

NON-ARM'S LENGTH INCOME OF SUPERANNUATION ENTITIES

EXPOSURE DRAFT EXPLANATORY MATERIAL



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# **Glossary**

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SMSF	Self-Managed Superannuation Fund



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# Chapter 1

## Non-arm's length income of superannuation entities

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### Outline of chapter

- 1.1 The amendments will ensure that the non-arm's length income rules for superannuation entities apply in situations where a superannuation entity incurs non-arm's length expenses in earning or producing income.
- 1.2 All references are to the ITAA 1997 unless stated otherwise.

### Context of amendments

- 1.3 The purpose of the non-arm's length income (NALI) provisions is to prevent the inflating of superannuation fund earnings through non-arm's length dealings, for example, non-commercial arrangements that stream income to the superannuation fund. The strategy is used by some individuals to increase superannuation savings in a way that is not caught by the concessional contributions cap and non-concessional contributions cap (contribution caps).
- 1.4 The NALI provisions contained in section 295-550 are essentially a re-write of the former provisions in section 273 of the ITAA 1936, the purpose of which was stated in the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999:
- to prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers.
- 1.5 The changes introduced by the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* lowered the annual contributions cap and threshold at which high income earners pay Division 293 tax on their concessional contributions. This increases the incentive to engage in arrangements that have the effect of circumventing these restrictions upon the transfer of wealth into superannuation.

### Operation of existing law

#### *Summary*

- 1.6 The purpose of the NALI provisions is to prevent the inflating of superannuation fund earnings through non-arm's length dealings.
- 1.7 The concept of 'non-arm's length' takes its ordinary meaning. In broad terms, the concept is interpreted as relating to transactions in which individuals or entities are not dealing with each other on a commercial, unrelated party basis. Parties do not have to be related to deal with each other on non-arm's length terms. Benefits they or others receive due to the transaction are considered relevant in determining whether a transaction is on arm's length, unrelated party terms.
- 1.8 The taxable income of a superannuation entity is generally taxed at 15 per cent. However, the non-arm's length component (NALC) is taxed at the top marginal rate. This ensures that income derived from a transaction that is not on unrelated party, commercial terms does not receive concessional treatment in superannuation.
- 1.9 There may be a technical deficiency in the NALI provisions whereby some non-arm's length expenses may not result in income being treated as NALI as intended. The amendments

seek to remove any such ambiguity and ensure that superannuation entities cannot circumvent the provisions by entering into schemes with non-arm's length expenditure.

### ***Detailed explanation***

1.10 The taxable income of a complying superannuation fund, complying approved deposit fund or pooled superannuation trust (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 per cent and a NALC which is taxed at the top marginal rate.

1.11 The NALC for an income year is the amount of the fund's NALI less any deductions to the extent that they are attributable to that income (subsection 295-545(2)).

1.12 The low tax component of the fund's taxable income is the amount of the fund's taxable income remaining after deducting the NALC from its total taxable income (subsection 295-545(3)).

### ***Non-arm's length income of superannuation entities***

1.13 There are several categories of NALI, including:

- ordinary or statutory income derived from a scheme where the parties are not dealing with each other at arm's length and the amount of the income is greater than what it would have been had the parties been dealing at arm's length in relation to the scheme (subsection 295-550(1)).

The other types of NALI are:

- private company dividends (including income attributable to dividends) unless the amount is consistent with an arm's length dealing (subsection 295-550(2)); and
- trust distributions:
  - income derived as a beneficiary of a trust, other than because of holding a fixed entitlement (that is, discretionary trust distributions) (subsection 295-550(4)), and
  - income derived 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 the income is more than what might have been expected to derive if those parties had been dealing with each other at arm's length (subsection 295-550(5)).

### ***Existence of a scheme, parties and dealings***

1.14 In order for the NALI provisions relating to ordinary and statutory income to apply, the NALI must have been derived from a scheme, in relation to which the parties were not dealing with each other at arm's length.

1.15 A 'scheme' is broadly defined in subsection 995-1(1) to cover a range of transactions and formal or informal arrangements. There must be one or more parties to a scheme and their dealings need to be examined to determine whether NALI results from a scheme.

### ***Amount of income***

1.16 The legislation requires the identification of a specific amount of ordinary or statutory income that is NALI. That is, the existence of an amount of NALI does not necessarily 'taint' all of a superannuation entity's income; it is necessary to specify the scheme in relation to which the NALI was derived.

1.17 As stated above, NALI can be ordinary or statutory income. Statutory income includes amounts such as net capital gains or amounts obtained as a refund of franking credits by virtue of the application of the tax offset for imputation credits attaching to franked distributions.



1.18 There may be a technical deficiency in Subdivision 295-H, such that its operation in relation to non-arm's length expenses is ambiguous. The amendments are intended to remove any such ambiguity.

