Non-arm's length income risk and LCR 2021/2

William Fettes, Senior Associate

DBA Lawyers

Ph: 03 9092 9400 Mob: 0438 019 977

Email: wfettes@dbalawyers.com.au

Web: www.dbalawyers.com.au Twitter: @DBALawyers

7 September 2021

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Overview

- Broadly, under s 295-550(1) the ordinary and statutory income of a super fund will be NALI and taxed at 45% where:
  - (a) there is income derived as a result of a scheme where the parties to the scheme were not dealing at arm's length and the amount of income derived is more than would be the case on an arm's length basis; or
  - (b) & (c) there is a loss, outgoing or expense incurred by a superannuation fund and the amount is less than arm's length amount or otherwise nil where an amount ought to have been incurred on an arm's length basis in respect of income derived on after 1 July 2018

NB1: Paras (b) & (c) were added for NALE from 1 July 2018

NB2: Deductible expenses attributable to the income reduce NALI (ITAA1997 s 295-545(2))

Overview

- Old NALI provisions (ie, prior to the reworded legislation) apply before 1 July 2018
- Concept of non-arm's length expenditure (NALE) applies from 1 July 2018 subject to PCG 2020/5 for FY2019 to FY2022 — implications for Part A of the IAR
- Proposed PCG from 1 July 2022 to cover 'reasonable attempts' to benchmark expenditures
- NALI associated with NALE applies to 'schemes' entered into prior to 1 July 2018
- An example of a pre-1 July 2018 scheme:

  SMSF acquires business real property from a related party based on curb side appraisal by a real estate agent in 2000 which has increased in value over 21 years by 400%

  - ATO detects large income, eg, a net capital gain on disposal
  - SMSF trustee self-assesses on the basis of the income not being NALI
  - ATO asserts NALI and taxpayer must prove it is not NALI
  - Ongoing income and any net capital gain can be at risk

Overview

- The NALE aspect of the **Superannuation Taxation Integrity Measures Consultation Paper** of 11 January 2018 was focused on LRBAs (the other measure in this CP was also aimed at LRBAs to include the loan amount in members' TSBs)
- The ***Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019* (Cth)** applies from 1 July 2018 (finalised as law on 2 October 2019)
- LCR 2021/2 was originally issued in draft in December 2018 as **LCR 2018/D10** and then revised in October 2019 as **LCR 2019/D3.** Both draft and the final LCRs reflect the **general expense nexus** issue
- The ATO did take on feedback along the way and recognising the **general expense nexus** view was causing controversy issued PCG 2020/5 on 29 May 2020 confirming no compliance resources would be allocated to review where a general expense enlivens NALE from 1 July 2018 to 30 June 2022
- **LCR 2021/2** issued on 28 July 2021. The ATO's practical approach from 1 July 2022 proposes no compliance action where reasonable benchmark evidence exists regarding services provided to an SMSF regarding a general expense

General & Specific NALE

General & Specific NALE

- Note that s 295-550(7) provides:

  Paragraphs (1)(b) and (c) and (5)(b) and (c) apply to a **loss, outgoing or expenditure** whether or not it is of **capital** or of a capital nature.

- LCR 2021/2 [14]-[17]:

  In applying s 295-550(1)(b) and (c) or s 295-550(5)(b) and (c) ([NALE] provisions), it is necessary to identify the relevant **scheme** under which the parties to the scheme were not dealing with each other at arm's length. …

  It is therefore necessary to identify both the **steps** of the relevant **scheme** and the **parties** that deal with each other under those steps of the scheme.

  ... it is then necessary to determine whether the ... **fund incurs [NALE]** in gaining or producing the ... income ...

  ... there **must be a sufficient nexus** between the **[NALE]** and the relevant ... **income**.

General & Specific NALE

- **General nexus NALE:** sufficient nexus to all of the ordinary and statutory income derived by the fund
- Not necessary for it to be deductible under s 8-1 for there to be NALE
- However, general nexus to all income will apply if an NALE expense is deductible under s 8-1, eg:
  - actuarial costs and accountancy fees (except where the deduction is covered under s 25-5)
  - audit fees
  - costs of complying with a 'regulatory provision' as defined in s 38A of the *Superannuation Industry (Supervision) Act 1993 (Cth)* (unless the cost is a capital expense)
  - trustee fees and premiums under an indemnity insurance policy
  - costs in connection with the calculation and payment of benefits to members (but not the cost of the benefit itself)
  - investment adviser fees and costs in providing pre-retirement services to members
  - other administrative costs incurred in managing the fund.

