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Technical Bulletin: Non-arm's length expenses – changing old habits

"Does my SMSF have to pay for that?" Or, "how much does my SMSF have to pay for that?" Both are pretty innocuous questions, but now more than ever SMSF expenditure is under the spotlight. In light of the recent 'Your Future, Your Super' best financial interest duty to be imposed on SMSF trustees, it appears the issues won't go away in a hurry. Expenses have for some time created compliance and taxation issues, largely around contributions, but since 1 July 2018 they can add a whole new layer of taxation pain for what could otherwise have been considered frugal operating practices in the best interest of an SMSF. The divide between SIS compliance and tax administration has often created issues but SMSF expenditure appears to be an issue that keeps on giving, or in this instance taking, and the key issues associated with fund expenses are the focus of this bulletin.

The tax disincentive

Over time tax law has evolved to disincentivise certain income from being diverted into SMSFs or to discourage trustees from engaging in certain practices to enhance their superannuation balance and reduce their tax liability. Having certain income treated as non-arm's length income (NALI) and being taxed at the highest marginal tax rate, is intended to be the disincentive in the concessionally taxed super environment.

As a flow on from the 2017 super reforms and resultant reduction in the contribution caps, the Government had concerns people would look for new ways to get more funds into SMSFs using various schemes or strategies. Anecdotally these concerns were based on the few rather than the many, but rather than address any core issue a catch all approach was taken. To broaden the scope of NALI, the Government introduced the concept of non-arm's length expenditure (NALE) which requires a fund to ensure that not only is all income derived on a commercial basis, but all expenses associated with fund income are commercial. These NALE provisions apply from 1 July 2018 and ideally target questionable investments.

Late in 2019 the ATO released Draft Law Companion Ruling LCR 2019/D3 'Non-arm's length income – expenditure incurred under a non-arm's length arrangement', which is a guide to how the NALE provisions will apply. This document has remained in draft format for the entirety of 2020, in part because of Covid-19 but also as a likely result of the significant feedback questioning how NALE would be applied.

In recognition, the ATO released Practical Compliance Guideline PCG 2020/5 'Applying the non-arm's length income provisions to non-arm's length expenditure', which indicates that they will not allocate compliance resources in relation to certain general expenses for the period from inception up to and including the 2020/21 Financial Year. This gives the Regulator time to finalise the draft ruling and it also gives industry time to adjust to existing practices if necessary.

It should be noted that the ATO make it clear that their interpretations within the LCR that relate to specific investments and the expenses associated with them have and will continue to apply from 1 July 2018. Therefore, any compliance review the ATO undertake throughout this period could identify certain expenses that result in NALI applying.

As NALI can have significant tax consequences for a fund it's important to understand what arm's length means, what NALI and NALE are, and what anomalies these new provisions create that need to be addressed at both a regulatory and trustee level, let's call these the common sense items.

What does arm's length mean to an SMSF?

The ATO state, arm's length is where "a prudent person, acting with due regard to his or her own commercial interests, would have agreed to the terms". As such, investments must be made and dealt with by an SMSF on a commercial basis in all circumstances and when dealing with all parties, related or otherwise. This is an objective versus subjective conundrum.

What is NALI and NALE?

Under the subsection 295.550(1) of the Income Tax Assessment Act 1997 (ITAA97), an amount of ordinary or statutory income is NALI if the parties to a scheme are not dealing with each other at arm's length in relation to the scheme. From 1 July 2018 NALI can apply if the amount of income received is more than what would have been received if dealing at arm's length OR expenses are comparatively low or non-existent.

Under the amended tax provisions, where the loss, outgoing or expenditure is less than what would have been incurred or there was no loss, outgoing or expenditure incurred compared to what you would expect when the parties were dealing at arm's length, NALI arises.

Essentially, when expenditure is less than what would be expected in an arm's length dealing, NALI can arise. The main issue is that most SMSFs rightfully take a "compliance first" approach and the SIS Act 'arm's length' rules are significantly different to the Tax Act 'arm's length' rules and related party transactions that favour the SMSF rather than the related party have largely been considered ok so long as they fit within the investment restriction guidelines and contribution rules. Tax rules don't distinguish which party is favoured.

How do we identify NALE?

To identify NALE we need to look at identifying if there is a scheme. The definition of a scheme, taken from subsection 995-1 of the ITAA97, "A scheme is defined as any arrangement, or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise". So ultimately a scheme means any dealings the SMSF trustee may have.

Once we have identified a scheme, there must also be a connection between the expenditure, or lack thereof, and the ordinary or statutory income a fund receives for NALE to apply. The expenditure must have been incurred in gaining or producing the relevant income or acquiring an entitlement to the income of a trust, or alternatively no expenditure occurred. The expenditure can be of a revenue or capital nature. Expenditure linked to specific investments is easily identified, such as rental property expenses linked to rental income and capital gains on the property. Where NALE arises on expenditure to acquire an asset, there will a sufficient nexus to all ordinary and statutory income of that particular asset and any capital gain on disposal of the asset. The following example highlights how NALI would apply to specific expenditure.

