



THE TAX INSTITUTE

22 December 2021

Ms Lynn Kelly
First Assistant Secretary, Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: lynn.kelly@treasury.gov.au

Dear Ms Kelly

Reform of Non-Arm's Length Income and Expense Rules

Further to recent correspondence, meetings and discussions with Senator Hume's office, Treasury and the Australian Taxation Office (**ATO**), we write to request Treasury urgently support the need to amend the existing non-arm's length income (**NALI**) and non-arm's length expenditure (**NALE**) rules in section 295-550 (**the provision**) of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

Following the release of the ATO's recent Law Companion Ruling [LCR 2021/2](#) (**LCR**) and Practical Compliance Guideline [PCG 2020/5](#) (**PCG**), it has become evident that the administration of the provision is broader than the original policy intent.

On this basis, the Professional Bodies (**Bodies**), as noted in **Appendix A**, either separately or together, have engaged with Senator Hume's office, Treasury and the ATO on numerous occasions to raise concerns with the ATO's interpretation and broad implications of the provision.

We refer to various previous meetings and correspondence with the Treasury and the ATO for background. The Bodies' technical concerns with the operation and administration of the provision and the detailed background are most clearly set out in a joint letter dated 3 September 2021 from the Bodies to Senator Hume.

The Bodies are supportive of the original policy intent of the provision as outlined in **Appendix B**. We do not disagree with its purpose.

We also acknowledge the original consultation on the implementation of the provision. However, the consultation at the time did not include all peak industry bodies and did not draw out the issues we are now seeing in practice given the manner in which the consultation focused on the specific mischief that was being addressed. It was only once the ATO's recent interpretative guidance containing various examples was released that the full implications of the provision became apparent. These implications had not been fully considered in the original consultation.

The ATO's recent interpretative guidance highlights the Bodies' concerns with the broad implications of the provision that clearly have implications beyond those originally intended. Accordingly, we consider that the law needs to be amended so that superannuation fund members do not face adverse and unintended tax implications and their retirement benefits are not depleted in inappropriate circumstances, both for APRA-regulated funds and self-managed superannuation funds (**SMSFs**).

It is our opinion that the provision could, and should, be amended to rectify its scope and application while preserving the original policy intent. We have set out our rationale in this regard in **Appendix B** and included proposed solutions in **Appendix C** for the sole purpose of furthering this discussion. Please note that the proposed solution we proffer is a suggested approach only, and this would need to be shaped into the form and style of Treasury drafting so it is fit for purpose. We consider it imperative that further consultation with all the professional bodies is needed to ensure that any new draft legislation operates as intended.

If you would like to discuss any of the above, please contact Andrew Mills, Executive Director of The Tax Institute, on (02) 8223 0005.

Yours faithfully,



Peter Godber

President

Cc:

Senator The Hon Jane Hume, Minister for Superannuation, Financial Services and the Digital Economy

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APPENDIX A

List of Professional Bodies involved

Professional Body	Name and Position
Actuaries Institute	<p>Tim Jenkins, Convenor – Superannuation & Investments Practice Committee</p> <p>Vanessa Beenders, Head of Public Policy & Practice Excellence</p>
The Association of Superannuation Funds of Australia	<p>Julian Cabarrus, Director – Policy Operations, Member Engagement & External Relation</p> <p>Ian Roberts, Head of Tax, Sunsuper</p> <p>Damien Ryan, Tax Partner, Superannuation & Funds, KPMG</p> <p>Ross Stephens, Director, Corporate Tax, KPMG</p>
Australian Institute of Superannuation Trustees	<p>Carlos Lopez, Policy & Regulatory Analyst</p>
Chartered Accountants Australia and New Zealand	<p>Simon Grant, Group Executive – Advocacy & International</p> <p>Tony Negline, Superannuation Leader</p>
CPA Australia	<p>Dr Gary Pflugrath, Executive General Manager, Policy & Advocacy</p> <p>Richard Webb, Policy Advisor Financial Planning and Superannuation, Policy and Advocacy</p> <p>Michael Davison, Senior Manager, Advocacy and Retirement</p>
Financial Planning Association of Australia	<p>Benjamin Marshan, Head of Policy, Strategy and Innovation</p>
Financial Services Council	<p>Michael Potter, Policy Director, Economics & Tax</p>
Institute of Public Accountants	<p>Tony Greco, General Manager Technical Policy</p>
National Tax and Accountants Association	<p>Geoff Boxer, CEO</p> <p>Andrew Gardiner, Senior Tax Manager</p> <p>Siobhan Simpson, Taxation Manager</p>
Self-managed Independent Superannuation Funds Association	<p>Michael Lorimer, Managing Director</p>

