Annexure A

THE TAX INSTITUTE

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Superannuation Taxation Integrity Measures

The Tax Institute welcomes the opportunity to make a submission in relation to the proposed superannuation reforms to the limited recourse borrowing arrangements (**LRBA**) and non-arm's length income (**NALI**) provisions.

The Government's proposed reforms are set out in the following consultation documents (collectively, **Consultation Documents**):

- Superannuation Taxation Integrity Measures Consultation Paper 11 January 2018;
- Exposure Draft Treasury Laws Amendment (2017 Measures No. 12) Bill 2017: TSY/45/253 Non-arm's length income (**Exposure Draft**); and
- Non-arm's length income of superannuation entities – Exposure Draft Explanatory Material (**Explanatory Memorandum**).

Our submission below comments on whether, in our opinion, the proposed amendments meet the stated policy objectives, have unintended consequences and whether we consider that there is a more efficient way to achieve the policy objectives.

Executive summary

The Tax Institute (**TTI**) considers that the amendments should not proceed. Under the proposed amendments, there is the potential for adverse and over-reaching long-term consequences as a result of trying to deal with the mischief identified in the policy objectives for the NALI provision amendments. Our preferred approach of addressing the mischief is via a mechanism for 'deeming' contributions to have been made.

If, notwithstanding our main submission above, the amendments proceed, we make the following points:

- The changes be prospective only – that is, they should only apply from 1 July 2018;
- Capturing cash contributions by a standard-employer sponsor under the proposed NALI amendments is fundamentally incorrect and shows the potentially inappropriate breadth of the proposed amendments;
- The amendments should apply to 'deductible expenses' that are insufficient – they should not cover capital outlays;
- Free and discounted services provided to superannuation funds should never give rise to NALI;

- For consistency with existing law, the amendments should only refer to income "derived from a scheme";
- TTI is concerned about the erosion in retirement income that may be caused by any excessive penalty where a breach of the rules may be unintended. Penalties under section 295-550 should be proportionate to the mischief and should only be applied to the extra net income, rather than the entire income;
- The amendments should eliminate any possibility of the dual application of both the new NALI provisions and an LRBA counting towards a member's total superannuation account balance **(TSB)** – only one 'penalty' provision should be able to be applied;
- All ATO decisions to apply the NALI rules should first be referred to its expert anti-avoidance panel for its recommendation, much like the ATO does before applying the general anti-avoidance rules in Part IVA. Further, Part IVA should not be capable of applying where NALI applies; and
- There is a risk that the LRBA amendments will result in recognising the loan as part of a member's TSB. This is anomalous when compared to other geared arrangements available to APRA-regulated funds and exempt public-sector superannuation schemes.

Policy objectives

TTI understands that the proposed measures in the Consultation Documents are essentially aimed at preventing the circumvention of contribution caps by members seeking to achieve inflated savings within the concessionally-taxed superannuation environment. More specifically, they are aimed at:

- expenses charged by related parties of members at an insufficient rate compared to arm's length commercial charges. The proposed measures seek to render income generated by complying superannuation funds (and other complying superannuation entities) from such expenses as NALI of the fund and consequently such income would be taxed at 45%; and
- loan debts of self-managed superannuation funds (**SMSF**s) owed under LRBAs. The proposed measures seek to count such debts towards a member's TSB caps. Once TSB caps are reached, this prevents or restricts further member contributions.

The Government's actual NALI announcement in the 2017 Budget said the following in relation to the objectives of the reforms:

> From 1 July 2018, the Government will further improve the integrity of the superannuation system by reducing opportunities for members to use **related party** transactions on non-commercial terms to increase superannuation savings. The non-arm's length income provisions will be amended to ensure **expenses** that would normally apply in a commercial transaction are included when considering whether the transaction is on a commercial basis. [***our emphasis added***]

Proposed amendments not required

TTI considers that the proposed amendments are not required as the contribution caps already adequately address the issues the NALI proposals seek to address.