1.19 For example, in cases where a superannuation entity acquires assets at less than market value (through arrangements entered into on non-arm's length terms), it may not have been clear whether the derived ordinary and statutory income from these assets falls within the scope of the Subdivision.

1.20 Similarly, the application of paragraphs 295-550(1)(b) and 295-550(5)(b) may be ambiguous where expenses incurred by a superannuation entity in respect of an asset are not on arm's length terms, but the amount of ordinary income or statutory income from the arrangement is the same as might be expected had the dealing been at arm's length. This may be the case, for example, where real property is acquired under a limited recourse borrowing arrangement (LRBA) and where the rent derived under the scheme is at market rates but the interest paid on the loan is not.

1.21 Finally, the current law may not apply to net capital gains in line with the policy intent of Subdivision 295-H. For example, a fund acquires an asset at less than its market value through non-arm's length dealings and then disposes of the asset for market value consideration. The resulting net capital gain may arguably be the same as the gain that would have resulted had the parties been dealing with each other at arm's length when the asset was acquired, due to the operation of the cost base market value substitution rules in section 112-20. This means that the current NALI rules may have no effect, even though the transaction diverts more wealth into the concessionally taxed superannuation entity than would have been possible had the relevant dealings been at arm's length.

## **Summary of new law**

1.22 This Bill clarifies the operation of Subdivision 295-H to ensure that complying superannuation entities cannot circumvent the non-arm's length income rules by entering into schemes involving non-arm's length expenditure.

1.23 The framework for the ordinary and statutory NALI rules remains the same:

- there must be a scheme,
- the party or parties must not be dealing with each other at arm's length by incurring less (or nil) expenditure than would otherwise be expected if the parties were dealing with each other on an arm's length basis in relation to the scheme, and
- the expense must be identifiable as a specific amount (including a nil amount), as must the income gained or produced.

1.24 Expenses may be of a revenue or capital nature, in the same way that NALI may be statutory or ordinary income.

## Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>Non-arm's length expenses incurred by a superannuation entity in gaining or producing assessable income will result in such income being included in the entity's non-arm's length component (NALC). This means the income will be taxed at the top marginal rate.</p> <p>This will be the case whether the expenses are of a capital or revenue nature.</p>	<p>It is not clear whether non-arm's length expenses of a superannuation entity in some circumstances make that income part of a superannuation entity's NALC. Accordingly, such income may be taxed at the concessional rate for superannuation entities.</p>
<p>Where the right to income from a fixed trust was acquired on a non-arm's length basis, that income will be included in a superannuation entity's NALC and taxed at the top marginal rate.</p>	<p>Where the right to income from a fixed trust was acquired on a non-arm's length basis, it is not clear whether that income will be included in a superannuation entity's NALC. Accordingly, such income may be taxed at the concessional rate for superannuation entities.</p>

## Detailed explanation of new law

### Non-arm's length expenses of superannuation entities

1.25 The amendments remove any ambiguity about how Subdivision 295-H applies to income derived from schemes where the superannuation entity has incurred non-arm's length expenditure.

1.26 A new provision is added to ensure that a superannuation entity's non-arm's length income includes income where expenditure incurred in gaining or producing it was not an arm's length expense. This includes where no expense was incurred (but might be expected to have been incurred if the transaction were on arm's length terms). *[Schedule xx, item 1, paragraphs 295-550(1)(b) and (c)]*

1.27 While subsection 295-550(1) has been restructured as part of the amendments, the restructure does not affect the application of the provision to income that would have been captured as NALI prior to the amendments.

1.28 Specifically, the scheme requirement formerly located in paragraph 295-550(1)(a) is now included in the chapeau, and the former requirement that an amount is NALI if it is more than the amount the entity might have derived on an arm's length basis in paragraph 295-550(1)(b) is now paragraph 295-550(1)(a) of the amending legislation. *[Schedule xx, item 1, paragraph 295-550(1)(a)]*

### **Example 1.1 Non-arm's length expenses of a superannuation entity**

An SMSF acquired a commercial property from a third party at its market value of \$1,000,000 on 1 July 2015.

The SMSF derives rental income of \$1,500 per week from the property (\$78,000 per annum).

The SMSF financed the purchase of the property under an LRBA from a related party on terms consistent with section 67A of the SIS Act.

The LRBA was entered into on terms that include no interest, no repayments until the end of the 25 year term and borrowing of the full purchase price of the commercial real property (i.e. 100 per cent gearing).

The SMSF was in a financial position to enter into an LRBA on commercial terms with an interest rate of approximately 5.8 per cent.

The amendments in this Bill make it clear that, as the SMSF has not incurred expenses that it might have been expected to incur in an arm's length dealing in deriving the rental income, that income will be NALI. The income (less deductions attributable to the income) will form part of the SMSF's NALC and will be taxed at the highest marginal rate.