Professional Body	Name and Position
SMSF Association	Peter Burgess , Deputy CEO
Tax & Super Australia	Pippa McKee , Chief Executive Officer Natasha Panagis , Head of Superannuation
The Tax Institute	Peter Godber , President Andrew Mills , Executive Director Scott Treatt , General Manager, Tax Policy and Advocacy Phil Broderick , Principal, Sladen Legal and Member of TTI's National Superannuation Technical Committee Daniel Butler , Director, DBA Lawyers and Member of TTI's National Superannuation Technical Committee

APPENDIX B

Policy intent

The original policy intent of the expansion of the scope of the NALI rule in section 295-550 of the ITAA 1997 was clearly expressed twice in the second reading speech to the *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019* by the Assistant Treasurer:

The bill also extends the existing non-arm's-length income rules to capture non-arm's-length expenses. This will ensure that superannuation funds can't circumvent the contribution caps by using non-arm's-length expenditure to inflate their overall income — for example, by borrowing money from a member at a reduced interest rate.

We have no disagreement with that policy intent.

Basis of concerns

As noted above, we have previously made representations to Senator Hume setting out our concerns with the operation and interpretation of section 295-550.

The introduction of the NALI rules and the ATO's interpretation of the provision, as published in the recently finalised LCR, will have far-reaching, harmful, consequences for members in commonplace scenarios. It is difficult to imagine that such needless outcomes were intended for hard-working Australians saving for their retirement. These rules apply with effect from 1 July 2018, including with respect to income derived as a result of an arrangement entered into prior to that date.¹

While the Bodies have a number of issues with the reach of these provisions, our overarching concern is that the ATO's interpretation of the law means that, rather than merely addressing the mischief at which the government policy was directed, the rules could result in unwarranted substantial and long-term detriment to fund members. It could also operate in conflict with a range of trustee obligations, including the newly enacted best financial interests duty (**BFID**) rule in the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SISA**).

Rationale for amendment

As mentioned above, consultation was undertaken, although it appears that not all the peak industry bodies were involved in that original consultation. In fact, reports from those who were involved suggest that the focus of the consultation was around addressing the narrower examples rather than the wider implications that arise, given the way the law was amended in October 2019.

That is, it seems that those involved in the consultation were not (and arguably could not be) fully aware of the potential scope of the amended provision. The scope of the law and the kind of practical issues and examples have come to light only following the release of the ATO's recent interpretative guidance. The current concerns of the Bodies were not anticipated or highlighted during the original consultation.

Our suggested proposal to amend section 295-550 does not alter in any way the original policy intent of the provision. In fact, it is intended that the provision still has the potential for broad application. However, we are aware that the kinds of issues that arise from the interaction of the

¹ Given the potentially severe consequences of the new law, the ATO has allowed a grace period in Practical Compliance Guide [PCG 2020/5](#). The ATO will not allocate compliance resources to determining whether the NALI general expenditure rule applies to the 2021–22 and earlier income years.

NALI/NALE provisions with the recently enacted BFID is an unintended consequence and could be addressed through better-targeted drafting of amendments.

We have worked through a number of case studies which we would be pleased to meet and discuss with you. Two of these are set out below at a high level, that illustrate that if the trustee of the fund does things at a discount for the fund, or does not charge the fund, the fund falls foul of the NALI rule that results in inappropriate and severe financial consequences for members.

