31 July 2023

Mr Kendrick Yim
Australian Taxation Office

Email: kendrick.yim@ato.gov.au

Dear Kendrick,

SMSF ASSOCIATION SUBMISSION – Draft Tax Determination TD 2023/D1 - Income tax: how the non-arm's length income and capital gains tax provisions interact to determine the amount of statutory income that is non-arm's length income.

The SMSF Association welcomes the opportunity to provide this submission in response to the Australian Taxation Office's (ATO) draft determination TD 2023/D1.

We acknowledge that the ATO's position, as set out in the draft determination, is in accordance with the operation of the legislation as it currently stands. This is due to the operation of the method statement in *Income Tax Assessment Act 1997* (Cth) s 102-5 and the treatment of statutory income in s 295-10.

The operation of the law is complex and not immediately apparent. As such, we would encourage the ATO to clearly step out the application of the law to assist practitioners. Noting the operation of the law does not align with industry's understanding on how non-arm's length capital gains would be treated. This view is reinforced when we consider the language in the explanatory memoranda to *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.* Some examples are extracted below:

> Example 3.1
>
> Non-arm's length interest on borrowings to acquire an asset will result in any eventual capital gain on disposal of the rental property being treated as non-arm's length income.
>
> Example 3.2
>
> Any net capital gain made on disposal of the units may also be non-arm's length income due to the amendments to subsection 295-550(1).
>
> Paragraph 3.41
>
> Where a fund acquires an asset for less than market value through non-arm's length dealings, the revenue generated by that asset may be non-arm's length income, as well as any statutory income (that is, net capital gains) resulting from the disposal of that asset.

The operation of the law as it currently stands therefore appears to be outside the policy intent. The intent was to target the income derived from a specific asset including capital gains. The resulting capital gains arising on disposal of a tainted asset, separately being subject to NALI. The tainting of arm's length capital gains is an unintended consequence.

The outcomes for taxpayers will differ, depending upon individual circumstances. As an example, a property held as tenants in common by two SMSFs may result in one fund paying a higher amount of tax, due to the presence of other capital gains in the income year in question. The pooling of the capital gains will result in the tainting of arm's length capital gains.

The following illustration is taken from example 1 of the draft determination:

	Fund A	**Fund B**
Non-arm's length capital gain	$2,000,000	$2,000,000
– Value of arm's length gain	$1,300,000	$1,300,000
Arm's length capital gain	-	$500,000
Current year capital loss	($200,000)	($200,000)
	$1,100,000	$1,600,000
⅓ CGT Discount	(366,667)	($533,333)
Net capital gain	$733,333	$1,066,667
NALI Tax Assessed (45%)	$329,999.85	$480,000.15

The above is seemingly an unintended consequence in the operation of the law.

There is need for a proportionate approach to be applied. There are well established examples contained within the taxation law that seek to apply a proportionate approach in a superannuation context. One example is the calculation of exempt current pension income. This allows for the proportionate taxation treatment of both ordinary and statutory income.

We acknowledge that any legislative changes are a policy consideration and outside of the ATO's remit. We would therefore encourage the ATO to engage with Treasury for an appropriate legislative solution. The Association will be engaging with Government and Treasury to advocate for a legislative amendment that will allow a proportionate approach to be applied. This will provide clarity and certainty on the operation of the law for all stakeholders and align the application of the law to the underlying policy intent.

A mechanism to allow for proportionality needs to be included in ITAA97 subdivision 295-H. The proposed amendments in exposure draft *Treasury Laws Amendment (Measures for Consultation) Bill 2023: Non-arm's length expense rules for superannuation funds* seek to introduce amendments to *ITAA97* s 295-545(2A) to specifically exclude contributions from the calculation of NALI. This demonstrates that a methodology can be introduced to address the deficiencies in the current legislative drafting, without interfering with the method statement at *ITAA97* s 102-5.

A proportionate approach could be considered where the non-arm's length capital gains are calculated as a percentage of the total capital gains. That percentage is then applied to the net capital gain after the operation of *ITAA97* s 102-5, to determine the non-arm's length amount, taxable at the applicable rate (45%).

Please refer to the illustration below.

Looking at the Fund B example in the table above, this proposed method would operate as follows:

	Fund B	**Proportion (%)**
Capital Gain 1 (NALI)	$1,300,000	72.22%
Capital Gain 2	$500,000	27.78%
Total Capital Gains	$1,800,000	100%

	Fund B	
Arm's length gain (NALI)	$1,300,000	
Arm's length capital gain	$500,000	
Current year capital loss	($200,000)	
	$1,600,000	
⅓ CGT Discount	($533,333)	
Net capital gain	**$1,066,667**	**Tax Calculation**
– NALI gain (72.22%)	$770,347	$346,656.15
– Low Tax gain (27.78%)	$296,320	$44,448
Total:	**$1,006,667**	**$391,102.15**

Proportionately provides for a more equitable outcome, aligning with both the underlying policy intent and industry expectations.

We would be pleased to further discuss our submission with you. If you have any questions about our submission, please do not hesitate to contact us.

Yours sincerely,

Peter Burgess
Chief Executive Officer

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing the self-managed superannuation fund (SMSF) sector which is comprised of over 1.13 million SMSF members and a diverse range of financial professionals. The SMSF Association continues to build integrity through professional and education standards for practitioners who service the SMSF sector. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial advisers, tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them with access to independent education materials to assist them in the running of their SMSF.