Since 1 July 2007, contribution cap tax rules have been the key mechanism for controlling excessive superannuation contributions. Tax Ruling TR 2010/1 is central to the ATO administration of the contribution rules.

This ruling says:

> 4. In the superannuation context, a contribution is anything of value that increases the capital of a superannuation fund provided by a person whose purpose is to benefit one or more particular members of the fund or all of the members in general.

TTI believes that the contribution rules already adequately deal with the acquisition of assets by superannuation funds for no consideration or insufficient consideration. In our opinion, it is inappropriate to tax all subsequent income and gains derived from such assets under the NALI rules and the proposed amendments should not proceed on this basis.

Both the Explanatory Memorandum and Consultation Paper use the example of the value able to be added to a superannuation fund through a LRBA with an interest rate that is lower than commercial rates to justify the NALI amendments. However, the commercial reality of a loan given on the terms mentioned in the example in the Explanatory Memorandum is that such a loan would carry an upfront premium.

Therefore, the loan would be an asset acquired by the superannuation fund for an insufficient value equal to that premium which should to have been paid. In these circumstances the value of the unpaid premium would already be covered by Tax Ruling TR 2010/1 and taxed as a contribution. Therefore, in our opinion, it is not appropriate to seek to apply the NALI rules in these circumstances.

TTI considers that it would be preferable to tighten the provisions regarding the deeming of contributions, if thought necessary, rather than enacting the NALI amendments.

If the NALI amendments proceed

If, notwithstanding The Tax Institute's primary submission outlined above, the s.295-550 NALI amendments do proceed then we recommend that the following further issues be addressed:

1. **Make changes prospective only:** The provisions should be restricted to income from assets acquired in the 2018-19 year or later. Otherwise, the rules operate with retrospective effect. Further, for many assets already acquired, there are regulatory prohibitions on selling assets and re-acquiring them from a related party at arm's length which will prevent a fund from self-correcting. In addition, even if such restructuring is permitted there are likely to be significant transaction costs. Therefore, it is important that the changes be prospective only.

2. **Employer contributions:** It should be considered how, on a literal reading of the proposed rules, a cash contribution by a standard-employer sponsor could be

excluded from triggering NALI. On our reading of the proposed amendments, such contributions would be caught because, although the employer and employee may be dealing at arm's length with one another, the superannuation fund has still had an increase in capital for arguably nil consideration from a related party. We acknowledge that there are various arguments under current law for employer contributions about consideration being provided in the form of increased liabilities for the fund. In our opinion, capturing cash contributions by a standard-employer sponsor under the proposed NALI amendments is fundamentally incorrect and shows the potential breadth of the proposed amendments.

3. **Deductible expenses, not capital outlays:** Application should be restricted in sub-section (1) and (5) of the Exposure Draft to 'deductible expenses' that are insufficient. They should not cover capital outlays which are insufficient as these should already be covered under contribution cap rules. In other words, there should be no double-counting. We note the Government budget announcement referred only to 'expenses' and not also capital outlays. Proposed sub-section (7) of the Exposure Draft, which explicitly extends the proposed changes to capital outlays, should therefore be deleted.

4. **Free and discounted services:** Free and discounted services provided to superannuation funds should never give rise to NALI. As examples:
    - members of a SMSF could manage the fund investments themselves for free;
    - a trustee of a corporate fund could provide in-house administration and meeting facilities and manage the fund's investments without charging the fund by using staff whose wages are paid by the employer-sponsor;
    - a non-profit fund trustee could limit its charge to the fund to cost recovery, rather than full commercial rates; or
    - an external professional investment manager could, for marketing or other strategic reasons, choose to provide a discount to a particular fund client.

    The ATO has already confirmed that the services in examples (i) and (ii) do not give rise to contributions in Tax Ruling TR 2010/1 (see examples 2 and 5).

