THE TAX INSTITUTE

4 December 2019

Mr Kendrick Yim
Australian Taxation Office
Public Advice and Guidance

By email: Kendrick.Yim@ato.gov.au

Dear Kendrick

Non-arm's length income and expenses – LCR 2019/D3 and PCG 2019/D6

The Tax Institute welcomes the opportunity to a make a submission in relation to the Law Companion Ruling LCR 2019/D3 (**LCR**) and Practical Compliance Guideline PCG 2019/D6 (**PCG**) about the recent non-arm's length income (**NALI**) and expenses (**NALE**) amendments to s.295-550 made by *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019*.

Summary

The Tax Institute considers that the LCR should not be finalised in its current form. Further, The Tax Institute considers that the LCR and PCG should be amended and reissued for further consultation.

As a general preliminary comment, The Tax Institute considers that a more practical and purposive approach to the application of s 295-550 should be taken by the ATO in the LCR and PCG.

The key issues discussed in this submission are as follows:

- The nexus requirement has changed from the imputed NALI being "derived from" the scheme to "as a result of" the scheme. NALE must also contain the same nexus requirement –**Paragraphs 9 and 10 - nexus** (unless otherwise stated, all paragraph references refer to the paragraphs in the LCR).
- NALI/NALE should not automatically apply to both income and capital gains. The target of the scheme should be identified as either affecting the income or capital account transactions - **Paragraphs 9 and 10 - nexus**

- The limitation on the breadth of the first positive limb of s8-1(1) should be mentioned in the LCR
- Transactions deemed to constitute a contribution should not be subject to NALI - **Limited recourse loans; Contributions**
  Error! Reference source not found.
- General fund expense having the ability to invoke NALI across a fund is particularly problematic and The Tax Institute recommends significant review and clarification. As it stands the nexus requirement in s 295-550 is not able to be satisfied - **Paragraphs 18, 21-22 and 42 - General fund expenses**
- Greater clarity by way of further examples of a trustee acquiring services at less than standard commercial prices
- **Paragraph 2.50 of EM - Pricing of services from parties related to the trustee**
- The LCR implies trustee/directors should be deterred from deploying their own specific skills and knowledge in running their own fund. This appears contrary to ASIC's public comments
- **Paragraphs 36 – 46 –Capacity in which activities are performed**
- Greater clarification around the application of the market value substitution rules is required
- **Paragraphs 52 to 58 - Application of the market value substitution rules**
- The LCR would benefit from the clarification of the NALI position in respect of guarantees provided by SMSF members in the case of LRBAs - **Treatment of guarantees**
- We submit that any ATO decision to apply NALI/NALE should first be referred to the GAAR or a similarly constituted panel - **Practicality/GAAR panel**
- The PCG should not be limited to providing relief for general expenses in the two years prior to the application of the LCR - **PCG 2019/D6**
- Section 295-550 also refers to "the entity" that derives the NALI or incurs the NALE. The entity is the complying superannuation fund. The Tax Institute submits that should also be made explicitly clear in the ruling.

We have provided detailed comments in relation to these key issues below.

Law Companion Ruling LCR 2019/D3

Page 1 - The wording in the box on page 1 above the table of contents 'Relying on this draft Ruling' will need updating when the ruling is finalised.

1. Paragraph 8

We request that the words 'remove any ambiguity in the application of the NALI provisions be removed' as this is not established from a legal perspective. This is new legislation and has entirely new provisions that seek to apply a tax on a new basis. We therefore disagree with this assertion.

2. Paragraphs 9 and 10 - nexus

When analysing whether statutory income such as a net capital gain is NALI, we consider the ATO needs to provide consideration to the nexus to any scheme that gives rise to that gain to determine whether NALI applies.

The legislation contained a nexus requirement that the imputed NALI be "derived from" the scheme, which has been amended to "as a result of" the scheme. In SCCASP Holdings Pty Ltd v Commissioner of Taxation [2013] FCAFC 45 at para 66-67, in relation to the precursor to s.295-550, it was stated that:

> "66. *The reason why the word "derived" is used in s 273(6) is to identify the source of the income: Sentry Life Assurance Limited v Life Insurance Commission [1983] FCA 208; (1983) 78 FLR 74 at 88. It is only that income which is sourced from a trust estate that is special income. The purpose of the use of the word "derived" in s 273(6) is to identify the source, not the receipt.*
>
> *67. For that reason, in our opinion, s 273(6) is concerned with source, not with receipt. What s 273(6) seeks to do is to classify as special income, income derived from a particular source …"*

The ATO should explain whether the use of the words "as a result of" in s 295-550 alters the existing "derived from" nexus requirement or merely confirms the existing nexus in s 295-550.

The nexus requirement should be stated in paragraph 9 and explained later in the ruling (rather than including simple assertions made about when the nexus requirement is met).

Similarly, for income to be NALI by reference to NALE, there is a nexus requirement in the provisions about NALE that must also be met. The NALE nexus is expressed in words which reflect the first limb of s.8-1.

A recent draft ruling, TR 2019/D4 issued by the ATO on the topic of deductions for work expenses under s 8-1 of the *Income Tax Assessment Act 1997* (**ITAA 1997)** discusses the first limb of s.8-1. The following extracts are taken from this draft ruling:

"In gaining or producing assessable income

13. The pivotal element of section 8-1 for work expenses is the requirement that expenses be incurred 'in gaining or producing assessable income'. The High Court majority in Payne [12] said it is well established that these words are to be understood as meaning incurred 'in the course of' gaining or producing assessable income, and do not convey the meaning of outgoings incurred 'in connection with' or 'for the purpose' of deriving assessable income.

