THE TAX INSTITUTE

6 June 2018

Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee

Email: Economics.Sen@aph.gov.au

Dear Mr Fitt

Inquiry into the Treasury Laws Amendment (2018 Measures No. 4) Bill 2018

The Tax Institute acknowledges the invitation to make a submission to the Senate Economics Legislation Committee in relation to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018 (**Bill**).

We received this invitation on Monday, 4 June 2018 and were only given until 6 June 2018 to respond. The Tax Institute does not consider that a three-day consultation period represents legitimate consultation. A three-day consultation period has not provided The Tax Institute with sufficient time to consider all the issues that arise in relation to the Bill. We are disappointed with this process and strongly advise the Committee to reconsider such time periods in the future if the Committee genuinely wants a legitimate consultation. As a general observation the absence of appropriate consultation time may require future legislative amendments for measures introduced.

Given the circumstances, we have made our best endeavours to provide some comments in relation to the Bill. Please note that these are not necessarily the only issues we would like to raise, they are simply the issues we had time to address.

Superannuation Guarantee amnesty

The Tax Institute understands that the objective of the amnesty provisions is to encourage employers to self-correct historical SG non-compliance for the benefit of employees who are legitimately entitled to their employer superannuation contributions.

We consider that to achieve the objective of the amnesty provisions, the amnesty should apply equally to all employers who have failed to comply with their SG obligations irrespective of whether they come forward voluntarily for the first time or have had an examination or audit by the ATO. In our opinion, the objective of correcting all outstanding SG obligations cannot be met if the amnesty provisions are confined to employers that the ATO is unaware of (ie those who have not come forward previously and those who have not been subject to an examination by the ATO).

In this regard, The Tax Institute notes that the amnesty will only benefit employers who "first" report a superannuation guarantee (**SG**) shortfall to the Commissioner during the

Level 10, 175 Pitt Street
Sydney NSW 2000
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 37

amnesty period (ie 24 May 2018 to 23 May 2019) (see proposed section 74(1)(a)(ii) of the *Superannuation Guarantee (Administration) Act 1992* (**SG Act**)).

Further, proposed section 74(1) of the SG Act provides that an employer will only qualify for the amnesty, amongst other conditions, if:

> "the Commissioner has not, at any time before the disclosure, informed the employer that the Commissioner is examining, or intends to examine, the employer's compliance with an obligation to pay the superannuation guarantee charge for the quarter. [our emphasis]

The Explanatory Memorandum to the Bill (**EM**) describes the operation of this provision at paragraphs 1.24 to 1.27. The provision is summarised at paragraph 1.24 as follows:

> "1.24 For a disclosure in respect of a quarter to qualify for the amnesty, the Commissioner must not have, at any time before the disclosure, informed the employer that they are examining, or intend to examine, the employer's compliance with their obligation to pay SG charge in relation to the quarter."

Paragraph 1.25 of the EM suggests that the reference to any "examination" must relate to "ATO compliance activity". However, paragraphs 1.26 and 1.27 suggest that a very broad interpretation should be given to the meaning of "examination" - extending "examination" to include "reviews, audits, verification checks, record-keeping reviews/audits and other similar activities".

The Tax Institute is concerned about the possible breadth of the reference to "examination". Employers need to be provided with appropriate guidance on the possible application of these provisions and the scope of the meaning of "examination" for these purposes. In its current form, the scope that might be given to section 74(1)(c) of the SG Act is potentially very broad. This will cause uncertainty. Accordingly, employers may not be properly incentivised to take advantage of the amnesty if there is a risk that the ATO may take a view that it does not apply due to past interactions that the employer has had with the ATO. This would defeat the purpose of the amnesty.

In particular, The Tax Institute considers that based on the current drafting of the Bill, employers are likely to be uncertain as to whether they would be entitled to the benefit of the amnesty if they have had an ATO representative visit their premises or contact them with a view to encouraging them to consider reviewing their service contracts to potentially re-classify contractors as employees or with another similar educative objective or they have had such an interaction at any time in the past.

