



# Non-arm's length expense rules for superannuation funds

Consultation paper

January 2023

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# Contents

- Contents ..... ii
- Consultation Process ..... 3
  - Request for feedback and comments ..... 3
- Non-arm’s length expense rules for superannuation funds ..... 4
  - Purpose of this consultation paper ..... 4
  - Background ..... 5
    - The non-arm’s length income provisions ..... 5
    - 2017-18 Budget changes ..... 5
    - ATO’s interpretation and compliance approach ..... 6
- Potential amendments ..... 8
  - Self-managed superannuation funds and small APRA-regulated funds ..... 9
  - Large APRA-regulated funds ..... 12

# Consultation Process

## Request for feedback and comments

The Government welcomes feedback and comments on this consultation paper. Interested parties are invited to comment on this paper by Tuesday, 21 February 2023. Any comments received will feed into the development of future policy.

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 do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment.

Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

### Closing date for submissions: 21 February 2023

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The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

# Non-arm's length expense rules for superannuation funds

## Purpose of this consultation paper

The Government is currently considering options to amend the non-arm's length income (NALI) provisions which apply to superannuation funds. This paper has been prepared by Treasury as the basis for engagement with stakeholders on potential reforms to the NALI provisions. The approach outlined in this paper is intended to facilitate a public consultation process and does not represent a settled position of the Government.

The NALI provisions are an integrity measure to prevent **income from being diverted into** superannuation funds to benefit from lower rates of tax compared to other entities, particularly the marginal rates applying to individual taxpayers. The income of superannuation funds is generally subject to a concessional tax rate of 15 per cent, with a one-third discount for capital gains tax, or zero per cent on fund earnings if they are on assets supporting a pension for an individual who has reached their preservation age, retired and started a retirement income stream.

Where income is deemed to be derived from a non-arm's length transaction, it is taxed at the highest marginal rate of 45 per cent. This ensures that any income derived from a non-arm's length arrangement does not receive the preferential tax treatment that superannuation income receives otherwise.

While the NALI provisions are operating broadly as intended, the Government appreciates recent feedback from superannuation stakeholders on these provisions. Some superannuation industry stakeholders have raised the potential for scenarios in which there are disproportionately severe outcomes for breaches of these rules, particularly those relating to general expenses of a fund. Stakeholders have also raised concerns the NALI provisions related to general expense arrangements place an onerous compliance burden on superannuation funds.

The potential approach outlined in this paper seeks to balance maintaining the integrity of the tax system with providing a greater level of certainty for funds that the consequences of any breaches would be proportionate to the magnitude of that breach and ensuring the rules are appropriately focussed.

The consultation process and any comments received in relation to the potential amendments outlined in this paper will inform the development of future policy regarding the NALI provisions, particularly in relation to general expenses of a superannuation fund.

# Background

## The non-arm's length income provisions

The NALI provisions in section 295-550 of the *Income Tax Assessment Act 1997* (ITAA) are intended to prevent superannuation funds from transacting on non-commercial terms. In general terms, NALI may arise if one party conducts a transaction with another party where those parties are not dealing with each other at arm's length, or through the fund owning an asset that produces income on a non-arm's length basis above the market rate.

The NALI provisions apply to self-managed superannuation funds (SMSFs), small APRA-regulated funds (SAFs) with 6 or fewer members, and large APRA-regulated funds.

The ITAA defines income as NALI to include situations where it is derived by a complying superannuation entity as a result of a scheme where the parties are not dealing with each other at arm's length, and 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.

In this context, the ITAA defines the term scheme as *"any arrangement or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise."*

## 2017-18 Budget changes

At the 2017-18 Budget, the Government announced changes to the definition of NALI. This measure expanded the definition of NALI to ensure that income from an asset where there are lower expenses (or no expenses) are captured by the provisions. Such arrangements are referred to as non-arm's length expenses (NALE).