14. The majority further stated that the meaning of 'in the course of' gaining or producing income was amplified in Ronpibon Tin NL where it was held that [13]:

    .....to come within the initial part of [s8-1] it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income, or if none be produced, would be expected to produce assessable income....

15. While the High Court authority indicates the nature of the connection that needs to be found between outgoings and assessable income, the sufficiency of the connection in a given case cannot simply be determined by reference to a precise formula. Section 8-1 is expressed in such terms that it is intended to cover any number of legal and factual situations. In many cases, only a proper consideration of all the relevant facts and circumstances will reveal whether the occasion of a particular outgoing is to be found in what produces assessable income.

Importance of facts and circumstances

16. For expenses incurred by employees, the fundamental question is whether an expense is incurred in the course of earning employment income. This involves considering the proper scope of the particular taxpayer's work activities to determine if the circumstances of the expense have a sufficiently close connection to earning the employment income."

It was also stated in Ronpibon Tin NL v FCT; Tongkah Compound NL v FCT (1949) 78 CLR 47 (**Ronpibon Tin Case**) per Latham CJ, Rich, Dixon, McTiernan, and Webb JJ:

> *"For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end. The words 'incurred in gaining or producing the assessable income' mean in the course of in gaining or producing such income …*

> *… it is both … sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income" (CLR pp 56-57).*

This nexus requirement is discussed more specifically below.

Is there a nexus for NALI when an asset is acquired for less than market value?

While there is the prospect for NALI to apply in certain cases of disposal gains, there needs to be a sufficient and relevant nexus between the acquisition of an asset and the income and/or net capital gain derived from that asset and the eventual disposal of that asset for NALI/NALE purposes.

Example 1 in the LCR shows that Armin selling a property to his SMSF valued at $800,000 for a $200,000 purchase price could invoke NALI. However, since the CGT market value substitution rule in s 112-20 applies, Armin is correlatively assessed as having received deemed market value proceeds under the CGT rules in accordance with s 116-30. Therefore, it is submitted that Armin should be treated as having made a non-concessional contribution (**NCC**) for the relevant amount, (ie the difference between the amount actually received and the asset's market value). We refer to TR 2010/1 at paragraph [26] and the ATO's approach to shares acquired by a superannuation fund in relation to an employee share plan where the employer provides a discount in relation to the shares issued in respect of an employee under an employee share plan.

Example 1 should be revised so that Armin is taxed on the net capital gain and his SMSF recognises the market value of the property as an NCC of $600,000. If Armin has exceeded his total superannuation balance or his NCC cap, then he will be subject to the excess contribution system which may potentially render him to tax at a rate that is 47% unless he elects to release the amount of his excess NCCs plus 85% of his associated earnings and Armin will then pay tax on 100% of his associated earnings.

Example 3 in the LCR shows Russell's SMSF purchasing listed shares for $500,000 valued at $900,000. This example should also be treated in a similar manner to Example 1 above.
The recognition of an NCC to reflect the fact that the super fund paid market value consideration for the asset, neutralises and should preclude NALI being invoked.

If the ATO now wish to apply NALI to the net capital gains in these types of examples (such as in Examples 1 and 3 above extracted from the LCR), then the ATO should urgently revise its approach to what a contribution is. However, we recommend that the ATO continue with its current approach to the treatment of contributions as outlined in TR 2010/1 and in the NTLG Superannuation Technical Sub-group meeting minutes, dated 3 September 2013 (**September 2013 NTLG Minutes**).

Assuming the ATO does with to change its long-standing approach on the treatment of contributions and now seek to apply NALI to such situations, we do not accept that if an asset is acquired at market value, the income and net capital gain should necessarily both be NALI. In the

case where the correct market value has been paid for an asset but there has been, say, a reduction in the arm's length interest rate on the LRBA by an SMSF, the (statutory income (eg net capital gain) from the asset should not automatically be considered NALI. The scheme would not have the result that, in relation to gaining the capital gain, an entity (ie, the SMSF) incurs a loss, outgoing or expenditure of the kind in new s 295-550(1)(b) or (c) because the relevant loss, outgoing or expenditure is not incurred in gaining or producing the (statutory) income by way of capital gain. To contend otherwise, may interact in unintended ways with the settled construction in s 8-1 of the ITAA 1997.

For example, in Example 4 of the LCR, Kellie's SMSF pays the $2M market value for the commercial property but gets a favourable LRBA which is on a non-arm's length basis (ie the loan is for 100% LVR, nil interest and a 25 year term; where repayment can be made at the end of 25 years). We accept that in this case, there would be sufficient nexus for the net rental to be exposed to NALE but it is not correct that any net capital gain on sale of the property – which was acquired at market value – is NALI. Indeed, it appears that the real driver of why the NALE provisions were introduced, were to address these types of LRBAs.

The following example provides greater clarity for the application of NALI to the capital gain of a fund asset:

> If an SMSF improves a property on a discounted, or no cost, basis by employing services of a related party builder, the new law is likely to apply to the capital gain received on sale of the property. NALI should however not apply if the improvement constitutes a deemed contribution. This is supported by TR 2010/1 and its September 2013 NTLG Minutes. As outlined below, the Commissioner should provide certainty that he will treat an improvement to an asset as a contribution in this situation (rather than NALI), as put forward by the ATO in these two publications and established practice since 2010.

Is there a nexus for NALI when an asset is acquired for market value?

