

Monday, 31 July 2023

Mr Kendrick Yim
Australian Taxation Office

Delivered by email – kendra.ym@ato.gov.au

Dear Kendrick

Draft Taxation 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

Chartered Accountants Australia and New Zealand, CPA Australia, the Institute of Public Accountants, the SMSF Association and The Tax Institute (**the joint professional bodies**) have been working with the Australian Taxation Office (**ATO**) for many years in relation to the superannuation fund non-arm's length income and expense (**NALI/E**) provisions.

In late 2021, the joint professional bodies, together with a number of other associations, submitted to the ATO a range of questions and concerns involving the superannuation fund NALI/E income provisions. A number of those issues involved how those provisions interact with the capital gains tax (**CGT**) provisions.

We are pleased that the ATO has commenced work on this matter and appreciate the opportunity to comment on the above draft Taxation Determination (**draft TD**).

Legislation governing non-arm's length income and expense (NALI/E) provisions not settled

As you are aware, Treasury has recently consulted on proposed changes to the NALI/E provisions in the *Income Tax Assessment Act 1997*¹ (**ITAA97**). This consultation follows an announcement by the government as part of the Federal Budget 2023–24².

The final form of the NALI/E rules is currently unknown, given that they are likely to be amended.

We therefore request that the ATO not finalise this draft TD until the law has been settled. If necessary, we request that, after the NALI/E provisions have been settled, the ATO republish the draft TD with suitable amendments as a revised draft before it is finalised.

In relation to the draft TD, we make the following points that we consider should be factored into any further drafts of the TD as well as the final TD:

- The examples in the draft TD deal only with specific expenses for self-managed superannuation funds (**SMSFs**) – we consider that examples involving large APRA-regulated superannuation funds would also be helpful.

¹ <https://treasury.gov.au/consultation/c2023-408585>

² https://budget.gov.au/content/bp2/download/bp2_2023-24.pdf - see pages 13 and 14

- It would be useful if the draft TD included examples as to how earnings for segregated and unsegregated pension assets would be treated under the NALI/E and CGT provisions.

We note that the current examples in the draft TD involve single trustees of SMSFs. As the ATO is aware, other than in rare situations, SMSFs are not permitted to have a single trustee regardless of how many members a fund might have. We therefore suggest the ATO adjust the examples in the draft TD so they reflect the correct regulatory framework.

We consider that there may be a calculation error in Step 4 of paragraph 21 of the draft TD. Based on the numbers, it seems that the result should be \$883,333.33, not \$833,333.33 that is currently in the draft TD.

In the time available to us, we have not been able to determine that the approach outlined in the draft TD is not incorrect in allocating capital losses against capital gains in the taxpayer's chosen manner for the purposes of calculating the non-arm's length and low tax components. In any event, we believe that the irrelevance of the ability to choose the order in which capital gains are offset by capital losses in steps 1 and 2 of the method statement in section 102-5 of the ITAA97 due to the operation of subsection 295-550(1) of the ITAA97 is not consistent with community expectations. We believe that this is a question of policy that needs to be urgently raised with Treasury.

We recognise that the results of the calculations in the draft TD arise because of section 102-5 of the ITAA97 which arrives at a single amount of statutory income, being the net capital gain. This provision works effectively for individual and corporate taxpayers who need to calculate a single amount of statutory income to include in their assessable income and which is taxed at either marginal tax rates or a flat corporate tax rate. However, superannuation funds face three possible tax rates – 0% for exempt current pension assets, 15% for non-pension assets and 45% for any NALI/E income.

The inability to disaggregate the net capital gain calculated under the method statement in section 102-5 of the ITAA97 interacts awkwardly with the operation of subsection 295-550(1) of the ITAA97 which is designed to identify NALI amounts and subject them to a higher rate of tax. The effect of the single amount of statutory income being used for the purposes of section 295-550 is that arm's length capital gains are aggregated with non-arm's length capital gains in calculating the net capital gain under section 102-5 of the ITAA97. This results in arm's length capital gains forming part of the non-arm's length component. This is a disproportionate outcome and unfairly taxes arm's length capital gains at a penal rate.

Section 102-5 of the ITAA97 appropriately applies to segregated and proportional pension assets because of Subdivision 295-F of the ITAA97. A similar approach needs to apply to NALI/E capital gains. We recognise that this is a policy matter which we will raise with the government and the Treasury.

Finally, we note there is significant complexity in determining the amount of the non-arm's length component under section 295-550 of the ITAA97, taking into account its interaction with the method statement in section 102-5 of the ITAA97. Aside from the issue discussed above relating to the inability to disaggregate arm's length capital gains from non-arm's length capital gains in calculating the net capital gain, taxpayers need to consider the operation of the market value substitution rules (**MVSRs**) in section 112-20 of the ITAA97 (relating to the cost base of a CGT asset) and section 116-30 of the ITAA97 (relating to capital proceeds). The operation of the MVSRs is further modified by subsections that deal specifically with NALI, for example section 116-30(2C).

The draft TD would benefit from further explanation and clarification regarding how the MVSRs affect the outcomes needed to correctly calculate the relevant capital gains. For example, the second bullet point in paragraph 16 of the draft TD would benefit from breaking down the calculation of the capital gain into its cost base and capital proceeds components to arrive at the capital gain, and how the MVSR affects, or does not affect, as the case may be, the cost base of the CGT asset in Example 1. Similarly, paragraph 20 of the draft TD would benefit from a more detailed explanation as to why the MVSR does not apply in the case of Example 3.

We would welcome the opportunity to discuss any aspect of this submission.

Yours sincerely,

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