



19 November 2019

Mr Kendrick Yim
Australian Taxation Office
By email: kendrick.yim@ato.gov.au

Dear Mr Yim,

Re: LCR 2019/D3 – Non-arm's length income – expenditure incurred under a non-arm's length arrangement

The National Tax and Accountants' Association ('NTAA') welcomes the opportunity to provide comments on the ATO's draft Law Companion Ruling ('LCR') 2019/D3.

This draft ruling addresses the ATO's views on the operation of the recent amendments to S.295-550 of the *Income Tax Assessment Act 1997* ('ITAA 1997'), which deals with the non-arm's length income ('NALI') rules for complying superannuation funds. These recent amendments had the effect of incorporating new non-arm's length expenditure provisions into S.295-550 (e.g., S.295-550(1)(b) and (c)), and were introduced by the *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019* ('the Bill'), which received Royal Assent on 2 October 2019.

The NTAA is a national member-based not-for-profit association, which currently represents the interests of (and is dedicated to providing support to) over 10,000 member firms, which include tax agents, accountants and superannuation professionals.

The NTAA submits the following feedback (including concerns) regarding LCR 2019/D3.

1. NTAA concerns regarding the ATO's approach to determining when non-arm's length expenditure has a "sufficient" nexus with a fund's ordinary or statutory income

Under the new non-arm's length expenditure provisions in S.295-550, where a complying superannuation fund ('fund') incurs non-arm's length expenditure (or does not incur any expenditure) under a non-arm's length arrangement, in gaining or producing ordinary or statutory income, this income will be treated as NALI and taxed at the rate of 45%.

Based on the Explanatory Memorandum ('EM') to the Bill, before any of a fund's ordinary or statutory income can be treated as NALI under these new provisions, there must be a **sufficient nexus** between the non-arm's length expenditure and that income (i.e., the relevant expenditure must be incurred, or not incurred, 'in' gaining or producing the relevant income). This is specifically addressed at paragraphs 2.38 to 2.40 of the EM to the Bill.

In this regard, at paragraph 2.38, the EM advises that, determining whether there is a **sufficient nexus** between non-arm's length expenditure and a fund's ordinary or statutory income (e.g., whether expenditure is incurred 'in' gaining or producing income), reflects the analysis that must be undertaken in determining whether an expense is deductible under S.8-1.

In effect, based on the above, the NALI rules are intended to apply under the recent amendments, where any non-arm's length expenditure of a fund can be attributed to particular amounts of ordinary or statutory income derived by the fund.

In this regard, the EM to the Bill makes certain specific references to illustrate when the NALI rules **are intended to apply** in respect of non-arm's length expenditure.

In particular, Example 2.1 of the EM deals with the situation where an SMSF borrows from a related party lender under a limited recourse borrowing arrangement, to acquire a commercial property, where the terms of the borrowing are not commercial (e.g., no interest is charged). In this case, the EM concludes that the rental income derived from the property (together with any capital gain that arises when the property is subsequently sold) will be treated as NALI.

Similarly, the EM (at paragraphs 2.35 to 2.37) indicates that, if a fund trustee provides property management services to the fund in their individual capacity (e.g., where they are a licensed real estate agent themselves), the NALI rules are intended to apply where these services are provided at a discounted rate or where no fees are charged at all for those services.

The above approach in establishing a **sufficient nexus** between non-arm's length expenditure and a fund's ordinary or statutory income is also acknowledged (and reiterated) by the ATO at paragraph 16 of LCR 2019/D3, and then illustrated in:

- Example 4 (which deals with a non-commercial limited recourse borrowing arrangement); and
- Example 7 (which deals with an SMSF trustee providing discounted property management services to their SMSF as a licensed real estate agent, using the equipment and assets of their business).

ATO's approach in LCR 2019/D3 goes beyond what was intended by Parliament and is not supported by the law – paragraph 18 and Example 2

However, the NTAA is concerned about further comments made by the ATO in LCR 2019/D3, which clearly indicate that the ATO proposes to take a much broader interpretation of what constitutes a **sufficient nexus**, when compared to what was intended by Parliament (based on the EM to the Bill, as noted above) and what is supported by the law.

This is because, at paragraph 18 of LCR 2019/D3, the ATO states the following:

*"In some instances, the non-arm's length expenditure will have a **sufficient nexus to all of the ordinary and/or statutory income derived by the fund.**" [Emphasis added]*

This is then illustrated by reference to Example 2 (at paragraphs 21 and 22). This example deals with Mikasa as trustee of her SMSF, who engages an accounting firm (where she is a partner), to provide free accounting services to the fund for the 2021 income year.

The ATO concludes that, for the purposes of S.295-550(1), the non-arm's length expenditure in this case (being the nil amount incurred for the services) has a **sufficient nexus** with **all of the ordinary and statutory income derived by the SMSF** for the 2021 income year. As a result, **all of the fund's income for the 2021 income year is NALI**.

The NTAA submits that this approach is **not** supported by the EM to the Bill. That is, there is **no evidence** in the EM (particularly at paragraphs 2.38 to 2.40) to indicate that it was Parliament's intention that "general expenses" (e.g., accounting fees) would have a sufficient nexus to **all of a fund's ordinary and statutory income** in respect of an income year.