The net capital gain in relation to many SMSF investments including property, shares and other investments arises from the original contract price. Therefore, having a low interest loan or say cheaper services that are on revenue account (eg the SMSF trustee collecting the rent on behalf of the SMSF rather than engaging a real estate agent) does not give rise to any additional net capital gain. Therefore, SMSFs that are passive investors and benefit from capital appreciation that occurs as a result long-term holding and capital appreciation should not have their net capital gains exposed to NALI if they incur a lower expense on an infrequent basis. The net capital gain in these cases generally remains the same despite any low interest rate, cheaper services or discounted expenses. Broadly, there is no sufficient and relevant nexus in these type of situations. as illustrated in the following example.

The Tax Institute accepts that there may be certain situations where NALI may apply to a net capital gain. For instance, where an SMSF acquires an asset that it could not have acquired without a flexible related party loan (eg as in Example 4 in LCR 2019/D3), the net capital gain

could be tainted by NALI. The nexus argument in respect of Example 4 would proceed on the basis that without the flexible related party loan, the SMSF would not have acquired that asset and the income derived from that asset.

However, this nexus would not be established if the SMSF could have acquired that asset and maintained that asset on an ongoing basis. The nexus with the rental income would be established in relation to a flexible related party loan but not in relation to the net capital gain as the scheme being the flexible related party loan did not give rise to the net capital gain which resulted from the usual capital appreciation of the asset that the fund could have acquired in any event. Therefore, the net capital gain under this scenario would not be NALI (ie as noted above, the net capital gain on eventual sale arises from the original purchase contract and capital appreciation over the holding period of that asset).

We acknowledge the potential for non-trustee services provided at a rate less than the market value in respect of an asset that was acquired at market value may taint the net revenue resulting from that asset but, ordinarily, not the net capital gain.

If services did result in an improvement to an asset, as explained below under the heading of 'Contributions', the ATO should apply its long standing view that the increase in value of that fund is a contribution. That is, those services increased the market value of that asset and the ATO have to date treated that increased value as a contribution. On this basis, there should be no need to invoke NALI since the NCC reflects the value of the services provided.

The ATO also needs to outline how it will apportion a net capital gain in appropriate situations.

Example: The Blue SMSF holds an investment property for 20 years which has seen a 400% increase in value over that time. In the final year prior to sale, the SMSF trustees did some free services to make sure the property was best presented for sale so the fund would realise the best sale price. As noted above and under the Contributions heading below, the free services should be treated as a contribution (eg an NCC if provided by the member reflective of the value of those services which should neutralise and overcome the need for the ATO to apply NALI).

If the ATO sought to apply NALI in this scenario, then the question of apportionment arises. That is, is the NALE incurred in gaining the capital appreciation over the prior 19 years, or only an appropriate amount reflecting the value enhancement caused by the NALE? It is submitted that the provisions should be interpreted so that the NALE applies only to a proportion of the gain to which the expenditure relates, as the capital appreciation over the prior 19 years should not be tainted just because the final (20th) year some free services were provided.

It seems unfair that a 400% increase in value could be tainted merely by the SMSF trustees provided some services in the final year of a 20 year holding period.

There are many other situations where an apportionment will be required such as when the value of an asset increases due to different factors over a period of time. If, for example, free services

are provided by a builder who is an SMSF trustee in relation to a property that is owned by his SMSF and during that time, the SMSF also obtains planning approval via an external consultant which itself significantly increases the value of the asset, then the increase in value needs to be apportioned between the services provided (which should first be treated as a contribution) and the increase in value that relates to the planning approval which does not give rise to any NALI risk.

We therefore recommend that the ATO include a number of other examples illustrating situations where the net capital gain in relation to an asset will not be tainted under NALI and several examples where an apportionment is appropriate. We note that the ATO has primarily provided examples where NALI applies.

We accept that there can be a nexus between the acquisition of an asset below market value and the income and net capital gain derived from that asset and the eventual disposal of that asset for NALI/NALE purposes in certain cases.

As noted above Example 4 in LCR 2019/D3 is one such example. The nexus argument in respect of Example 4 would proceed on the basis that without the flexible related party loan, the SMSF would not have acquired that asset and the income including the net capital gain derived from that asset.

However, we do not accept that if an asset is acquired at market value, the income and net capital gain should both automatically be NALI. In the case where the correct market value has been paid for an asset but there has been, say, a reduction in the arm's length interest rate on the LRBA by an SMSF, the income from the asset should not be NALI. The scheme would not have the result that an entity (ie the SMSF) incurs a loss, outgoing or expenditure of the kind in new s 295-550(1)(b) or (c) in relation to the capital gain because the relevant loss, outgoing or expenditure is not incurred in gaining or producing the (statutory) income. To contend otherwise, may interact in unintended ways with the settled construction in s 8-1 of the ITAA 1997.

For example, in Example 4 of the LCR, Kellie's SMSF pays the $2M market value for the commercial property but gets a favourable LRBA which is on a non-arm's length basis. We accept that in this case, there would be nexus for the net rental to be exposed to NALE but it is not correct that any net capital gain on sale of the property – which was acquired at market value – is NALI.

The following example provides greater clarity for the application of NALI to the net capital gain of a fund asset:

> If an SMSF improves a property on a discounted, or no cost, basis by employing services of a related party builder, the new law is likely to apply to the net capital gain received on sale of the property. NALI should however not apply to the extent that such an improvement constitutes a deemed contribution. This is supported by TR 2010/1 and the NTLG Superannuation Technical Sub-group meeting minutes, dated 3 September 2013 (**September 2013 NTLG Minutes**). As outlined below, the Commissioner should provide certainty that, in this situation, he will apply the deemed contribution rules in

place of NALI, as put forward by the ATO in these two publications and his established and communicated administrative practice since 2010.

