

LCR 2018/D10 - Non-arm's length income - expenditure incurred under a non-arm's length arrangement

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Page status: **draft only – for comment**

Non-arm's length income – expenditure incurred under a non-arm's length arrangement

Relying on this draft Ruling

This publication is a draft for public comment and describes how the Commissioner will apply the law proposed in the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill to section 295-550 of the *Income Tax Assessment Act 1997* with respect to non-arm's length income.

When the final ruling issues, it will provide the following level of protection:

If you rely on this Ruling in good faith, you will not have to pay any underpaid tax, penalties or interest in respect of matters covered by this Ruling if it does not correctly state how a relevant provision applies to you.

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What this draft Ruling is about

1. This draft Ruling¹ clarifies how the proposed amendments to section 295-550 of the *Income Tax Assessment Act 1997*² operate in a scheme where a superannuation entity incurs non-arm's length expenditure (or where expenditure is not incurred) in gaining or producing ordinary or statutory income. The amendments 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 2018.³
2. All references are to the *Income Tax Assessment Act 1997*, including as it is proposed to be amended, unless otherwise indicated.

Overview of amendments to the non-arm's length income provisions

3. The taxable income of a complying superannuation fund, complying approved deposit fund or pooled superannuation trust⁴ (together, *complying superannuation entities* as defined in subsection 995-1(1)) is made up of two components – a *low tax component*, which is taxed at 15%, and a *non-arm's length component*, which is taxed at the top marginal tax rate.
4. The non-arm's length component for an income year is the amount of a complying superannuation fund's non-arm's length income (NALI) less any deductions to the extent that they are attributable to that income.⁵ To the extent that the ordinary and statutory income of a complying superannuation fund is NALI, the income is not exempt current pension income.⁶
5. The low tax component of a complying superannuation fund's taxable income is the amount of the fund's taxable income remaining after deducting the non-arm's length component from its total taxable income.⁷
6. Prior to the proposed amendments, the relevant NALI provisions⁸ applied to arrangements where a complying superannuation fund:
 - derived ordinary or statutory income under a scheme where
 - the parties were not dealing with each other at arm's length in relation to the scheme, and
 - the amount of income is more than what might have been expected to have been derived if those parties had been dealing with each other at arm's length in relation to the scheme, and

¹ All further references to 'this Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.

² See Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

³ See item 4 to Schedule 3 of the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

⁴ For the purposes of readability, this Ruling will refer to how the provisions apply to a 'complying superannuation fund'. However, the provisions apply equally to a complying approved deposit fund and a pooled superannuation trust.

⁵ Subsection 295-545(2).

⁶ Paragraphs 295-385(2)(a), 295-390(2)(a) and 295-400(2)(a).

⁷ Subsection 295-545(3).

⁸ Paragraphs 295-550(1) and 295-550(5) – provisions prior to the proposed amendments.

- derived income as a beneficiary of a trust through holding a fixed entitlement to the income of the trust where
 - the fund acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm’s length, and
 - the amount of income is more than what might have been expected to have been derived if those parties had been dealing with each other at arm’s length.

7. While retaining the previous rules, the proposed amendments remove any ambiguity in the application of the NALI provisions by clarifying their application where a complying superannuation fund incurs a loss, outgoing or expenditure (or does not incur a loss, outgoing or expenditure) in certain circumstances (as outlined in paragraphs 8 to 11 of this Ruling).