The Tax Institute recommends that amendments be made to the Bill and EM to make it clear that such interactions would not preclude employers from taking advantage of the amnesty. Should our recommendation not be accepted by the Committee, at a minimum, we consider that further guidance needs to be provided by the ATO in the form of confirmation that general discussions held with employers or "friendly" visits with a view to assisting employers with their SG compliance will not constitute an "examination" or an "intent to examine" an employer's compliance with SG.

NALI Provisions

In this regard, we note that on 19 February 2018, we made a submission in relation to the Superannuation Tax Integrity Measures and we specifically addressed the non-arm's length income (**NALI**) provisions. We have attached this submission in Annexure A (**Previous Submission**).

Our Previous Submission contains comments that are relevant in relation to the NALI provisions in the Bill. Therefore, we request the Committee to review the comments in our Previous Submission.

In addition to the Previous Submission, we have outlined the following points for your consideration.

Practicality of Transitional Relief

The Bill does not provide any grandfathering of current arrangements or any transitional time to comply with the provisions of the Bill. The Tax Institute considers that the provisions should only apply to transactions occurring from the date the Bill receives Royal Assent.

Paragraph 3.52 of the EM refers to the application of the proposed NALI provisions. It states that the amendments will apply to income derived in the 2018-19 income year and later years (regardless of the start date of the scheme/investment). The issue with this start date is that even though it is prospective, it practically has a retrospective application. Further, it does not allow taxpayers any transitional relief to re-organise their affairs to ensure that any relevant schemes are rectified so that they better reflect arm's length terms (assuming such rectification can be achieved which will not be possible in all circumstances – for example, in the case of an asset acquired from a third party many years ago such rectification would not now be possible).

An example of the issue is highlighted by the EM in example 3.1 which references an SMSF which has invested in property. The SMSF in the example would not practically have time to apply rectifications by 30 June 2018 to make their transaction 'an arm's length dealing'. In order for this to be achieved, documentation to change the loan agreement would need to be drafted, as well as preparation and registration of a mortgage on title.

The Tax Institute suggests that a transition period should be applied in relation to the measures in the Bill (we would suggest a period of at least 2 years is appropriate). This will provide adequate time for all SMSFs to assess whether their investments and transactions are carried on at arm's length. Further, to the extent possible, it will also provide a reasonable time-frame to unwind or amend those transactions to ensure that any related income is not subject to the proposed section 295-550 under the Bill.

Retrospective Nature of Amendments

Paragraphs 3.9 and 3.18 of the EM have the effect of retrospectively applying the proposed legislation and the proposed NALI concepts to existing transactions and structures. These paragraphs specifically state that the EM intends to change the way that the current NALI laws apply to certain existing arrangements. It is possible that fund trustees and other taxpayers may have received advice on these arrangements in relation to the current NALI provisions, and therefore established lawful structures and transactions as a result of that advice.

It is unfair that certain taxpayers, having exercised relevant planning, care and diligence to establish structures and arrangements, moving forward will automatically be caught by the proposed NALI provisions.

Fund trustees who have previously received advice (particularly in relation to the issues referred to in paras 3.9 and 3.18 of the EM) are likely to require further updated advice in relation to the application of proposed laws to investments previously made and whether it is possible to make relevant changes to existing investment structures and arrangements so as to not be caught by the proposed provisions.

Notwithstanding any transitional relief that might be made available, it is noted that in some cases (particularly where an asset has been acquired on more favourable terms – for example, from a co-investor under the exercise of pre-emptive or similar buy-out rights arrangement) it may not be possible for there to be any restructuring of the past acquisition or investment and the proposed NALI laws will be left to apply retrospectively and adversely to these funds.

