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NALI – is the ATO's net too wide?

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Overview

Recently the ATO released draft Law Companion Ruling 2019/D3 ('LCR') on the newly passed non-arm's length income ('NALI') amendments to s 295-550 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997').

One key criticism of the draft LCR is the breadth of the ATO's view in relation to the 'nexus' that is required between the scheme and the income and net capital gains that are caught by NALI.

The ATO have been criticised for taking the view that where a loss, outgoing or expense ('Expense') is incurred by a fund and the amount is less than arm's length, then all of the fund's ordinary and statutory income should be taxed at 45%.

Extrapolating the ATO's view on this point would lead one to consider that any future income or net capital gain on all assets held by the fund (whether an SMSF or APRA fund) at that time would also give rise to NALI.

Based on the current draft ATO view, for example, a $100 reduction in an accounting cost for an SMSF could expose all future income and, on an extrapolation of the current ATO view, all future net capital gains on all assets to NALI.

In preparing this article, we wish to acknowledge the valuable input of The Tax Institute of Australia's National Superannuation Committee. Indeed, many tax and SMSF advisers that we have liaised with agree that this is an extreme and an extraordinary outcome which the legislative provisions were not intended to produce.

This nexus point is the sole focus of this article. All references are to the ITAA 1997 unless otherwise stated.

What nexus?

Section 295-550(1) contains a nexus requirement in paragraphs (b) and (c) –– that 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) …

(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.

We focus here on the words 'in gaining or producing the income', noting that s 295-550(1) commences with the following words:

An amount of *ordinary income or *statutory income is ***non-arm's length income*** of a *complying superannuation fund … 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 …

This nexus point is not critically examined in the draft LCR.

Case law and other ATO materials

We refer to several relevant extracts below to provide some context.

The High Court in *Ronpibon Tin NL v FCT; Tongkah Compound NL v FCT* (1949) 78 CLR 47 ('Ronpibon Tin Case') per Latham CJ, Rich, Dixon, McTiernan, and Webb JJ held:

For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end. The words 'incurred in gaining or producing the assessable income' mean in the course of in gaining or producing such income …

… it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income. (CLR pp 56-57).

The ATO recently released TR 2019/D4 on claiming deductions for work expenses under s 8-1 that quotes the above High Court decision. Whilst exploring a different topic, the ATO's comments in this draft ruling are analogous to the current determination and

assist in understanding how the ATO view a work related expense incurred 'in gaining or producing assessable income'. The following paragraphs are extracted from this draft ruling:

In gaining or producing assessable income

13. The pivotal element of section 8-1 for work expenses is the requirement that expenses be incurred 'in gaining or producing assessable income'. The High Court majority in *Payne* [12]said it is well established that these words are to be understood as meaning incurred 'in the course of' gaining or producing assessable income, and do not convey the meaning of outgoings incurred 'in connection with' or 'for the purpose' of deriving assessable income.
14. The majority further stated that the meaning of 'in the course of' gaining or producing income was amplified in *Ronpibon Tin NL*where it was held that:

…to come within the initial part of [s8-1] it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income, or if none be produced, would be expected to produce assessable income…

15. While the High Court authority indicates the nature of the connection that needs to be found between outgoings and assessable income, the sufficiency of the connection in a given case cannot simply be determined by reference to a precise formula. Section 8-1 is expressed in such terms that it is intended to cover any number of legal and factual situations. In many cases, only a proper consideration of all the relevant facts and circumstances will reveal whether the occasion of a particular outgoing is to be found in what produces assessable income.

Importance of facts and circumstances

16. For expenses incurred by employees, the fundamental question is whether an expense is incurred in the course of earning employment income. This involves considering the proper scope of the particular taxpayer's work activities to determine if the circumstances of the expense have a sufficiently close connection to earning the employment income.

Footnote [12] in TR 2019/D4 is: Commissioner of Taxation v Payne [2001] HCA 3.

What nexus?

Broadly, the LCR suggests that most situations give rise to NALI so long as there is some (even if tenuous) nexus between the acquisition of an asset and any eventual net capital gain derived where an Expense that is less than an arm's length amount is incurred.

The explanatory memorandum that introduced this new law supports the view that the NALI 'net' cast in draft LCR goes too far. Paragraph 2.38 of the explanatory memorandum states:

[w]here there is a scheme that produced non-arm's length income 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.

The ATO do confirm that if an Expense relates directly to a particular scheme such as a particular investment property, it will only seek to apply NALI to the income (including any net capital gain) derived from that asset. However, the ATO do not identify any nexus between a discounted accounting fee and any income.

To assist in analysing the ATO's view, we discuss two key scenarios below; firstly, where an asset is acquired below market value, and secondly, where an asset is acquired at market value.

Assets acquired below market value – is there a nexus?

The LCR gives an example of a member selling their property with a market value of $800,000 for $200,000 to their SMSF. According to the LCR, all the income and net capital gain from that property is NALI.

However, what is not taken into consideration in this example is the application of the CGT market substitution rule and the ATO's established practice of treating a transfer of an asset below market value as a contribution.

Where the CGT market value substitution rule in s 112-20 applies, the member transferring the asset to the fund below market value is deemed to have received the market value of the asset that exceeds any consideration received as capital proceeds in accordance with s 116-30. Therefore the member in this example has effectively made a non-concessional contribution ('NCC') equal to the difference between the sale price ($200,000) and the asset's market value ($800,000) resulting in a $600,000 contribution. This approach is consistent with the ATO view reflected in TR 2010/1; the ATO's tax ruling on what is a contribution.