General & Specific NALE

- **Specific nexus NALE:** expenditure, outgoing or loss with a sufficient nexus to a particular source of income (eg, ordinary and statutory income associated with a particular fund asset)
  - **Example 1** – Armin NALE on acquiring property ([22] to [23])

    Armin's SMSF purchases from himself commercial property valued at $800k for $200k. A third party tenant leases the property. The rental income and net capital gain on disposal is NALI

General & Specific NALE

- Thus, the ATO view is that a lower expense (NALE) can result in a 45% tax on:
  - for general nexus - all of the ordinary and statutory income of the fund
  - for specific nexus – all of the ordinary and statutory income from the relevant asset
- ATO view that a lower general expense can taint a large APRA fund's income too.
- Large APRA funds are reviewing their operations, contracts, etc

General & Specific NALE

- Practical tips:
  - Need to be vigilant on NALE/NALI risks
  - Benchmark evidence required for related party dealings
  - Annual review related party dealings, eg, review of leases, LRBAs and services supplied
    - Are the terms and conditions being complied with, eg, rental indexing?
  - Check for evidence on significant prior acquisitions from related parties
  - No need to qualify opinion in Part A of the IAR for general expense NALE for FY2019 to FY2022
  - NB: PCG 2020/5 does not cover specific nexus NALE!

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Capacity

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Capacity

- Certain **trustee services** do not give rise to NALE, eg, the trustee doing bookkeeping or accounting (without using business resources, etc)
  - Section 17A of the SISA precludes an SMSF trustee being remunerated [40]
- Services provided in **individual capacity** do give rise to NALE, eg, a builder doing work without remuneration [43]
- There are four factors in s 17B of the SISA relevant to trustee remuneration [41]:
  - Service or duties performed in non-trustee capacity
  - Appropriately qualified, and holds all necessary licences
  - Provides services to the public as part of that person's business
  - Remuneration no more favourable than arm's length
- NB: These rules do not apply to unit trust trustees!

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Capacity

- A Trustee is required to perform certain actions, including:
  - Statutory obligations
  - Fiduciary obligations
  - Trust deed obligations [44]
- Skills and knowledge, by itself, do not suggest individual capacity [46]
- A Trustee should be presumed to be acting in their capacity as trustee. Factors pointing to individual capacity:
  - Charging a fee
  - Use of equipment and assets of a business, profession or employment **unless minor, infrequent or irregular**
  - A licence and/or qualification is required to provide the service
  - Insurance coverage [47]

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Capacity

- **Example 6** – Leonie the accountant doing accounts ([54])

  Leonie is a trustee of an SMSF ... She is a chartered accountant and registered tax agent who is employed in an accounting and tax agent business. **Leonie in her capacity as trustee**, prepares the accounts and annual return for the fund. She **does not use the equipment or assets of her employer**, nor does she lodge the annual return using her tax agent registration. As she performs these duties or services as trustee of the SMSF, she does not charge the fund for this work. The **[NALE] provisions do not apply** as the duties or services performed by Leonie are **in her capacity as trustee …**

- **Example 7** – Levi financial advisor ([55] to [57])

  When at home, but not while working or billing clients, Levi undertakes the bookwork and occasionally makes online investments for his SMSF using the computer and office equipment supplied by the business. … Levi performs these activities as trustee … Levi's use of the computer and office equipment at home is minor and incidental in nature …

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Capacity

- **Example 9** – Plumber with 2 x rental properties ([61] to [69])

  Trang is the trustee of her SMSF of which she is the sole member. She is also a plumber by trade and runs her own business as a sole trader in which she also employs an apprentice, Novee.

  Property #1 – income is not NALI:

  Trang's SMSF has two investment properties which are leased for a commercial rate of rent.

  Trang fits some equipment supplied by the tenant after work using her tools.

  Trang's use of the tools of her trade in respect of this property is minor, infrequent or irregular…

  Property #2 – Rental income and future net capital gain on disposal is NALI:

  … Trang undertakes a complete renovation of the bathroom and kitchen. She schedules time in her work calendar to undertake the work and uses the tools of her trade to undertake all plumbing work on the renovations. She also engages Novee in all works.

  Trang does not charge the SMSF for the work undertaken …

  In this instance, Trang's use of the tools of her trade will not be considered minor, infrequent or irregular in nature. Considering all her activities, she will be considered to be undertaking these services in her individual capacity, rather than as trustee for her SMSF.