Rather, the EM to the Bill clearly indicates that **a far more direct nexus is necessary** between any non-arm's length expenditure and a fund's ordinary or statutory income, compared to the ATO's approach at paragraph 18 and Example 2 of LCR 2019/D3.

Furthermore, the NTAA submits that the ATO's approach in Example 2 is **not supported by the law**. This is because, as noted above, non-arm's length expenditure of a fund will only have a sufficient nexus with a particular amount of ordinary or statutory income of the fund where the expenditure is incurred (or would have been incurred under an arm's length arrangement) **'in'** gaining or producing that income. Based on established case law, this means that the relevant expenditure must be incurred (or would have been incurred under an arm's length arrangement) **"in the course of gaining or producing"** the fund's relevant income. Refer to *Amalgamated Zinc (De Bavay's) Ltd v FC of T* (1935) 54 CLR 295.

On this basis, although accounting fees are generally tax deductible (e.g., under S.25-5 of the ITAA 1997), for the purposes of applying the NALI rules, it would be difficult to see how such fees can be incurred (or would be incurred under an arm's length arrangement) by an SMSF in the **"course of gaining or producing"** its ordinary and statutory income. In other words, it is difficult to see how accounting fees incurred (or would have been incurred under an arm's length arrangement) by an SMSF would have a **sufficient** nexus to the fund's ordinary and statutory income.

This is essentially because accounting services (e.g., the preparation of a fund's annual tax return, including its financial accounts) would normally be independent of the process by which a fund derives its ordinary income or statutory income (e.g., interest income, dividend income and any net capital gains) during the relevant income year. As a result, accounting fees would normally be incurred (or would be incurred under an arm's length arrangement) **after** the fund's income for the year has been derived (and **not** in the course of that income being derived).

The NTAA also submits that any potential argument that accounting fees can result in the fund's income being considered NALI based on S.25-550(1)(a) (i.e., where this results in the fund's income being more than what it would have been under an arm's length arrangement) would **not** be warranted. This is because a fund's total ordinary and statutory income for an income year would **not** be altered by whether or not an arm's length rate for accounting services was charged to the fund for that year.

2. Further clarification on the period(s) during which a fund's ordinary or statutory income will be considered NALI in respect of non-arm's length expenditure – Example 7

In Example 7, a trustee/member of an SMSF (Sharon) runs a licensed real estate business that provides property management services in relation to rental properties. The member provides property management services to the SMSF as a licensed real estate agent in relation to a residential rental property held by the fund. The member charges the fund 50% of the price of her services that she would otherwise charge a non-related party.

The ATO concludes that the rental income derived by the fund from this property would be NALI for each income year that the non-arm's length dealing remains in place.

For the avoidance of doubt, the NTAA submits that, it would be useful if the example could make it clearer that the fund's rental income from the property would **not** be considered NALI in a later income year where the fund was charged arm's length fees for property management services for the entire year.

Furthermore, the NTAA believes that the example should also address the implications of the fund selling the property at a later date and using the services of the trustee's (Sharon's) real estate agency business to facilitate this sale. That is, the example should also address whether any capital gain in respect of the sale would be considered NALI, depending on whether an arm's length fee was charged to the fund in relation to the sale.

3. Further clarification on the period(s) during which a fund's ordinary or statutory income will be considered NALI in respect of non-arm's length expenditure – Example 4

In Example 4, an SMSF enters into a limited recourse borrowing arrangement with a related party lender to acquire a commercial property, where the terms of the borrowing are not commercial (e.g., a discounted rate of interest is charged).

The ATO concludes that the non-arm's length expenditure incurred by the fund in this case would result in both of the following being NALI:

- The rental income derived by the fund from the commercial property; and
- Any capital gain that arises when the property is subsequently sold.

A similar example is also provided in Example 2.1 of the EM to the Bill (as noted above).

The NTAA submits that Example 4 should make it clearer as to whether such a non-commercial loan will result in the fund's rental income from the property in all future years (during which the property is still held by the fund), as well as any subsequent capital gain (when the property is sold), being considered NALI.

For example, what if the loan in Example 4 is placed on commercial terms, say, three years after it was entered into – does this mean that the fund's rental income from the commercial property in all future years, as well as any capital gain that arises when the property is sold, will still be considered NALI?

4. Free or discounted services provided to an SMSF by a related party of the fund (not being a trustee or a director of the corporate trustee)

It is often the case that free or discounted services will be provided to an SMSF by a related party of the fund who is **not** a trustee (or a director of the corporate trustee) of the fund.

This can occur where, for example:

- a husband and wife (who are the sole trustees/members of an SMSF) obtain assistance from an adult child (who is a qualified accountant and a registered tax agent) to prepare the fund's annual financial accounts and tax return for no charge or for a discounted fee; or
- a husband and wife (who are the sole trustees/members of an SMSF) obtain assistance from an adult child (who is a licenced real estate agent) to provide free or discounted property management services to the fund in respect of a commercial property owned by the fund.

However, LCR 2019/D3 does not directly address the above situation.

As a result, the NTAA submits that the ATO's ruling should address the above situation (i.e., where free or discounted services are provided to an SMSF by a non-trustee/director related party). This should also include a discussion on whether the outcome in respect of NALI would be different in this situation, according to whether or not the related party provides the relevant services using the equipment and assets of their employer (or business).

Yours faithfully,



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Chief Executive Officer, NTAA

Chief Executive Officer, NTAA