



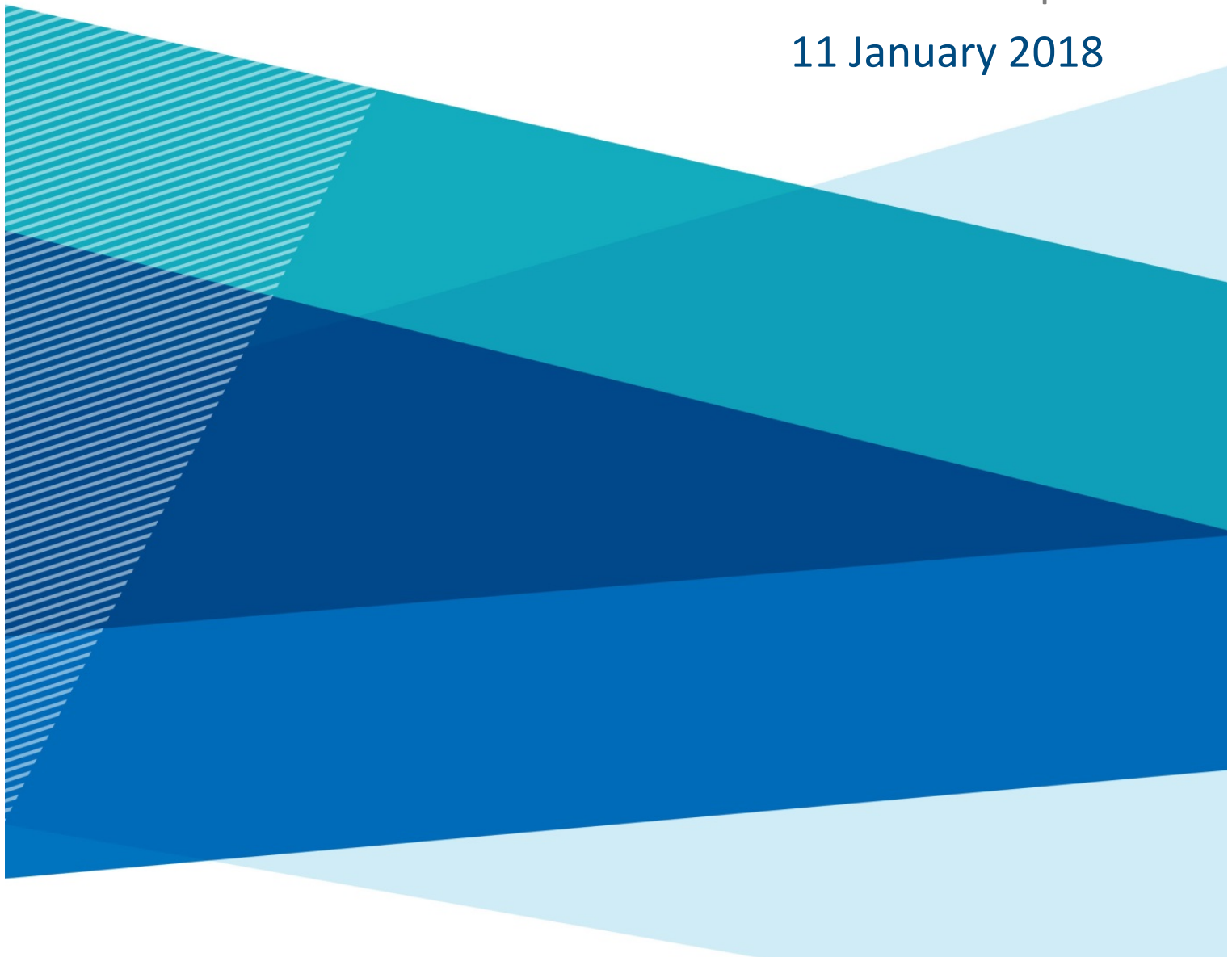
Australian Government
The Treasury

TSY/AU

Superannuation Taxation Integrity Measures

Consultation Paper

11 January 2018



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Manager
Editorial, Media and Speeches Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

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Consultation Process

Request for feedback and comments

Interested parties are invited to comment on this consultation paper. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails are not sufficient for this purpose. If you would like only part of your submission to remain confidential, please provide this information clearly marked as such in a separate attachment.

Closing date for submissions: 09 February 2018

Email	superannuation@treasury.gov.au
Mail	Robb Preston Manager Retirement Income Policy Division The Treasury Langton Crescent PARKES ACT 2600
Enquiries	Enquiries can be initially directed to Robb Preston
Phone	02 6263 2786

Superannuation Taxation Integrity Measures

Introduction

1. The Government has announced two superannuation taxation integrity measures:
 - 1.1. The first measure includes a member's share of the outstanding balance of a Limited Recourse Borrowing Arrangement (LRBA) in their total superannuation balance (TSB).
 - 1.2. The second measure ensures that non-arm's length expenditure is taken into account when determining whether the non-arm's length income (NALI) taxation rules apply to a transaction.
2. These measures are intended to ensure that LRBA's or related party transactions cannot be used to circumvent contribution caps. They are not intended to prevent the use of LRBA's.
3. This discussion paper explains how the measures are intended to operate and seeks comment about:
 - 3.1. whether the two measures meet their policy objectives;
 - 3.2. whether those objectives could be achieved in some other way; and
 - 3.3. whether the measures may give rise to unintended consequences.
4. This document is intended to be read in conjunction with the exposure draft legislation and draft explanatory memoranda for those two measures, being items 4-7 of the *Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: limited recourse borrowing arrangements (Attachment A)* and the *Treasury Laws Amendment (2017 Measures No. 12) Bill 2018: Non-arm's length income (Attachment B)*. The examples in this document below are intended to supplement the examples contained in the draft explanatory memoranda (Attachments A and B), which provide a more detailed explanation of how both provisions will function.