3. Paragraph 16 – first positive limb of s 8-1(1)

A requirement for NALE is that the imputed expenditure be incurred "in" gaining assessable income. This language picks up the first positive limb of s 8-1(1), not the second. To the extent that an expense would fall only under the second limb, that expense cannot be NALE. Many statutory deductions, including some black hole shut down expenditure and 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 NALE.

The limitation to expenses falling within the first positive limb should be mentioned in the LCR.

4. Contributions

The Tax Institute recommends the content of the LCR be reconciled with Tax Ruling TR 2010/1 that deals with contributions.

Taxation Ruling TR 2010/1 Income tax: superannuation contributions sets out the Commissioner's view on the ordinary meaning of the word 'contribution' in so far as it is used in relation to a superannuation fund, approved deposit fund or retirement savings account in the ITAA 1997. Paragraph 4 of this ruling provides:

> *"In the superannuation context, a 'contribution' is anything of value that increases the capital of the 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."*

Taking steps to improve an asset or add value to an asset of the fund is considered to be a contribution for tax purposes. In particular TR 2010/1 states:

> *"29. The fund's capital may be increased when a person (other than the superannuation provider) increases the value of an existing asset of the fund, for example, by making an improvement to the asset.[8]*
>
> *30. A contribution by way of an improvement to an asset of a fund, such as making an improvement to land or a building owned by a superannuation provider, is made when ownership of the improvement passes to the superannuation provider. In the absence of a lease or other agreement that provides otherwise, ownership of the improvement would pass immediately on the improvement becoming a fixture to the land or building."*

The ATO in its September 2013 NTLG Minutes at item '*7.3 Value of a superannuation contribution effected by improvements to property*', the ATO stated:

> *"As explained in the ATO's previous response to the question at agenda item 7.9 of this Subgroup's meeting on 5 March 2013, the ATO considers that an improvement to an asset of*

an SMSF made by a related party of the fund at no cost to the fund may increase the value of the asset, and therefore the capital of the SMSF. If the improvement is made by the related party with the purpose of benefiting one or more members of the fund, it will be a 'contribution' within the ordinary meaning.

The ATO considers that if a related party of an SMSF provides the materials used to make an improvement to real property owned by the fund at no cost to the fund (or for less than market value consideration), and supplies labour/services to effect the improvement free of charge, the increase in the value of the real property as a result of the improvement, will increase the capital of the fund. In such a case, the ATO considers that the contribution to the SMSF is being made by way of improvement to an asset of the fund (the real property), rather than by providing the materials, and supplying the services/labour, used to give effect to that improvement. It is the resultant improvement that constitutes 'the thing of value' that increases the capital of the fund that may be considered a contribution to the fund."

To avoid any potential double taxation of the same or similar amount, the LCR should explicitly state (and do so outside of any example, and in a way that legally binds the ATO) that a contribution under TR 2010/1 does not result in NALI. The LCR should confirm that personal contributions, and employer contributions made under the terms of employment contracts, do not result in NALI.

If the ATO cannot confirm this, then in the view of The Tax Institute, legislative amendments need to be referred back to Treasury as a matter of urgency for further review. It is a fundamental objective of superannuation that contributions to save for retirement are treated in a consistent manner and not subject to what, in essence, may result in double taxation.

As it stands, it appears from paragraphs 24 to 26 of the LCR that the ATO is only administratively prepared to say that a contribution reported at its full arm's length value does not result in NALI. The Tax Institute fails to see how a contribution whether the contribution is in cash or kind should be treated differently. For example:

- A member makes a $100,000 contribution in cash to an SMSF. The SMSF provides no consideration as the contribution is a mere gift. This contribution is recorded in the fund's accounts as an NCC.
- In contrast, a member contributes listed shares worth $100,000 as an NCC. The SMSF provides no consideration and the $100,000 market value of the shares are recorded in the fund's accounts as an NCC.

The Tax Institute does not see any mischief or difference with the two above contributions. In particular, there is no basis for applying NALI where a member is undertaking an ordinary transaction with a super fund. The LCR needs to be brought in line with long established practice.

Furthermore, while a sale contract in relation to real estate usually specifies the interest (whether all or part) and the consideration payable under that contract, if the contract does not make it clear

that only part of the asset is being acquired, this should not invoke NALI (as set out in paragraph 24 of the LCR). This position does not appear consistent with the ATO's approach in the ATO's position in paragraph 26 of TR 2010/1.

In situations where a contract relates to a part (or tenants in common) interest of real estate, the amount of the contribution made is typically recorded in a trustee resolution. Further evidence, such as a valuation report or similar information, is usually relied on to confirm the sale price and the amount of the 'in-kind' contribution.

The ATO should also note that a super fund could correct the amount of a contribution reported within 30 days (as required by section 390-115 of Sch 1 of the *Taxation Administration Act 1953* (Cth)), and not apply NALI.

The LCR should also recognise that some things that the ATO considers contributions for tax purposes in TR 2010/1 are not treated as contributions for regulatory purposes. There is no contribution for SISA or SISR purposes by an SMSF trustee recording free or discounted services as a contribution in accordance with the ATO's view in TR 2010/1 and the September 2013 NTLG Minutes.

The Tax Institute suggests that comments in the LCR that services performed by the trustee in its capacity as such and which the trustee does not charge the fund for do not give rise to contributions be reconciled with s 295-173 which says trustee contributions are NCCs.

5. Limited recourse loans

Consideration should be given to including an example of an SMSF that acquires a derivative or swap as an alternative to limited recourse borrowing to acquire the underlying asset. Much the same risk exposure to the underlying asset can be achieved using a derivative or swap without criticism that NALI applies because the lending ratio is too high.