8. An amount of ordinary or statutory income will be NALI of a complying superannuation fund where:

- there is a scheme in which the parties were not dealing with each other at arm’s length
- the fund incurs a loss, outgoing or expenditure of an amount in gaining or producing the income, and
- the amount of the loss, outgoing or expenditure is less than the amount that the fund might have been expected to incur had those parties been dealing with each other at arm’s length in relation to the scheme.⁹

9. Further to paragraph 8 of this Ruling, the income is also NALI if the fund does not incur a loss, outgoing or expenditure that the fund might have been expected to incur if those parties had been dealing with each other at arm’s length in relation to the scheme.¹⁰

10. Further, other income derived by a complying superannuation fund as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is NALI of the fund where:

- there is a scheme in which the parties were not dealing with each other at arm’s length
- the fund incurs a loss, outgoing or expenditure of an amount in acquiring the entitlement or in gaining or producing the income, and
- the amount of the loss, outgoing or expenditure is less than the amount that the fund might have been expected to incur if those parties had been dealing with each other at arm’s length in relation to the scheme.¹¹

11. Further to paragraph 10 of this Ruling, the income is also NALI if the fund does not incur a loss, outgoing or expenditure that the fund might have been expected to incur if those parties had been dealing with each other at arm’s length in relation to the scheme.¹²

12. For the purposes of this Ruling, a reference to ‘non-arm’s length expenditure’ includes a loss, outgoing or expenditure incurred as referred to in paragraphs 8 and 10 of this Ruling and a loss, outgoing or expenditure that is not incurred as referred to in paragraphs 9 and 11 of this Ruling.

13. While the Explanatory Memorandum (EM) to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018 provides general guidance as to the

⁹ Paragraph 295-550(1)(b).

¹⁰ Paragraph 295-550(1)(c).

¹¹ Paragraph 295-550(5)(b).

¹² Paragraph 295-550(5)(c).

application of the amended NALI provisions, this Ruling provides guidance as to the application of the NALI provisions to the specific circumstances and issues outlined.

Purchase of an asset under a non-arm's length arrangement

14. Where a complying superannuation fund purchases an asset at less than market value under a scheme where the parties were not dealing at arm's length, the fund incurs non-arm's length expenditure for the purposes of applying the NALI provisions in subsections 295-550(1) and (5). In applying the NALI provisions, the loss, outgoing or expenditure under the non-arm's length arrangement may be of a revenue or capital nature.¹³

15. In situations where the terms of a contract between the complying superannuation fund and the seller of the asset 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.

16. An in-specie contribution can be made in conjunction with a complying superannuation 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.

The complying superannuation fund will not have incurred non-arm's length expenditure for the purposes of subsections 295-550(1) or (5) where that part of the asset acquired under the contract is purchased at market value. However, if the fund pays less than market value for the part of the asset purchased, then the NALI provisions apply for the reasons outlined in paragraph 14 of this Ruling. This would be the case even if the in-specie contribution relating to the other part of the asset is recorded in the fund's accounts and the member's interest at market value.

17. A consequence of the NALI 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.

Example 1 – purchase less than market value and no in-specie contribution – NALI

18. *During the 2018–19 income year, Russell, as trustee of his self-managed superannuation fund (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 specifies 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.*

19. *The non-arm's length dealing between Russell's SMSF and his related entity amounts to a scheme, which has resulted in his superannuation fund incurring capital expenditure that was less than would otherwise be expected if those parties were dealing with each other at arm's length in relation to the scheme. The capital expenditure was incurred in gaining or producing the dividend income. Any dividend income derived by the superannuation fund from the shares will be NALI.*

20. *The non-arm's length expenditure incurred in acquiring the shares will also result in any capital gain that might arise from a subsequent CGT event happening in relation to the shares (such as a disposal of the shares) being NALI. Refer to Example 7 at paragraph 43 of this Ruling for an explanation of how this operates in conjunction with the market value substitution rule.*

¹³ Subsection 295-550(7).

Example 2 – purchase financed through a limited recourse borrowing arrangement on non-arm’s length terms – NALI

21. During the 2018–19 income year, Kellie, as trustee of her SMSF, entered into a non-commercial limited recourse borrowing arrangement (LRBA) with herself in her personal capacity to purchase a commercial property valued at \$2 million. Her SMSF borrowed 100% of the purchase price and the terms of the loan included interest being charged at a rate of 1.5% per annum and repayments only being made on an annual basis over a 25 year period. Kellie’s SMSF received a commercial rate of rent from the property of \$12,000 per month.

