

# ***LCR 2021/2EC - Compendium***



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## Public advice and guidance compendium – LCR 2021/2

### **❶ Relying on this Compendium**

This Compendium of comments provides responses to comments received on draft Law Companion Ruling LCR 2019/D3 *Non-arm's length income – expenditure incurred under a non-arm's length arrangement*. 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**

<b>Issue number</b>	<b>Issue raised</b>	<b>ATO response</b>
<b>General expenses and nexus</b>		
1	<p>The Commissioner's view in relation to general fund expenses is not the correct construction of the law and is inconsistent with the intent of the legislative changes. Further technical analysis is required.</p> <p>It is not considered that the legislation was drafted with the intention that general expenses have a sufficient and necessary nexus to all of the income of the fund. Rather, the legislation provides a basis for expenses that have a sufficient and relevant nexus to assets and income of the fund where an inappropriate advantage has been arranged.</p> <p>The wording of section 295-550 refers to 'an amount' of ordinary or statutory income is non-arm's length income (NALI). Further, the Commissioner's approach is not supported by the Explanatory Memorandum (EM) to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 or common law.</p> <p>The EM states:</p> <p>2.16 The legislation requires the identification of a specific amount of ordinary or statutory income that is non-arm's</p>	<p>We consider the views expressed in the final Ruling to be the better interpretation of paragraphs 295-550(1)(b) and (c). That is, in some instances, non-arm's length expenditure (NALE) will have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund.</p> <p>We also consider the views to be consistent with statements in the EM. Paragraph 2.38 of the EM draws parallels between the requisite nexus with respect to paragraphs 295-550(1)(b) and (c) and (5)(b) and (c), and the application of section 8-1.</p> <p>The final Ruling contains additional guidance to assist trustees to comply with the NALI provisions. This includes a number of examples of general expenditure that could be deductible under section 8-1, including interactions with other specific deduction rules (such as 25-5).</p> <p>However, in recognition of the impact of the interpretative position on general expenses, the Appendix in the final Ruling sets out our compliance approach to considering whether general expenses are on 'arm's length' terms.</p>

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	<p>length income. This ensures that the consequences of an amount of income being non-arm's length income are restricted to that amount of income and any related deductions.</p> <p>While paragraph 2.16 refers to 'amount', this should be read, in context, as 'an amount in respect of specific income or a category of income'.</p> <p>The EM, while referencing section 8-1 of the <i>Income Tax Assessment Act 1997</i><sup>1</sup> also makes clear that a specific amount of income needs to be identified when calculating a super entity's non-arm's length component. The ATO's interpretation appears to be far broader.</p> <p>If relying on a nexus due to section 8-1, this nexus is not sufficient and necessary for the NALI provisions which require that the expense must have been incurred 'in' gaining or producing the relevant income. That is, the expenditure must be incurred in the course of producing such income and cannot be an expense that is incurred at a point in time either too early or too late to be related to the production of income of the super entity.</p> <p>If the Commissioner maintains the legislative interpretation, then consideration of certain expenses such as section 25-5 and expenses on establishment or winding up should be clarified.</p>	

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<sup>1</sup> All legislative references in this Compendium are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