The Tax Institute recommends a grandfathering of existing arrangements to ensure an orderly transition for arrangements that have been entered prior to this change. A comparable significant change that involved complex and often non-market listed investments was the 2009 change to the definition of *in-house assets*. The changes to section 71 of the *Superannuation Industry (Supervision) Act 1993* (**SISA**) provided a 10 year transition for existing arrangements to allow an orderly restructure or exit. We propose that a similar timeframe is implemented in respect of the proposed amendments to section 295-550 of the ITAA 1997.

Whole transaction tainted as a result of minor NALI

It is acknowledged that one of the proposed changes to the concept of NALI is that non-arm's length expenditure now is captured by the NALI definition. However, the proposed outcome of minor non-arm's length transaction expenditure can result in excessive adverse tax outcomes relating to an SMSF's investment moving forward.

Paragraphs 3.29 and 3.30 of the EM, as well as Example 3.2, outline a scenario where brokerage is not charged to a retail superannuation fund at arm's length. As a result, the retail superannuation fund in the example will derive income that is classified as NALI. In addition, the same example also states that the net capital gain from the investment may also be considered as non-arm's length.

The outcome of Example 3.2 of the EM is that the 'penalty disproportionately outweighs the crime'. The non-arm's length component of the transaction was a minor part of the overall investment. Therefore, it seems unreasonable that all income and capital gains derived from the investment should be tainted by only a minor non-arm's length component of the transaction.

In relation to SMSFs, there are additional risks. If an SMSF were to invest in a private unit trust (analogous to the example outlined in Example 2), there may be a risk that a minor part of the SMSF's dealing with the trust would not be at arm's length. This may be an oversight between the parties, as opposed to a pre-meditated scheme, that results in a non-arm's length component. For example, similar brokerage may not be factored into the purchase price (ie costs to issue unit certificates and update the trust's records), or some trust transfer formalities could be relaxed due to the private nature of the transaction – and these examples could be construed as not being at arm's length.

In accordance with the EM, the minor examples outlined above would have significant adverse tax consequences for the SMSF in relation to deriving income, and even disposal of the unit trust investment. These tax outcomes appear to be excessive in relation to what may be a slight oversight by the SMSF.

The Tax Institute recommends that the Bill be amended so that minor oversights do not result in significant tax outcomes for SMSFs.

Internal arrangements

We refer to point 4 on page 4 of the Previous Submission regarding 'Free and Discounted Services'. In addition to those points, we draw your attention to the comments outlined below in relation to internal arrangements.

Paragraphs 3.31 – 3.37 of the EM indicate that certain tasks undertaken by trustees in relation to an SMSF's compliance activity may be considered as being subject to the non-arm's length income rules.

There appears to be a great deal of uncertainty for SMSFs in relation to what may trigger the non-arm's length income rules in relation to 'internal arrangements'. For example, the EM does not provide a specific benchmark which could cause a trustee's usual functions to trigger the NALI rules.

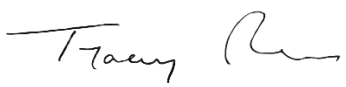
Trustees undertake numerous tasks on behalf of their SMSF. Examples include book-keeping (as outlined in paragraph 3.34 of the EM), investment decisions, meeting facilities, and review of accounts. Some trustees may undertake tasks which overlap as part of that person's specific professional training or vocation. In these circumstances, the EM appears to be ambiguous in relation to what trustee tasks may constitute NALI.

Paragraph 3.36 of the EM outlines that paragraph 17A(1)(f) of the SISA requires trustees to not charge for trustee services. However, unless this area is clarified further, there is a risk that a trustee may charge for services with the intention of satisfying the proposed NALI provisions, and may inadvertently contravene paragraph 17A(1)(f) of the SISA.

* * * * *

If you would like to discuss, please contact either me or Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely



Tracey Rens
President

Annexure A

THE TAX INSTITUTE

19 February 2018

Mr Robb Preston
Manager
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Superannuation Taxation Integrity Measures

The Tax Institute welcomes the opportunity to make a submission in relation to the proposed superannuation reforms to the limited recourse borrowing arrangements (**LRBA**) and non-arm's length income (**NALI**) provisions.