Example 1 - Specific Investment Income - rental expenses not on arm's length

The Jones Superannuation Fund holds multiple investment properties as part of their considered investment strategy. These properties were purchased on arm's length terms and the rent is also considered to be arm's length. As part of the ongoing maintenance of the properties Mr & Mrs Jones engage Mrs Jones' brother, a qualified electrician, to install smoke detectors in all properties. He charges for the SMSF for the parts but not the labour. Therefore, a specific nexus between the expense and the rental income exists and NALI applies as follows:

Fund income and expenditure	
Rental income	$100,000
Rental expenses	$15,000
Other income	$18,000
Contributions	$40,000
General expenses	$6,000

Non-Arm's length component	
Rental income	$100,000
Rental expenses	$15,000
	$85,000
Tax at 45%	$38,250

Low-tax component	
Other income	$18,000
Contributions	$40,000
General expenses	$6,000
Other	$52,000
Tax at 15%	$7,800
Total Tax	$46,500

General expenses

The biggest issue with these changes is that the ATO deem that some expenses, such as accounting fees, have a sufficient connection to ALL of the ordinary and statutory income of a fund, according to LCR 2019/D3. This is where greater clarity from the ATO is still required as this has the capacity to impact many funds and is surely not the intent behind big ticket schemes the Government were attempting to stamp out such as interest expenses on LRBAs.

Example 2 - General Income - Fund expense not on arm's length

Let's revisit the Jones Superannuation Fund. Mr Jones works at an accounting firm and he prepares and lodges the fund's annual return using the company resources, the company does not charge the SMSF. Their standard SMSF accounting fee is $2,500 pa. Based on LCR 2019/D3 in its current form, a nexus exists between the expenditure and all fund income and as a result NALI applies as follows:

Fund income and expenditure	
Rental income	$100,000
Rental expenses	$15,000
Other income	$18,000
Contributions	$40,000
General expenses	$6,000
Non-Arm's length component	
Rental income	$100,000
Rental expenses	$15,000
Other income	$18,000
Contributions	$40,000
General expenses	$6,000
	$137,000
Tax at 45%	$61,650

Accounting Fee Perspective

To put some perspective on this, the ATO recently released their annual statistical overview for the year ended 30 June 2018. For the first time ever the ATO broke down fund expenses between investment and operating expenses. On average, operating expenses represent less than 0.5% of total fund assets. In the bigger picture discounted accounting fees is hardly a scheme by which the average SMSF trustees is trying to funnel monies into superannuation to minimise tax, abuse contribution caps, manipulate the total superannuation balance and increase savings. Conversely most funds will pay slightly higher tax by not having an associated deductible operating cost to offset the income and increased super savings will have an adverse impact on the total superannuation balance.

Administrative costs aside, there are two key issues that cloud this matter, the first is under what capacity are certain functions being performed? The second issue is that these changes undermine long held practices of treating certain transactions as contributions. Where does that leave us with reference to these issues?

Trustee v individual capacity

The NALE provisions are not intended to apply where a trustee provides services to their SMSF in their capacity as trustee. This requires an objective consideration of the individual's circumstances to assess their ability to perform an activity.

The following factors are provided by the ATO to assist in determining whether a function is performed in an individual rather than trustee capacity:

- An individual charges the SMSF for the services performed;
- An individual uses equipment and other assets of their business (or employment);
- An individual performs activities pursuant to a licence and or qualification related to their business, profession or employment
- The activity is covered by an insurance policy related to their business or professions or employment.

So, to be clear, where an individual performs services in their capacity as trustee and they do not charge for the service NALI provisions will not apply. This in itself is incorporated into the definition of an SMSF, SISA 17A, where trustees cannot be remunerated. Referencing the example above, if Mr Jones used his home computer and lodged his SMSF return personally then there is no issue and no NALI. That's a huge tax differential based on which computer was used!

Under section 17B of the SIS Act, a trustee can be remunerated for services performed if the services are performed other than in capacity as trustee and they are appropriately qualified and licenced to do so, and they charge commercially. This measure was brought in following significant industry discussion about SMSFs engaging related party builders and how a fund should deal with such engagement. Whether as a direct result or not, it was a progression from the period the ATO was contemplating what constituted a contribution with one of the key factors in contributions being anything that increases the capital of the fund, more on that in a moment. Jump forward eight (8) years and we are now in a position where if a trustee performs a service in their individual capacity, the NALI provisions will apply where remuneration is paid by the fund on non-arm's length terms. It should also be noted that if the SMSF has individuals rather than a corporate trustee, it will also breach Section 17B. This applies whether the fund underpays and where no remuneration is provided.

As it stands the industry is still unclear about the Jones' and performing accounting services but there is absolutely no question when it comes to services providers such as builders where there is a link to a specific asset. If it is clear that related parties are doing a fund a favour by not charging full price they might be doing a disservice to the tune of 45% tax on future earnings.