While the previous NALI rules ensured non-arm's length income was taxed at the highest marginal income tax rate, rather than concessional superannuation rates, they did not capture non-arm's length expenses in all circumstances. If the level of income, before expenses were deducted, was on an arm's length basis the pre-2017-18 Budget NALI rules would not apply to tax minimisation strategies where fund expenditures were reduced through non-arm's length dealings.

The NALI rules were extended to expenses with the passage of *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019*. Income is now treated as NALI where expenditure incurred in gaining or producing it was a non-arm's length dealing. If an expense is considered NALE, it taints any income associated with the scheme as NALI, which is then taxed at the highest marginal rate.

These amendments ensure that all types of superannuation entities cannot circumvent the NALI provisions to benefit from the preferential tax treatment of superannuation income compared to other entities by entering into schemes with non-arm's length expenditure. This addressed integrity issues for all types of superannuation funds related to trustees incurring non-arm's length expenses in gaining or producing income.

These NALI provision amendments also manage the integrity risk of SMSF trustees in particular engaging in arrangements that have the effect of circumventing the lower contribution caps and the Division 293 threshold, both of which were revised in the 2016-17 Budget tax reform package.

## ATO's interpretation and compliance approach


On 29 May 2020, the ATO published Practical Compliance Guidance (PCG) 2020/5 which established a transitional compliance approach to the NALI rule changes. As a result of consultation, the ATO recognised that trustees may not have been aware that the amendments would apply to NALE of a general nature which is linked to all income of the fund (also referred to as general expenses).

Superannuation fund expenses can be divided into 2 broad categories: expenses of a general nature and expenses of a specific nature. General expenses are those that have a sufficient nexus to *all* ordinary and/or statutory income of a given fund, for example fees for accounting, auditing and actuarial services. Specific expenses are those that have a sufficient nexus to a specific asset held by a given fund, for example a maintenance expense on a property, which relates to a particular amount of income being derived by the fund.

In PCG 2020/5 the ATO announced it would not allocate compliance resources to determine whether the NALI provisions applied to a complying superannuation fund for the 2018-19, 2019-20, 2020-21 income years where the fund incurred NALE of a general nature that has a sufficient nexus to all ordinary and/or statutory income derived by the fund in those respective income years. In April 2021, PCG 2020/5 was updated to include the 2021-22 income year.

On 28 July 2021, the ATO released Law Companion Ruling (LCR) 2021/2 which provided details as to how the ATO intends to apply the updated NALI provisions with extensive examples. The ATO noted it is aware of the significant tax consequences that may result from the NALI rules and a wide variety of minor NALE breaches have the potential to result in disproportionate tax liabilities.

LCR 2021/2 explained that where NALE incurred by a trustee of a superannuation fund is of a general nature, the relevant expenses can have a sufficient nexus to all of the income of a superannuation fund. This could result in all of a fund's income being classified as NALI and assessed at the highest marginal tax rate, currently 45 per cent. LCR 2021/2 provided the following list of instances in which expenditure has a sufficient nexus to all income derived by the fund:

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- actuarial costs – except those incurred in complying with, or managing, the fund’s income tax affairs and obligations which are ordinarily deductible under section 25-5 of the ITAA;
  - accountancy fees – except those incurred in complying with, or managing, the fund’s income tax affairs and obligations which are ordinarily deductible under section 25-5 of the ITAA;
  - audit fees;
  - costs of complying with a ‘regulatory provision’ as defined in section 38A of the Superannuation Industry (Supervision) Act 1993 (unless the cost is a capital expense);
  - trustee fees and premiums under an indemnity insurance policy;
  - costs in connection with the calculation and payment of benefits to members (but not the cost of the benefit itself); for example, interest on money borrowed to secure temporary finance for payment of benefits and medical costs in assessing invalidity benefit claims;
  - investment adviser fees and costs in providing pre-retirement services to members; and
  - other administrative costs incurred in managing the fund.