The Government's proposed reforms are set out in the following consultation documents (collectively, **Consultation Documents**):

- Superannuation Taxation Integrity Measures Consultation Paper 11 January 2018;
- Exposure Draft Treasury Laws Amendment (2017 Measures No. 12) Bill 2017: TSY/45/253 Non-arm's length income (**Exposure Draft**); and
- Non-arm's length income of superannuation entities – Exposure Draft Explanatory Material (**Explanatory Memorandum**).

Our submission below comments on whether, in our opinion, the proposed amendments meet the stated policy objectives, have unintended consequences and whether we consider that there is a more efficient way to achieve the policy objectives.

Executive summary

The Tax Institute (**TTI**) considers that the amendments should not proceed. Under the proposed amendments, there is the potential for adverse and over-reaching long-term consequences as a result of trying to deal with the mischief identified in the policy objectives for the NALI provision amendments. Our preferred approach of addressing the mischief is via a mechanism for 'deeming' contributions to have been made.

If, notwithstanding our main submission above, the amendments proceed, we make the following points:

- The changes be prospective only – that is, they should only apply from 1 July 2018;
- Capturing cash contributions by a standard-employer sponsor under the proposed NALI amendments is fundamentally incorrect and shows the potentially inappropriate breadth of the proposed amendments;
- The amendments should apply to 'deductible expenses' that are insufficient – they should not cover capital outlays;
- Free and discounted services provided to superannuation funds should never give rise to NALI;

- For consistency with existing law, the amendments should only refer to income "derived from a scheme";
- TTI is concerned about the erosion in retirement income that may be caused by any excessive penalty where a breach of the rules may be unintended. Penalties under section 295-550 should be proportionate to the mischief and should only be applied to the extra net income, rather than the entire income;
- The amendments should eliminate any possibility of the dual application of both the new NALI provisions and an LRBA counting towards a member's total superannuation account balance **(TSB)** – only one 'penalty' provision should be able to be applied;
- All ATO decisions to apply the NALI rules should first be referred to its expert anti-avoidance panel for its recommendation, much like the ATO does before applying the general anti-avoidance rules in Part IVA. Further, Part IVA should not be capable of applying where NALI applies; and
- There is a risk that the LRBA amendments will result in recognising the loan as part of a member's TSB. This is anomalous when compared to other geared arrangements available to APRA-regulated funds and exempt public-sector superannuation schemes.

Policy objectives

TTI understands that the proposed measures in the Consultation Documents are essentially aimed at preventing the circumvention of contribution caps by members seeking to achieve inflated savings within the concessionally-taxed superannuation environment. More specifically, they are aimed at:

- expenses charged by related parties of members at an insufficient rate compared to arm's length commercial charges. The proposed measures seek to render income generated by complying superannuation funds (and other complying superannuation entities) from such expenses as NALI of the fund and consequently such income would be taxed at 45%; and
- loan debts of self-managed superannuation funds (**SMSF**s) owed under LRBAs. The proposed measures seek to count such debts towards a member's TSB caps. Once TSB caps are reached, this prevents or restricts further member contributions.

The Government's actual NALI announcement in the 2017 Budget said the following in relation to the objectives of the reforms:

> From 1 July 2018, the Government will further improve the integrity of the superannuation system by reducing opportunities for members to use **related party** transactions on non-commercial terms to increase superannuation savings. The non-arm's length income provisions will be amended to ensure **expenses** that would normally apply in a commercial transaction are included when considering whether the transaction is on a commercial basis. [***our emphasis added***]

Proposed amendments not required

TTI considers that the proposed amendments are not required as the contribution caps already adequately address the issues the NALI proposals seek to address.

Since 1 July 2007, contribution cap tax rules have been the key mechanism for controlling excessive superannuation contributions. Tax Ruling TR 2010/1 is central to the ATO administration of the contribution rules.