If a member exceeds their NCC cap, then they will be subject to the excess contribution system which may potentially expose them to tax at a rate of 47% unless they elect to release the excess amount of NCCs plus 85% of their associated earnings, in which case the member will then pay tax on 100% of their associated earnings.

There is no guidance in the LCR about what takes precedence –– contributions or NALI –– to avoid any potential double treatment. Indeed, the recognition of an NCC to reflect the fact that the super fund has effectively provided market value consideration for the asset, should neutralise NALI being invoked. This is the view of the High Court in *Cook v Benson* [2003] HCA 36 per Gleeson CJ, Gummow, Hayne And Heydon JJ in relation to contributions made by a member who was made bankrupt, at [36]:

… the first respondent made contributions in return for the undertaking by the trustees of the funds of obligations to pay death, retirement or other related benefits, to him or his nominees, in accordance with the rules of the respective funds. He obtained consideration in money's worth in return for the payments.

If the ATO do not wish to continue with their current approach to the treatment of contributions as outlined in TR 2010/1, they should revise this ruling and communicate its revised approach as soon as practicable.

Assets acquired for market value – is there a nexus?

We submit that if a lower revenue Expense is incurred by an SMSF in relation to the acquisition of an asset at market value, that only the ordinary income that should be considered NALI in that financial year and not any net capital gain (statutory income) that may be realised when that asset is eventually sold.

This is because the net capital gain was not '*as a result*' of the lower revenue Expense, ie, the lower revenue Expense was not incurred in relation to 'gaining or producing the [statutory] income' under s 295-550(1)(b) or (c).

The following provides an example of a net capital gain on a fund's asset that was acquired at market value:

If an SMSF improves a property on a discounted, or no cost, basis by employing services of a related party builder, NALI may apply to the net capital gain received on sale of the property as a lower Expense was incurred in relation to 'in gaining or producing the [statutory] income'.

However, we submit that NALI should not apply if the improvement constitutes a deemed contribution. This is supported by TR 2010/1 and the NTLG Superannuation Technical Sub-group meeting minutes, dated 3 September 2013. The Commissioner should confirm whether he will treat an improvement to an asset as a contribution in this situation (rather than NALI), as put forward by the ATO in these two ATO publications.

One example where a net capital gain may constitute NALI is reflected in Example 4 of the LCR where Kellie's SMSF pays $2M market value for a commercial property but gets a favourable LRBA which is on a non-arm's length basis (ie, the loan is for 100% LVR, nil interest and a 25 year term; where repayment can be made at the end of 25 years).

We accept that in this case, there is likely to be a nexus and any net capital gain on the eventual sale of the commercial property would give rise to NALI if Kellie's SMSF would not have been able to acquire that asset without the flexible loan (of 25 years, no interest and 100% LVR).

In contrast, SMSFs that are passive investors and benefit from long-term capital appreciation that occurs as a result of long-term holding should not have their net capital gains exposed to NALI if they incur a lower revenue Expense.

The net capital gain in this type of case generally remains the same despite a lower Expense such as a discounted service. Broadly, there is no sufficient and relevant nexus between the lower revenue Expense and the subsequent net capital gain that may eventually be realised on disposal.

Indeed, the net capital gain in relation to many SMSF investments including property, shares and other investments arises from the original contract price.

For example, if the Star Superfund holds an investment property for 20 years which has seen a 400% increase in value over that time and in the final year prior to sale, the SMSF trustees did some free services to best present the property for sale so the fund could realise the best sale price, that net capital gain should not constitute NALI.

When should income or a net capital gain be apportioned?

If, despite this analysis, the ATO still sought to apply NALI in this scenario, then the question of apportionment needs to be considered by the ATO as the capital appreciation over the prior 19 years should not be tainted just because in the final (20th) year some free services were provided.

There are many other situations where an apportionment is required such as when the value of an asset increases due to different factors over a period of time. If, for example, free services are provided by a builder who is also an SMSF trustee in relation to a property that is owned by his SMSF and during that time, the SMSF also obtains planning approval via an external consultant which, by itself, significantly increases the value of that property, that increase in value needs to be apportioned between the services provided (which should first be treated as a contribution) and the increase in value that relates to the planning approval. This scenario should not give rise to a NALI risk if the SMSF engaged a town planner to obtain planning approval.

Further comments

We also note that most of the ATO's examples in the LCR are of circumstances where NALI applies. We therefore recommend that the ATO include a number of examples illustrating situations where a net capital gain in relation to an asset will not invoke NALI. The ATO should also include several examples where an apportionment is appropriate.

Moreover, as noted above, the ATO has for many years treated free services that added value to an asset as a contribution (eg, an NCC if provided by the member reflective of the value of those services). As noted above, if an NCC was recognised for these free services, this should neutralise any need for the ATO to apply NALI.

Reverting back to Example 4 above, it is also arguable that if Kellie's SMSF could have paid for and maintained its $2M commercial property without a flexible loan (but an arm's length loan), no nexus would be established, resulting in only the net rental income

being subject to NALI. No additional net capital gain arises as a result of the scheme. Thus, the net capital gain under this scenario should not be treated by the ATO as NALI.

Conclusions

The ATO should carefully review and revise the LCR to ensure it is technically correct and consistent with the nexus position outlined above and the established treatment on what a contribution is. Much greater clarity and guidance is required before the draft LCR should be finalised.

Please note that the LCR is still in draft form and hopefully will be revised before being finalised.

SMSF trustees and advisers need to tread carefully in relation to any transactions that may give rise to any NALI risk.

Always remember that sufficient and appropriate benchmark evidence is the best type of defence against a NALI assessment.

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