Background

Financial Systems Inquiry (FSI)

5. The Financial System Inquiry (FSI) recommended in 2014 that superannuation funds not be permitted to use LRBA's. The Government did not agree to the recommendation, but asked the Council of Financial Regulators and the Australian Tax Office (ATO) to monitor leverage and risk in the superannuation system and report back in 2018. The ATO is also undertaking further data collection on the use of LRBA's.
6. The taxation integrity measures contained in the draft legislation are not a response to the FSI's recommendations and are not designed to limit the use of borrowing by SMSFs.

Superannuation Taxation Reform Package

7. Legislation to implement the Government's Superannuation Taxation Reform Package (Reform Package) was passed by the Parliament on 23 November 2016, following its announcement in the 2016-17 Budget and extensive consultation.

8. The reforms better target tax concessions to ensure the superannuation system is sustainable and improves confidence in the system by reducing the extent that superannuation is used for tax minimisation and estate planning.
9. This includes an indexed \$1.6 million 'transfer balance cap' (TBC) on the total amount of superannuation savings that can be transferred from a concessional tax 'accumulation account' to a tax-free 'retirement account'.
 - 9.1. Superannuation savings accumulated in excess of the cap can remain in an accumulation superannuation account, where earnings will be taxed at 15 per cent.
 - 9.2. Individuals who breach the cap are required to remove the excess capital from their retirement phase account and are liable to pay tax on the notional earnings attributable to the excess capital.
10. The legislation also lowered the annual non-concessional (post-tax) contributions cap to \$100,000 and introduced a new constraint such that individuals with a TSB of \$1.6 million or more will no longer be eligible to make non-concessional contributions.
11. From 1 July 2018, members will be able to make 'carry-forward' concessional super contributions if they have a TSB of less than \$500,000. They will be able to access their unused concessional contributions cap space on a rolling basis for five years.
12. In the process of implementing the Reform Package, concerns were raised about the ability of SMSF members to use LRBA to circumvent the TBC and reduce their TSB.
13. The first of these integrity concerns related to the potential to use LRBA repayments to circumvent the transfer balance cap by shifting value into the earnings-tax free retirement phase.
 - 13.1. In response to this concern, the Government legislated to ensure that repayments of LRBA entered into on or after 1 July 2017 will count towards the transfer balance cap where they shift value into the retirement phase. The *Treasury Laws Amendment (2017 Measures No. 2) Act 2017* will commence on 1 July 2018.
14. The second integrity concern related to the ability of an SMSF member to use an LRBA to reduce their TSB, allowing them to make additional non-concessional contributions or access the carry forward arrangements for concessional contributions.
 - 14.1. The Minister for Revenue and Financial Services advised key stakeholders on 28 May 2017 of a proposal to address this concern by including a member's share of an outstanding LRBA in their TSB, followed by the release of exposure draft legislation for public consultation between 27 April 2017 and 2 May 2017.
15. In response to stakeholder concerns, the Government deferred the introduction of the TSB integrity measure until 1 July 2018 to allow further public consultation.
 - 15.1. The Government also announced that the measure would be amended to ensure it does not apply to refinancing of existing LRBA loans and certain contracts that straddle the application date of the measure. The exposure draft legislation for the TSB measure ([Attachment A](#)) will be amended to reflect this change.

16. The Government announced in the 2017-18 Budget that it would amend the Non-Arm's Length Income (NALI) provisions of the superannuation tax legislation to ensure they apply in situations where there is non-arm's length expenditure from 1 July 2018.

LRBAs and Total Superannuation Balance

17. As set out in items 4-7 of the *Treasury Laws Amendment (2017 Measures No. 2) Bill 2017 (Attachment A)*, the Government will amend subsections 307-230 and add in 307-231 of the *Income Tax Assessment Act 1997* to include a member's share of the outstanding balance of an LRBA entered into on or after 1 July 2018 in their TSB.
18. A member's TSB is based upon the value of their superannuation interests. For a retirement phase interest, this is generally the value the member would receive if they commuted their interest for a lump sum. Similarly, the value of an accumulation phase interest will usually equal the total amount that could be withdrawn or rolled over into another fund.
19. Therefore, the liability under an LRBA currently reduces a member's TSB by reducing the amount available for commutation or withdrawal. The new measure will cancel out this effect, so that a member's TSB will not be affected by whether their fund has an LRBA liability or not. This integrity measure addresses the potential for an SMSF member to use an LRBA to facilitate additional non-concessional contributions and increase the fund's asset base beyond what would otherwise be possible under the contribution caps.
20. This approach reflects that additional assets acquired under an LRBA will generally produce additional untaxed earnings and capital appreciation for the fund on an ongoing basis. However, under the current law, this higher gross asset base and associated earning capacity is not reflected in a member's TSB.
21. The new integrity measure also ensures that SMSF members that have attained a condition of release cannot circumvent the caps by withdrawing lump sums and re-contributing the funds as a loan.

