

NALI + NALE = NASTY

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5 April 2022



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Overview – NALI/NALE = NASTY

- Background
- Related party acquisitions
- Related party and services from firms
- Useful ATO materials to guide us including LCR 2021/2, TR 2010/1, PCG 2016/5, etc
- Private companies
- Unit trusts and
- Conclusions
 - Unless stated otherwise:
 - References to Trustee are references to an SMSF trustee and include references to a director of a corporate trustee of an SMSF
 - References to legislation are references to the *Income Tax Assessment Act 1997* (Cth)



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Background

- The NALE aspect of the **Superannuation Taxation Integrity Measures Consultation Paper** of **11 January 2018** was focused on LRBA's (the other measure in this CP was also aimed at LRBA's 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 where a general expense invokes NALE, initially for FY2019, FY2020 and FY2021. (This PCG was subsequently extended to FY2022.)
- **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

Background

- Government announced **legislative review** on 22 March 2022
- **Industry view:** ATO interpretation is not what the legislation intended
- On **9 April 2021** PCG 2020/5 extended to FY2021-22
- LCR 2021/2 at [92] – no compliance resources on general expense NALE from 1 July 2022 provided reasonable benchmark evidence
- Thus the ATO view of NALE has caused great controversy with large fund and SMSF industries which prompted a review of the legislation
- Interestingly, the ATO's recently released material on s 100A – reimbursement agreements in a family setting – has raised a lot of controversy in the tax industry
- A Government announcement supported by the Labor Government also will now review the legislation
- **QUERY:** Is the ATO playing law maker with its broad construction of the law? OR
Is it simply administering the law?

Background

- The Government's announcement on 22 March 2022:

*The Morrison Government intends to **make legislative changes** to ensure the **NALE provisions operate as envisaged**.*

*To achieve this, the **Government and Treasury will consult** with relevant industry stakeholders **on the appropriate operation of the NALI and expense provisions, ...***

*The Government understands that **some industry stakeholders have concerns regarding the interpretation of these provisions by the ATO** in a recent Law Companion Ruling and the implications of this ruling for both APRA-regulated funds and SMSFs.*

*Senator Jane Hume stated: "We have heard the concerns of the industry and **will work to amend the law to make sure it operates as intended.**"*

Background

- ATO view that a lower expense (**NALE**) can result in a 45% tax on:
 - General expense - all ordinary and statutory income of the fund
 - Specific expense - the ordinary and statutory income from that asset
- ATO view that a lower general expense can taint a large APRA fund's income too. The following paragraphs are from the Appendix to the LCR:

90 It is particularly important for trustees of large APRA-regulated superannuation funds to have appropriate internal controls and processes in place to enable trustees to demonstrate that they have made reasonable attempts to determine arm's length expenditure amounts when making acquisitions from related parties. ...

91 Nevertheless, the Commissioner is alive to concerns that a finding 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**.

Background

- The ATO view is that a general expense, eg, a \$100 discount on an accounting fee results in all ordinary and statutory income being taxed at 45% (including concessional contributions). For a large fund this will result in many blue collar workers' compulsory minimum SG contributions being taxed at 45% - this aspect proved very controversial!
- Prior to LCR 2021/2 being finalized, the ATO's view was that once tainted, the fund would forever be tainted, eg, an SMSF with \$1.1 million of diversified share investments - all of the income and any future capital gains whenever derived in the future from the investments held at that time would have been taxed including all concessional contributions. (This was labelled the '*universal view*' as, broadly, the \$100 discount had a relevant nexus to everything)
- Fortunately, the ATO adjusted its final ruling to make a distinction between general NALE on acquisition of an asset (tainting everything forever) compared to general NALE post-acquisition (tainting only relevant FYs)

Background

- Extracts from LCR 2021/2:

18. [NALE] *incurred to **acquire an asset** (including associated financing costs) will have a **sufficient nexus to all ... income** derived by the ... 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 ...*

...

