



Public advice and guidance compendium – TD 2024/5

❶ Relying on this Compendium

This Compendium of comments provides responses to comments received on draft Taxation Determination TD 2023/D1 *Income tax: how the non-arm's length income and capital gains tax provisions interact to determine the amount of statutory income that is non-arm's length income*. It is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this Compendium does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

Summary of issues raised and responses

All legislative references in this Compendium are to the *Income Tax Assessment Act 1997*, unless otherwise indicated.

Issue number	Issue raised	ATO response
1	It is requested that this draft Determination not be finalised until Treasury's proposed law change to the non-arm's length income (NALI) provisions as outlined in the Exposure Draft issued on 19 June 2023 are passed.	We have noted this submission.
2	We acknowledge that the ATO's position, as set out in the draft Determination, is in accordance with the operation of the legislation as it currently stands. However, the ATO view does not align with industry's view of how non-arm's length capital gains should be treated.	We acknowledge this submission that the view proposed in the draft Determination does not reflect how industry considers non-arm's length capital gains should be treated, notwithstanding that the draft Determination is in accordance with the law as it stands. This comment raises issues of policy. We must administer the law as it applies.

Issue number	Issue raised	ATO response
3	We recognise that the results of the calculations in the draft Determination arise because section 102-5 arrives at a single amount of statutory income, being the net capital gain. This provision works effectively for individual and corporate taxpayers who need to calculate a single amount of statutory income which is taxed at either marginal tax rates or a flat corporate tax rate. However, superannuation funds face 3 possible tax rates: • nil for exempt, current pension assets • 15% for non-pension assets, and • 45% for any NALI income.	We acknowledge the comment, however, also note that the Commissioner must administer the law as it applies.
4	The ATO view does not accord with [our view of] the policy intent.	We acknowledge the comment made, however note that it raises issues of policy. We consider that the view reflected in the final Determination accords with the statutory provisions.
5	A proportionate approach should be applied, where non-arm's length capital gains tax (CGT) is calculated as a percentage of total capital gains. This percentage is then applied to the net capital gain after the operation of section 102-5.	Careful consideration was given to the proportionate approach proposed. Section 102-5 outlines the method statement to determine the net capital gain, which is the statutory income referred to in subsection 295-550(1). The proportionate approach relies on 'an amount of' statutory income – being the net capital gain worked out under the method statement in subsection 102-5(1) – being a proportion of the net capital gain that was attributable to non-arm's length capital gains at the penultimate step of the method statement in subsection 102-5(1). It is noted that this approach requires a dissection of the net capital gain by focusing on the amount of the capital gain after some (but not all) of the steps in the method statement in subsection 102-5(1) are applied. We consider that any such dissection of the net capital gain amount is not available on the wording of subsections 102-5(1) and 295-550(1) when considering how those provisions interact. A net capital gain is a single amount of statutory income for the purposes of subsection 295-550(1), calculated after all the steps in the method statement subsection 102-5(1) are undertaken.

Issue number	Issue raised	ATO response
		As outlined in the Determination, we consider that the phrase in subsection 295-550(1) of 'an amount of' statutory income can, as a matter of ordinary usage, apply to an amount which is part of a larger amount. However, the amount that is NALI is determined by reference to the amount of the non-arm's length capital gain, being the capital proceeds less the cost base arising from the scheme in which the parties were not dealing at arm's length, that gives rise to the application of subsection 295-550(1). No part of that process contemplates or requires any dissection of that singular net capital gain, or the process undertaken to calculate it. As such, we consider the view as expressed in the Determination is the better view.
6	Law change is required to allow a proportionate approach.	This raises a policy issue. We must administer the law as it applies.
7	The operation of the law is complex in determining the amount of the non-arm's length component under section 295-550, taking into account its interaction with the method statement in section 102-5. The ATO should clearly step out the application of the law.	We acknowledge the feedback provided and as a result, updates have been made in the final Determination to Example 1 with additional facts; and further explanation outlining the application of the CGT market value substitution rule in section 112-20.
8	The examples outlined in the draft Determination deal only with specific expenses for self-managed superannuation funds (SMSFs). Examples involving large Australian Prudential Regulation Authority (APRA) regulated superannuation funds would also be helpful.	We acknowledge the feedback provided, however, we consider that the existing examples in the Determination are sufficient to highlight the ATO's view as to how the NALI and CGT provisions interact in determining the amount of statutory income that is NALI where a capital gain arises as a result of non-arm's length dealings. The principles outlined are applicable to APRA-regulated superannuation funds, where the requirements in the relevant provisions are met.
9	The draft Determination should also include examples as to how earnings for segregated and unsegregated pension assets would be treated under the NALI and CGT provisions.	We acknowledge the feedback provided, however we consider that this additional detail is outside the scope of the Determination. We consider that the existing examples are sufficient to highlight the ATO's view as to how the NALI and CGT provisions interact in determining the amount of statutory income that is NALI where a capital gain arises as a result of non-arm's length dealings.

