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Gnarly about NALI – the changes and impacts on SMSFs

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Introduction

In May of 2018, the government introduced a Bill to restructure section 295-550 of the *Income Tax Assessment Act (ITAA) (1997)*, in order to capture ordinary or statutory income as non-arm's length income (NALI), where a superannuation fund incurs a loss or expenditure when deriving income that is less than what might have been expected had the parties been dealing with each other at arm's length (amongst other changes to the NALI provisions).

What does that mean in English? Well, under current law, if a fund receives income on an investment that is higher than what one would expect from a dealing on arm's length terms, then all the income the fund receives from that investment would be considered NALI and taxed at the highest marginal tax rate. What the changes propose is even though the income might be on arm's length terms, if the fund has incurred expenses which are less than the amount expected from an arm's length dealing, including where the fund incurs no expense, then the income received from the investment will also be treated as NALI.

The NALI rules already provided a potential minefield for trustees and their Intermediaries, given the penalties involved for transgressions. The proposed changes may mean SMSF trustees and intermediaries must scrutinize investments to ensure all expenses are the same as if there had been a dealing on an arm's length basis.

But first, let's go through some history to see how we've got here, then we'll work our way through the changes.

Background – The Mischief

The purpose of the NALI provisions is to prevent the inflating of superannuation fund earnings through non-arm's length dealings; for example, non-commercial arrangements that stream income to a superannuation fund. The NALI provisions contained in section 295-550 are essentially a re-write of the former provisions in section 273 of the ITAA (1936), the purpose of which was stated in the Explanatory Memorandum (EM) to the Superannuation Legislation Amendment Bill (SLAB) (No. 2) 1999:

…to prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers."

The changes introduced by the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* are seen by Treasury as further inducing SMSF trustees to engage in NALI arrangements that circumvent the restrictions to monies being held in the concessionally-taxed superannuation environment.

NALI of superannuation entities

The relevant legislation is section 295-550, which states NALI includes ordinary or statutory income derived from a scheme where the parties are not dealing with each other at arm's length and the amount of the income is greater than what would have been had the parties been dealing at arm's length in relation to the scheme (section 295-550(1)).

Other types of NALI include the following:

- private company dividends (including income attributable to dividends) unless the amount is consistent with an arm's length dealing (subsection 295-550(2)); and
- trust distributions:
    - income derived as a beneficiary of a trust, other than because of holding a fixed entitlement (that is, discretionary trust distributions) (subsection 295-550(4)), and
    - income derived as a beneficiary of a trust through holding a fixed entitlement to the income of the trust where the fund acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm's length, and the amount of the income is more than what might have been expected to derive if those parties had been dealing with each other at arm's length (subsection 295-550(5)).

It is interesting to note that a Limited Recourse Borrowing Arrangement (LRBA) is considered a scheme for the purposes of the NALI provisions in the proposed amendments (and previously by the Australian Taxation Office (ATO) in various publications).

This paper will not explore the types of NALI of superannuation entities; but will rather focus on the key changes proposed, the issues raised by the SMSF industry and clarifications provided by the ATO. The paper will conclude with a brief overview and issues that still need resolution.

Apparent technical deficiencies of the existing NALI provisions

The Bill introduced – *Tax Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018* – according to the EM that accompanied the proposed Bill – identifies supposed technical deficiencies in the existing NALI provisions that, in their eyes at least, could make the operation of the provisions ambiguous. Therefore, the amendments proposed seek to remove such ambiguity.

One of the key issues identified is where expenses incurred by a superannuation entity, in respect of an asset, are not on arm's length terms, but the amount of ordinary or statutory income from the arrangement is the same as might be expected had the dealing been at arm's length. This includes the situation where no expenses are charged.

The new provisions propose to include as NALI income where expenditure incurred in gaining or producing it was not an arm's length expense. This includes where no expense was incurred (but might be expected to have been incurred if the transaction were on arm's length terms).

The EM to the Bill states the NALI rules do not apply with respect to a superannuation entity's arrangements that are purely internal. This is because an entity's internal functions are not undertaken with another party on any terms, non-arm's length or otherwise.

Let's have a look at an example to illustrate the point.

Example 1 – Marilyn providing accounting services at no charge

In the Case Study, Marilyn was a member and trustee of the Good Life Super Fund. Marilyn is a chartered accountant and runs a small accounting business. In her capacity as trustee of the Good Life Super Fund, she prepares the accounts and annual return of the fund. Marilyn does not charge the fund for this work. The question then becomes, given Marilyn is dealing with the fund, where no arm's-length expenditure is being charged, does such an arrangement give rise to NALI?

In short, the answer is no. The EM explains that *"Such internal arrangements are outside the scope of the non-arm's length income rules as they do not constitute a scheme between parties dealing with one another on an arm's length basis".*[1]

NALI *may* apply regarding expenditure, however, where a trustee may undertake activities in performing its duties or outsource those functions to third parties. The EM muddies the waters somewhat; it states trustees performing services at less than market rates may mean the NALI provisions are triggered. If the trustee undertakes a service on a non-arm's length basis, the question of whether the proposed NALI rules apply depends on the capacity in which the trustee undertakes that service or activities.