Once that is recognised, then it should be accepted that the income from borrowing may be no greater than what could be achieved with derivative or swap counterfactuals, and therefore borrowing may not result in NALI.

Further, borrowers with insufficient equity to borrow 100% are able to purchase mortgage insurance. The insurance policy contract then becomes an asset of the borrower. Consideration should be given to including an example where a member loan guarantee is treated as a contribution of an amount equal to what the cost of mortgage insurance would have been.

Interest rate on limited recourse loans

As a more general observation, The Tax Institute believes the ATO should provide solution orientated examples, particularly where it is a practical compliance guideline.

A low or nil interest loan, should be viewed as itself a valuable asset that has a purchase premium, with that value able to be recognised as a contribution and without NALI necessarily arising.

If a member on-charges in full to the fund the interest on money he/she on-lends to the fund, interest payments by the fund could be paid using subsequent non-concessional contributions. Once that possibility is recognised, the issue of the interest rate the member charges the fund may in many cases become inconsequential from a NALI perspective. Imposing NALI where interest is not charged on back-to-back loans from the member is not appropriate as it is merely an exercise in semantics. In fact, charging interest in full will often result in a net 15% tax deduction for the fund, so might be expected to be less preferred from a revenue collection standpoint.

6. Paragraphs 18, 21-22 and 42 - General fund expenses

Neither the explanatory memorandum nor second reading speech give any indication that general fund expenses such as accountancy fees that are undercharged should cause all the income of the fund to become NALI. We submit that this outcome is inappropriate.

The Tax Institute considers the ATO interpretation to be incorrect. A scheme not to charge (or charge less than market rates) for accountancy services or other general fund services provided to a fund typically has nothing directly to do with generating the income from fund assets. As noted above, low or nil expenses can be NALE only if the expense would satisfy the first limb of s.8-1 (ie there needs to be the relevant nexus). Referring back to the Ronpibon Tin Case, discussed above, there needs to be a sufficient and relevant nexus established:

> *"… it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income. (CLR pp 56-57)."*

The ATO should not seek to seek to taint everything.

The application of the ATO's current general expense view also needs to be considered in relation to a large Australian Prudential Regulation Authority (**APRA**) funds. Some of these funds have millions of members and manage many billions of dollars. As acknowledged at [42] in LCR 2019/D3:

> *"42. A fund might enter into arrangements that result in it receiving discounted prices. Such arrangements will still be on arm's length terms where they are consistent with normal commercial practices. Similarly, although pricing based on a cost-recovery basis will not generally be consistent with an arm's length dealing, there may be limited circumstances where a party operating on a simple cost-recovery basis for particular services is commercially justifiable because of the economies of scale it achieves within its business by providing other services. For example, this may occur with respect to services provided to* ***a large Australian Prudential Regulation Authority fund*** *either by the trustee acting in a separate capacity or by a related third party."*

Given the ATO has to administer tax law on a fair basis between SMSFs and large APRA funds, it would obviously cause a tremendously large tax liability on taking such a view if a large APRA fund was subject to a NALI assessment for a lower fee being charged to such a fund by a related party of a contributing employer. The Tax Institute notes the prospect of serious adverse implications for large funds (non-SMSFs) if the ATO maintains this position.

Indeed, extrapolating the ATO view on this point, would lead one to think that any future income or net capital gain on any asset held by that fund (whether an SMSF or APRA fund) at that time would give rise to NALI. Based on the draft ATO view, for example, a $100 reduction in an accounting cost for an SMSF at one time could expose all future income and all future net capital gains on assets held at that time to NALI. We contend that this is an inappropriate result which the legislative provisions were not intended to give rise to.

For the provisions to apply, there must be a sufficient and necessary nexus between the lower or nil cost and the actual income tainted by the scheme between the parties.
Moreover, as mentioned above, in appropriate cases, there needs to be apportionment of the income resulting from the scheme where NALI applies so that anomalous outcomes as noted above do not eventuate.

7. Paragraph 2.50 of EM - Pricing of services from parties related to the trustee

It would be useful for the LCR to include some examples where trustees acquire services from related parties for less than standard commercial prices, such as:

- where a trustee of a not-for-profit fund only charges the fund at cost;
- where an employer entity provides in-house administration services for free (or less than market value) to support its corporate or APRA-regulated default fund;
- where a fund trustee (or related party managed investment trust in which it invests) receives a wholesale brokerage discount;
- where a fund trustee is provided with a promotional discount, or incidental free services as part of a larger service offering; and
- where the member in Example 7 provides her property management services to the fund from outside her business (rather than from in it).

We also recommend that the ATO define what are typically considered to be trustee services compared to services 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 and suppliers of services.

- Overseeing any investments or projects (eg a building project or repair being conducted by a builder, tradesperson, contractor), 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.

The following may fall outside a list of typical trustee services:

- The building of a new building where significant skill, resources such as tools and equipment and training is involved.
- Software and IT support and platforms.
- Marketing and sponsorship services.

8. Paragraphs 36 – 46 –Capacity in which activities are performed

The tone of the LCR implies SMSF trustees/directors should be deterred from using their own time, skills and knowledge that they may have available to them to enhance their fund's retirement benefits.

ASIC in its Media Release MR 19-277 recently stated, among other things, that:

> 'SMSFs may be an attractive option for investors wanting more control over their superannuation investment strategy, but it requires real skill, care and diligence to manage your own superannuation. SMSFs are not for everyone simply because not everyone can meet the significant time, costs, risks and obligations associated with establishing and running one.'