Issue number	Issue raised	ATO response
10	There is a typographical error at Step 4 of paragraph 21 of the draft Determination. The result should be \$883,333.33, not \$833,333.33.	The typographical error has been corrected in the final Determination.
11	Allowing capital losses in Steps 1 and 2 of the method statement in section 102-5 to offset non-arm's length capital gains (wholly or partly) is consistent with community expectations. Section 102-5 applies to segregated and proportional pension assets because of Subdivision 295-F. A similar approach needs to apply to NALI capital gains. We recognise that these are policy matters which we will raise with the Government and Treasury.	This raises a policy issue. We must administer the law as it applies.
12	The draft Determination would benefit from further explanation and clarification regarding how the CGT market value substitutions rules apply. For example, the second dot point in paragraph 16 of the draft Determination would benefit from breaking down the calculation of the capital gain into its cost base and capital proceeds components to arrive at the capital gain. Similarly, paragraph 20 of the draft Determination would benefit from a more detailed explanation as to why the market value substitution rules (MVSR) do not apply in the case of Example 3 outlined in the draft Determination.	We acknowledge the feedback provided and note that updates have been made in the final Determination to Example 1 with additional facts; and further explanation outlining the application of the CGT MVSR in section 112-20. Paragraph 28 of the draft Determination contains details as to the operation of subsection 116-30(2C), which provides that the market value substitution rule in subsection 116-30(2) does not apply where the capital proceeds from the CGT event exceed the market value and assuming that those capital proceeds were statutory income, the proceeds would be NALI.
13	The ATO does not have proper regard to the operation of subsection 102-5(1) insofar as the application of the CGT discount is concerned. We disagree that the CGT discount is applied on a 'collective' basis under subsection 102-5(1). Instead, Step 3 of the method statement is as follows (with emphasis added): <i>'Reduce by the discount percentage each amount of a *discount capital gain remaining after step 2 (if any).'</i>	We acknowledge the feedback provided and agree that Step 3 in the method statement of section 102-5 requires a consideration of each capital gain. For clarity, updates have been made in the final Determination to paragraph 64 to remove the word 'collective'. Careful consideration was also given to the alternative view as proposed. It is noted that we do not consider that the view outlined in the Determination treats discount capital gains as not being a discount capital gain. Rather, the ATO view accords with the method statement in section 102-5 where all capital gains (both arm's length and non-arm's length) are taken into account. The capital gains are subject to any of the reductions in