Example 1

Laura is the sole member of her SMSF, which holds \$2 million in accumulation phase.

- Laura takes a lump sum of \$500,000 from the SMSF, on 1 June 2019 which reduces her TSB as at 30 June 2019 to \$1.5 million;
- On 30 June 2019, Laura lends the \$500,000 on commercial terms back to her SMSF under an LRBA;
- The SMSF uses \$1 million of its existing assets and the borrowed \$500,000 to acquire a \$1.5 million investment property.

Current law

Laura's TSB as at 30 June 2019 is \$1.5 million, comprising the net value of the property of \$1 million (\$1.5 million purchase price less the \$500,000 LRBA) as well as the other assets valued at \$500,000.

As her TSB is below \$1.6 million, Laura can make further non-concessional contributions of up to \$100,000 in the year ending 30 June 2020.

As the SMSF repays the LRBA, the net value of the fund will increase and Laura's TSB will approach the \$1.6 million threshold. However just prior to reaching the \$1.6 million threshold, she could withdraw another lump sum and enter into a new LRBA to acquire another income-producing asset. This would reduce her TSB again, allowing more contributions to be made to the SMSF.

New law

Laura's TSB at 30 June 2019 is \$2 million comprising the net value of the property of \$1 million, the other assets valued at \$500,000 and the \$500,000 outstanding loan balance under the LRBA. As her TSB exceeds \$1.6 million, Laura cannot make non-concessional contributions in the year ending 30 June 2020. Entering into a new LRBA arrangement with the SMSF will no longer increase Laura's capacity to make non-concessional contributions for that year.

The trustee can continue to repay the LRBA but cannot use non-concessional contributions to do so.

22. The policy intent of the new rules is that, if the gross assets of the member exceed \$1.6 million, the member will not be able to make non-concessional contributions. This will mean that people can use non-concessional contributions to repay LRBA's that build total superannuation asset holdings up to \$1.6 million per member, but not beyond that level. If the gross balance is above \$500,000, they will not be able to make catch-up concessional contributions.
23. This measure will apply to new LRBA's entered on or after the new law commences on 1 July 2018. Refinancing of existing loans and certain contracts entered into prior to that date will also be excluded. (The exposure draft legislation at [Attachment A](#) will be amended to reflect this change.)

24. This measure should only affect those funds whose members have a TSB at, exceeding or approaching \$1.6 million. It would only affect capacity to use an LRBA where the borrowing cannot be repaid using the fund's own resources in combination with concessional contributions. The measure should not affect a fund's ability to borrow in many situations, including:
- 24.1. Where a member has a TSB of more than \$1.6 million but the fund repays the LRBA with income from the LRBA asset, other fund earnings or concessional contributions.
 - 24.2. Where the member's TSB (including the outstanding balance of the LRBA) is below \$1.6 million, allowing the member to make non-concessional contributions to help meet the LRBA repayments.

Non-arm's length income

- 25. The Government will also amend the NALI rules contained in section 295-550 of the *Income Tax Assessment Act 1997* (Cth) to ensure that superannuation entities cannot circumvent these rules by using non-arm's length expenditure rather than non-arm's length income.
- 26. This amendment is intended to deny concessional taxation treatment to income derived from a non-arm's length arrangement where fund expenditure is set below-market rates, reducing opportunities for members to increase superannuation savings in a way that is not included in the contribution caps.
- 27. A non-arm's length arrangement exists where the trustee of an SMSF enters into a transaction with a party, often a related party, where in respect of the dealing the outcome is not reflective of real bargaining - for example, where a member loans funds to their SMSF or leases a business real property at above market rates from the SMSF. These dealings will usually be on better terms than can be obtained from a third party, e.g. no interest or higher rent.
- 28. The current NALI rules ensure that *income* derived from related party transactions does not receive concessional tax treatment if it is higher than could be derived on commercial terms. However, the rules do not currently take into account *fund expenditure* incurred that would normally apply in a commercial transaction, which reduce non-arm's length income e.g. where interest is not paid on the loan from a related party, meaning the fund's net income is higher than it would have been in a commercial transaction.
- 29. The proposed amendment would include these expenses, meaning that these arrangements with higher net income will not receive concessional tax treatment.

Example 2

Shahzeb loans his SMSF \$1 million under an LRBA. Shahzeb does not charge interest on the loan, and no repayments are required until the end of the 25 year loan term.

The SMSF uses this loan to purchase an income-producing rental property worth \$1 million. At the time of purchase his SMSF has \$450,000 cash in the bank and some listed securities. The rental income derived from the asset is \$1,750 per week (the market rate).

The terms of the LRBA are not consistent with an arm's length dealing. (For further guidance about what might be expected of an arm's length arrangement, see Practical Compliance Guideline 2016/5).

It is assumed that the SMSF incurs expenditure other than principal and interest repayments during the relevant income years in gaining or producing the rental income, for example payment of council rates.

Current Law

As the rent is not more than would have been derived if the parties had been dealing with each other at arm's length in relation to the LRBA, the current NALI rules would not apply.

New Law

Under the proposed law, the rental income derived each year by the SMSF will be assessable as NALI. This is because the SMSF has incurred a loss, outgoing or expenditure (including capital expenditure) in gaining or producing the rental income that is less than the amount that it might have been expected to incur if had entered into the LRBA on arm's length terms.

Any capital gain the SMSF derives on the disposal of the rental property will also be NALI.