22. If Kellie’s SMSF had entered into an LRBA on arm’s length terms, it would be expected that repayments of principal and interest would have occurred on a monthly basis and interest would be charged on the LRBA at a commercial rate. The loan to market value ratio would have also not exceeded commercial levels.

23. For the purposes of subsection 295-550(1), the scheme involves the SMSF entering into the LRBA with Kellie, complying with the terms of the LRBA, purchasing the commercial property, and deriving the rental income. The terms of the LRBA constitute a non-arm’s length dealing between the SMSF and Kellie, which resulted in the SMSF incurring expenditure in gaining or producing rental income that was less than would otherwise be expected if those parties were dealing with each other at arm’s length in relation to the scheme. The rental income derived from the commercial property is therefore NALI.

24. The non-arm’s length expenditure incurred under the LRBA will also result in any capital gain that might arise from a subsequent CGT event happening in relation to the property (such as disposal of the property) being NALI.

Example 3 – part purchase/part in-specie contribution at market value – not NALI

25. During the 2018–19 income year, Nadia owns commercial premises that she leases to a third party which use the premises to carry on a business. The commercial premises have a market value of \$500,000. Nadia would like to transfer it to her SMSF but her fund only has \$400,000 in cash. 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 in the commercial premises (valued at \$250,000). The acceptance of the in-specie contribution by Nadia as trustee of the SMSF is recorded by her in writing and the market value of the in-specie contribution is reported in the fund’s accounts. The SMSF reports the non-concessional contribution to the ATO.

26. 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.

Activities performed in the capacity of trustee of a fund

27. The NALI provisions are not intended to apply to services provided by a trustee (or a director of a corporate trustee) of a complying superannuation fund in their capacity as trustee (or director of a corporate trustee).¹⁴ In this context, we will administer the NALI

¹⁴ See paragraph 3.31 to 3.35 of the Explanatory Memorandum to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

provisions consistent with the policy as articulated in the Explanatory Memorandum to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

28. Where an entity performs services in their capacity as a trustee (or a director of a corporate trustee) of a complying superannuation fund and does not charge for those services, this is not a non-arm's length arrangement for the purposes of the NALI provisions. Services of this kind do not form part of a non-arm's length scheme between the parties as they relate to the trustee's obligation in respect of the fund. For example, the NALI provision will not apply where a trustee performs book keeping or accounting services for the fund for no remuneration.

29. If, however, the trustee outsources its functions to third parties and the outsourcing arrangement is not on arm's length terms, the NALI provisions apply.

30. Where a trustee (or a director of a corporate trustee) of a complying superannuation fund performs services other than in those capacities (for example, in their personal capacity) to a complying superannuation fund for remuneration¹⁵, the NALI provisions will apply where the remuneration is incurred by the fund in gaining or producing ordinary or statutory income and the remuneration is non-arm's length expenditure. The NALI provisions will also apply in these situations where no remuneration is provided.

31. When determining whether a complying superannuation fund incurs non-arm's length expenditure when remunerating the trustee or director of a corporate trustee acting in their personal capacity, regard needs to be had to objective factors including how the individual charges for performing those services for unrelated parties.¹⁶

32. 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. Similarly, although pricing based on a cost-recovery basis will not generally be consistent with an arm's length dealing, there may be limited circumstances where a party operating on a simple cost-recovery basis for particular services is commercially justifiable because of the economies of scale it achieves within its business by providing other services. For example, this may occur with respect to services provided to a large APRA fund either by the trustee acting in a separate capacity or by a related third party.¹⁷

Example 4 – Internal arrangement within an SMSF – trustee provides services to the fund

33. *Leonie is a trustee of an SMSF of which she is the sole member. She is a chartered accountant and also runs an accounting business. Leonie in her capacity as trustee, prepares the accounts and annual return for the fund. As she performs these duties or services as trustee of the SMSF, she does not charge the fund for this work.¹⁸ The NALI provisions do not apply as the duties or services performed by Leonie are in her capacity as trustee rather than under an arrangement in which parties are dealing with one another on a non-arm's length basis.*

¹⁵ For a self-managed superannuation fund, see section 17B of the *Superannuation Industry (Supervision) Act 1993* (SISA) for exceptions to the general prohibition against trustees receiving remuneration from the fund.

