THE TAX INSTITUTE

THE MARK OF EXPERTISE

20 December 2016

Ms Kasey MacFarlane
Assistant Commissioner
Superannuation
Australian Taxation Office
PO Box 9977
BRISBANE QLD 4001

By email: kasey.macfarlane@ato.gov.au

Dear Kasey,

Taxation Determination TD 2016/16

The Tax Institute wishes to make a submission to the Australian Taxation Office (**ATO**) in relation to Taxation Determination TD 2016/16 (**TD**) issued by the Commissioner on 28 September 2016.

While The Tax Institute welcomes the TD and notes that it represents an improvement over the products it replaced (being ATO ID 2015/27 and ATO ID 2015/28), The Tax Institute remains concerned that there are still significant practical, technical and process issues flowing from the Commissioner's approach to subsection 295-550(1) of the *Income Tax Assessment Act 1997 (Cth)* (**1997 Act**) in the context of related party limited recourse borrowing arrangements (**LRBAs**) entered into by trustees of self-managed superannuation funds (**SMSFs**).

The Tax Institute is concerned that the TD may give rise to further questions resulting in more uncertainty for the SMSF industry. In view of this, the Institute queries whether the Commissioner would be prepared to review the TD to address the issues identified below or otherwise offer further clarification through additional guidance for trustees of SMSFs with related party borrowings genuinely entered into in good faith and reflected in views prevailing pre-December 2014[1].

Summary of issues

The example used in the TD presents quite an extreme kind of borrowing arrangement, particularly in view of the zero interest rate, the 100 percent loan to market value ratio (**LVR**) and the repayment not due until the end of the 25 year term. As such, the TD

[1] Note ATO Interpretative Decision 2014/40 was published on 12 December 2014.

fails to offer practical guidance by not providing a range of examples; especially one to illustrate how the 'hypothetical' test would apply to an arrangement in the 'grey' area.

We consider that sub-section 295-550(1) should be applied strictly to the nature of the 'income' being on arm's length terms and that the attempt to throw borrowing arrangements into the concept of a 'scheme' takes the application of the provision too far; particularly where many parties to the purported 'scheme' are in fact dealing on arm's length terms – including the vendor of the asset and lessees. While not expressly cited in the TD, the Commissioner's analysis appears to draw on the decision of the Full Federal Court in *Allen v Federal Commissioner of Taxation* (2011) 195 FCR 416. *Allen* is distinguishable on the facts and law[2].

Other than in extreme cases, the mischief which sub-section 295-550(1) is designed to address as an anti-avoidance measure does not align with the Commissioner's application of the measure to a related party LRBA otherwise permitted by section 67A of the *Superannuation Industry (Supervision) Act 1993 (Cth)* (**SIS Act**) or the predecessor provision under former sub-section 67(4A).

The counterfactual provided at paragraph 10 of the TD is too narrow. It assumes the position that given arm's length borrowing terms, the investment would not have been made at all. The analysis in the TD limits consideration to the particular scheme – involving the "borrowing" by the SMSF trustee. We consider that the proper factual inquiry should be about what might have been the reasonably expected outcome. This requires a detailed factual analysis of the fund's overall position having regard to the members of that fund and this analysis had to be conducted on a case-by-case basis.[3]

While issues relevant to determining whether the borrowing *could* have been made and following such, the asset acquired, are set out under paragraph 19 (of the Explanation section of the TD – not being legally binding), they fail to have regard to various alternative means that may have been available to wholly or partly finance the investment, including (at the time the loan was entered into and the asset acquired):

- whether members may have been in a position to make additional contributions;
- whether further rollovers into the fund could have been made by members;
- whether additional members may have joined the fund and further contributions and rollovers would also be made in respect of them; and
- whether other investments of the fund may have been sold or generated a sound yield (including via capital appreciation), etc.

[2] We are happy to expand on why this is the case should the ATO require it.

[3] See *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* (2010) 81 ATR 180. Note that the framework of ss 295-550(1) is very similar to section 177C of the 1997 Act.

Without consideration of these matters, it is not appropriate for the Commissioner to conclude or reasonably predict that the asset would not have been acquired. The Tax Institute disagrees with the Commissioner to the extent that the Commissioner states that other steps and/or parties cannot be considered as part of the counterfactual (see paragraph 17 of the TD).

Further, the Institute is concerned about the weight that may be placed by ATO officers on the matters set out at paragraph 20 of the TD to determine whether the SMSF trustee *would* have entered into the borrowing, in particular any analysis of the investment strategy, which might be stated in very broad terms and the assessment of "optimal use" of funds which may be difficult for ATO officers to reasonably assess.

Moreover, this statement does not reflect the obligations placed on SMSF trustees under superannuation or tax law. An SMSF trustee is certainly required to invest in a prudent manner and in the best financial interests of members. However, determining what is an 'optimal use' of the SMSF's assets is a subjective exercise that is difficult to quantify or enforce, and that goes beyond the duty to exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide for under section 52B of the SISA. If the ATO views SMSF trustee investment decisions as requiring optimal positively geared investments that generate an accretive return from the date the particular asset is acquired, SMSF trustees will be held to a standard above that required by superannuation and trust law and will find it increasingly difficult to identify asset classes in which to invest, given the risk of a negative return inherent in all but the most conservative of investments.

Finally, and as a matter of public policy, the Institute is concerned that the clear result of the Commissioner's analysis at paragraph 19 is that SMSFs with more liquidity and access to assets and resources are unlikely to be found to have non-arm's length income (**NALI**) as a consequence of a related party borrowing; whereas a fund experiencing more difficult financial circumstances, with limited liquidity or access to alternative financial resources will be more likely to be assessed for NALI and penalised. We suggest that such analysis does not therefore align with the anti-avoidance purpose of subsection 295-550(1).

Suggestion

The ATO may wish to consider issuing a practice statement or practical guidance to accompany the TD to expand on the Commissioner's reasoning and give more examples. This document could also give guidance to ATO officers about the weight to give to different factors to assist officers to assess an arrangement, especially an arrangement involving an SMSF trustee to help determine what *could have* and *would have* occurred in a hypothetical borrowing arrangement.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Arthur Athanasiou
President