The ATO’s ongoing compliance approach (applying only in respect of general expenditure) outlined in LCR 2021/2 focusses on reviewing whether appropriate internal controls and processes are in place for large APRA-regulated superannuation funds and whether a reasonable attempt was taken to determine an arm’s length expenditure amount in the case of SMSFs. The ATO’s ongoing compliance approach supports SMSFs and large funds implementing the correct practices to avoid NALI applying.

On 10 June 2022, the ATO released a further update to PCG 2020/5 which extended the transitional compliance approach to NALE of a general nature incurred in the 2022-23 income year. This transitional compliance approach only applies to general expenditure that is incurred on or before 30 June 2023.



## Potential amendments

For the purposes of stakeholder consultation Treasury has developed potential policy changes to the NALI provisions, where they relate to general expenses. These potential changes are intended to ensure the rules continue to operate in line with their original policy intent and provide a greater level of certainty to trustees ahead of the expiry of the transitional compliance approach (PCG 2020/5) on 30 June 2023.

These potential amendments would be intended to apply to general expenses which have a sufficient nexus to *all* ordinary and statutory income derived by the fund. Potential amendments to the NALI provisions for superannuation funds could be adopted as follows:

- SMSFs and SAFs would be subject to a factor-based approach which would set an upper limit on the amount of fund income taxable as NALI due to a general expenses breach. The maximum amount of fund income taxable at the highest marginal rate would be 5 times the level of the general expenditure breach, calculated as the difference between the amount that would have been charged as an arm's length expense and the amount that was actually charged to the fund. Where the product of 5 times the breach is greater than all fund income, all fund income will be taxed at the highest marginal rate.
- Large APRA-regulated funds would be exempted from the NALI provisions for general expenses.

Under this potential approach, the functioning of NALI provisions would only change for breaches due to schemes involving expenses of a general nature. This would be intended to mitigate the 'tainting effect' highlighted by industry stakeholders, where all income of the fund is potentially subject to the top marginal tax rate due to a relatively minor breach of the rules due to a general expense.

For all funds, where a NALE is related to a specific asset, the current NALI rules would continue to apply, such that all the income of that asset will be NALI and subject to the highest marginal tax rate. This is in line with the original intent of the NALI provisions to disincentivise non-arm's length transactions that artificially inflate the earnings of the fund.

### Consultation questions

We invite feedback on the following question:

1. Are there any potential unintended adverse consequences for superannuation funds, their members and other stakeholders from adopting a sector-specific approach to the NALI provisions related to general expenses which applies different treatment to large APRA-regulated funds and SMSFs and SAFs?

## Self-managed superannuation funds and small APRA-regulated funds

Under the potential amendments outlined above, where SMSFs and SAFs have breached the NALI provisions for general expenses that are linked to all fund income, the amount of fund income treated as NALI in relation to that breach would be subject to an upper limit.

The maximum amount of fund income which would be assessable as NALI in relation to a particular general expenses breach would be calculated by applying a factor of 5 to the difference between the amount that would have been charged as an arm's length expense and the amount that was actually charged to the fund. This would partially break the link between the general expenses breach, and the income of the fund as a whole for the purposes of NALI.

At the current highest marginal tax rate of 45 per cent, a maximum effective tax rate of 225 per cent (5 multiplied by 45 per cent) would be applied to the general expenditure breach.

It is expected that trustees would determine an arm's length price when applying this calculation method. Where a breach has been identified, the ATO may request information from a fund to support the suitability of the identified arm's length price. Consistent with the current approach to valuations, a valuation would need to be based on objective and supportable data (see the [ATO website](#) for further information).

These potential amendments would be intended to maintain the disincentive for SMSFs and SAFs to use non-arm's length arrangements to circumvent the superannuation contribution caps through related party dealings, as funds would be demonstrably better off in complying with the NALI rules (see Example 1A). They would be intended to ensure any adverse tax outcomes for SMSFs and SAFs where a general expenses breach occurs are broadly proportional to the level of artificial benefit created by the breach of the NALI provisions and that the rules continue to disincentivise such behaviour.