> ASIC's research also found that SMSFs are not an appropriate investment option for people who want a simple superannuation solution, particularly if they have a low level of financial literacy or limited time to manage their own financial affairs. On average, SMSF trustees spend more than 100 hours a year managing their SMSF.

It is likely SMSF trustees/directors are more 'hands on' than a mere 'turn-key' solution such as is the case with a large retail or industry APRA fund where the trustee has a fiduciary duty to manage the fund for its members. As currently drafted, the LCR has the potential of applying NALE to a large percentage of SMSFs along with numerous APRA Fund arrangements.

The position reflected in the LCR sends a negative signal and is impracticable and inefficient from an overall superannuation and retirement policy perspective. For example, a trustee who is an accountant, lawyer, real estate agent or similar adviser is not encouraged to use their special skill and knowledge. These SMSF trustees/directors should not generally be penalised for simply applying some of their skills and expertise towards managing their SMSF's activities.

There may be some exceptions 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. For example, where a builder does substantial work on a property owned by an SMSF that adds value to that property and that builder satisfies all of the following criteria:

- the trustee (or, if applicable, director of a body corporate) performs the duties or services other than in the capacity of trustee; and
- the trustee/director is appropriately qualified, and holds all necessary licences, to perform the duties or services; and
- the trustee/director performs the duties or services in the ordinary course of a business, carried on by the trustee, of performing similar duties or services for the public; and
- the remuneration is no more favourable to the trustee/director than that which it is reasonable to expect would apply if the trustee/director were dealing with the relevant other party at arm's length in the same circumstances.
- It should be noted in the LCR that the fiduciary duties of a trustee, or a director of a corporate trustee, require the individual to exercise the same standard of care as if they were dealing with their own assets.
- The ATO needs to outline what is a trustee and what is a non-trustee service to ensure clarity in relation to when remuneration can be paid and when it cannot be paid by an SMSF to an SMSF trustee/director.

The LCR appears to suggest that any work undertaken by a SMSF trustee/director can invoke NALE. In paragraph [37], the ATO states:

> *"37. Whether activities are performed by an individual in their capacity as trustee (or as a director of a corporate trustee) of a complying superannuation fund will be highly fact dependent and requires an objective consideration of the circumstances in each case."*

The ATO at paragraph [39] goes on to 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)."

We note that there is inconsistency between the factors in paragraph [39] and ss 17A and 17B of the SISA. The Commissioner's position as administrator of the tax acts should align with his function as regulator under the SISA.

We also query why some of the factors in paragraph [39] should make any difference. For example:

- An individual should only charge an SMSF if they satisfy s 17B. If the individual is not an SMSF trustee/member (eg another family member) then that person is not covered by s 17B and therefore could charge for a non-trustee service. Note that within a family, a family member may carry out activities on behalf of a family member (eg, a child who is not a member doing the bookkeeping work for their parents who are the SMSF members).

- Employees often take advantage of equipment and resources of their employers and may have a range of benefits available to them via their employer. Thus, an SMSF member who regularly uses his/her employer's computer/internet facilities to do regular check-ups on their SMSF portfolio including trading of shares and other investments should not, by itself, subject that SMSF to NALE/NALI.

- As discussed above, the fact that an SMSF trustee/director has special skills and knowledge or qualifications is a key reason why they may be successful at investing in their own SMSF. However, the ATO is seeking to link this with NALE when it is very common that an SMSF trustee/director will leverage off their own special skill/knowledge/expertise/qualifications. For example, The Tax Institute members are aware of SMSFs where:

    - The SMSF trustee/director has special knowledge and skills in art works and the SMSF has made some sound investments in art-work. Why should that special knowledge and skill be applied to invoke NALE even if there is some use of employer resources that are associated with the usual course?

    - Similarly, where an SMSF trustee/director has a licence and/or qualification relating to their business, or their profession or employment, that that, by itself, should also not invoke NALE. For example, a real estate agent should be able to do work in their trustee capacity without invoking NALE.

    - Similarly, where the activity is covered by an insurance policy relating to their business, or their profession or employment (for example, indemnity insurance). Again, this, by itself, should not invoke NALE.

In paragraph [40], the ATO broadly accepts that when a trustee/director performs a service in their trustee capacity that will not invoke NALE.

However, in paragraph [41] the ATO broadly states that where a trustee/director performs services in a non-trustee capacity, then NALE will be invoked.

The Tax Institute does acknowledge, subject to the comments under the Contributions heading, there may be certain situations where NALE may be invoked in relation to the provision of non-trustee services. Where the ATO does seek to invoke NALE in these situations, we recommend that:

- The ATO should first examine that the circumstances warrant the application of NALE as many SMSF trustee/directors are providing a range of services that are on the lower end that may be considered by the ATO to invoke NALE (eg, an SMSF trustee/director painting a picket fence or repairing a letter box on the SMSF's rental property where the ATO may argue that is a non-trustee service).
- The ATO should also examine whether, in accordance, with the ATO's well established practice (as reflected in its public binding ruling TR 2010/1, the September 2013 NTLG Minutes and its ongoing well established administrative practice and publicly communicated position since TR 2010/1) whether the services increase the value of the property so as to constitute a contribution. Further details regarding the contribution position are set out under the heading 'Contribution' below.
- The ATO should then consider whether there is any potential application of NALE after considering the other issues raised in this submission.

In paragraph [42] the ATO acknowledges that obtaining discounts that are consistent with normal commercial arrangements will not invoke NALE. We ask that the LCR provides examples illustrating this. For example, if in Example 7 – Sharon's licensed real estate agent business if all her staff are entitled to 50% discount on real estate activities, would this invoke NALE? Similarly, in an incorporated accounting practice, if staff/directors/partners are offered 50% off the firm's services, would this invoke NALE?