Trustee remuneration v contribution

As highlighted above, trustee remuneration had a direct link to what constituted a contribution. Two rulings will forever be linked to this matter, barring their withdrawal from publication:

- TR 2010/1 Income tax: superannuation contributions; and
- SMSFR 2010/1: the application of subsection 66(1) of the Superannuation Industry (Supervision) Act 1993 to the acquisition of an asset by a self managed superannuation fund from a related party

TR 2010/1 was significant for identifying three key issues that are directly impacted by these new NALE provisions:

- In-specie asset transfers
- Increasing the value of a fund asset
- Indirectly increasing the capital of the fund

SMSFR 2010/1 is linked, not only to TR 2010/1 but also SISA 17B and of course these NALE provisions due to its analysis of the following when dealing with related parties:

- Performance of a service
- Acquisition of listed shares

The upshot and subsequent consensus of the events raised as examples in the above rulings was that if market value wasn't paid for an asset or a service (of significance), therefore increasing the capital of the fund, then contributions to the value of the capital enhancement would be the compliance solution. It's a process that passed them smell test. However, and rather alarmingly, the draft LCR states if an asset is transferred to an SMSF and the difference between market valuation and actual consideration paid is treated as an in-specie contribution that will constitute a NALE unless the consideration paid and the in-specie contribution are clearly identified in the contract. On face value this seems to be red tape madness and a tax grab on something that is often caused by the ATO strict interpretation of when a contribution is made for off-market transfers.

Trustee remuneration v contribution

Off-market transfers (OMTs), otherwise known as in-specie contributions, could be the catalyst for future NALI issues due largely to the ATO's interpretation of when these contributions are made. This issue first became one of prominence in 2005/06 when the Government announced the introduction contribution caps and provided a one-off

$1m cap introduced on Federal Budget night. For the 2005/06 Financial Year the ATO audited all funds who contributed greater than $1m to determine when the contributions were made. In the instances of OMTs they requested copies of the transfer form and the holding statements. The ATO's views were formalised in TR 2010/1 where the Commissioner states:

18. The fund's capital will be increased when a person transfers an asset to the superannuation provider but the provider pays no consideration or pays consideration less than the market value of the asset.

19. For example, a person might transfer shares they own in a stock exchange listed company to the superannuation provider to make a superannuation contribution.

20. A contribution by way of a transfer of an asset will be made when the superannuation provider obtains ownership of the asset from the contributor. The Commissioner accepts the superannuation provider obtains ownership of an asset when beneficial ownership of the asset is acquired and that beneficial ownership can be acquired earlier than legal ownership.

It is clear from the ruling that the ATO provide for the contribution to be made when beneficial ownership changes hand. They define beneficial ownership as follows:

24. A superannuation provider acquires the beneficial ownership of shares or units in an Australian Stock Exchange listed company or unit trust when the provider obtains a properly executed off-market share transfer in registrable form.

25. A contributor or superannuation provider who seeks to argue a contribution of property occurs when beneficial, not legal, ownership of property passes must retain sufficient evidence of the relevant transactions and events to precisely identify when the change of beneficial ownership occurs.

The following example is provided in TR 2010/1.

Example 7 - when in specie contribution of shares is made

On 26 June 2009, Cheung signs an off-market share transfer form to effect a contribution of shares from herself to Cho Pty Ltd, the trustee of her self-managed superannuation fund. However, Cheung leaves certain parts of the form blank for completion by her stock broker, as her shareholdings, and those of Cho Pty Ltd are broker sponsored. Cheung posts the transfer form to her broker on the same day.

Cheung's broker adds the omitted information on 2 July 2009 and completes the transfer through CHESS. Cho Pty Ltd is registered as a shareholder on 5 July 2009.

Cheung's contribution will be made on 2 July 2009 as it is not until that day that the relevant transfer has been completed to registrable form.

If we take the OMT process from TR 2010/1 and apply the principle to the NALE rules then we create an issue if the consideration for the shares is completed on a date and the form is executed on a later date and the share value has subsequently increased. The draft LCR implies that the difference between the consideration on the contract (OMT) and the price on the execution date are different and as such the fund has paid less than expected. Even though the fund treats the difference as an increase in the contribution, meeting all the SIS requirements and the contribution definition, it falls foul of the NALE provisions potentially resulting in future income of the investment being taxed higher.

Herein lies the trustee remuneration, contribution and non-arm's length income conundrum. By applying practices that many have used for over a decade, that are otherwise insignificant because the end result is SIS compliance, we now may be creating a tax issue and that for many is not the intention of this law.

This law at its core was to stop trustees from benefiting from untoward/uncommercial transactions without consequences.

There is no doubt that certain expenses, such as interest on related party LRBAs, should reflect commercial rates. Similarly most would accept that building and labour contracts should reflect commercial terms, but when we start questioning administrative practices that at most represent 0.5% of fund assets, or tampering with contributions rules that largely work, are we reaching for outcomes that aren't there?

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