Wednesday, 22 February 2023

Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Dear Sir/Madam

Non-arm's length expense rules for superannuation

We thank you for the opportunity to comment on the Consultation Paper on Non-arm's length expense rules for superannuation funds.

Chartered Accountants Australia and New Zealand, CPA Australia, Institute of Financial Professionals Australia, Institute of Public Accountants, National Tax & Accountants Association, SMSF Association and the Tax Institute do not support the policy outlined in the Consultation Paper.

Our submission does not directly comment on the recommendations contained in the Consultation Paper.

We believe that poor law design can lead to inequitable outcomes. In our opinion it is an over-reach and seeks to solve problems that no longer exist. The Government has other legislation in place to identify potential offenders who may unintentionally or intentionally breach the regulations in place. Suitable existing penalties will discourage future bad behaviour.

In the enclosed document we propose a better long-term solution.

We would be happy to discuss with Treasury any aspect of our submission.

Sincerely,

CHARTERED ACCOUNTANTS AUSTRALIA + NEW ZEALAND

CPA AUSTRALIA

INSTITUTE OF FINANCIAL PROFESSIONALS AUSTRALIA

IPA INSTITUTE OF PUBLIC ACCOUNTANTS

NTAA

SMSF ASSOCIATION

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21 February 2023

Hon Stephen Jones MP
Minister for Financial Services
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600

Delivered by email: Stephen.Jones.MP@aph.gov.au

Dear Minister,

Non-arm's length income provisions applying to superannuation funds

The current version of the non-arm's length income (NALI) provisions, found in Sec 295-550 of the *Income Tax Assessment Act 1997* (ITAA97), were amended in 2019 with a commencement date of 1 July 2018. The 2019 amendments extended the NALI provisions to specifically deal with non-arm's length expenditure incurred by a superannuation fund.

The original policy intent of NALI was to apply income tax penalties to superannuation funds involved in specific non-arm's length dealings.

Its purpose was not to circumvent contribution caps as detailed in the Treasury Consultation Paper[1] (Consultation Paper).

The principles of good law design are efficiency, equity and simplicity. As the Tax White Paper said, "There will more often than not be a tension between efficiency, equity and simplicity when developing tax policy. For example, sometimes to address an integrity issue very complex rules may be needed, and choices have to be made as to whether the integrity benefits are worth the complexity cost.[2]" Equity is not a principle that should be compromised with regards to an integrity measure.

The 2019 amendments and the (Consultation Paper) proposals do not satisfy the original purpose, the new purpose and good law design.

We believe we have a solution, which we detail in this letter, that follows the principles of good law design yet also provides adequate safeguards and proportionate penalties.

The current NALI provisions have been the source of considerable concern for the superannuation sector since their amendment in 2019, as acknowledged in your 24 January 2023 press release[3]. These concerns need to be addressed as a matter of urgency.

[1] https://treasury.gov.au/consultation/c2023-323132
[2] https://treasury.gov.au/speech/tax-white-paper
[3] https://ministers.treasury.gov.au/ministers/stephen-jones-2022/media-releases/consultation-open-non-arms-length-expense-rules

The NALI rules, as anti-avoidance provisions, have existed in some form in the income tax laws for over 60 years[4]. It is our view that given the tax concessions that attach to superannuation an anti-avoidance NALI provision remains necessary.

However, we believe the current (as amended) version of the NALI provisions is an unnecessary over-reach and seeks to solve a problem that no longer exists. The current version of NALI might apply with other tax laws so that a taxpayer could find themselves taxed more than twice for the same transaction. Furthermore, the present laws conflict directly with superannuation funds' best financial interest duty (BFID)[5], as well as existing Government policy to reduce fees charged to members of all superannuation funds, but APRA-regulated superannuation funds in particular.

For the reasons outlined below, we request that the Government considers amending the non-arm's length provisions to reverse the 2019 amendments. This is our view notwithstanding the Government's proposed changes to the NALI provisions as set out in the Consultation Paper (the 'Consultation Paper').

Current NALI rules an over-reach

Under the NALI provisions (as amended), the NALI rules can be invoked by superannuation funds performing common activities, where they may not be provided on an arms-length basis, such as:

- in-house bookkeeping or auditing activities performed for low or no fees
- services being provided to funds with little or no mark-up by entities owned by the fund (common for many APRA regulated superannuation funds)
- trustees unable to indemnify basic costs (e.g., postage) due to evidential burden of proof requirements imposed by the BFID

Trustees are often required to act in the best financial interests of their members (a requirement of the superannuation laws for trustees as noted above) by choosing a lower cost option.