Case study 1 — SMSF member who is a plumber

A member of an SMSF is a qualified plumber who carries on a business. The SMSF holds a residential rental property. The member undertakes a renovation of the bathroom in the property and on-charges only the cost of materials. As a result of the renovation, the managing estate agent suggests the rent should be increased by \$50 per week.

Under the current law, the ATO's view is that not only is **all** rent forever subject to NALI tax at the top rate of 45%, but the whole of the capital gain on disposal of the property in the future is also subject to the NALI tax rate of 45%.

Proposal: Our alternative proposal is that either the opportunity is given to correct the underpayment (in appropriate circumstances) or *only the additional rent* (for as long as is appropriate) *and/or only an appropriate part of the capital gain* is subject to the consequences of the provision.

Case study 2 — APRA-regulated fund

A common structure for large APRA-regulated funds is where the trustee company incurs, in addition to the mere appointment of directors and payment of trustee/directors' liability insurance, the various trustee office costs (occupancy costs, staff costs, etc). In some cases, in addition to the trustee office costs, the trustee company (in its personal/corporate capacity) may also be the party contracting with third parties such as the external administrator or custodian.

This structure is observed both in the profit for member sector (i.e. corporate superannuation funds, public sector superannuation funds and industry superannuation funds), and in the usual model in the retail sector.

However, while the trustee fee paid by the superannuation funds in the retail sector will frequently include a profit margin, the usual structure for those superannuation funds in the profit for member sector is that the only fee paid by superannuation funds to their corporate trustees is comprised of cost recovery of the underlying costs.

Based on the current interpretation of the law, as these expenses are general in nature, the NALI rule applies to treat all income of the APRA-regulated Fund (which may have millions of members) to be subject to 45% (including 45% tax on compulsory minimum superannuation guarantee (SG) contributions).

Proposal: Our alternative proposal is that unless (a) this can be determined to be a non-arm's length arrangement, and (b) a member was involved, it would be unnecessary to apply the provision.

APPENDIX C

We have set out below suggested approaches to potentially reform section 295-550. The suggested wording should be considered in conjunction with the guiding principles and notes described below.

Guiding Principles

When drafting the revised provisions below, we have proceeded on the assumptions of the guiding principles listed below:

- The provisions would be redrafted to operate consistently with other anti-avoidance provisions. In particular, we consider that the provision should not apply automatically. Instead, the provision should apply upon the exercise of the Commissioner's determination. This approach is consistent with the Commissioner's power to make determinations present throughout the tax legislation. Further, we consider that the provision should be targeted at the relevant mischief rather than, for example, all the income or expenditure of a fund.
- Under both options, the Commissioner would be empowered to make a determination that, where a transaction to which a member was a party was not undertaken at arm's length, the Commissioner would make such adjustments and consequential adjustments that were necessary to reflect the tax consequences of the transaction as if it had been conducted at arm's length.
- The Commissioner would have the discretion to allow the rectification of the breach of the NALE amount by the trustee and any other party. We consider that a discretion to allow rectification is an important aspect of the provision. It will encourage greater self-compliance and correction by trustees and their tax advisers, proactively engaging with the system to resolve NALE amounts.
- We consider that the provisions should not apply a punitive tax to a fund's income or expenditure. Rather, penalties for intentional non-compliance or repeated breaches could instead be imposed on the trustees themselves or any other party to the arrangement in accordance with the regime under Subdivision 284-C of Schedule 1 to the *Taxation Administration Act 1953* (Cth).

Option 1: re-write of the provision

The first proposed option aims to re-write the existing legislation with new principles that, in our view, ensure a reasonable outcome while achieving the same policy intent described above in **Appendix B**. This is our preferred approach as it ensures the provisions are drafted in a simple and effective manner to give effect to both the policy intent and our guiding principles above.