    There is also the potential for these changes to impact APRA-regulated funds and exempt public sector superannuation schemes that may have selected a related party service provider, for example, through a tender process on the basis that the related party will waive or discount fees or offer other favourable terms.

5. **Income "derived from a scheme" and income "as a result of a scheme":** Both phrases are used in the proposed amendments, while only the former is used in existing legislation. TTI submits that the new wording should not be inserted as it will only increase uncertainty (which already exists with the current wording). Further, it may potentially be construed in a very broad way with unintended and unknown consequences.

    Income that is derived as a "result" of a scheme clearly provides scope for a much broader link to be drawn between the expense incurred and income earned by the superannuation fund. If this is a deliberate change in meaning, it should be

explicitly stated in the Explanatory Memorandum. Further, examples should be provided to demonstrate the difference. TTI is concerned that without further clarification there will be significant industry debate and potential litigation regarding the application of this wording.

6. **Excessive penalty:** Penalties for NALI under section 295-550 are excessive compared to other anti-avoidance rules and should be reduced. The penalty may result in up to 67.5% of all the income earned being lost as a result of increasing the tax rate from 0% to 45%, plus a 50% penalty rate.

   For example, under the proposal, an investment manager that charges a managed unit trust a slightly discounted fee one year for managing a particular asset class in order to cement their business relationship will cause the entire profit distributions from the managed unit trust to a pension fund unitholder from then on plus the capital gain made by the pension fund when it ultimately sells the units to be taxed at 45% (instead of 0%), plus a penalty of up to 50%.

   Another example is a tradesman that uses his 5% trade discount at a hardware store to purchase materials in his capacity as trustee of his own SMSF for minor repairs to be undertaken on the SMSF's rental property. This will cause the entire rent from then on plus the capital gain on ultimate sale of the property to be taxed at 45%, plus a penalty of up to 50%.

   TTI is concerned about the erosion in retirement income that may be caused by any excessive penalty where a breach may be unintended. By contrast, the related NALI rule for managed investment trusts in the new section 275-610 taxes only the extra income.

   Penalties under section 295-550 should also be proportionate to the mischief and should only be applied to the extra net income, rather than the entire income. By further contrast, most SMSF regulatory breaches result in a requirement to remedy the breach, and potentially a mandated education course for the members and fine of up to $12,600 for 60 penalty units x $210 each.

7. **Dual penalty:** The amendments should eliminate any possibility of the dual application of both the new NALI provisions and an LRBA counting towards a member's TSB – only one 'penalty' provision should be able to be applied.

8. **ATO anti-avoidance expert panel:** NALI is an anti-avoidance rule. All ATO decisions to apply the NALI rules in section 295-550 to a taxpayer should first be referred to its expert anti-avoidance panel for its recommendation, much like the ATO does before applying the general anti-avoidance rules in Part IVA. Further, Part IVA should not be capable of applying where NALI applies.

Inclusion of outstanding LRBA debt in TSB is inequitable

TTI considers that the implementation of this measure is inequitable because it disadvantages SMSFs compared to other superannuation funds, and the Government should therefore not proceed with it.

Other superannuation funds frequently invest into geared vehicles, which can even be captive investment trusts. Their gearing does not count towards members' TSBs and the same approach should apply to gearing by an SMSF through a LRBA. Fair and equitable treatment should be maintained across the different sectors of the industry.

Any concern about interest rates charged that are insufficient can and should be dealt with as contributions as discussed above, which resolves the issue without creating any inequity.

Further, the proposed amendments may create:

- an administrative burden for all SMSF's with LRBAs to report and allocate their LRBAs between members, even if no member is approaching their cap; and
- create confusion for members about the quantum of their superannuation, because their TSB will not equal their account balance.

For all the reasons discussed above, TTI recommends that the proposed amendments are not implemented.

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If you would like to discuss any aspects of this submission, please contact either me or Tax Counsel, Angie Ananda, on [redacted].

Yours sincerely

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Tracey Rens
President