 295-550(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?

In short, non-arm's length LRBA's were out-lawed by the ATO before the 2018 NALI amendments were announced in the 2017 Federal Budget<sup>14</sup>. To date, no evidence of other misdemeanours or the need for policy development based on data driven evidence has been presented for any other superannuation fund activities.

### **Proposed rules in the NALI consultation paper also an over-reach**

In the context of non-arm's length expenditure, the effect of the limited proposed changes in the Consultation Paper, released by Treasury on 24 January 2023, are as follows:

- NALI will apply to general and specific non-arm's length expenses of Self-Managed Superannuation Funds (SMSFs) and Small APRA Funds
- NALI will apply to specific non-arm's length expenses of APRA regulated superannuation funds.

In our view this proposed solution is unacceptable. The proposed penalty of five times for general expense breaches for SMSFs is extreme. The difference between general and specific expenses will be very complicated and costly for all superannuation funds to administer.

In the Consultation Paper it is stated that, "to the extent that non-arm's length arrangements providing general services to large APRA-regulated funds are in place, these are generally entered into with the primary intention of reducing cost and passing savings on to members, rather than for the dominant purpose of obtaining a tax benefit."

It is also stated that, the "NALI provision amendments also manage the integrity risk of SMSF trustees in particular engaging in arrangements that have the effect of circumventing the lower contribution caps and the Division 293 threshold, both of which were revised in the 2016-17 Budget tax reform package."

Professionals, for example tax agents, accountants or solicitors, performing general everyday tasks for their SMSF are not performing these tasks to circumvent the contribution rules as suggested by the Consultation Paper. These tasks are completed personally by fund trustees, members, or by colleagues, because this is easier and is commercially sensible. The same approach is used for their personal and other related entity or entities legal and tax obligations. A secondary motivation may be cost savings and passing those savings on to members, as deemed acceptable for APRA-regulated super funds in the Consultation Paper.

It is our view that the government's proposals will create considerable risk for many regulated superannuation funds and will lead to additional cost. The cost of imposing a requirement on trustees to determine an arm's length shortfall amount, even if the shortfall amount is insignificant or even just a few dollars, does not warrant the type of approach being proposed in the Consultation Paper. To our knowledge there is no evidence that superannuation fund trustees have been entering into non-arm's length expenditure arrangements. However, we do acknowledge this could be an outcome and therefore propose a different and much simpler and more equitable approach below.

The superannuation sector is a dynamic market and there are often significant variations in the type and scope of services provided. Therefore, determining what is an arm's length commercial expense

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<sup>14</sup> <https://archive.budget.gov.au/2017-18/bp2/bp2.pdf>

is not always a simple task and, in some cases, may involve a degree of subjectivity. For example, the services or investment opportunities provided to one superannuation fund trustee are often tailored and may involve a reduced or different level of servicing compared to other trustees where the entity providing the service may not have the same ready access to information, assurance or scale.

We therefore reject the government's proposals as contained in the consultation paper.

### **Other solutions available**

It is our view that the most ideal and workable and least disruptive solution would be for the 2019 amendments to Sec 295-550 of the ITAA97 to be repealed and returned to its terms before the amendments were enacted.

Any residual concerns about non-arm's length arrangements with any superannuation fund can be dealt with by the ATO and the superannuation sector applying Tax Ruling TR 2010/1 because TR 2010/1 says that if a superannuation fund trustee takes steps to improve the value of a fund investment on non-arm's length terms (including using their own skills and resources), then in most cases the entire value of the improvement will be treated as a contribution.

If the government were to take the view that additional safeguards are necessary then it could elect to amend Sec 109<sup>15</sup> of the SIS Act to prohibit trustees from conducting any transactions with any party other than on arm's length terms.

We note that Sec 109 of the SIS Act is a civil penalty provision and an "operating standard". As such trustees are expected to comply with this law at all times. Compliance with Sec 109 is checked by all external auditors of Self-Managed and APRA regulated superannuation funds each year. If a breach is deemed to be material, then it can be reported to the respective regulator which can then examine the fund and determine if a penalty is appropriate. Under the SIS Act the regulators are given a wide range of powers to examine such breaches and to determine what action, if any, needs to be taken by a trustee to correct a breach and, if necessary, to determine what penalties should apply. In extreme cases, a superannuation regulator could determine a superannuation fund to be "non-complying" with most of that fund's assets, valued at net market value, being taxed at 45 per cent. As Sec 109 is a civil penalty provision a superannuation regulator could seek court-imposed penalties.

It is our understanding that the government has considered this alternative solution and we encourage you to revisit it. We believe this solution requires minimal law change and better meets the principles of good law design.

We have reviewed the examples in the ATO's Law Companion Ruling LCR 2021/2<sup>16</sup>, which we note is a very pro-revenue ruling, and sought to apply our suggested solution. We believe that our suggested solution provides an effective outcome in place of the punitive and unacceptable outcomes that occur under the NALI provisions. That is, it will not give rise to unacceptable loopholes, therefore maintaining an appropriate level of disincentive from entering into non-arm's length transactions.

We are willing to publicly support the adoption of our suggested solution.

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<sup>15</sup> Investments of superannuation entity to be made and maintained on arm's length basis

<sup>16</sup> Non-arm's length income – expenditure incurred under a non-arm's length arrangement

Finally, we do acknowledge that the original version of Sec 295-550 is far from perfect and needs reform. At this time, we consider this to be a longer-term project and would be happy to talk to you about this matter on another occasion.

We would welcome the opportunity to speak to you about this letter.

Yours sincerely,



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