The proposed amended wording for section 295-550 under the first option is set out below:

- (1) The Commissioner may make a determination² that this section applies where a member, an associate of a member, or another person under an arrangement between the member and that other person, enters into a scheme or arrangement with the trustee of the member's fund, and as a consequence of that scheme or arrangement, one or more of the following applies:

² We understand that, in the process of making this determination, the Commissioner is bound by the usual rules of administrative decision making and therefore such determination must always be reasonable.

- (a) an amount of income of the fund is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;
 - (b) in gaining or producing an amount of income of the fund, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;
 - (c) in gaining or producing an amount of income of the fund, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.
- (2) If the Commissioner has made a determination that this section applies, he must give a notice to the trustee of that determination and of the difference between the relevant amount (or part thereof) of a transaction and the arm's length amount of that transaction (the **Arm's Length Shortfall Amount**).
- (3) Within 60 days of receiving the notice, or such further time approved by the Commissioner, the trustee must:
- (a) if the Commissioner is satisfied that the Arm's Length Shortfall Amount arose from an honest or inadvertent error, enter into an agreement with the Commissioner to rectify the transaction such that it reflects the correct arm's length amount; or
 - (b) advise the Commissioner that it will treat the Arm's Length Shortfall Amount as an excess concessional contribution of the relevant member or members, and unless the Commissioner is satisfied that the Arm's Length Shortfall Amount arose from an honest or inadvertent error:
 - (i) not claim a deduction for the arm's length shortfall amount; or
 - (ii) where the arm's length shortfall amount would otherwise be included, or deemed to be included, either directly or indirectly, in the cost base or reduced cost base of an asset, reduce the cost base or reduced cost base of the asset by that amount.
- (4) If the trustee fails to so advise the Commissioner, the Commissioner may make whichever of the adjustments in (3) that he or she deems appropriate.
- (5) Where the trustee makes a choice under (3) to treat the Arm's Length Shortfall Amount as an excess concessional contribution, the trustee must release, the Arm's Length Shortfall Amount as an excess concessional contribution less the applicable tax payable by the complying superannuation entity.³
- (6) This section does not apply to a transfer of an asset to a complying superannuation entity by a member where the arm's length shortfall amount is treated as a non-concessional contribution of that member.

³ We note that this subsection may need to be inserted into another area of the law to ensure it operates as intended.

- (7) This section does not apply to an amount that is a concessional contribution.

Option 2: re-draft utilising existing principles within the provision

The second proposed option below utilises the existing principles in the provisions and makes modifications to achieve the guiding principles described above. This is not our preferred approach given the inherent complexity in the drafting.

The proposed amended wording for section 295-550 under the second option is below:

- (1) An amount of ordinary income or statutory income is non-arm's length income of a complying superannuation entity if, as a result of a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme, the Commissioner determines⁴ one or more of the following applies:
- (a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;
 - (b) in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;
 - (c) in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.
- (2) The Commissioner may determine that an amount of *ordinary income or *statutory income is also non-arm's length income of the entity if it is:
- (a) a *dividend paid to the entity by a *private company; or
 - (b) ordinary income or statutory income that is reasonably attributable to such a dividend;
- to the extent that the amount is not consistent with an *arm's length dealing.

Subsections (3) and (4) remain unchanged

- (5) The Commissioner may determine that other income *derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is non-arm's length income of the entity to the extent that if, as a result of a *scheme the parties to which were not dealing with each other at *arm's length in relation to the scheme, one or more of the following applies:
- (a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;

⁴ We understand that, in the process of making this determination, the Commissioner is bound by the usual rules of administrative decision making and therefore such determination must always be reasonable.

- (b) in acquiring the entitlement or in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme; or
- (c) in acquiring the entitlement or in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.

The determination is limited to the **Arm's Length Shortfall Amount**.