### **Expenses relating to a superannuation entity as beneficiary of a trust**

1.29 When a superannuation entity holds a fixed entitlement to the income of a trust and derives income as a beneficiary of that trust, non-arm's length expenses incurred in acquiring the entitlement or in gaining or producing the income will cause the income to fall within the superannuation entity's NALC. [*Schedule xx, item 2, paragraphs 295-550(5)(b) and (c)*]

#### **Example 1.2 Unit trust**

A retail superannuation fund trustee acquires units in a unit trust, but pays a lower amount for the units than stated in the promotional material for the unit trust due to a scheme the fund has entered into with the broker.

In acquiring the entitlement to a share of the unit trust's earnings, the retail superannuation fund trustee did not incur expenditure it might have been expected to incur if dealing at arm's length with the broker in purchasing the units.

The income derived from the units would have been the same whether or not they were acquired under an arm's length transaction.

The amount earned is non-arm's length income of the retail superannuation fund.

Any net capital gain made on disposal of the units may also be NALI due to the amendments to subsection 295-550(1).

### **Attributing non-arm's length expenses to particular amounts of income**

1.30 Assuming there is a scheme that produced NALI by applying non-arm's length expenses, there must also be a sufficient nexus between the expense/s and the income, that is, the expenditure must have been incurred 'in' gaining or producing the relevant income. This reflects the analysis that must be undertaken in determining whether an expense is deductible under section 8-1, or can be included in the entity's cost base for the transaction if the expense is of a capital nature (see further under the next heading, Non-arm's length capital expenditure that results in NALI).

1.31 For example, where the non-arm's length expense is an interest payment, the identification of the relevant amount of income should be straightforward. That is because a superannuation entity can only borrow under an LRBA, which means that the borrowed funds must be used to acquire a single, separately identifiable asset (subsection 67A(1) of the SIS Act). Where such an asset is used in deriving assessable income, the income so derived will be NALI (see the rental income in Example 1.1 above). However, income derived from other assets that the superannuation entity holds – such as dividend income from publicly listed shares – would not be NALI merely because the superannuation entity incurred a non-arm's length interest expense under the LRBA.

1.32 In order to calculate a superannuation entity's NALC (that is, the amount of taxable income that is taxed at the highest marginal rate), it will also be necessary to identify any deductions that are attributable to NALI. Those deductions may include the non-arm's length expense that caused an amount of an income to be NALI (in the foregoing example, interest expenses).

### **Non-arm's length capital expenditure that results in NALI**

1.33 Non-arm's length capital expenditure can result in a superannuation entity earning NALI. Where a fund acquires an asset for less than market value through non-arm's length dealings, not only will any revenue generated by that asset be NALI, but any statutory income (that is, net capital gains) resulting from the disposal of that asset will also be assessed as NALI. *[Schedule xx, item 1, paragraph 295-550(1)(b); item 3, subsection 295-550(7)]*

1.34 This ensures that there is less of an incentive for trustees of funds to acquire assets at less than market value for the purpose of generating potentially significant ongoing amounts of income which would be sheltered from marginal rates of tax. It further ensures that such income cannot escape taxation entirely where the assets are held in the retirement phase (that is, the income would no longer be treated as exempt current pension income).

1.35 Section 66 of the SIS Act separately prohibits the acquisition of assets by the trustee of a fund from related parties. While there are exceptions to this rule, the prohibition means that compliant superannuation funds are less likely to have acquired assets from related parties on non-arm's length terms.

1.36 As such, the consideration about whether an asset has been acquired on non-arm's length terms should largely be question that is relevant to transactions with unrelated parties, which can occur where the parties enter into a broader non-arm's length scheme. However, if the trustee of a fund were to acquire an asset from a related party on non-arm's length terms in contravention of section 66 of the SIS Act, any income that is generated from the asset would also be NALI.

### **Range of transactions may be on arm's length terms**

1.37 It can be difficult to determine an exact price that is 'non-arm's length'. An 'arm's length' price may be accepted to fall within a range of commercial prices. For example, loans may be available at different interest rates based on a range of factors. Accordingly, for example, an SMSF may be able to apply an acceptable commercial rate of interest to a loan within a band of rates available to it on an arm's length basis.

1.38 Transactions that are on arm's length terms, for example, borrowing arrangements financed by Authorised Deposit-taking Institutions and other commercial lenders or that meet the safe harbour terms in ATO Practical Compliance Guideline PCG 2016/5 are not impacted by these amendments.

1.39 It is unlikely that the measure would affect in-house provision of, or in-sourcing of, functions by large APRA regulated funds as those arrangements are expected to be on an arm's length basis because the trustee of an APRA Regulated fund is likely to be independent of members so does not have the incentive to shelter member funds in the superannuation entity to circumvent contributions caps.

### **Application and transitional provisions**

1.40 The amendments made by this Schedule 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.