30. This measure should only affect LRBAs that are not at arm's length and have expenses set at levels that are uncommercial (for example, a loan from a member to their SMSF that is interest-free). The changes should generally not affect:
 - LRBAs entered into with unrelated third parties, such as financial institutions;
 - LRBAs with commercial rates of interest (and other expenses).
31. There may also be circumstances in which both the NALI integrity changes and the TSB integrity measure outlined above would apply.

Example 3

Ipsitt is the sole member of an SMSF with total assets of \$1.5 million, all in the accumulation phase. The assets generate a 6 per cent gross return (\$90,000).

Ipsitt lends the fund \$1 million, under an LRBA, to acquire a commercial property worth \$1 million. The interest rate on the loan is set at a non-commercial rate of 1 per cent per annum, with no principal repayments required until the end of the 25 year loan term. At the time of purchase Ipsitt's SMSF has cash assets of \$450,000.

If the terms of the LRBA were consistent with an arm's length dealing, it could be expected that the SMSF would make principal and interest repayments of \$5,800 per month.

The rental income derived from the property is \$91,000 for the year. Interest on the loan is \$10,000 per year. The fund therefore generates additional net income of \$81,000 per year (before tax) as a result of the arrangement (ignoring other costs the fund may have to pay in relation to the property).

Current law

It is arguable that the NALI rules may not apply to the ordinary and statutory income the SMSF derives under the scheme and that the rental income is not NALI.

Therefore, the SMSF would generate net after-tax earnings of \$145,350 (\$171,000 less 15 per cent income tax).

Meanwhile, Ipsitt's TSB is not affected by entering into the LRBA and he can continue to make additional non-concessional contributions.

New law

Under the proposed law, the income derived from the rental property will be NALI, because the borrowing expenses incurred by the SMSF are less than what it might have been expected to incur if he had entered into the LRBA on an arm's length basis (the interest rate is only 1 per cent).

Therefore, the rental income derived by the SMSF less borrowing expenses (\$81,000) will be taxed at the highest marginal rate (currently 47 per cent), amounting to \$38,070. The remaining assessable income of the SMSF (\$90,000) will be taxed at 15 per cent amounting to \$13,500. Therefore, the SMSF's total earnings after-tax will be \$119,430.

Further, the LRBA transaction would cause Ipsitt's TSB to exceed the \$1.6 million threshold, so he could not make any further non-concessional contributions.

Questions for consultation

32. Does the exposure draft legislation achieve the policy intent of these measures?
33. Is there some other way in which that policy intent could be achieved?
34. Is there a risk of unintended consequences?

Attachment A - Treasury Laws Amendment
(Measures No. 2) Bill 2017: limited recourse
borrowing arrangements (exposure draft) and
explanatory memorandum (exposure draft)

EXPOSURE DRAFT

EXPOSURE DRAFT

1
2
3
4
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Inserts for
**Treasury Laws Amendment (2017
Measures No. 2) Bill 2017: limited
recourse borrowing arrangements**

Commencement information

Column 1	Column 2	Column 3
Provisions	Commencement	Date/Details
1. Schedule #	The first 1 January, 1 April, 1 July or 1 October to occur after the day this Act receives the Royal Assent.	

EXPOSURE DRAFT

Schedule #—Superannuation integrity measures

Income Tax Assessment Act 1997

1 Subsection 294-25(1) (at the end of the table)

Add:

- 5 a *transfer balance the amount of the credit at the time provided by
6 credit arises under specified in section 294-55
7 section 294-55 because section 294-55
 of a repayment of a
 limited recourse
 borrowing arrangement

2 At the end of Subdivision 294-B

Add:

294-55 Repayment of limited recourse borrowing arrangement

- 12 (1) A *transfer balance credit arises in your *transfer balance account
13 if:
- 14 (a) a *superannuation provider makes a payment in respect of a
15 *borrowing under an *arrangement that is covered by the
16 exception in subsection 67A(1) of the *Superannuation*
17 *Industry (Supervision) Act 1993* (which is about limited
18 recourse borrowing arrangements); and
- 19 (b) as a result, there is an increase in the *value of a
20 *superannuation interest that supports a *superannuation
21 income stream of which you are the *retirement phase
22 recipient; and
- 23 (c) the superannuation interest is in a *superannuation fund that
24 is covered by subsection (4) at the time of the payment.
- 25 (2) The amount of the credit is the amount of the increase in *value.
- 26 (3) The credit arises at the time of the payment.

EXPOSURE DRAFT

-
- 1 (4) A *complying superannuation fund is covered by this subsection at
2 a time if any of these requirements are satisfied:
3 (a) the fund is a *self managed superannuation fund at the time;
4 (b) there are less than 5 *members of the fund at the time.

5 **3 At the end of subsection 307-230(1)**

6 Add:

- 7 ; (d) if you have an LRBA amount under section 307-231 (about
8 limited recourse borrowing arrangements) in relation to one
9 or more *regulated superannuation funds—the sum of those
10 LRBA amounts.