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2	<p>The amendments to section 295-550 and the Commissioner's view in relation to general fund expenses have a significant impact on a complying superannuation fund where:</p> <ul style="list-style-type: none"> <li>the parties deal on non-arm's length terms, and</li> <li>the fund incurs a loss, outgoing or expenditure (or none) that is less than the amount the fund might have been expected to incur had the parties dealt at arm's length.</li> </ul> <p>This significant impact will result in income of the fund being NALI where the market value of the relevant loss, outgoing or expenditure is relatively small compared to the relevant income. This disproportionate outcome is not consistent with the policy intent of the amendments. This is an issue for self-managed superannuation funds (SMSF) and APRA-regulated funds.</p> <p>Actions required to be taken to avoid this disproportionate outcome (for example, substantiating values) may themselves be regarded as excessive and a compliance burden.</p> <p>Some practical solution should be considered to provide certainty, such as a de minimus amount, materiality level, safe harbour or guidance on arrangements the ATO views as 'high' and 'low' risk. This would significantly reduce the compliance burden on trustees, advisers and auditors.</p>	<p>We acknowledge the concerns raised regarding our view on general fund expenses and that it is likely to have a very significant tax impact on complying superannuation funds, even where the relevant expenses are immaterial.</p> <p>To further assist taxpayers, the Appendix in the final Ruling sets out our compliance approach in relation to general fund expenses, according to whether the fund is an SMSF or an APRA-regulated fund. In the circumstances specified in the Appendix, we will not allocate compliance resources from 1 July 2022 to determine whether those general fund expenses are in fact on arm's length terms.</p> <p>This compliance approach does not impact the approach set out in Practical Compliance Guideline PCG 2020/5 <i>Applying the non-arm's length income provisions to 'non arm's length expenditure' – ATO compliance approach for complying superannuation entities</i>.</p>
<b>Contributions</b>		
3	<p>The application of the NALE provisions and the Commissioner's views on contributions should be more clearly articulated.</p> <p>Additional guidance should be provided as to how Taxation Ruling TR 2010/1 <i>Income tax: superannuation contributions</i> interacts with the NALI provisions.</p>	<p>We consider that this Ruling contains sufficient content, including examples, to assist trustees to comply with the NALI provisions.</p> <p>However, we have issued for consultation a draft update to Taxation Ruling TR 2010/1 with the Commissioner's preliminary views on the interaction between the NALI and contribution provisions. The draft update includes a proposed compliance approach for the 2018–19 and later income years. Under this approach, compliance resources would not be allocated to determine whether a contribution is made in certain circumstances when income is characterised as NALI.</p>

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	<p>For example, the Commissioner should clarify that the same under-valued expense would not be subject to both the NALI and contributions provisions.</p> <p>Transactions deemed to constitute a contribution should not be subject to NALI.</p>	
<b>Capacity in which activities are performed – SMSFs</b>		
4	<p>It is submitted that an individual can:</p> <ul style="list-style-type: none"> <li>act in their personal capacity</li> <li>act in their capacity as a trustee of a superannuation fund, and</li> <li>act in both capacities at the same time.</li> </ul>	<p>We accept that an individual may act in different capacities, but they cannot act in more than one capacity at the same time.</p> <p>A trustee (or director of a corporate trustee)<sup>2</sup> must determine when they are acting in the capacity of trustee of the fund or in some other legal capacity. Paragraphs 40 to 48 of the final Ruling includes updates to provide further guidance to assist trustees.</p>
5	<p>Greater clarification is sought on when a trustee of a fund provides services in their capacity as trustee or in some other capacity.</p> <p>Further guidance could include:</p> <ul style="list-style-type: none"> <li>defining what are typically considered to be trustee services, compared to those services that generally would not be provided by a trustee of a super fund. The list of trustee services could be distinguished between APRA funds and SMSFs. For example, accounting, bookkeeping, broad financial advice, governance services, minor repairs, overseeing investments and representing the fund</li> <li>providing further examples of a trustee acquiring services from related parties at less than standard commercial prices</li> <li>examples of other trades could be provided including a plumber, electrician or landscaper.</li> </ul>	<p>We have provided further content, including examples, in the final Ruling to assist trustees to comply with the NALI provisions. This includes content in determining whether an individual is acting in the capacity of trustee of an SMSF (see paragraphs 40 to 48 of the final Ruling).</p>

<sup>2</sup> Any reference in this compendium to the ‘trustee’ of the fund will be a reference to the trustee of a fund and a director of the corporate trustee of the fund, unless otherwise specified.