Again, it is worthwhile using an example to illustrate this point.

Example 2 – Joe providing real estate services to the SMSF

Joe and Rosie have substantial assets in the JR Super Fund, one of which is residential real estate. It is part of a project undertaken with Joe's good friend and business associate, Sammy G. The property has a reliable, long-term tenant, but the Real Estate Agents Joe has used in the past charge a percentage fee for managing the property that, to Joe's mind at least, appears excessive. Even though he's 85, he is still active, likes to drive around and get out of the house and would be more than happy to undertake the management of the property; liaise with the tenant, be the point of contact for repairs and maintenance, direct debit for rent, etc. Joe will not charge a fee for this service. In fact, he's considering undertaking this service with other fund properties in the future, given Rosie and he are considering buying more property through the SMSF.

Does this mean the property management expense fee saving leads to the rental income (and future capital gain from the property) being NALI?

The answer to this question is not entirely clear. There is an example in the EM, where an SMSF has a rental property and, rather than outsource the management of the rental property to a Real Estate Agent, the SMSF trustee attends to the service themselves. In this scenario, where the SMSF trustee charges a less-than-commercial fee for managing the property, including no fee at all, then it *could be construed* that the NALI rules are intended to apply.

[1] Treasury Laws Amendment (2018) Superannuation Measures No. 1) Bill 2018, paragraph 3.34.

New focus on the expense/income nexus

It appears that, rather than distinguishing between internal and external arrangements to see if the new NALI rules apply, there is a greater focus on whether expenses can be distinctly associated with a source of income. With the bookkeeping services, they could also be outsourced, however, the expenses themselves cannot be specifically associated with a source of income, rather, they relate to the fund. However, the property management costs (or lack of any cost), can be specifically linked to the income of that property.

Tension between new NALI rules and SIS requirements

Now, keep in mind that these proposed new NALI rules reside in the Tax Act, the 1997 one. However, an SMSF must also comply with SIS and this is noted in the Memorandum:

"As a general rule, the trustee of an SMSF is prevented from charging for the services or functions that it undertakes in its capacity as trustee by paragraph 17A(1)(f) of the SIS Act".[2]

It is further noted, in the Memorandum, that section 17B of the SIS Act:

"permits a trustee to charge up to an arm's length amount for duties or services performed other than in the capacity as trustee".[3]

Yes, this is correct, but not the whole story. For a trustee to charge for management of the fund's property, it must comply with all of s.17B. That is:

1. the trustee is appropriately qualified, and holds all necessary licenses, to perform the duties or services; and
2. the trustee performs the duties or services in the ordinary course of a business, carried on by the trustee, of performing similar duties or services for the public; and
3. the remuneration is no more favourable to the trustee than that which it is reasonable to expect would apply if the trustee were dealing with the relevant other party at arm's length in the same circumstances.

If the SMSF trustee cannot show that they are appropriately qualified, hold the necessary licenses to be a property manager and are carrying on a business of property management, then they do not comply with s.17B. How many SMSF trustee will comply with all the requirements of 17B?

Let's change the asset from property to listed securities. Costs associated with managing a listed stock portfolio can be associated with the income from that same portfolio. The management of that portfolio can also be outsourced. If the SMSF trustee manages the portfolio themselves and charges a commercial fee to do so (in order not to have NALI), will they comply with 17B? That is, are they a licensed financial adviser (appropriately qualified and holding the necessary licenses) and do they operate a business providing such a service to the public?

[2] Treasury Laws Amendment (2018) Superannuation Measures No. 1) Bill 2018, paragraph 3.36.
[3] Treasury Laws Amendment (2018) Superannuation Measures No. 1) Bill 2018, paragraph 3.37.

So, is it a case of "have NALI and don't breach 17B" or "have no NALI but breach 17B"? Quite the conundrum it would seem.

ATO provides guidance on proposed new NALI rules

The ATO has issued a draft guideline on how the proposed changes to the non-arm's length income (NALI) rules will apply to superannuation funds, particularly SMSFs. Draft law companion ruling (LCR) 2018/D10 was released for comment on 19 December 2018 and appears to provide a much narrower application then was initially thought after the release of the Bill and Explanatory Memorandum that contains the proposed amendments.

As mentioned above, there is potential conflict between the proposed new NALI rules, which sit in the Tax Act and the rules concerning SMSF trustees charging for services, which sit in the SIS Act. Whilst the proposed changes to NALI are included in a Bill which is still before the Senate, the ATO's draft LCR provides guidance on how they will administer the changes. It is worthwhile noting that if the Bill is not passed prior to the Federal Election being called, the Bill will lapse and consequently the proposed changes will not apply unless they are re-introduced by the elected political party and passed by the Parliament post the election. From this perspective, it is interesting that the ATO has issued a guide on changes that are not law yet (and may never become law).

