



26 November 2019

Mr Kendrick Yim
Australian Taxation Office

Email: Kendrick.Yim@ato.gov.au

Dear Mr Yim,

SMSF ASSOCIATION SUBMISSION ON NON-ARM'S LENGTH INCOME (NALI) AND EXPENDITURE (NALE) - LCR 2019/D3 AND PCG 2019/D6

The SMSF Association welcomes the opportunity to provide a submission on LCR 2019/D3. We are generally supportive of the Australian Taxation Office's (ATO) efforts to provide some guidance on the operations of the non-arm's length expenditure (NALE) provisions, in particular to clarify the distinction between personal and trustee services as best possible.

However, we believe that further clarifications are necessary due to the disproportionate outcome related to typical trustee services which are of a general nature and the significant tax liabilities that may occur when the ATO treat all fund income and future capital gains as non-arm's length income (NALI) due to a minor discount on a loss, outgoing or expense.

We do not believe the legislation was drafted with the intention that general expenses have a sufficient and necessary nexus to all of the income of the fund. Rather, the legislation provides a basis for expenses that have a sufficient and relevant nexus to assets and income of the fund where an inappropriate advantage has been arranged. As the explanatory memorandum states, the purpose of the non-arm's length income provisions is to prevent the inflating of superannuation fund earnings through non-arm's length dealings.

Noting we do have concerns with the ATO's current interpretation in LCR 2019/D3, we support the intent behind the ATO's current PCG 2019/D6 and compliance approach for complying superannuation funds in respect of applying the NALI provisions to non-arm's length expenditure of a general nature.

We also emphasise that we support the positions taken by The Tax Institute in their submission to the ATO. This includes their detailed analysis of the sufficient and necessary nexus application to market values, general expenses and trustee services, ensuring that that a contribution under TR 2010/1 does not result in NALI and clarification of NALI application to fixed trusts.

General expenses

We refer to the below examples in our commentary:

Example 2 - non-arm's length expenditure incurred has a nexus to all income of the fund - NALI



For the 2020-21 income year, Mikasa as trustee of her SMSF, engages an accounting firm, where she is a partner, to provide accounting services for the fund. The accounting firm does not charge the fund for those services.

22. For the purposes of subsection 295-550(1), the scheme involves the SMSF acquiring the accounting services under a non-arm's length arrangement. The non-arm's length expenditure (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 2020-21 income year. As such, all of the SMSF's income for the 2020-21 income year is NALI.

Example 6 - internal arrangement within an SMSF - trustee provides services to the fund

43. Leonie is a trustee of an SMSF of which she is the sole member. She is a chartered accountant and registered tax agent who is employed in an accounting and tax agent business. Leonie in her capacity as trustee, prepares the accounts and annual return for the fund. She does not use the equipment or assets of her employer, nor does she lodge the annual return using her tax agent registration. As she performs these duties or services as trustee of the SMSF, she does not charge the fund for this work. The non-arm's length expenditure provisions do not apply as the duties or services performed by Leonie are in her capacity as trustee rather than under an arrangement in which parties are dealing with one another on a non-arm's length basis.

Is there a sufficient nexus?

As s295-550(1) states, one or more of the following must apply to invoke NALI:

- a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;*
- b) in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme*
- c) in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.*

The language in b) and c) picks up the first positive limb of s8-1(1) of the *Income Tax Assessment Act 1997*.

In identifying whether the complying superannuation fund has invoked NALI, there must be a 'sufficient and necessary nexus' between the non-arm's length expenditure and the relevant ordinary or statutory income.

However, in our opinion, in the examples described above there is not a **sufficient and necessary** nexus between the accounting services (or general expense services) and all ordinary or statutory income of the fund.

This can be summarised as following:



1. The explanatory memorandum while referencing s8-1 also makes it clear that a specific amount of income needs to be identified when calculating a super entity's non-arms length component. The ATO's interpretation appears to be far broader and has the potential to challenge policy intent to ensure that the consequences of an amount of income being NALI is restricted to that amount of income and any related deductions.
2. Expenses incurred in complying with, or managing the fund's income tax affairs and obligations are ordinarily deductible under s25-5 where there is no nexus between expenses and income.
3. If relying on a nexus due to s8-1, this nexus is not sufficient and necessary for the NALI provisions which require that the expense must have been incurred 'in' gaining or producing the relevant income. That is, the expenditure must be incurred in the course of producing such income and cannot be an expense that is incurred at a point in time either too early or too late to be related to the production of income of the super entity.