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6	<p>Paragraph 38 of the draft Ruling states that determining in what capacity an individual is acting requires a consideration of the trust deed.</p> <p>What terms of the trust deed require consideration? If this requires objective consideration, please provide an example.</p>	<p>Additional content, including examples, has been added in the final Ruling to assist trustees to comply with the NALI provisions. This includes content concerning determining whether an individual is acting in the capacity as a trustee of an SMSF (see paragraphs 40 to 48 of the final Ruling).</p>
7	<p>The ATO should discuss trustee services in the NALI context in line with the <i>Superannuation Industry (Supervision) Act 1993</i> (SISA) position.</p> <p>There are inconsistencies between the factors listed in paragraph 39 of the draft Ruling and sections 17A and 17B of the SISA.</p> <p>The draft Ruling infers that if a fee is charged, you are likely to be operating in a non-trustee capacity.</p> <p>The position should be that if no charge is made for a service, there is strong presumption that a person is acting as trustee, unless there is evidence to the contrary.</p>	<p>Whether section 17B of the SISA applies is outside the scope of this Ruling. However, we have included additional guidance to address the consideration of relevant SISA provisions (in particular, see paragraphs 40 to 48 of the final Ruling).</p>
8	<p>Does a trustee of a fund contravene section 17A of the SISA where it provides a service to the fund but it is not clear in what capacity they are providing that service and, as a matter of caution, charges the fund an arm's length price for that service?</p> <p>Would this give rise to issues concerning the application of the sole purpose test in section 62 of the SISA?</p>	<p>Whether sections 17A and 62 of the SISA have been contravened is outside the scope of this Ruling. However, additional content, including examples, has been added in the final Ruling to assist trustees to comply with the NALI provisions. This includes content concerning determining whether an individual is acting in the capacity as a trustee of an SMSF (see paragraphs 40 to 48 of the final Ruling). This additional content includes consideration of relevant SISA provisions.</p>
9	<p>The draft Ruling implies that trustees and directors should be deterred from using their own skills and knowledge to enhance their fund's retirement benefits.</p>	<p>Paragraph 46 of the final Ruling has been updated to clarify that utilising your skills and knowledge (based on business, profession, life experiences or employment) in performing your duties as trustee of an SMSF will not, of itself, indicate that you are not acting in that capacity.</p>

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<b>Other potential non-arm's length dealings</b>		
10	<p>Further guidance should be provided in respect of services from related parties.</p> <p>NALI should not apply (or only apply in excessive instances) where the trustee enters into a non-arm's length dealing with a separate legal entity that is, for example:</p> <ul style="list-style-type: none"> <li>• related to the trustee of the fund</li> <li>• any other associate of the trustee of the fund</li> <li>• the employer of the trustee of the fund, or</li> <li>• a friend of the trustee of the fund.</li> </ul> <p>For example, a husband and wife as trustees of their SMSF obtain assistance from their adult child (a qualified accountant) to prepare the fund's annual financial accounts. NALI should not apply in this case.</p>	<p>Additional content, including examples, have been added to the final Ruling (see Examples 6 to 11) to assist trustees to comply with the NALI provisions. This includes content concerning determining whether an individual is acting in the capacity as a trustee of an SMSF or in some other capacity (see paragraphs 40 to 48 of the final Ruling).</p> <p>The NALI provisions will apply where, as a result of a scheme the parties to which were not dealing with each other at arm's length with respect to the scheme, a trustee of a superannuation fund, incurs NALE.</p> <p>The Appendix in the final Ruling sets out our compliance approach to considering whether general expenses are on 'arm's length' terms.</p>
11	<p><b>Discounts</b></p> <p>NALI should not apply where a discount is available to all employees, office holders, etc, and those people are not able to influence the discounts provided to them or where the discount is excessive.</p> <p>Further examples are required to explain the application of the discount policy.</p>	<p>Paragraph 51 of the final Ruling confirms that discount policies will still be on arm's length terms where they are consistent with normal commercial practices. For example, an individual acting in their capacity as trustee being entitled to a discount under a discount policy where the same discounts are provided to all employees, partners, shareholders, or office holders.</p> <p>See also Example 8 of the final Ruling.</p>
12	<p><b>Pro bono work</b></p> <p>Work to build relationships for future business should be excluded with respect to the application of the NALE provisions.</p>	<p>Paragraph 52 of the final Ruling confirms that services provided to a complying superannuation fund on a pro bono basis will still be on arm's length terms where the trustee of the fund is not able to influence the service provider's decision to supply the services on a pro bono basis.</p>
13	<p><b>Cost-recovery policies</b></p> <p>Paragraph 42 of the draft Ruling should make clear that a cost-recovery approach to fees charged to a large</p>	<p>We have updated paragraph 53 of the final Ruling to clarify that a trustee of large APRA-regulated fund that charges the fund on a cost-recovery basis will not result in the NALE provisions applying.</p>