11 **4 At the end of Subdivision 307-D**

12 Add:

13 **307-231 Limited recourse borrowing arrangements**

- 14 (1) You have an amount under this section (an *LRBA amount*), in
15 relation to a *regulated superannuation fund in which you have one
16 or more *superannuation interests, if:
17 (a) the *superannuation provider in relation to the fund has made
18 a *borrowing under an *arrangement that is covered by the
19 exception in subsection 67A(1) of the *Superannuation*
20 *Industry (Supervision) Act 1993* (which is about limited
21 recourse borrowing arrangements); and
22 (b) the borrowing has not been repaid at the time of working out
23 your *total superannuation balance; and
24 (c) at that time, the asset or assets that secure the borrowing
25 support, to an extent, a *superannuation interest of yours; and
26 (d) the fund is covered by subsection (3) at the time of the
27 payment.
- 28 (2) The amount of your LRBA amount in relation to the *regulated
29 superannuation fund is the sum of the amounts worked out using
30 the following formula for each such *borrowing:

31
$$\text{Outstanding balance} \times \frac{\text{Value of your supported super interests}}{\text{Value of all supported super interests}}$$

32 where:

EXPOSURE DRAFT

1 *outstanding balance* means the outstanding balance on the
2 *borrowing at the time of working out your *total superannuation
3 balance.

4 *value of all supported super interests* means the sum of the *values
5 at that time of all *superannuation interests in the *regulated
6 superannuation fund that are supported by the asset or assets that
7 secure the *borrowing.

8 *value of your supported super interests* means the sum of the
9 *values at that time of each *superannuation interest of yours that is
10 supported by the asset or assets that secure the *borrowing.

11 (3) A *regulated superannuation fund is covered by this subsection at a
12 time if any of these requirements are satisfied:

- 13 (a) the fund is a *self managed superannuation fund at the time;
14 (b) there are less than 5 *members of the fund at the time.

15 *Taxation Administration Act 1953*

16 **6 At the end of subsection 390-5(9) in Schedule 1**

17 Add:

- 18 ; (d) if the superannuation plan is a *regulated superannuation
19 fund in relation to which the individual has an LRBA amount
20 under section 307-231 of the *Income Tax Assessment Act*
21 *1997* (about limited recourse borrowing arrangements)—the
22 amount of the LRBA amount.

23 **7 Application**

24 The amendments made by this Schedule apply in relation to borrowings
25 entered into on or after the commencement of this Schedule.

TREASURY LAWS AMENDMENT (2017 MEASURES NO. 2) BILL 2017:
LIMITED RECOURSE BORROWING ARRANGEMENTS

EXPOSURE DRAFT EXPLANATORY MATERIALS

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DRAFT

Glossary

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

<i>Abbreviation</i>	<i>Definition</i>
Amending Act	<i>Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
IT(TP) Act 1997	<i>Income Tax (Transitional Provisions) Act 1997</i>
LRBA	Limited recourse borrowing arrangement
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SMSF	Self-managed superannuation fund

Superannuation reform package amending provisions - limited recourse borrowing arrangements

Outline of chapter

1.1 The amendments in Schedule 1 amend the transfer balance cap and total superannuation balance rules that were enacted through the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016*.

1.2 The changes ensure that the transfer balance cap rules apply appropriately where there is a repayment of a limited recourse borrowing arrangement that transfers value from accumulation interests into retirement phase interests. The changes also ensure that where a fund has limited recourse borrowing arrangements in place, the total value of its assets is properly accounted for in working out individual members' total superannuation balances.

1.3 All legislative references in this Chapter are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise stated.

Context of amendments

1.4 The *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (the Amending Act) legislated the Government's superannuation reform package that was announced in the 2016-17 Budget.

1.5 The amendments contained in Schedule 1 relate to the transfer balance cap measure and the definition of total superannuation balance that were included in that package.

Transfer balance cap

1.6 The transfer balance cap was enacted through Division 294 and limits the total value of capital that can be transferred into the tax exempt 'retirement phase' of superannuation in respect of an individual.

1.7 It does this by requiring individuals to commute one or more of their superannuation income streams where they have ‘excess transfer balance’. An individual has excess transfer balance when the transfer balance in their transfer balance account exceeds their transfer balance cap (\$1.6 million for the 2017/18 financial year) (see section 294-30). Subdivision 136-A of Schedule 1 to the *Taxation Administration Act 1953* sets out the determination process that initiates a mandatory reduction of an individual’s retirement phase superannuation interests.

1.8 The transfer balance in an individual’s transfer balance account changes according to the transfer balance credit and transfer balance debit entries made to the account. A credit reduces the amount of available cap space that an individual has, whereas as a debit increases the amount available.

1.9 For superannuation income streams that commence on or after 1 July 2017, an individual will receive a ‘transfer balance credit’ equal to the value of the interest that supports the superannuation income stream when they start to be the ‘retirement phase recipient’ of the income stream (see item 2 of the table in subsection 294-25(1)). Individuals also receive a transfer balance credit equal to the value of the superannuation interest that supports a superannuation income stream of which they are a retirement phase recipient just before 1 July 2017 (see item 1 of the table in subsection 294-25(1)).

1.10 The transfer balance in an individual’s transfer balance account is reducible by ‘transfer balance debits’ (see section 294-80), which facilitate roll-overs and ensures that an individual’s transfer balance reflects the net amount of capital that has been transferred into the retirement phase in respect of them. Individuals receive debits for commutations of a superannuation income stream of which they are the retirement phase recipient, and for other events that reduce the value of superannuation interests they have in the retirement phase.

Total superannuation balance

1.11 The concept of ‘total superannuation balance’ was introduced by the Amending Act. The term is defined by section 307-230 and, with some modifications, is designed to reflect the total value of all interests that an individual has in the superannuation system.