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 (see Example 2 of this Ruling). Interest expenses incurred under a ... (LRBA) is an example of recurrent expenditure that is incurred in relation to an acquisition of an asset.*

Background

- Sec 295-550(1):

*An amount of *ordinary income or *statutory income is **non arm's length income** of a *complying superannuation fund ... 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:*

ITAA 1997

- (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.*

[Emphasis added]

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

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Related party acquisitions

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Related party acquisitions

- Related party acquisitions should be undertaken at arm's length to 'avoid' NALI
- Sufficient and appropriate evidence is required to prove this
- Most acquisitions are undertaken by purchase
- Some are by 'in specie' contributions
- ATO have clarified what its view on the distinction between purchase and 'in specie' contribution means
- Naturally, s 66 of SISA needs to be considered

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Related party acquisitions

- The ATO has since 2010 taken 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 to the market value of the asset (see TR 2010/1)
- The ATO is seeking to clarify the current position so that both NALI and a contribution do not arise on the same transaction/amount and is proposing to amend TR 2010/1 to clarify this relationship
- Where an asset is purchased under market value, NALF will be invoked LCR 2021/2 at [28]:

28. In situations where the terms of a contract between the ... fund and the seller ... make it clear that the asset is being purchased by the fund, the difference between the consideration paid (if any) by the fund and the market value of the asset purchased under the contract cannot represent the value of an in specie contribution made by the other party. ...

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Related party acquisitions

- Further extracts from LCR 2021/2:

29 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.*

30 A consequence of the [NALE] provisions applying to the purchase of either all, or a part, of the asset is that all of the income derived from that asset will be NALI, including any capital gains from the disposal of the asset.

Related party acquisitions

- Example 3 – *Russell purchases less than market value [31] – [33]:*

... Russell (as trustee of his SMSF) purchased listed shares from a related entity for \$500,000. The market value of the shares at the time of purchase was \$900,000. The terms of the agreement specified the purchase price as \$500,000, rather than \$900,000. Accordingly, the arrangement did not involve an in specie contribution being made to the SMSF.

- Example 5 – *Nadia part purchase/part contribution [38] – [39]:*

Nadia's SMSF purchases 50% of the commercial premises under a contract from Nadia for \$250,000. Nadia makes an in specie non-concessional contribution of the remaining 50% interest ... (valued at \$250,000). The ... market value of the in specie contribution is reported in the SMSF's accounts. ...

Nadia's SMSF continues to lease the commercial premises to the third party at a commercial rate of rent. As the commercial premises were acquired by the SMSF at market value and a commercial rate of rent was charged, the rental income derived by the SMSF is not considered to be NALI. Any capital gain that might arise from the disposal of the factory will also not be NALI.

Related party services

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Related party services

- **Trustee services** do not give rise to NALE, eg, the Trustee doing bookkeeping or accounting (without using business resources, etc)
 - Sec 17A SISA precludes an SMSF trustee being remunerated [40]
- **Individual services** do give rise to NALE, eg, a builder doing work who is not paid [43]
- There are 4 factors in s 17B for a Trustee to be remunerated [41]:
 - Non-trustee service
 - Appropriately qualified, and holds all necessary licences
 - Provides services to the public as part of that person's business
 - Arm's length payment

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Related party services

- A Trustee is required to perform certain actions, including:
 - Statutory
 - Fiduciary
 - Trust deed [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]

Related party services

Some examples from the LCR:

Example 6 – of Leonie the accountant doing accounts at [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 ...

Related party services

- **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:

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 in nature ...

Property-2:

... 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.

The rental income will ... be NALI. The [NALE] will also result in any capital gain that might arise from the subsequent disposal of the second SMSF rental property being NALI.

Related party services

- **Example 10 – Jean the licenced electrician**

- *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.*

- **Practical tips:**

- Accounting/adviser firms need to confirm their employee, partner discount policy
- Staff training on how to detect Trustee v Individual capacity
- Client education and newsletters

Related party services

LCR 2021/2, Example 11 – Sharon the real estate agent at [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. **[NB: this para 75 was added – presumably due to it being a recurrent expense not related to the acquisition of the asset]***

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Private Companies

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Private companies

- Sec 295-550(2) & (3) have not changed and, prima facie, all ordinary and statutory income from private companies is NALI
- The SMSF can, however, self-assess against the criteria in TR 2006/7
- If an SMSF holds shares in a private company, the SMSF trustee needs to ensure that all dealings in relation to the company and within the company are at arm's length to minimise the risk of NALI being invoked
- NALI can apply even if the company is unrelated
- An SMSF trustee may not have any influence, direction or control in relation to the company
- Some key risks:
 - SMSF member or part 8 associate is working for the company
 - The company obtains a low or no interest loan
 - Payments to the company are greater than arm's length