But I digress. As outlined previously in this paper, when the Bill and EM were first released, there was a concern that these NALI changes may have a much broader application and would capture virtually all services that a trustee provides to their own fund on a non-arm's length basis, aside from a small number of services a trustee performs in their capacity of trustee of the fund.

However, what the draft ruling appears to be saying is that if the trustee provides a service to their fund and they are not able to charge their fund because they are not licensed to provide that service, the non-charging of that fee won't invoke the new NALI rules. It would appear this is due to it be being considered the trustee has provided the service in their capacity as trustee and consequently, per section 17A of the SIS Act, is prohibited from charging the SMSF for the service.

The draft ruling states:

"*The NALI provisions are not intended to apply to services provided by a trustee (or a director of a corporate trustee) of a complying superannuation fund in their capacity as trustee (or director of a corporate trustee)"*[4]

It goes on to say:

"Where an entity performs services in their capacity as a trustee (or a director of a corporate trustee) of a complying superannuation fund and does not charge for those services, this is not a non-arm's length arrangement for the purposes of the NALI provisions. Services of this kind do not form part of a non-arm's length scheme between the parties as they relate to the trustee's obligation in respect of the fund. For example, the NALI provision will not apply where a trustee performs book keeping or accounting services for the fund for no remuneration."[5]

[4] Draft Law Companion Ruling LCR 2018/D10 paragraph 27.
[5] Draft Law Companion Ruling LCR 2018/D10 paragraph 28.

Another example, in our view, would be where the SMSF owns a rental property and the trustee manages the property, rather than outsource to a real estate agent. The trustee collects the rent, arranges repairs (may even do some of the repairs themselves) and attend to paying the rental property bills. Here, the trustee is performing duties in their capacity as trustee – attending to maintaining the assets of the fund and maximising member benefits.

However, as the draft ruling further explains:

"*If, however, the trustee outsources its functions to third parties and the outsourcing arrangement is not on arm's length terms, the NALI provisions apply*."

So, when might this occur?

The draft ruling provides an example of an SMSF trustee, Sharon, who is also a licensed real estate agent and runs a real estate business, which includes property management services. The SMSF holds a residential property, which is leased. Sharon provides property management services in her personal capacity to her SMSF, that is, not in her capacity as trustee. Sharon only charges her SMSF 50% of the normal fee she would charge her real estate property management clients.

The proposed new NALI rules would only apply where a service is provided to an SMSF, by the trustee or a related party and the trustee or related party is:

- Qualified and holds the necessary license to provide the service; and
- Provides the services as part of a business that they conduct;
- A fee less than what would be considered commercial is charged to the SMSF.

If the trustee provides a service to their SMSF and they are not able to charge their SMSF, because they are not licensed to provide that service, the non-charging of that fee won't invoke the new NALI rules.

In the above Sharon example, the conclusion reached in the in the draft ruling was that the arrangement would be caught by the proposed changes to the NALI rules, resulting in the rental income from the rental property being treated as NALI and taxed at 45%

However, we believe this example requires further clarification. The example refers to Sharon providing the service in her personal capacity so could it not be argued that Sharon has provided this service in her capacity of a trustee and therefore is not permitted to charge her fund anything for this service under section 17B of the SIS Act?

Perhaps this example could be amended by removing the word 'personal' and referring to Sharon providing this service utilising the services and resources of her real estate business. In our view it would then be clearer that the proposed new NALI provisions would apply as the service has been outsourced to a third party on non-commercial terms.

But what about a family situation? Would NALI apply in the following circumstance?

Example 3 – Joe providing financial planning services to the SMSF

Not only do Joe and Rosie have property in the JR Super Fund, they also have a substantial equity portfolio.

Joe has maintained his accreditation and, at 85, is still a qualified financial adviser.

He provides portfolio recommendations to the JR Super Fund in his personal capacity and charges the fund a fee that covers the cost of using the company research software, which is what he does with the select clients he has maintained and continues to provide advice on an informal basis.

Does this mean the income (and any future capital gains) from the substantial share portfolio will be subject to NALI?

The is a grey area that needs clarification. Whilst the draft ruling does allay concerns regarding the application of the proposed rules, in our view there needs to be more focus in the ruling on what constitutes a service a trustee performs in their capacity of trustee of the SMSF. In our example, where a financial adviser provides investment advice to their own SMSF and doesn't charge their fund for that advice, will that invoke the new NALI rules? What if Joe provides advice and charges nothing, but uses none of the resources of Better Than Gold Financial Services?

Our view is that type of service should constitute a service a trustee performs in their capacity of a trustee and, therefore, shouldn't invoke the new NALI rules. But it's difficult to reach that conclusion reading the draft ruling and the Explanatory Memorandum. Further clarification would be welcomed in the final version of the ruling (assuming the Bill is passed before the election is called).

Submissions to the draft ruling close 22 February 2019.