1.12 To determine an individual’s total superannuation balance, the following amounts are added together:

- The accumulation phase value of all superannuation interests that are *not* in the retirement phase;

- The transfer balance in their transfer balance account, subject to certain modifications (but not where the balance is less than nil);
- The amount of each roll-over superannuation benefit that is not reflected in the individual's accumulation phase or transfer balance.

1.13 The total superannuation balance is used in the non-concessional contribution cap rules, the unused concessional cap carry forward rules, the definition of disregarded small fund asset rules, and in the spouse tax offset.

Limited recourse borrowing arrangements

1.14 'Limited recourse borrowing arrangements' (LRBAs) are an exception to the general prohibition on borrowing that applies to the trustees of regulated superannuation funds contained in subsection 67(1) of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

1.15 The exceptions for LRBAs are also provided by sections 67A and 67B of the SIS Act. Section 67A relates to borrowing arrangements that the trustee of a registered superannuation fund uses to acquire an 'acquirable asset' and section 67B extends the exception to replacement assets.

1.16 The term, 'acquirable asset' is defined by subsection 67A(2) as a single asset that is not money. Subsection 67A(3) also extends sections 67A and 67B so that they apply to collection of identical assets in the same way as they apply to a single asset (for example, a collection of shares of the same class in a single company).

1.17 In addition to requirement about the rights and interest that a trustee has in an acquirable asset, subsection 67A(1) contains conditions about limiting any rights against the trustee for a default on the arrangement to rights in respect of the acquirable asset.

Summary of new law

1.18 Schedule 1 amends the transfer balance cap rules to create an additional transfer balance credit. This credit will arise where the repayment of an LRBA shifts value between accumulation phase interests and retirement phase interests in a superannuation fund that is a self-managed superannuation fund (SMSF) or a complying superannuation fund with less than 5 members. The amount of the credit that an individual member receives is equal to the increase in the value of their retirement phase superannuation interests.

1.19 Schedule 1 also amends the total superannuation balance so that it takes into account the outstanding balance of an LRBA that is entered into by the trustee of a regulated superannuation fund that is an SMSF or that has less than 5 members. As a result of these changes, an individual member's total superannuation balance is increased by the share of the outstanding balance of an LRBA related to the assets that support their superannuation interests.

Detailed explanation of new law

Transfer balance credit for LRBA repayments

1.20 An individual will receive a transfer balance credit where a superannuation provider makes a payment in respect of an LRBA that increases the value of a superannuation interest that supports a superannuation income stream of which they are a retirement phase recipient. *[Schedule 1, items 1 and 2, item 5 in the table in subsection 294-25(1) and subsection 294-55(1)]*

1.21 For the transfer balance credit to arise, the superannuation interest must be in a complying superannuation fund that is a self-managed superannuation fund or that has less than 5 members. *[Schedule 1, item 2, paragraph 294-55(1)(c) and subsection 294-55(4)]*

1.22 The transfer balance credit arises at the time of the payment, and the amount of the credit that the individual receives is the amount by which the superannuation income stream increased in value. *[Schedule 1, items 1 and 2, item 5 in the table in subsection 294-25(1) and subsections 294-55(2) and (3)]*

1.23 This credit ensures that the transfer balance in an individual's transfer balance account reflects shifts of value between a fund's retirement phase and accumulation assets. This treatment is consistent with the way transfers from accumulation phase assets are treated when a superannuation income stream is commenced.

1.24 A repayment of an LRBA increases the value of a superannuation interest that is supported by the asset acquired through the LRBA. A repayment sourced from assets that support the same superannuation interest will not increase the value of that interest because the reduction in the LRBA liability is offset by a corresponding reduction in cash. Therefore, repayments that are made under these conditions will not give rise to a transfer balance credit as they do not satisfy the requirement that there is an increase in value of the superannuation interest supporting a superannuation income stream.

1.25 However, if the repayment is sourced from other assets (for example, assets that support separate accumulation interests that the individual has in the fund), then there will be no offsetting decrease in the value of the retirement phase superannuation interest, meaning that its overall value will be increased by the amount of the repayment. In such cases, the transfer from the other assets would not result in a credit to the transfer balance account under the current transfer balance credit items. The new transfer balance credit addresses this gap by ensuring that the transfer balance cap takes into account the increase in value that has occurred through the repayment.

1.26 The restriction of the transfer balance credit in relation to superannuation interests in funds that are SMSFs or that have less than 5 members is consistent with the one taken for disregarded small fund assets (see section 295-387). Limiting the transfer balance credit in this way recognises that in larger superannuation funds, there is unlikely to be a direct connection between a specific asset of the fund and the superannuation interests of an individual member.

1.27 The condition in the new transfer balance credit about a payment being made in relation to an LRBA identifies the LRBA by reference to a borrowing under an arrangement that is covered by the exception in subsection 67A(1) of the SIS Act. [*Schedule 1, item 2, paragraph 294-55(1)(a)*]

Example 1.1 – repayment for assets solely supporting retirement interests

Bob is 65 and is the only member of his SMSF. Bob's superannuation interests are valued at \$3 million and are based on cash that the SMSF holds.

Bob's SMSF acquires a \$2 million property. This property is purchased after 1 July 2017 using \$500,000 of the SMSF's cash and an additional \$1.5 million that it borrows through an LRBA.