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	superannuation fund by a related entity (whether the related entity be wholly owned or controlled) is in all cases considered to be commercially justifiable, on the basis of maximising returns within the fund for its members, and is therefore consistent with arm's length dealings.	
<b>Determining the NALI amount</b>		
14	<p>The draft Ruling refers to capital gains forming part of NALI when, in practice, only net capital gains form part of ordinary and statutory income.</p> <p>Capital gains tax (CGT) discounts should also be applied in the examples. Greater clarification around the application of the market value substitution rules is required.</p>	<p>The CGT provisions, including discounts and market value substitutions rules, operate in conjunction with the NALI provisions.</p> <p>Paragraphs 81 and 82 of the final Ruling address the application of the market value substitution rules in determining the amount of NALI.</p> <p>Addressing all instances of the application of the CGT provisions and NALI is outside the scope of this Ruling.</p>
15	<p>NALI and NALE should not automatically apply to both income and capital gains.</p> <p>Is there a sufficient nexus for the application of the NALI provisions when an asset is acquired for less than market value? In referring to Examples 1 and 3 of the draft Ruling, if the ATO wishes to apply NALI to net capital gains it should urgently revise its approach to contributions as outlined in TR 2010/1.</p> <p>Is there a sufficient nexus when the asset is acquired for market value but financed using a limited recourse borrowing arrangement (LRBA) that was not on arm's length terms? In this instance, any capital gain on the asset should not be subject to NALI.</p> <p>The ATO needs to outline how it will apportion the application of NALI to part of a capital gain.</p> <p>Disagree with the outcome in Example 4 of the draft Ruling that the income and capital gain is NALI.</p>	<p>Our position is that where an asset is acquired for less than market value and the NALI provisions apply, there is a sufficient nexus between the NALE and the income derived from that asset, including any capital gain on sale, for the income to be NALI. This is also the case where the purchase price may be on arm's length terms but the trustee of the fund has obtained financing under an LRBA that is not on arm's length terms in order to put the fund in the position to acquire the asset. This position is consistent with Example 2.1 of the EM.</p> <p>Section 295-550 does not provide for a mechanism to apportion income.</p>
16	Example 9 of the draft Ruling refers to 'gross' capital gain, which is not a term used in the legislation.	Example 13 of the final Ruling has been updated to remove 'gross' from the reference to capital gain.



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17	NALI should be assessed on net amounts. For example, profit making enterprise where goods are bought and then sold with a profit margin.	Subsection 295-545(2) states that the non-arm's length component is the entity's NALI for that year less any deductions attributable to that income.
<b>Other comments</b>		
18	Paragraph 8 of the draft Ruling that refers to the amendments removing 'ambiguity' as to the application of the NALI provisions should be removed.	We disagree and consider the paragraph is consistent with statements made in paragraph 2.9 of the EM.
19	<p>For the avoidance of doubt, it would useful if Example 7 of the draft Ruling makes clear that the fund's rental income from the property would not be considered NALI in a later income year where the fund was charged arm's length fees for the entire year.</p> <p>Example 7 should also address the implications of the fund selling the property at a later date and using the services of the trustee's real estate agency business to facilitate the sale. That is, would any capital gain from the sale be considered NALI?</p>	<p>We have provided further clarification of the effect of the changes in non-arm's length arrangements at paragraph 20 of the final Ruling. Example 2 of the final Ruling has been updated to clarify that income of the fund in a later income year will not be NALI where the arrangement is changed such that expenditure incurred by the SMSF is now on arm's length terms.</p> <p>Example 11 of the final Ruling outlines the application of the NALI provisions to any future capital gain in the circumstances of that example.</p>
20	NALI or NALE may arise due to oversight or human error. SMSFs should be given an opportunity to rectify in line with arm's length terms as soon as practicable after they detect an issue.	We encourage the early engagement of taxpayers who identify they have incurred NALI due to the operation of section 295-550.
21	<p>A practical manner of substantiating the value of services provided is required. What benchmark of evidence is required to show an amount is arm's length?</p> <p>For example, where a qualified accountant, financial advisor or lawyer provides services to their SMSF should they charge the business rate or should they charge a rate of \$40 for an unqualified person?</p>	<p>The market rate is a question of fact in each case.</p> <p>The Appendix in the final Ruling provides further guidance on evidentiary expectations, including the allocation of our compliance resources from 1 July 2022 in considering whether expenses of a general nature are on arm's length terms.</p>
22	The amendments to section 295-550 are retrospective in nature.	The relevant amendments to section 295-550 apply in relation to income derived in the 2018–19 income year and later income years, regardless of whether the scheme was entered into before 1 July 2018.