Retaining a significant, but still proportional, tax penalty under this potential approach would address tax integrity risks for the fund types in which members have the capacity to control or influence the general expense arrangements of the fund in a way which could directly inflate their superannuation balance, including through non-arm's length arrangements. While the tax integrity risks for SAFs (which are required to be overseen by APRA licenced trustees) may be less significant than those of SMSFs, applying the amendments consistently between these fund types is justified as members of both SAFs and SMSFs may have capacity to influence arrangements for general fund services.

### Example 1A: SMSF using an accountancy service

An SMSF trustee uses his brother's accountancy services, which would usually cost \$5,000 if provided under an arm's length arrangement. As his brother charges the SMSF \$0 for these services, this is a non-arm's length arrangement.

The SMSF's income (after relevant expenses) in the 2023-24 financial year is \$100,000. The applicable rate of tax on this income would have otherwise been 15 per cent.

Under the current NALI rules, there is a sufficient nexus between the accounting services expense and all income of the SMSF. The SMSF's total income in the financial year would be taxed at the highest marginal tax rate of 45 per cent. The SMSF would pay \$45,000 in tax in 2023-24, resulting in \$55,000 in after-tax income.

Under the potential amendments, the income 'tainted' as NALI would be limited by the market value of the accounting service, since no fee was charged to the SMSF. The amount of income would be calculated by applying a factor of 5 on the difference between the market value of the accounting service and the actual fee charged the fund. The trustee would pay tax at a rate of 45 per cent on \$25,000 of fund income, and at a rate of 15 per cent on the remaining \$75,000 of income. The SMSF would pay \$22,500 in tax in 2023-24 and have after tax income of \$77,500.

In comparison, if the fund had incurred an expense for the accountancy services as per its usual cost of \$5,000, the SMSF would pay \$14,250 in tax (i.e., 15 per cent of \$95,000) and have after tax income of \$80,750.

### Example 1B: SMSF using an accountancy service (lower fund income)

As in Example 1A, the SMSF trustee uses his brother's accounting services that would usually cost \$5,000, but the brother charges \$0. The SMSF's income (after relevant expenses) in the 2023-24 financial year is \$20,000.

Under the potential amendments, the trustee would pay tax at a rate of 45 per cent on all the income of the fund, as 5 times the NALE breach is greater than the total income of the SMSF. The SMSF would pay \$9,000 in tax for the 2023-24 financial year (i.e., 45 per cent of \$20,000), as would occur under the current NALI provisions.

## Example 2: SMSF acquires an asset at non-arm's length price

Pippa holds commercial property with a market value of \$1,000,000. During the 2020-21 income year, Pippa sells the commercial property to her SMSF for \$200,000. The SMSF leases the property to a third party and earns net rental income of \$50,000 in 2020-21.

Under the current rules there is a sufficient nexus between the non-arm's length expenditure incurred in acquiring the property and the rental income the SMSF derives from leasing the property. The SMSF would pay tax on the rental income at 45 per cent. Tax payable on the net rental income from the property in 2020-21 would be \$22,500. Any capital gain derived from sale of the property would also be treated as NALI. The transitional compliance approach contained in PCG 2020/5 would not apply in this case as the expense is not of a general nature.

Under the potential amendments, this scenario would not be impacted as the NALE is not a general expense with a sufficient nexus to all the income of the fund. The income treated as NALI would remain the same, as under the current rules, as the current NALI rules will continue to apply to NALE breaches relating to specific assets and income sources. The SMSF would pay the same total tax as under the current rules.

## Consultation questions

We invite feedback on the following questions:

2. Would the approach outlined of setting an upper limit on the amount of fund income that is taxable as NALI due to a general expenses breach be sufficient to mitigate the 'tainting effect', where all income of the fund is potentially subject to the top marginal tax rate due to a relatively minor breach of the rules due to a general expense?
3. Are there any potential unintended adverse consequences for SMSFs or SAFs from setting an upper limit on the amount of fund income taxable as NALI due to a general expenses breach? Would there be unintended consequences from calculating the upper limit using a factor of 5?