Bob then commences an account-based superannuation income stream. The superannuation interest that supports this superannuation income stream is backed by the property, the net value of which is \$500,000 (being \$2 million less the \$1.5 million liability under the LRBA). Bob therefore receives a transfer balance credit of \$500,000 under item 2 of the table in subsection 294-25(1).

In the first year, Bob's SMSF makes monthly repayments of \$10,000. Half of each repayment is made using the rental income generated from the property. The other half of each repayment is made using cash that supports Bob's other accumulation interests.

At the time of each repayment, Bob receives a transfer balance credit of \$5,000, representing the increase in value of the superannuation interest that supports his superannuation income stream.

The repayments that are sourced from the rental income that the SMSF receives do not give rise to a transfer balance credit because they do not result in a net increase in the value of the superannuation interest that support his superannuation income stream.

1.28 This transfer balance credit does not directly affect the borrowing arrangements that a fund can enter into, or the manner in which it repays any such arrangements.

1.29 While individuals whose transfer balance accounts are less than the transfer balance cap will have less unused cap space to commence any new superannuation income streams, this outcome appropriately reflects the assets that have been transferred into the retirement phase in respect of their superannuation income streams.

1.30 A transfer balance credit may result in an individual having an excess transfer balance. Where this occurs, an amount equal to the credit can be rolled-back through a commutation or partial commutation of the superannuation income stream. The commutation of the superannuation income stream will entitle the individual member to a transfer balance debit under item 1 in the table in subsection 294-80(1). The commutation of the superannuation income stream does not require any changes to the underlying assets in the fund, although the decrease in the current pension liabilities of the fund will appropriately affect the fund's access to the various earnings tax exemptions.

1.31 The transfer balance credit for repayments will not apply to the extent that a repayment is made in respect of asset supporting a superannuation interest related to a defined benefit income stream. This is because the right to payments that an individual has under a defined benefit income stream is unaffected by the assets or investments of a fund. As a result, the decrease in liabilities over an asset in the fund will not affect the value of the superannuation interest that supports the income stream.

LRBAs count towards total superannuation balance

1.32 An individual's total superannuation balance is increased by an amount if an asset that supports one or more of their superannuation interests is subject to an LRBA. *[Schedule 1, items 3 and 4, paragraph 307-230(1)(d) and subsection 307-231(1)]*

1.33 The amount by which an individual's total superannuation balance is increased is equal to a proportion of the outstanding balance of the LRBA. This proportion is based on the individual's share of the total superannuation interests that are supported by the asset that is subject to the LRBA. *[Schedule 1, item 4, subsection 307-231(2)]*

1.34 This increase to an individual member's total superannuation balance ensures that it more accurately reflects the overall values of the assets in a fund that support the individual's superannuation interests. This approach is appropriate because total superannuation balance is relevant in working out whether a fund can apply the segregated method, and the way in which an individual can increase the asset base of a fund through contributions (specifically by using the unused concessional cap carry forward rules and making non-concessional contributions).

1.35 As with the transfer balance credit for repayments, the addition to the total superannuation balance identifies an LRBA that a fund has by reference to a borrowing under an arrangement that is entered into by a regulated superannuation fund and which is covered by the exception in subsection 67A(1) of the SIS Act. [*Schedule 1, item 4, paragraph 307-231(1)(a)*]

1.36 Similarly, the increase to an individual's total superannuation balance will only occur where the LRBA was entered into by a superannuation provider of a regulated fund that is an SMSF or that has less than 5 members. [*Schedule 1, item 4, paragraph 307-231(1)(d) and subsection 307-231(3)*]

1.37 For the increase to apply to an individual's total superannuation balance, a regulated superannuation fund must have used the borrowing to acquire one or more assets, and any such assets must support the superannuation interests of an individual at the time at which the total superannuation balance is determined.

1.38 The connection between an asset of a fund and an individual member's superannuation interests relates to the way in which the fund has allocated its assets to meet its current and future liabilities in relation to the member's interests. The test requires a fund to determine which of its LRBA assets support which members' interests, as well as the extent to which those interests are supported. While this is a new requirement in respect of LRBAs, the assessment builds on the framework that already exists for funds in tracking the way in which income from its assets is allocated between the interests of its members.

1.39 The outstanding balance of an LRBA is the amount still owing under the LRBA. Where an individual has a superannuation interest that is supported by an asset that is subject to an LRBA, the increase to their total superannuation balance is based on their share of this outstanding balance.

1.40 While an individual's total superannuation balance can generally be measured 'at a time', it is only relevant at the end of a particular income year. This is because the non-concessional contribution cap rules, the unused concessional cap carry forward rules, the disregarded small fund asset rule and the spouse tax offset rule all use the total

superannuation balance ‘just before the start of the income year’ (see paragraphs 290-230(4A)(b), 291-20(3)(b), 292-85(2)(b) and 295-387(2)(c)). This means that the outstanding balance of an LRBA only needs to be identified at the end of an income year for the purposes of adding a share of that outstanding balance to an individual’s total superannuation balance.

1.41 Including this proportion of the outstanding balance in a member’s total superannuation balance prevents double counting of the outstanding balance from occurring where more than one member has an interest supported by an asset that was acquired through an LRBA.

1.42 Where only one member’s interests are supported by an asset, the proportion will be equal to 1, meaning that an amount equal to the outstanding balance is added to the member’s total superannuation balance.