¹⁶ Noting that in the context of a SMSF, paragraph 17B(1)(c) and paragraph 17B(2)(c) of the SISA require the duties or services to be performed in the ordinary course of a business, of performing similar duties or services for the public.

¹⁷ See paragraph 3.50 of the Explanatory Memorandum to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

¹⁸ In accordance with paragraph 17A(1)(f) of the SISA.

Example 5 – SMSF trustee carrying out duties in their personal capacity

34. Sharon is a trustee of an SMSF of which she is the sole member. She is a licensed real estate agent and runs a real estate business which includes 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 in her personal capacity to the SMSF with respect to the residential property. She charges the SMSF 50% of the price for her services that she would otherwise charge a non-related party.

35. For the purposes of subsection 295-550(1), the scheme involves the SMSF obtaining the services from Sharon and deriving the rental income. The price Sharon charges the SMSF constitutes a non-arm's length dealing between the SMSF and Sharon, which resulted in the SMSF incurring expenditure in gaining or producing rental income that was less than would otherwise be expected if those parties were dealing with each other at arm's length in relation to the scheme. The rental income derived from the residential property is therefore NALI.

Expenditure relating to a superannuation entity as a beneficiary of a trust

36. As explained in paragraphs 10 and 11 of this Ruling, the amendments extend the application of the NALI provisions to expenditure incurred (or that might have been expected to have been incurred) by a fund as a beneficiary of a trust. Examples of expenditure to which paragraphs 295-550(5)(b) and (c) may apply include:

- a complying superannuation fund incurs non-arm's length expenditure in acquiring the interest in the trust, or
- the fund enters into an LRBA on non-arm's length terms in order to obtain funds to acquire the fixed entitlement.

Example 6 – SMSF incurs non-arm's length expenditure in acquiring a fixed entitlement in a unit trust

37. During the 2016–17 income year, Scott, as trustee of his SMSF, entered into a non-commercial LRBA with himself in his personal capacity to purchase units, valued at \$50,000, in a stock exchange listed unit trust. The SMSF borrowed 100% of the purchase price and the terms of the loan included no interest being charged and repayments of principal not being required until the end of the 25-year term of the loan. The units provide the SMSF with a fixed entitlement to the income of the unit trust. The unit trust distributes \$8,000 to the SMSF at the end of the 2018–19 income year.

38. If Scott's SMSF had entered into an LRBA on arm's length terms, it would be expected that repayments of principal and interest would have occurred monthly and interest would have been charged under the LRBA at a commercial rate. It could have also used its own cash assets to fund part of the purchase to reduce the loan to market value ratio to commercial levels.

39. For the purposes of subsection 295-550(5), the scheme involves the SMSF entering into the LRBA with Scott, complying with the terms of the LRBA, purchasing the units in the unit trust, and deriving income from those units. The terms of the LRBA constitute a non-arm's length dealing between the SMSF and Scott, which resulted in the SMSF incurring expenditure in gaining or producing income that was less than would otherwise be expected if those parties were dealing with each other at arm's length in relation to the scheme. The \$8,000 distribution derived from the units in the unit trust in 2018–19 and any distribution derived in future years is, therefore, NALI.

40. The non-arm's length expenditure under the LRBA will also result in any capital gain that might arise from a subsequent CGT event happening in relation to the units (such as a disposal of the units) being NALI.