Many statutory deductions, including tax agent services in completing income tax returns are not incurred under the first positive limb of s 8-1(1) and therefore cannot be the subject of NALIE. The limitation on the breadth of the first positive limb should be mentioned in the LCR.

Secondly, we note the ATO may believe there may be 'some' nexus due to section 8-1 which provides a deduction for management and administration fees and other general expenses to the extent they relate to the gaining or producing of income.

General expenses, which may have some nexus to income, do not form a sufficient enough nexus to specific income when considered with the intent of the legislation. It is made clear in the explanatory memorandum that the intention of the legislation is that there must be 'identification of a specific amount of ordinary or statutory income that is non-arm's length income'. In other words, there is a sufficient and necessary nexus between the expense and a specific tainted asset or income where the trustee is involved in a scheme to get an inappropriate advantage. The LCR works effectively for those scenarios where the expense is not general, however, where the expense is general the LCR delivers a disproportionate outcome.

In the referenced examples we believe the fund's income is irrespective of how the trustee seeks to provide for the accounting service. Whether the trustee uses the equipment of her employer or not to provide accounting services does not affect, with any sufficient and necessary nexus, all of the income of the fund. The preparation of a tax return and financials in the above examples have no sufficient and necessary relationship or link to the gaining or producing of income.

As per ATOID 2002/768, it is also arguable that certain general expenses occur too soon to be part of the income producing process. This could be attributed to legal, financial planning and advice fees which is expenditure that is associated with putting the income earning investment in place. In the same vein, accounting fees are an expense incurred too late in the income producing process as it is simply a retrospective exercise to account for income producing activity during a financial year.

In contrast, where there is a sufficient and necessary nexus between a discounted expense and the gaining or producing of income from an asset in a superannuation fund, it is clearer that income will be more than the amount the entity might have been expected to derive. For example, in a scenario



where the trustee engages in a scheme with a property manager for their fund's property at a lower rate than otherwise expected because of their relationship, it is arguable that the superannuation fund would not have derived the same amount of income from the property if it had to encounter the expense at an arm's length amount. We believe this is the intention of the legislation.

We see no justification for the fact that an individual undertaking or receiving a general service expense such as accounting fees is doing so via an inappropriate scheme to increase the income of all the fund's assets. Rather, the majority of individuals are appropriately and efficiently using their own time, skills and knowledge available to undertake legislated or necessary trustee services. The fact the ATO felt that a PCG was necessary highlights defects in the legislative drafting and an overburdening response to general expenses.

For these reasons, we do not believe there is a sufficient nexus between a general expense and all of the income of the fund.

Furthermore, in situations when it is deemed that a non-arm's length expense has a sufficient nexus with all of the superannuation funds ordinary and statutory income, the penalty will be 45% tax on all the income. This is a significant penalty.

We believe that most scenarios where this penalty would apply would be for minor monetary amounts and without purposeful intent, such as not charging a market rate for accounting services when the trustee undertakes some of the work at their office. As per example 2 above, Mikasa's minor breach of not charging accounting expenses would invoke a significant taxation liability.

We would expect penalties of this nature should only be for breaches with sufficient nexus, scale and purposeful intent through a scheme.

We recommend that LCR 2019/D3 is amended to clarify the application of the 'sufficient nexus' test. If an expense does not have a sufficient nexus to the income being earned by the fund, that being the expense did not affect the income or market value of assets of the fund in any abundant way, then the legislation should not be applicable to the transaction or at least not to the entire income of the fund.

Is it a trustee service?

The ATO should continue to use this opportunity to clarify the distinction between a personal and trustee service. This would include better defining what services are trustee services and do not involve NALI.

In paragraph 39 they state:

39. *Factors that indicate that the individual is performing their activities in their individual capacity and not in their capacity as a trustee (or a director of a corporate trustee) include:*
- *The individual charges the complying superannuation fund for performing the services. However, the individual can still be acting in their individual capacity if they do not charge the fund for performing the services.*
 - *The individual uses the equipment and other assets of their business, or used in their profession or employment.*
 - *The individual performs the activities pursuant to a licence and/or qualification relating to their business, or their profession or employment.*



- *The activity is covered by an insurance policy relating to their business, or their profession or employment (for example, indemnity insurance).*

While we understand the intent of these factors, the LCR should indicate that no single factor can be isolated as determinative of the question of whether an individual is performing their activities in their capacity as a trustee or not.