Example 1.2– total superannuation balance where there is more than one member

Peter and Sue are the only members of their SMSF. The value of Peter’s superannuation interests in the fund is \$1 million. The value of Sue’s superannuation interests is \$2 million. All of the assets of the fund that support their interests are cash.

The SMSF acquires a \$3.5 million property. The SMSF purchases the property using \$1.5 million of its own cash and borrows an additional \$2 million using an LRBA.

The SMSF now holds assets worth \$5 million (being the sum of the \$1.5 million in cash and the \$3.5 million property). The fund also has a liability of \$2 million under the LRBA.

Of its own cash that it used, 40 per cent (\$600,000) was supporting Peter’s superannuation interests and the other 60 per cent (\$900,000) was supporting Sue’s interests. These percentages also reflect the extent to which the asset supports Peter and Sue’s superannuation interests.

Peter’s total superannuation balance is \$1.8 million. This is comprised of the \$400,000 of cash that still supports his superannuation interest, the 40 per cent share of the net value of the property (being \$600,000), and the 40 per cent share of the outstanding balance of the LRBA (being \$800,000).

Sue’s total superannuation balance is \$3.2 million. This is comprised of the \$1.1 million of cash that still supports her superannuation interest, the 60 per cent share of the net value of the property (being \$900,000), and the 60 per cent share of the outstanding balance of the LRBA (being \$1.2 million).

1.43 In contrast to the transfer balance credit for repayments of an LRBA, there is no requirement that particular superannuation interests be in the retirement phase for the increase to total superannuation balance to apply. This is because total superannuation balance assigns an appropriate value to all of an individual's superannuation interests in a fund, irrespective of whether those interests are in the retirement phase or not.

1.44 The amendments also extend the matters that may be included in the member contribution statement to include an LRBA amount that relates to an individual's total superannuation balance. [*Schedule 1, item 6, paragraph 390-5(9)(d) in Schedule 1 to the Taxation Administration Act 1953*]

1.45 Although the matters covered by subsection 390-5(9) in Schedule 1 to the *Taxation Administration Act 1953* do not limit the information that the Commissioner of Taxation can request in the member contribution statement, this amendment makes it clear that this will be information that a fund will be required to report.

1.46 Because the information relates to the liabilities that a fund has in respect of its assets, the outstanding balance of an LRBA is information that will be already known by the trustee of a regulated superannuation fund. However, although this information will now need to be identified on a member basis, trustees will only have to do so in respect of the end of a particular income year.

Application and transitional provisions

1.47 The amendments made by this Schedule apply in relation to borrowings that are entered into on or after the Schedule commences (being the first 1 January, 1 April, 1 July or 1 October that occurs after the day the Act containing Schedule 1 receives the Royal Assent). [*Schedule 1, item 7*]

Attachment B - Treasury Laws Amendment
(2017 Measures No. 12) Bill 2018: Non-arm's
length income (exposure draft) and explanatory
memorandum (exposure draft)

EXPOSURE DRAFT

EXPOSURE DRAFT

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Inserts for
**Treasury Laws Amendment (2017
Measures No. 12) Bill 2017: TSY/45/253
Non arm’s length income**

Commencement information		
Column 1	Column 2	Column 3
Provisions	Commencement	Date/Details
1. Schedule ??	The first 1 January, 1 April, 1 July or 1 October to occur after the day this Act receives the Royal Assent.	

EXPOSURE DRAFT

Schedule ??—Non arm’s length income of complying superannuation entities

Income Tax Assessment Act 1997

1 Subsection 295-550(1)

Repeal the subsection, substitute:

(1) An amount of *ordinary income or *statutory income is ***non-arm’s length income*** of a *complying superannuation fund, a *complying approved deposit fund or a *pooled superannuation trust 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 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.

This subsection does not apply to an amount to which subsection (2) applies or an amount *derived by the entity in the capacity of beneficiary of a trust.

2 Subsection 295-550(5)

Repeal the subsection, substitute:

(5) 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

EXPOSURE DRAFT

1 length in relation to the scheme, one or more of the following
2 applies:

- 3 (a) the amount of the income is more than the amount that the
4 entity might have been expected to derive if those parties had
5 been dealing with each other at arm's length in relation to the
6 scheme;
- 7 (b) in acquiring the entitlement or in gaining or producing the
8 income, the entity incurs a loss, outgoing or expenditure of
9 an amount that is less than the amount of a loss, outgoing or
10 expenditure that the entity might have been expected to incur
11 if those parties had been dealing with each other at arm's
12 length in relation to the scheme;
- 13 (c) in acquiring the entitlement or in gaining or producing the
14 income, the entity does not incur a loss, outgoing or
15 expenditure that the entity might have been expected to incur
16 if those parties had been dealing with each other at arm's
17 length in relation to the scheme.

18 **3 After subsection 295-550(6)**

19 Insert:

- 20 (7) Paragraphs (1)(b) and (c) and (5)(b) and (c) apply to a loss,
21 outgoing or expenditure whether or not it is of capital or of a
22 capital nature.

23 **4 Application of amendments**

24 The amendments made by this Schedule apply in relation to income
25 derived in the 2018-19 income year and later income years.

NON-ARM'S LENGTH INCOME OF SUPERANNUATION ENTITIES

EXPOSURE DRAFT EXPLANATORY MATERIAL

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Glossary

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

Chapter 1

Non-arm's length income of superannuation entities

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.