Issue number	Issue raised	ATO response
	'Discount capital gain' has the meaning given by Subdivision 115-A, based on meeting various requirements (including the minimum 12-month holding rule). Only a specific capital gain can be a discount capital gain. Accordingly, in the context of applying Step 3 of the method statement, it is necessary to identify specific capital gains which are remaining after Step 2. Then under Step 5, it is necessary to 'add up' the amounts of capital gains remaining after Step 4. Again, this clearly requires specific capital gains to be identified. It is further contended that there might be similar arguments with respect to the application of capital losses against capital gains under Steps 1 and 2 of the method statement. However, we acknowledge that there is one key difference in that these steps allow a taxpayer to choose how current and prior year capital losses are applied. By comparison, Step 3 does not provide for a choice, but rather the reduction of the capital gain by the CGT discount (where eligible) automatically applies. Accordingly, in the context of determining the amount of NALI as part of a net capital gain and by reference to a non-arm's length capital gain, it is clear that where the non-arm's length capital gain is a discount capital gain (within the meaning of Subdivision 115-A), the amount of that non-arm's length capital gain which forms part of the superannuation fund's net capital gain will never exceed the discounted amount (that is, two-thirds of the capital gain). Other external commentators consider that under the ATO's view as currently expressed in the draft Determination, non-arm's length capital gains are effectively being treated as not being discount capital gains, which is clearly not in accordance with Subdivision 115-A (within which there are certain types of gains specified as not being discount capital gains in sections 115-40, 115-45, 115-50 and 115-55).	subsection 102-5(1), including the application of any capital losses (including net capital losses), discount percentage and small business concessions in Subdivisions 152-C to 152-E. This then calculates the fund's net capital gain, a single amount which is its statutory income. However, the amount of that statutory income that is NALI must also satisfy the requirements of subsection 295-550(1). We do not consider that the approach outlined in the submission, where the NALI can never be more than the discounted capital gain in respect of a non-arm's length capital gain, is available on the wording of the provisions. We consider the view as expressed in the Determination is the better view.

Issue number	Issue raised	ATO response
	It is requested that the final version of the draft Determination is updated to reflect that for a non-arm's length capital gain which is a discount capital gain, the part of the superannuation fund's net capital gain which is NALI can never be more than the discounted gain amount, as a 'lesser of' alternative to the superannuation fund's overall net capital gain.	
14	The draft Determination would be well served by including one or more examples showing an allocation of deductions attributable to NALI arising from a non-arm's length capital gain, including guidance as to apportionment.	We acknowledge the feedback provided, however we consider that the current examples in the draft Determination explain the ATO's view as to how the non-arm's length income and CGT provisions interact in determining the amount of statutory income that is NALI where a capital gain arises as a result of non-arm's length dealings.
15	Under the ATO's view as currently expressed in the draft Determination, arm's length capital gains are treated as NALI which is an entirely inappropriate outcome and against the policy intent of the NALI rules. The operation of the law as it currently stands appears to be outside the policy intent. The intent was to target the income derived from a specific asset including capital gains. The capital gains arising on disposal of a tainted asset, separately being subject to NALI. The tainting of arm's length capital gains is an unintended consequence. The inability to disaggregate the net capital gain calculated under the method statement in section 102-5 interacts awkwardly with the operation of subsection 295-550(1) which is designed to identify NALI amounts and subject them to a higher rate of tax. The effect of the single amount of statutory income being used for the purposes of section 295-550 is that arm's length capital gains are aggregated with non-arm's length capital gains in calculating the net capital gain under section 102-5. This results in arm's-length capital gains forming part of the non-arm's length component. This is a disproportionate outcome and unfairly taxes arm's length capital gains at a penal rate.	Careful consideration was given to the disaggregation approach proposed, being similar to the 'proportionate approach' as discussed in Issue 5 of this Compendium. See also our response at Issue 5, being equally applicable here.

Issue number	Issue raised	ATO response
16	The current examples in the draft Determination involve single trustees of SMSFs. Other than in rare situations, SMSFs are not permitted to have a single trustee regardless of how many members a fund might have. We therefore suggest the ATO adjust the examples in the draft Determination so they reflect the correct regulatory framework.	We acknowledge the feedback provided and note that the examples have been updated in the final Determination to reflect the correct regulatory framework.

© AUSTRALIAN TAXATION OFFICE FOR THE COMMONWEALTH OF AUSTRALIA

You are free to copy, adapt, modify, transmit and distribute this material as you wish (but not in any way that suggests the ATO or the Commonwealth endorses you or any of your services or products).