If the NALI provisions apply to the common actions noted above, a penalty tax rate of 45 per cent, or more, can apply to the income generated by the non-arm's length activity AND on all employer contributions (including compulsory minimum Superannuation Guarantee contributions) and future income of the fund. Depending upon circumstances, Division 293 tax, excess contribution tax and the general anti-avoidance provisions – often referred to as "Part IVA" – might also apply.

For example, it is possible that as well as the NALI provisions applying, the Australian Taxation Office's Tax Ruling TR 2010/1[6] might also deem the same amounts to be contributions. Anything caught by NALI rules can face penalty tax that attaches to that provision and also be deemed to be contributions and dealt with under the contribution cap rules in the ITAA97[7] including being classed as excess concessional and non-concessional contributions.

Clearly these impacts are beyond the scope of the intended policy and may have a disproportionate impact on taxpayers' superannuation balances.

For an average Australian with an income of around $90,000 and super balance of $135,000, the inadvertent triggering of the NALI provisions by the superannuation fund results in an effective tax

[4] Over the years the ANLI rules have had different names such as "special income".
[5] Refer Part 6 of the *Superannuation Industry (Supervision) Act 1993*
[6] Income tax: superannuation contributions
[7] See Divisions 290, 291 292 and 293 of the ITAA97

increase of $6,000 per year. This could significantly impact the ability for Australians to better support themselves during retirement.

Increased tax at penalty rates for all superannuation funds could result in lower growth of superannuation balances, with superannuation balances potentially cut by 30 per cent or more. Noting the broad scope of this issue, there is a significant risk of a large cumulative impact on the balance of Australians' superannuation balances.

Further to the above, the NALI provisions are disproportionate in a number of respects. Of note, any non-arm's length dealings will trigger a 45 per cent tax rate on all the net income (and potentially gains) attaching to a specific asset (if the dealings relate to an asset) or a 45 per cent tax rate on all the net income, concessional contributions and capital gains of the fund (if the dealings do not relate to specific assets). For example, a failure of an APRA-regulated fund to pay a market service fee to a related service provider could result in all of the of the income of that fund being taxed at 45 per cent (with the corresponding reduction of members' benefits).

Current NALI rules solving a problem that no longer exists

The current version of the NALI provisions was introduced to ensure that superannuation funds could not enter into Limited Recourse Borrowing Arrangements (LRBAs), as permitted under Sec 67A and 67B of the *Superannuation Industry (Supervision) Act 1993* (SIS Act), with a related party lender on non-arm's length terms.

These arrangements were initially specifically permitted by the Australian Taxation Office (ATO).

That said, the ability to enter into these arrangements was a matter of obvious concern. They were effectively out-lawed before 1 July 2018 by the Australian Taxation Office when it issued Practical Compliance Guide PCG 2016/5[8] on 6 April 2016. This Practical Compliance Guide was reissued to take into account the publication of the ATO's Tax Determination TD 2016/16[9] on 28 September 2016. We note that the ATO's Tax Determination applies to income years before it was issued. In effect TD 2016/16 would apply to all non-arm's length LRBAs including those put into place before 28 September 2016 and any that were put into place after that date.

In short, non-arm's length LRBAs were out-lawed by the ATO before the 2018 NALI amendments were announced in the 2017 Federal Budget[10]. To date, no evidence of other misdemeanours or the need for policy development based on data driven evidence has been presented for any other superannuation fund activities.

Proposed rules in the NALI consultation paper also an over-reach

In the context of non-arm's length expenditure, the effect of the limited proposed changes in the Consultation Paper, released by Treasury on 24 January 2023, are as follows:

- NALI will apply to general and specific non-arm's length expenses of Self-Managed Superannuation Funds (SMSFs) and Small APRA Funds

[8] Income tax – arm's length terms for Limited Recourse Borrowing Arrangements established by Self-Managed Superannuation Funds

[9] Income tax: will the ordinary or statutory income of a Self-Managed Superannuation Fund be non-arm's length income under subsection 295-550(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) when the parties to a scheme have entered into a limited recourse borrowing arrangement on terms which are not at arm's length?