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Unit trusts

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Unit trusts

- Similar issues arise as to private company, as discussed above, but s 295-550(5) needs to be considered, especially para (a)
- Many SMSFs own property via a unit trust (whether a pre-99, unrelated or non-g geared unit trust) and where a member or part 8 associate provides any services, then NALI can easily be invoked
- Many such unit trusts do not engage a real estate agent to manage the property and this saving is an issue
- Under the current status, engaging a real agent may be better than risking NALI
- Sec 295-550(5) has 3 limbs – (b) and (c) relate to NALE and (a) to NALI. Para (a) is of concern here

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NALE & unit trusts

- Sec 295-550(5) – where SMSF has a fixed trust entitlement:

ITAA 1997

*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 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;*
- (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;*
- (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.*

[Emphasis added]

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

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Useful ATO materials

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Useful ATO materials

- PCG 2016/5 provides a 'safe harbour' for LRBAs. This PCG was recently updated at [17A] to confirm that non-arm's length LRBAs that were in place pre-31 January 2017 but complied with the PCG since that time will not, due to the pre-Feb 2017 status be subject to NALE
- Note that NALE applies regardless of the date of the 'scheme'
- PCG 2020/5 confirms no compliance resources to general expense NALE for FY2019, FY2020, FY2021 and FY2022
- PCG 2021/2 provides further confirmation that there will be no compliance resources to general expense NALE from 1 July 2022
- Safe harbours provide no protection especially if ATO detect in usual course of activities including by way of ACRs

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Useful ATO materials

- TR 2010/1-DC provides draft comments on the ATO's view on the distinction between what is a contribution and what is NALI
 - Broadly, in relation to SMSFs that acquire shares under an employee share scheme, the ATO's current view would appear that any share acquired at a discount will be forever tainted by NALI
 - However, prior to the ATO's U-turn on its long-standing practice established in TR 2010/1, the discount was treated as a NCC on the basis that the discount was assessed to the employee and therefore treated as a NCC
 - The joint professional bodies that have been liaising with Government, Treasury and the ATO, have not been in a position to provide any constructive feedback on TR 2010/1-DC as it is still wanting to obtain clarity on the great uncertainty relating to the ATO's views on NALI/NALE in LCR 2021/2
- TR 2006/7 for private companies, discretionary and fixed trusts

Recurrent expenses

- Example 2 – *Mikasa accounting services* [24] – [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
 - * However, PCG 2020/5 provides comfort

Pricing & discounts

- LCR at [51]:

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*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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Conclusions

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Conclusions

- The NALI/NALE provisions favour the Revenue:
 - 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 for services:
 - PCG 2020/5: for FY2019 to FY2022.
 - Proposed PCG from 1 July 2022 for reasonable evidence of arm's length expenditure

Conclusions

- Ideally, legislative change at least:
 - A general expense should not taint everything
 - Express apportionment, eg, 'to the extent that ...'
 - Only the excess income should be taxed at 45%
 - SMSFs should be given a chance to rectify
- In the meantime, more care is required to minimise risk, eg, solid valuation and benchmarking evidence, etc
- Advisers need to be vigilant with all related party dealings especially any property development

- Questions ???

- Further reading here:

- <https://www.dbalawyers.com.au/nali-advice/>

- DBA Lawyers present regular SMSF Online Updates:

- <http://www.dbanetwork.com.au/dbalawyers/seminars3/1119/1683/SMSF-Online-Updates.html>

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Abbreviations

- ITAA 1997: *Income Tax Assessment Act 1997* (Cth)
- LCR: law companion ruling
- LRBA: limited recourse borrowing arrangement
- NALI: non-arm's length income
- NALE: non-arm's length expenditure
- NALE Act: *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019* (Cth)
- PBR: private binding ruling
- PCG: practical compliance guideline
- SISA: *Superannuation Industry (Supervision) Act 1993* (Cth)
- SISR: *Superannuation Industry (Supervision) Regulations 1994* (Cth)
- TSB: total superannuation balance

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Legal notice

These notes are a general guide only based on our view of the law as of 5 April 2022 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). Copyright resides in DBA Lawyers apart from the other source noted (eg, ATO and other).