This ruling says:

> 4. In the superannuation context, a contribution is anything of value that increases the capital of a superannuation fund provided by a person whose purpose is to benefit one or more particular members of the fund or all of the members in general.

TTI believes that the contribution rules already adequately deal with the acquisition of assets by superannuation funds for no consideration or insufficient consideration. In our opinion, it is inappropriate to tax all subsequent income and gains derived from such assets under the NALI rules and the proposed amendments should not proceed on this basis.

Both the Explanatory Memorandum and Consultation Paper use the example of the value able to be added to a superannuation fund through a LRBA with an interest rate that is lower than commercial rates to justify the NALI amendments. However, the commercial reality of a loan given on the terms mentioned in the example in the Explanatory Memorandum is that such a loan would carry an upfront premium.

Therefore, the loan would be an asset acquired by the superannuation fund for an insufficient value equal to that premium which should to have been paid. In these circumstances the value of the unpaid premium would already be covered by Tax Ruling TR 2010/1 and taxed as a contribution. Therefore, in our opinion, it is not appropriate to seek to apply the NALI rules in these circumstances.

TTI considers that it would be preferable to tighten the provisions regarding the deeming of contributions, if thought necessary, rather than enacting the NALI amendments.

If the NALI amendments proceed

If, notwithstanding The Tax Institute's primary submission outlined above, the s.295-550 NALI amendments do proceed then we recommend that the following further issues be addressed:

1. **Make changes prospective only:** The provisions should be restricted to income from assets acquired in the 2018-19 year or later. Otherwise, the rules operate with retrospective effect. Further, for many assets already acquired, there are regulatory prohibitions on selling assets and re-acquiring them from a related party at arm's length which will prevent a fund from self-correcting. In addition, even if such restructuring is permitted there are likely to be significant transaction costs. Therefore, it is important that the changes be prospective only.

2. **Employer contributions:** It should be considered how, on a literal reading of the proposed rules, a cash contribution by a standard-employer sponsor could be

excluded from triggering NALI. On our reading of the proposed amendments, such contributions would be caught because, although the employer and employee may be dealing at arm's length with one another, the superannuation fund has still had an increase in capital for arguably nil consideration from a related party. We acknowledge that there are various arguments under current law for employer contributions about consideration being provided in the form of increased liabilities for the fund. In our opinion, capturing cash contributions by a standard-employer sponsor under the proposed NALI amendments is fundamentally incorrect and shows the potential breadth of the proposed amendments.

3. **Deductible expenses, not capital outlays:** Application should be restricted in sub-section (1) and (5) of the Exposure Draft to 'deductible expenses' that are insufficient. They should not cover capital outlays which are insufficient as these should already be covered under contribution cap rules. In other words, there should be no double-counting. We note the Government budget announcement referred only to 'expenses' and not also capital outlays. Proposed sub-section (7) of the Exposure Draft, which explicitly extends the proposed changes to capital outlays, should therefore be deleted.

4. **Free and discounted services:** Free and discounted services provided to superannuation funds should never give rise to NALI. As examples:
    - members of a SMSF could manage the fund investments themselves for free;
    - a trustee of a corporate fund could provide in-house administration and meeting facilities and manage the fund's investments without charging the fund by using staff whose wages are paid by the employer-sponsor;
    - a non-profit fund trustee could limit its charge to the fund to cost recovery, rather than full commercial rates; or
    - an external professional investment manager could, for marketing or other strategic reasons, choose to provide a discount to a particular fund client.

    The ATO has already confirmed that the services in examples (i) and (ii) do not give rise to contributions in Tax Ruling TR 2010/1 (see examples 2 and 5).

    There is also the potential for these changes to impact APRA-regulated funds and exempt public sector superannuation schemes that may have selected a related party service provider, for example, through a tender process on the basis that the related party will waive or discount fees or offer other favourable terms.

5. **Income "derived from a scheme" and income "as a result of a scheme":** Both phrases are used in the proposed amendments, while only the former is used in existing legislation. TTI submits that the new wording should not be inserted as it will only increase uncertainty (which already exists with the current wording). Further, it may potentially be construed in a very broad way with unintended and unknown consequences.