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23	<p>Further clarification is needed for SMSFs that invest in unit trusts as the guidance provided so far is not sufficient.</p> <p>The draft Ruling does not provide any examples where an SMSF trustee is assisting with managing the activities of a unit trust that owns real estate. We query whether these would be treated in a similar manner to the situation where the trustee provides internal or trustee type services directly to a SMSF.</p>	<p>We consider the Ruling provides sufficient guidance on the key principles to assist trustees to determine how the provisions apply.</p> <p>Trustees may seek certainty on their specific circumstances through the private ruling process</p>
24	<p>A number of points need to be addressed in the final Ruling relating to:</p> <ul style="list-style-type: none"> <li>• COVID-19</li> <li>• LRBA</li> <li>• Practical Compliance Guideline PCG 2016/5 <i>Income tax – arm's length terms for Limited Recourse Borrowing Arrangements established by self managed superannuation funds</i>, and</li> <li>• similar administrative concessions where NALI is not strictly applied.</li> </ul> <p>For example, if an SMSF structures an LRBA in accordance with PCG 2016/5, that should generally not give rise to NALI unless there is some other reason why NALI should be applied.</p> <p>For example, a low or nil interest loan should be viewed as a valuable asset and be able to be recognised as a contribution.</p>	<p>Guidance on the ATO's interpretation of section 295-550 and practical compliance approach with respect to LRBA arrangements are set out in:</p> <ul style="list-style-type: none"> <li>• Taxation Determination TD 2016/16 <i>Income tax: will the ordinary or statutory income of a self-managed superannuation fund be non-arm's length income under subsection 295-550(1) of the Income Tax Assessment Act 1997 (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?</i>, and</li> <li>• PCG 2016/5.</li> </ul>
25	<p>Further clarification is needed for SMSFs that borrow and the status of different types of guarantees that are entered into on an ongoing basis by SMSF trustees and units trusts or companies in which SMSFs may invest. The draft Ruling is silent on this issue.</p> <p>Given that the provision of a guarantee may give rise to a NALI or NALE risk, we request that this important and uncertain topic be dealt with in the final Ruling. We refer you</p>	<p>Further interpretive guidance on these topics are outside the scope of this Ruling, the purpose of which is to clarify the Commissioner's view on the application of the amendments to section 295-550.</p> <p>Trustees may seek certainty on their specific circumstances through the private ruling process.</p>

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	<p>to one of the latest ATO examples, for instance, Example 3 of SMSF Regulator's Bulletin SMSFRB 2020/1 <i>Self-managed superannuation funds and property development</i>.</p> <p>Also, updates for employee share plans are required. The ATO website material refers to the following:</p> <p>For example, when shares acquired under an ESS are transferred to an SMSF at less than market value, the acquisition results in a super contribution because the capital of the fund increases and the purpose of the acquisition is to benefit a member, or members, of the fund.</p>	
26	Include an example that involves a derivative or swap.	<p>No changes have been made to the final Ruling. The Ruling provides adequate examples that illustrate the key principles.</p> <p>Trustees may seek certainty on their specific circumstances through the private ruling process.</p>
27	<p>The NALI and NALE rules are anti-avoidance rules that can have substantial, adverse tax implications. Any decision to apply NALI or NALE should be referred to the General Anti-avoidance Rules panel or similarly constituted panel with outside experts.</p>	<p>This comment relates to our processes rather than our views on the application of the amendments to section 295-550. No changes have been made to the final Ruling.</p> <p>It is noted that individuals may utilise existing review rights where we issue an amended assessment.</p>