[10] https://archive.budget.gov.au/2017-18/bp2/bp2.pdf

- NALI will apply to specific non-arm's length expenses of APRA regulated superannuation funds.

In our view this proposed solution is unacceptable. The proposed penalty of five times for general expense breaches for SMSFs is extreme. The difference between general and specific expenses will be very complicated and costly for all superannuation funds to administer.

In the Consultation Paper it is stated that, "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."

It is also stated that, the "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."

Professionals, for example tax agents, accountants or solicitors, performing general everyday tasks for their SMSF are not performing these tasks to circumvent the contribution rules as suggested by the Consultation Paper. These tasks are completed personally by fund trustees, members, or by colleagues, because this is easier and is commercially sensible. The same approach is used for their personal and other related entity or entities legal and tax obligations. A secondary motivation may be cost savings and passing those savings on to members, as deemed acceptable for APRA-regulated super funds in the Consultation Paper.

It is our view that the government's proposals will create considerable risk for many regulated superannuation funds and will lead to additional cost. The cost of imposing a requirement on trustees to determine an arm's length shortfall amount, even if the shortfall amount is insignificant or even just a few dollars, does not warrant the type of approach being proposed in the Consultation Paper. To our knowledge there is no evidence that superannuation fund trustees have been entering into non-arm's length expenditure arrangements. However, we do acknowledge this could be an outcome and therefore propose a different and much simpler and more equitable approach below.

The superannuation sector is a dynamic market and there are often significant variations in the type and scope of services provided. Therefore, determining what is an arm's length commercial expense is not always a simple task and, in some cases, may involve a degree of subjectivity. For example, the services or investment opportunities provided to one superannuation fund trustee are often tailored and may involve a reduced or different level of servicing compared to other trustees where the entity providing the service may not have the same ready access to information, assurance or scale.

We therefore reject the government's proposals as contained in the consultation paper.

Other solutions available

It is our view that the most ideal and workable and least disruptive solution would be for the 2019 amendments to Sec 295-550 of the ITAA97 to be repealed and returned to its terms before the amendments were enacted.

Any residual concerns about non-arm's length arrangements with any superannuation fund can be dealt with by the ATO and the superannuation sector applying Tax Ruling TR 2010/1 because TR 2010/1 says that if a superannuation fund trustee takes steps to improve the value of a fund investment on non-arm's length terms (including using their own skills and resources), then in most cases the entire value of the improvement will be treated as a contribution.

If the government were to take the view that additional safeguards are necessary then it could elect to amend Sec 109[11] of the SIS Act to prohibit trustees from conducting any transactions with any party other than on arm's length terms.

We note that Sec 109 of the SIS Act is a civil penalty provision and an "operating standard". As such trustees are expected to comply with this law at all times. Compliance with Sec 109 is checked by all external auditors of Self-Managed and APRA regulated superannuation funds each year. If a breach is deemed to be material, then it can be reported to the respective regulator which can then examine the fund and determine if a penalty is appropriate. Under the SIS Act the regulators are given a wide range of powers to examine such breaches and to determine what action, if any, needs to be taken by a trustee to correct a breach and, if necessary, to determine what penalties should apply. In extreme cases, a superannuation regulator could determine a superannuation fund to be "non-complying" with most of that fund's assets, valued at net market value, being taxed at 45 per cent. As Sec 109 is a civil penalty provision a superannuation regulator could seek court-imposed penalties.

It is our understanding that the government has considered this alternative solution and we encourage you to revisit it. We believe this solution requires minimal law change and better meets the principles of good law design.

We have reviewed the examples in the ATO's Law Companion Ruling LCR 2021/2[12], which we note is a very pro-revenue ruling, and sought to apply our suggested solution. We believe that our suggested solution provides an effective outcome in place of the punitive and unacceptable outcomes that occur under the NALI provisions. That is, it will not give rise to unacceptable loopholes, therefore maintaining an appropriate level of disincentive from entering into non-arm's length transactions.

We are willing to publicly support the adoption of our suggested solution.

Finally, we do acknowledge that the original version of Sec 295-550 is far from perfect and needs reform. At this time, we consider this to be a longer-term project and would be happy to talk to you about this matter on another occasion.

We would welcome the opportunity to speak to you about this letter.

Yours sincerely,

CHARTERED ACCOUNTANTS
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[11] Investments of superannuation entity to be made and maintained on arm's length basis
[12] Non-arm's length income – expenditure incurred under a non-arm's length arrangement

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