



Non-Arm's Length Expenditure (NALE)

Over time tax law has evolved to disincentivise certain income from being diverted into SMSFs or to discourage trustees from engaging in certain practices to enhance their superannuation balance and reduce their tax liability. As a result of super reforms and reduced contribution caps, the Government are concerned that people will look for new ways to get more funds into SMSFs using various schemes or strategies. Having certain income treated as non-arm's length income (NALI) and being taxed at the highest marginal tax rate, is intended to be the disincentive in the otherwise concessional taxed super environment. To broaden the scope of NALI, the Government have introduced the concept of non-arm's length expenditure (NALE) which requires a fund to ensure that not only is all income derived on a commercial basis but that all expenses associated with fund income are commercial. These new NALE provisions apply from 1 July 2018.

The ATO has released Draft Law Companion Ruling LCR 2019/D3 'Non-arm's length income – expenditure incurred under a non-arm's length arrangement', which is a guide to how the provisions will apply. They have also released Practical Compliance Guideline PCG 2020/5 'Applying the non-arm's length income provisions to non-arm's length expenditure', which indicates that the ATO will not allocate compliance resources in relation to certain general expenses, as identified below, for the period from inception up to and including the 2020/21 Financial Year. This gives them time to finalise the draft ruling.

Essentially, when expenditure is less than what would be expected in an arm's length dealing, NALI can arise. This can have significant tax consequences for a fund so it's important to understand, what arm's length means, what NALI and NALE are and examples of expenses that are considered non-arms length.

What does arm's length mean to an SMSF?

According to the ATO, arm's length is where "a prudent person, acting with due regard to his or her own commercial interests, would have agreed to the terms". As such, investments must be made and dealt with by an SMSF on a commercial basis in all circumstances and when dealing with all parties, related or otherwise.

What is NALI and NALE?

Under the Income Tax Assessment Act 1997, section 295.550(1), an amount of ordinary or statutory income is non-arm's length income if the parties to a scheme are not dealing with each other at arm's length in relation to the scheme. This can be the case if the amount of income received is more than what would have been received if dealing at arm's length or it can relate to the expenditure involved, which is what we will focus on here.

Where the loss, outgoing or expenditure is less than what would have been incurred OR there was no loss, outgoing or expenditure incurred compared to what you would expect when the parties were dealing at arm's length, NALI arises. To summarise:

Income is more than would be expected on arm's length dealing
OR
Expenditure is less than (or nil) would be expected on arm's length dealing

How do we identify NALE?

To identify NALE we need to look at identifying if there is a scheme. In LCR 2019/D3, the ATO state that "A scheme is defined as any arrangement, or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise".

There must also be a connection between the expenditure and the ordinary or statutory income a fund receives. The expenditure must have been incurred in gaining or producing the relevant income (or acquiring an entitlement to the income of a trust). The expenditure can be of a revenue or capital nature. Expenditure linked to specific income is easily identified, such as rental property expense and rental income. Where NALE arises on expenditure to acquire an asset, there is a sufficient nexus to all ordinary and statutory income of that particular asset and any capital gain on disposal of the asset. The following example, taken from LCR 2019/D3 indicates how NALI would apply to specific expenditure.

Example from LCR 2019/D3 – No. 1 Specific Expenditure – NEXUS to SPECIFIC INCOME

Armin holds a commercial property and sells it to his SMSF for less than market value. This is a scheme, clearly capital expenditure is less than arm's length; and a sufficient nexus exists between the NALE incurred on acquisition of the property and the property income. Therefore rental income derived will be NALI as will any future capital gain.

The problematic issue is that in some cases, such as accounting and audit fees, the NALE will have a sufficient connection to ALL of the ordinary and statutory income of a fund and that is where greater clarity from the ATO is still required.

Example from LCR 2019/D3 – No. 2 General Expenditure – NEXUS TO ALL FUND INCOME

Mikasa engages an accounting firm where she is a partner to provide accounting services for her fund and they do not charge her for the services. There is a scheme in place and the expenditure (nil) is less than would be expected in an arm's length dealing. The NALE has a sufficient nexus with all of the ordinary and statutory income derived by the fund for the relevant financial year and therefore all income that year will be NALI.

Trustee v individual capacity

The NALE provisions are not intended to apply where a trustee provides services to their SMSF in their capacity as trustee. This requires an objective consideration of the individual's circumstances and their business, profession or employment to assess their skills and knowledge to perform an activity.

The LCR provides that the following factors may assist to determine if an individual is performing their activities in their individual capacity (as opposed to their capacity as trustee):

- Individual charges the SMSF for the services (see below)
- Individual uses equipment and other assets of their business or used in profession or employment
- Individual performs the activities pursuant to a licence and or qualification related to their business, profession or employment
- Activity is covered by an insurance policy related to their business or professions or employment

Where a trustee performs services in their capacity as trustee of an SMSF and they do not charge for the service, this will not be a non-arm's length arrangement and NALE provisions will not apply.

Example from LCR 2019/D3 – No.6 – NOT NALI/NALE

Leonie is a chartered accountant and registered tax agent and employed in an accounting and tax agent business. As trustee for her SMSF, she prepares the accounts and annual return for her fund. She uses her own equipment and does not charge the SMSF. The NALE provisions do not apply as the services are performed in her capacity as trustee and not under an arrangement where the parties are dealing with each other on a non-arm's length basis.

It's important to distinguish this example with example 2 as they have very different outcomes. The capacity in which activities are performed is crucial.

Where a trustee performs a service in their individual capacity, the NALI provisions will apply where remuneration is paid by the fund on non-arm's length terms. This is also the case where no remuneration is provided.

Trustee remuneration

Under section 17B of the SIS Act, a trustee can be remunerated for services performed if the services are performed other than in capacity as trustee and they are appropriately qualified and licenced to do so. They must also perform the services in the ordinary course of business and on arm's length terms. Trustee remuneration can also create other issues in an SMSF, for example, if undercharged should a contribution arise? If overcharged, is that financial assistance? Both can create NALI issues for a fund.

What does Xpress Super as an administrator need to focus on?

We need to know what income items we might need more info about to determine if they are arm's length. We also need to know where an expense hasn't been paid through the SMSF bank account so we can determine what issues arise.

The ATO will need to finalise LCR 2019/D3 and hopefully it has a common-sense approach for general NALE. In any case, all SMSF transactions should be undertaken on commercial arm's length terms.