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Capacity

- **Example 10** – Jean the licenced electrician ([70] to [71])

  Jean undertakes electrical work on the rental property that can only be done by a licenced electrician. In that instance, the work done by Jean is not as trustee of his SMSF but in his individual capacity. Jean charges the SMSF the commercial rate for the work undertaken on the rental property.

  Accordingly, the [NALE] provisions will not apply.

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Recurrent expenses

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Recurrent expenses

- NALE connected with asset acquisitions by an SMSF has a specific nexus and will typically forever taint the asset's income, see, eg [18]:

  [NALE] incurred to acquire an asset (including associated financing costs) will have a **sufficient nexus to all ... income derived by he ... fund in respect of that asset**. This includes any capital gain derived on the disposal of the asset (see Example 1 of this Ruling). … even where the trustee subsequently refinances the borrowing arrangement on arm's length terms …

- This appears to preclude rectification strategies to cure NALI
- NALE that is not connected with an asset's acquisition can be recurrent and subject to rectification for future income years
- LCR 2021/2 [21]:

  Where a … fund incurs [NALE] of a **recurrent nature** (**that does not relate to the acquisition** of an asset) under a scheme that only has a **nexus** with the fund deriving … income during **a particular income year**, and subsequently ceases to incur that [NALE] in a later income year, income derived by the fund in that later income year is not NALI…

  Interest expenses incurred under a … (LRBA) is an example of recurrent expenditure that is incurred in relation to an acquisition of an asset.

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Recurrent expenses

- **Example 4** – Kellie's non-commercial LRBA ([34] to [37])

  Kellie's SMSF pays the $2M for a property using a non-commercial LRBA (ie, the loan is for 100% LVR, 1.5% p.a. interest and repayment on an annual basis over a 25 year term).

  If Kellie's SMSF had entered into an LRBA on arm's length terms, it would be expected that repayments of principal and interest would have occurred on a **monthly** basis and interest would be charged on the LRBA at a commercial rate. The loan to market value ratio would have also not exceeded commercial levels.

  The [NALE] incurred under the LRBA will also result in any capital gain that might arise from a subsequent CGT event happening in relation to the property … being NALI. This will be the case **regardless of whether the LRBA is subsequently refinanced** on arm's length terms.

Query if this phrasing is compatible with PCG 2016/5 and TD 2016/16?
What about a loan agreement entered into based on appropriate evidence of arm's length commercial dealings that is not P&I and not monthly repayments?

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Recurrent expenses

- **Example 2** – Mikasa accounting services ([24] to [26])

  Mikasa's SMSF engages her accounting firm (she is a partner) to prepare the financials for FY2021 for no fee. All of the fund's income for that FY is NALI*****.

  However, in FY2022 an arm's length fee is charged and there is no NALI

  ***** PCG 2020/5 provides some comfort in relation to FY2021 in any event

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Recurrent expenses

- **Example 11** – Sharon the real estate agent ([72] – [75])

  Sharon is a director of the corporate trustee of an SMSF of which she is the sole member. She is a licensed real estate agent and is the director of Ringo Real Estate Pty Ltd (**Ringo RE**) which runs a real estate business, including property management services for rental properties. The SMSF holds a residential property which it leases for a commercial rate of rent. Sharon provides property management services to the SMSF as a licenced real estate agent. She **utilises the equipment and assets of** Ringo RE (including the business' website) in performing these services. Her actions are covered by the applicable **insurance policies** …. Accordingly, Sharon provides property management services in her individual capacity to the SMSF with respect to the residential property. Ringo RE does not have a discount policy … **She charges the SMSF 50% of the price for her services** that Ringo RE would otherwise charge a party.

  As such, there is sufficient nexus between the [NALE] and the rental income derived from the residential property. …

  Due to the nature of the [NALE], there will not be a sufficient nexus between the non-arm's length expenditure and any future capital gain made by the SMSF on the disposal of the residential property.