    Income that is derived as a "result" of a scheme clearly provides scope for a much broader link to be drawn between the expense incurred and income earned by the superannuation fund. If this is a deliberate change in meaning, it should be

explicitly stated in the Explanatory Memorandum. Further, examples should be provided to demonstrate the difference. TTI is concerned that without further clarification there will be significant industry debate and potential litigation regarding the application of this wording.

6. **Excessive penalty:** Penalties for NALI under section 295-550 are excessive compared to other anti-avoidance rules and should be reduced. The penalty may result in up to 67.5% of all the income earned being lost as a result of increasing the tax rate from 0% to 45%, plus a 50% penalty rate.

   For example, under the proposal, an investment manager that charges a managed unit trust a slightly discounted fee one year for managing a particular asset class in order to cement their business relationship will cause the entire profit distributions from the managed unit trust to a pension fund unitholder from then on plus the capital gain made by the pension fund when it ultimately sells the units to be taxed at 45% (instead of 0%), plus a penalty of up to 50%.

   Another example is a tradesman that uses his 5% trade discount at a hardware store to purchase materials in his capacity as trustee of his own SMSF for minor repairs to be undertaken on the SMSF's rental property. This will cause the entire rent from then on plus the capital gain on ultimate sale of the property to be taxed at 45%, plus a penalty of up to 50%.

   TTI is concerned about the erosion in retirement income that may be caused by any excessive penalty where a breach may be unintended. By contrast, the related NALI rule for managed investment trusts in the new section 275-610 taxes only the extra income.

   Penalties under section 295-550 should also be proportionate to the mischief and should only be applied to the extra net income, rather than the entire income. By further contrast, most SMSF regulatory breaches result in a requirement to remedy the breach, and potentially a mandated education course for the members and fine of up to $12,600 for 60 penalty units x $210 each.

7. **Dual penalty:** The amendments should eliminate any possibility of the dual application of both the new NALI provisions and an LRBA counting towards a member's TSB – only one 'penalty' provision should be able to be applied.

8. **ATO anti-avoidance expert panel:** NALI is an anti-avoidance rule. All ATO decisions to apply the NALI rules in section 295-550 to a taxpayer should first be referred to its expert anti-avoidance panel for its recommendation, much like the ATO does before applying the general anti-avoidance rules in Part IVA. Further, Part IVA should not be capable of applying where NALI applies.

Inclusion of outstanding LRBA debt in TSB is inequitable

TTI considers that the implementation of this measure is inequitable because it disadvantages SMSFs compared to other superannuation funds, and the Government should therefore not proceed with it.

Other superannuation funds frequently invest into geared vehicles, which can even be captive investment trusts. Their gearing does not count towards members' TSBs and the same approach should apply to gearing by an SMSF through a LRBA. Fair and equitable treatment should be maintained across the different sectors of the industry.

Any concern about interest rates charged that are insufficient can and should be dealt with as contributions as discussed above, which resolves the issue without creating any inequity.

Further, the proposed amendments may create:

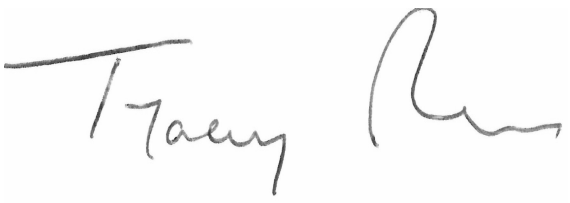
- an administrative burden for all SMSF's with LRBAs to report and allocate their LRBAs between members, even if no member is approaching their cap; and
- create confusion for members about the quantum of their superannuation, because their TSB will not equal their account balance.

For all the reasons discussed above, TTI recommends that the proposed amendments are not implemented.

* * * * *

If you would like to discuss any aspects of this submission, please contact either me or Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely



Tracey Rens
President