We recommend that the factor regarding professional equipment is removed or amended. The fact that an individual uses equipment of their business should not render a service to be in an individual capacity. A trustee using their professional equipment does not always mean they are providing the same service they would professionally to an independent client.

We also believe scale should be relevant factor in the determination of trustee services. If a trustee is performing a service that is relatively minor in resource usage and monetary benefit this is an indication the trustee is undertaking a trustee service.

This will be in contrast to where a 'contribution' of an SMSF trustee/director's skill and expertise is so substantial in nature, it is not within the realm of a trustee service and is one that can be remunerated under s 17B of SISA. Eg:

- A trustee builder fixing a letter box compared to a trustee builder completing a renovation.
- A trustee accountant using employer software to complete their own return compared to a trustee accountant's SMSF being completed by a staff member of their firm.

Guidance can be taken from SMSFR2010/1 and the Commissioner's view. Example 5 lists a scenario where section 66(1) is not breached as the performance of the service for the SMSF along with the provision of goods are of insignificant value and function. The scenario is:

1. A member of an SMSF fixes taps in rental properties owned by the SMSF by replacing the tap washers. As the tap washers are insignificant in value and function, the substance of the transaction is the performance of a service.

Example 6 lists scenarios where a breach of section 66(1) has occurred as there has been performance of a service for the SMSF along with the provision of assets that are not insignificant in value and function. The scenarios are:

1. A member of an SMSF buys and installs ducted air-conditioning in a rental property owned by the SMSF. As the ducted air-conditioning components are not insignificant in value and function, the SMSF does acquire an asset.
2. A member of an SMSF buys all necessary building materials and builds a house on land owned by the SMSF. The member does some of the building work and also pays contractors to do some of the building work. As the building materials are not insignificant in value and function, the SMSF does acquire an asset.

As per paragraph 42 of the LCR regarding discounted services, if an individual charges for the service this should not automatically invoke the service as one of a personal capacity. This detail should be imparted into the factors of paragraph 39.

With regards to example 7, Sharon is providing a property service pursuant to her real estate licence and insurance policy and with use of business equipment and assets (such as inside her business) which has a sufficient and necessary nexus to an asset. This is identified as an individual service.



However, if Sharon as a trustee performed these services ‘outside of typical hours’, not pursuant to her insurance, utilising her own personal time, skills and knowledge rather than relying on her independent business structure as a whole to provide the service (and her ancillary business use is reasonable), we believe this would be a trustee service. The factors provided by the ATO should reflect this interpretation.

This could be reflected by a factor which incorporates the inability to separate the activity undertaken from a professional capacity to personal capacity, i.e, the skills and qualifications one would use in their capacity as a trustee are inextricably linked to their profession and employment.

Define services

For simplicity, the ATO could define what are typically considered to be trustee services compared to a service that would not typically be provided by a trustee of a superannuation fund. This list of trustee services could provide a list for an APRA superannuation fund and an SMSF. For example, the following are typical trustee services:

- Accounting, bookkeeping and related record keeping.
- Managing general administrative tasks and managing communications and relationships with advisers, investment bodies, banks, suppliers of services, etc.
- Broad financial investment advice
- Overseeing any investments or projects, eg, a building project or repair being conducted by a builder, tradesperson, contractor, etc, to ensure what is being delivered is per the contractual specifications.
- Representing a fund in relation to APRA, ATO, ASIC and any other third party to ensure the fund is managed and administered in accordance with all relevant legislative and regulatory requirements.
- Trustee governance services.
- Minor repairs on SMSF property.

The following may fall outside a typical trustee service:

- The building of a new building where significant skill, resources such as tools and equipment and training is involved.

Given we believe many of these services would fail to have a sufficient nexus to income or assets this may be another administratively simple and clear approach the ATO are able to take.

Discounted services

In paragraph 42 the ATO state, in other circumstances, parties may enter into arrangements that result in discounted prices or favourable terms. This could occur where a party operates on simple cost-recovery basis for particular services but is able to justify doing so in commercial terms because of the economies of scale it achieves within its business by providing other services. For example, where services are provided to a large APRA fund either by the trustee acting in a separate capacity or by a related third party.

We would recommend the ATO provides SMSF examples of this arrangement.



If you have any questions about our submission please do not hesitate in contacting us.

Yours sincerely,

A handwritten signature in black ink that reads 'John L. Maroney'.

John Maroney
CEO
SMSF Association

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing the SMSF sector which is comprised of over 1.1 million SMSF members who have \$750 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.