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Recurrent expenses

- Tips:
  - Training on recurrent expenses and detecting the nexus with:
    - the acquisition of the asset – all ordinary and statutory income is exposed
    - the ongoing holding of the asset – exposes ordinary and statutory income in particular FYs
  - Careful checking on acquisition of assets from all related parties. If the value of an asset cannot supported say many years later, there is a risk of NALI due to ATO benchmarking detection techniques when a significant gain is realized

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Pricing & Discounts

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Pricing & discounts

- LCR at [51]:

  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****. Such arrangements will still be on arm's length terms where they are consistent with normal commercial practices, such as an individual acting in their capacity as trustee (or a director of a corporate trustee) being entitled to a discount under a discount policy where the* ***same discounts*** *are provided to* ***all*** *employees, partners, shareholders or office holders.*

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Pricing & discounts

- LCR at [53]:

  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 … (APRA) fund either by the trustee acting in a separate capacity or by a related third party. In this context, a trustee of a large APRA fund that charges the fund on a cost-recovery basis will not result in the non-arm's length expenditure provisions applying.*

- No comfort for SMSFs, eg, where property building/renovation work is charged on a cost recovery basis

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Pricing & discounts

- Note in the EM at [2.49]:

  *It can be difficult to determine an exact price that is 'non-arm's length'. An **'arm's length' price** may be accepted to **fall within a range of commercial prices**. For example, loans may be available at different interest rates based on a range of factors. Accordingly, an SMSF may be able to apply an acceptable commercial rate of interest to a loan within a band of rates available to it on an arm's length basis.*

- Valuers often provide a range, eg, the property's market value is between $1 to $1.1 million
  - The ATO generally willing to accept a value between a range that is supported by sufficient and appropriate evidence
  - NB: best evidence is a full valuation report from an independent qualified valuer for real estate and ensure their methodology is reasoned and appropriate
  - Do not relay on website and curb site appraisals
  - Refer also to ATO QC 26343 on acceptable valuation evidence

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Pricing & discounts

- Practical tips:
  - Need to ascertain and carefully review all discounts
  - Is there a firm policy supporting the discount being available for all employees/partners/shareholders/officeholders?
  - Appropriate and sufficient valuation evidence is the key

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Contributions Vs. NALE

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Contributions vs. NALE

- In TR 2010/1 the ATO previously expressed the view that a member who sells an asset to an SMSF for less than its market value makes a contribution for the amount of discount (see TR 2010/1)
  - This is no longer the ATO's view
- The ATO is seeking to clarify the current position so that both NALI and a contribution do not typically arise on the same transaction
- TR 2010/1DC sets out proposed revisions to the contributions ruling in TR 2010/1 to provide clarity

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Contributions vs. NALE

Principles from LCR 2021/2 and TR 2010/1DC:

- Purchasing an asset below MV under a sale contract gives rise to NALI and does not result in the difference b/n the MV and the consideration being treated as a contribution
- An in specie contribution can be made in conjunction with a … fund purchasing part of an asset where a contract makes it clear the fund is only acquiring part of the asset. In such situations, the fund:
  - purchases the interest in the asset specified under the contract, and
  - receives the in specie contribution of the remaining interest in the asset.
- An in specie contribution is required to be reflected at its market value in the fund's accounts and the member's superannuation interest
- The person making the contribution and the superannuation provider must act on an arm's length basis to ensure the NALI provisions are not enlivened

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Conclusions

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Conclusions

- In broad terms the NALI/NALE provisions favour the Revenue:
  - It does not matter how small or marginal the advantage is
  - A small amount of NALE can taint the entire income and capital gain (there is no apportionment, eg, ‘to the extent that …’)
  - NALI applies even if the SMSF is in pension mode
- There is some relief for general fund expenses :
  - PCG 2020/5 for FY2019 to FY2022 – no evidence required but its advisable to still have some
  - Proposed PCG from 1 July 2022 in relation to reasonable attempts to establish arm’s length expenditure

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Conclusions

- Extreme care is required to minimise NALI/NALE risk, eg, solid valuation and benchmarking evidence, strong record keeping, explanation of how all costs were incurred and paid on an arm’s length basis, etc
- Advisers need to be vigilant with all related party dealings especially any property development
- Industry bodies are making submissions regarding the potential for legislative change including in relation to:
  - Express apportionment, eg, ‘to the extent that …’
  - Only excess income being taxed at 45%
  - No general nexus concept tainting all income
  - Carve out for large APRA-regulated funds

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Questions

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Legal notice

These notes are a general guide only based on our view of the law as of 7 September 2021 and also reflect views of the ATO and others as indicated throughout these notes. This material involves new and complex provisions and is no substitute for expert advice. Anyone seeking to rely on these notes should obtain expert and up to date advice to confirm particular issues especially as this area is subject to ongoing changes and substantial tax and penalties can be imposed. We are not licensed to provide financial product advice under the *Corporations Act 2001* (Cth).

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