The Tax Institute considers that the two above examples do not involve a scheme between the parties (including the employee's SMSF) and the employer to give rise to a lower non-arms' length expense to the SMSF but the discount is offered in accordance with normal commercial arrangements within businesses.

Similarly, although pricing based on a cost-recovery basis will not generally be consistent with an arm's length dealing, there may are numerous circumstances where a party operating on a simple cost-recovery basis for particular services is commercially justifiable because of the economies of scale it achieves within its business by providing other services. The ATO provide an example in relation to an APRA fund (either by the trustee acting in a separate capacity or by a related third party).

It would be helpful here if the ATO could provide an example, where an SMSF trustee/director, who is a builder that satisfies all the criteria in s 17B, provides services on a cost recovery basis where the SMSF procures all the materials directly from third party suppliers (to not contravene s 66 and SMSFR 2010/1) and charges the SMSF for their services plus a builder's margin on the cost of materials – say 6% - that reflects the builder's time to obtain those materials on behalf of the fund. This type of example is relevant to SMSF trustees doing building work.

Further examples to supplement the current examples in the LCR are needed where, instead of the member providing discounted services to the fund through her business, the member provides those services from outside their business entity at full price, for a discount and for free.

9. Paragraphs 52 to 58 - Application of the market value substitution rules

In paragraphs [52] to [58] it is unclear as to how s 112-20 of the ITAA 1997 will apply if an asset is acquired by an SMSF below market value. In our view, the ATO's analysis set out in Example 9 suggests that the gross capital gain is $100,000. We consider that this is incorrect. We are unsure of why the ATO refers to 'gross' capital gain as that is not a term used in the ITAA 1997. We also query why the ATO has ignored the usual technical analysis in s 102-5 of the ITAA 1997 and why the ATO has not applied the usual one third discount in accordance with the method statement in s 102-5 and div 115-100(b). We therefore request that the ATO provide a revised detailed explanation and example of the application of this rule in the context of the LCR.

10. Net amounts

Some income is assessed on a net basis, for example under building contracts. There may be lower recognised expenses and lower recognised income, but the same overall net income. For example, profit making schemes and assets bought for resale at a profit.

The Tax Institute believes it would be inappropriate to apply NALI where both expenditure and income are affected by equal measure as a result of a related party transaction. Accordingly, the LCR should include an example and comment to reflect this point.

11. Fixed trusts

The LCR does not provide any examples where an SMSF trustee is assisting with managing the activities of a unit trust that owns real estate or other investments. The LCR only provides one example, Example 8, where an SMSF acquires units in a unit trust with a low interest rate LRBA.

As outlined above under the heading *"Is there a nexus for NALI when an asset is acquired for market value?"*, The Tax Institute does not see why NALI should be invoked in Example 8 where the units are acquired at market value and the fund had sufficient cash to make the acquisition of

the $50,000 of stock exchange listed units acquired at market value. While we accept that the $8,000 of distributions derived in FY2019 from those units would be NALI, we do not accept — for the reasons already outlined — that the net capital gain is. There is no sufficient and necessary nexus in relation to the low interest loan and the derivation of the net capital gain in relation to the units. The net capital gain will be a function of how the units perform.

We request further examples be provided where NALI will not apply and some where NALI might apply and some examples where NALI might apply in part and an apportionment may be warranted as we requested above.

We also ask that the ATO provide some examples where the SMSF trustee/directors provide internal or trustee type services to the unit trust. We query whether these would be treated in a similar manner to the situation where the SMSF trustee/directors provide internal or trustee type services directly to an SMSF?

Urgent clarification is required on this point as there may be many SMSFs with investments in unit trusts where such services are supplied by the SMSF trustees/members. Given that this issue has not been raised in the past, is there any change required by these unit trusts. If such unit trusts are for example required to pay SMSF trustees/members for unit trust trustee related services, will this be allowed by the ATO? What if the service is a non-unit trust trustee service, will the SMSF trustees/members be required to satisfy a similar test as in s 17B of SISA?

For example, if an SMSF that is invested in a non-geared unit trust that owned a factory and the SMSF trustee/director arranged trades people to carry out repairs from time to time, prepared the accounts each financial year and instructed the accountant on an annual basis — would the ATO treat these services in a similar fashion to internal trustee services?

We recommend that a new paragraph 12A (or 13 if the remaining paragraphs are renumbered) be inserted in LCR 2019/D3 to clarify the application of new s 295-550(5)(b) and (c) as follows:

> *The new paragraphs (b) and (c) in subsections 295-550(5) apply if as a result of a non-arm's length scheme the amount of the loss, outgoing or expenditure relating to acquiring that entitlement or producing that income was less than (including nil) if the relevant parties were dealing at arm's length. That is, there must be a nexus between the scheme, the income and the loss, outgoing or expenditure concerned. For example, this will include where units in a unit trust are purchased for lower than the market value of the net tangible assets in that unit trust.*

Further, the term 'fixed entitlement' needs to be clarified given the outline in TR 2006/7 that was drafted in relation to the former s 273 of the Income Tax Assessment Act 1936 (Cth) (**ITAA 1936**). TR 2006/7 provides:

> “206. The term 'fixed entitlement' is not defined for the purposes of section 273. The meaning to be ascribed to these terms must therefore be determined according to the ordinary meaning of the words having regard to the context in which they appear.
>
> 207. When inserting subsections 273(6) to (8), Parliament sought to distinguish between investment returns on 'fixed entitlements' in 'unit trusts' and distributions made to persons as beneficiaries of 'discretionary trusts' resulting from the exercise of discretions. Parliament considered it appropriate that the latter should be treated as special income taxed at the non-concessional rate whereas the former should only be treated as special income if the acquisition of the fixed entitlement or the derivation of the income failed to satisfy an arm's length test.
>
> 208. Having regard to the statutory context, it is considered that the composite expression 'income derived....by virtue of a fixed entitlement to the income' is designed to test whether an amount of trust income that had been included in the assessable income of a superannuation entity under subsection 97(1) was included because the entity had an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee.
>
> 209. To have an interest in the income of a trust estate, a person must have a right with respect to the income of the trust that is susceptible to measurement; a right merely to be considered as a potential recipient of income is not sufficient. An interest in the income of a trust estate will be vested in interest if it is bound to take effect in possession at some time and is not contingent upon any event occurring that may or may not take place. In contrast to a vested interest, a contingent interest will be one which gives no right at all unless or until some future event happens such as the exercise of a discretion by the trustee or some other person.”

We note that PCG 2016/16 which covers ‘fixed entitlements and fixed trusts’ expressly provides:

> “1. This Guideline outlines the factors the Commissioner will consider when deciding whether to exercise the discretion [1] to treat an interest in the income or capital of a trust as being a fixed entitlement. This can result in a trust being treated as a fixed trust under the trust loss provisions and is also relevant when applying other provisions in the tax legislation which rely on the concept of 'fixed entitlement'
>
> 4. This Guideline does not apply:
>
> For the purposes of the 'non-arm's length income' rules in section 295-550 of the Income Tax Assessment Act 1997 (ITAA 1997) or the 'special income' rules in the former section 273 of the ITAA 1936. The Commissioner's view of the concept of fixed entitlement in those provisions is explained in Taxation Ruling TR 2006/7 Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income.”

Given there has been some time period since TR 2006/7 and development in the law, the Commissioner should clarify the status of fixed trusts and 'fixed entitlement' in view of the guidance already provided in TR 2006/7 and PCG 2016/16; the latter which the Commissioner has stated does not apply for NALI purposes.

12. Substantiation

A practical manner of substantiating the value of services provided is required. For example, where an SMSF trustee provides services, what benchmark evidence is required? In the examples provided, there are both white collar and blue collar workers including professionals who may provide services. Where say a qualified accountant, financial planner or lawyer provides services to their own SMSF via their business entity in contrast to their own individual capacity and not in any trustee capacity, what is the correct amount that they should charge a fund?

For example, if an accountant usually charges out in their business entity at $200 per hour and attends to some accounting work personally in an individual capacity, would the ATO accept a rate of say $40 per hour to reflect a general hourly rate for an unqualified person?

The difficulty of establishing the correct amount to charge is critical for the industry to have clear practical guidance from the ATO on. In this regard, the ATO could provide some guidance material that would set some parameters for SMSF trustees and directors to comply with. For example, if instead of engaging a real estate agent to collect rent and have direct contact with a tenant in a rental property which may cost 4% to 7% pa of the gross rent collected, could the SMSF pay the SMSF trustee an hourly rate for their time attendances and record their time and seek to benchmark to certain benchmark hourly rates that have a safe harbour status from the ATO?

13. Treatment of guarantees

As you will appreciate certain SMSFs may not be able to obtain a borrowing without an SMSF trustee/director offering a guarantee.

A guarantee may be provided as a standard commercial/legal requirement and there may be no differential in the other terms and conditions of a loan, with or without a guarantee (eg, the lender would still charge the same interest rate and the same LVR). However, many lenders will only offer a loan if a guarantee is provided.

Further, certain non-bank lenders are requiring guarantees to be supported by security such as a first registered mortgage/charge on the SMSF trustee/director's family home.

It is not uncommon for LRBAs to require a guarantee to be provided. The LCR is silent on how guarantees are to be treated for NALE purposes and The Tax Institute requests the LCR includes this guidance.

14. Practicality/GAAR panel

The NALI/NALE rules are anti-avoidance rules that have serious ramifications as technically they can be invoked for small matters, yet have substantial adverse tax implications. We consider that any ATO decision to apply the NALI/NALE provisions should be first referred to the General Anti-Avoidance review (**GAAR**) or a similarly constituted panel with outside experts to ensure these anti-avoidance provisions are applied appropriately.

15. PCG 2019/D6

The PCG should apply across the board to any taxpayers where the ATO seeks to apply the new NALI/NALE provisions for any of the FY2019 or FY2020 periods.

As noted above, The Taxation Institute rejects the ATO's position that the PCG be limited so as to apply only in the instance where a general expense taints all the fund's income.

The ATO may also wish to outline in the PCG the type of services that are typically considered a trustee/internal arrangement compared to those that are external/non-trustee type service.

The PCG should also set out a position with respect to matters that should be regarded as de minimis and ignored.

16. Paragraph 59 - Date of effect

We recommend that given the delay in introducing the NALE reforms, that the ruling in relation to the NALE measures only take effect from 1 July 2020. This will provide the ATO with reasonable opportunity to communicate the changed measures leading up to the 30 June 2020 deadline.
The Taxation Institute members have already reported that substantial changes may need to be made in order to address the new provisions.

17. Submission to Treasury on the draft Bill

For completeness, we attach a copy of the detailed our submission lodged with Treasury in relation to the draft legislation. We feel that the ATO should gain a deeper insight to our members' concerns by also taking into account this submission as we did not support the recent legislative changes.

* * * * *

If you would like to discuss, please contact either me or Tax Counsel, Angie Ananda, on 02 8223 0050.

Yours sincerely

President

Annexure A

Vxep lvlrq#0#
Vxshudqqxdwlrq#Frp

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