## Large APRA-regulated funds

Under the potential amendments, large APRA-regulated funds would be exempted from the NALI provisions for general expenses, while remaining subject to the provisions for specific expenses linked to specific asset and income sources. This policy approach would be intended to lower the compliance burden for large APRA-regulated funds as there is a lower level of tax integrity concern for non-arm's length arrangements involving general expenses for these funds.

To the extent that non-arm's length arrangements providing general services to large APRA-regulated funds are in place, these are generally entered into with the primary intention of reducing cost and passing savings on to members, rather than for the dominant purpose of obtaining a tax benefit.

Retaining the currently operating NALI provisions for expenses related to specific revenue and capital items under the potential amendments outlined above would minimise the scope for large APRA-regulated funds to pursue tax avoidance practices. In comparison to general expense arrangements there can be significantly greater possible tax benefits associated with certain specific investments for large APRA-regulated funds. These can involve shifting capital gains from related companies and acquiring units in related unit trusts for less than market value. The existing NALI provisions for specific expenses provide the ATO with substantive integrity provisions to prevent tax avoidance.

### Example 3: Large APRA-regulated fund utilising trustee services

In the 2023-24 financial year, Large Super Fund Pty Ltd is the corporate trustee of a large APRA-regulated fund and provides a range of services to the fund including administration, accounting services and investment advice valued at \$1 million. Large Super Fund Pty Ltd receives \$200,000 in remuneration for managing the fund, an amount which is non-arm's length. The amount of remuneration paid by the fund does not reflect the assets used, the functions performed and/or risks assumed to manage a complex fund.

The fund's total income for 2023-24 is \$1 billion (after relevant expenses). The applicable average rate of tax on this income would have otherwise been 10 per cent.

Under the current NALI rules, the fund would trigger the NALI provisions as the fund incurred expenditure less than what would otherwise be expected if the parties were dealing with each other at arm's length. Trustee services would be considered as general expenses, with a sufficient nexus with entire income of the fund for the 2023-24 income year. Total income of the fund would be taxed at the top marginal tax rate of 45 per cent. The fund would pay \$450 million in tax for the 2023-24 income year.

Under the potential amendments, general expenses for APRA funds would not be subject to the NALI provisions. The fund would therefore not be in breach of the NALI provisions, and Large Super Fund Pty Ltd could continue to provide services to the fund for \$200,000. The fund would continue to be taxed at the concessional rates for superannuation funds and pay total tax of \$100 million for the 2023-24 income year.

## Example 4: Large APRA-regulated fund acquires an asset at a non-arm's length price

A large APRA-regulated superannuation fund acquires 500,000 shares in XYZ service company that is a related party of the fund for \$1 per share in the 2022-23 income year. The market value of the shares at the time of acquisition is \$5 per share.

In the 2023-24 income year, the superannuation fund receives a \$150,000 cash dividend from XYZ service company.

Under the current rules, the fund would trigger the NALI provisions as the fund incurred expenditure less than what would otherwise be expected if the parties were dealing with each other at arm's length. There is a sufficient nexus between the NALE incurred in acquiring the shares and the dividend income the superannuation fund derives from its investment. The superannuation fund would pay tax on the dividend income received from XYZ at the top marginal tax rate of 45 per cent in the 2023-24 income year. Any capital gain derived from sale of the XYZ shares would also be treated as NALI.

Under the potential amendments, the income treated as NALI would not be impacted as the NALE is not a general expense with a sufficient nexus with all income of the fund. The fund would pay the same total tax on dividend and capital gain income derived from the shares in XYZ, as the current NALI rules will continue to apply to NALE breaches relating to specific assets.

## Consultation questions

We invite feedback on the following questions:

4. Would carving out large APRA-regulated funds from the NALI provisions for general expenses appreciably lower the compliance burden for large APRA-regulated funds?
5. Are there any unintended adverse consequences for large APRA-regulated funds, their members and other stakeholders from carving out large APRA-regulated funds from the NALI provisions for general expenses?