Subsections (6) and (7) remain unchanged

- (8) Subsections (1) and (5) do not apply in relation to an amount that is a loss, outgoing or expenditure incurred, or might otherwise be expected to be incurred, by a complying superannuation entity for the provision of services by a Trustee, a Director of a company which is a Trustee, or a member of the complying superannuation entity to the complying superannuation entity or a fixed trust in which the complying superannuation entity holds an interest, where:
 - (a) the services were provided by a Trustee, or a Director of a company which is a trustee, of the complying superannuation entity, unless those services were provided, directly or indirectly, under an arrangement with a member; or
 - (b) if the services were provided by a member or, directly or indirectly, under an arrangement with a member of the complying superannuation fund, then within 60 days of being notified of the determination, or such further time approved by the Commissioner, the trustee:
 - (i) if the Commissioner is satisfied that the Arm's Length Shortfall Amount arose from an honest or inadvertent error, enter into an agreement with the Commissioner to rectifies the transaction such that it reflects the correct arm's length amount; or
 - (ii) advises the Commissioner that it will treat the Arm's Length Shortfall Amount as an excess concessional contribution of the relevant member or members, and unless the Commissioner is satisfied that the Arm's Length Shortfall Amount arose from an honest or inadvertent error, that it will:
 - a. not to claim a deduction for arm's length shortfall amount; and
 - b. where the arm's length shortfall amount would otherwise be included, or deemed to be included, either directly or indirectly, in the cost base or reduced cost base of an asset, reduce the cost base or reduced cost base of the asset by that amount.
- (9) Where a member makes an election under subsection (8)(b)(ii), the complying superannuation entity must release, and the Commissioner must permit the release of, the amount treated as an excess concessional contribution less the applicable tax payable by the complying superannuation entity.⁵

⁵ We note that this subsection may need to be inserted into another area of the law to ensure it operates as intended.

- (10) Subsection (1) does not apply to a transfer of an asset to a complying superannuation entity by a member where the arm's length shortfall amount is treated as a non-concessional contribution of that member.
- (11) Subsection (1) does not apply to ordinary shares acquired by a fund in respect of the employment of a member where any discount on acquisition of those shares is included in the assessable income of the employee under Subdivision 83A-B or Subdivision 83A-C of this Act, where:
- (a) the complying superannuation entity pays for the acquisition of the shares;
 - (b) the member chooses for any discount assessed under Subdivision 83A-B or Subdivision 83A-C of this Act to be treated as a non-concessional contribution to the fund; and
 - (c) the member's non-concessional contribution limit is not exceeded.
- (12) This section does not apply to an amount that is a concessional contribution.

Definitions:

Arm's length shortfall amount is the difference between the relevant amount (or part thereof) of a transaction and the arm's length amount of that transaction.

Notes

When considering the draft provisions above, please note that:

- The above drafts are for illustrative purposes only. We note that the design of these alternative provisions would benefit from further consultation with industry, including the testing of case studies we may not have considered. The Tax Institute is of the strong view that further consultation with all the professional bodies should be undertaken to ensure any amended provisions operate as intended.
- We consider that determinations are more desirable in this instance than a discretion. The use of a discretion leads to uncertainty, especially given the ATO's current views on the application of the provision are over-reaching their intended operation. Requiring the Commissioner to make a determination ensures that the provision continues to operate as intended, but empowers the Commissioner to not make a determination if doing so would result in inappropriate outcomes.
- Our proposed options set out above ensure that there is a controlled mechanism to facilitate the rectification of non-arm's length dealings where the application of the provisions would otherwise give rise to inappropriate and unintended outcomes. Accordingly, the Commissioner would have the ability to not make a determination in minor cases. Examples of minor instances include the provision of bookkeeping or accounting services by a member or trustee of a fund that may otherwise result in all of the fund's income including SG contributions being tainted.⁶

⁶ Paragraph 91 of LCR 2021/2 notes 'that general fund expenses are non-arm's length is likely to have a very significant tax impact on the complying superannuation fund, even where the relevant expenses are immaterial.'

- The proposed rectification continues to operate as a disincentive for the targeted non-arm's length arrangements. The alternative provisions instead encourage trustees, members and advisers to undertake the proper compliance activities and engage with the Commissioner to resolve non-arm's length transactions. As currently drafted, the consequences of the provisions have such severe consequences that these parties are not incentivised to engage and resolve these issues.