Application of the market value substitution rules

41. Where a superannuation fund acquires a CGT asset at less than its market value, the market value substitution rules in section 112-20 may apply to modify the cost base or reduced cost base of the asset. The superannuation fund, when determining the cost base of its CGT asset, is treated as having acquired the asset at market value.¹⁹ This affects the amount of any capital gain that may arise from a later CGT event, but does not affect the application of the NALI provisions in determining whether the asset was acquired by the fund at market value.

42. Any capital gain that the fund makes from a subsequent CGT event happening in relation to the asset (such as a disposal of the CGT asset) will be NALI.

Example 7 – market value substitution rules (CGT consequences for the transferor and the fund)

43. *Continuing with Example 1 at paragraph 18 of this Ruling, Russell's SMSF sells the shares it acquired for \$500,000 for \$1 million two years later.*

44. *When calculating the capital gain for the fund on disposal of the shares, the cost base of the shares will be modified by the market value substitution rule in section 112-20²⁰ as the parties did not deal with each other at arm's length in relation to the acquisition.*

45. *This means that the cost base for the shares will be their market value at the time of acquisition by Russell's SMSF, which was \$900,000. The SMSF has therefore realised a gross capital gain of \$100,000 (\$1 million sale proceeds less deemed cost base of \$900,000).*

46. *The \$100,000 capital gain derived by the superannuation fund is NALI. This is because the amount of expenditure incurred by the superannuation fund in acquiring the asset was less than what the superannuation fund might have been expected to incur if the parties were dealing with each other at arm's length.*

47. *It should also be noted that the market value substitution rules in paragraph 116-30(2)(b) would have applied in relation to the capital proceeds received by the related entity at the time Russell's SMSF acquired the shares as the parties were not dealing with each other at arm's length. The rules have the effect of replacing the capital proceeds from the disposal with the market value of the shares at the time the disposal took place.*

Date of effect

48. It is proposed that this Ruling will be finalised as a public ruling, effective from the application date of the Bill as passed. If passed as introduced, the amendments in the Bill apply in relation to income derived in the 2018–19 income year and later income years, regardless of whether the scheme was entered into prior to 1 July 2018.

Commissioner of Taxation

19 December 2018

¹⁹ Assuming that none of the exceptions in subsection 112-20(3) apply.

²⁰ Assuming that none of the exceptions in subsection 112-20(3) apply.

Appendix 1 – Your comments

49. You are invited to comment on this draft Ruling including the proposed date of effect. Please forward your comments to the contact officer by the due date.

50. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments, and
- be published on the ATO website at www.ato.gov.au.

51. Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **22 February 2019**

Contact officer details have been removed.

References

ATOlaw topic(s)	Superannuation ~~ Income tax – funds (superannuation) ~~ Non-arm's-length
Legislative references	ITAA 1997 ITAA 1997 112-20 ITAA 1997 112-20(3) ITAA 1997 116-30(2)(b) ITAA 1997 295-385(2)(a) ITAA 1997 295-390(2)(a) ITAA 1997 295-400(2)(a) ITAA 1997 295-545(2) ITAA 1997 295-545(3) ITAA 1997 295-550 ITAA 1997 295-550(1) ITAA 1997 295-550(1)(b) (proposed) ITAA 1997 295-550(1)(c) (proposed) ITAA 1997 295-550(5) ITAA 1997 295-550(5)(b) (proposed) ITAA 1997 295-550(5)(c) (proposed) ITAA 1997 295-550(7) ITAA 1997 995-1(1) SISA 1993 SISA 1993 17A(1)(f) SISA 1993 17B SISA 1993 17B(1)(c) SISA 1993 17B(2)(C)
Other references	Treasury Laws Amendment (2018 Superannuation measures No. 1) Bill 2018 Explanatory Memorandum to the Treasury Laws Amendment (2018 Superannuation measures No. 1) Bill 2018
ATO references	1-E0NA2DE
ISSN	2209-1300
BSL	SPR

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