



26 October 2023

Senate Economics Legislation Committee  
PO Box 6100  
Parliament House  
Canberra ACT 2600

Dear Sir/Madam,

***Submission on Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023***

The Institute of Financial Professionals Australia welcomes the opportunity to provide this submission on the *Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023*.

Our submission is confined to Schedule 7 of the Bill which makes changes to the non-arm's length expenses (NALE) rules that relate to superannuation funds.

We have long raised our concerns in relation to the application of the NALE rules and the non-arm's length income (NALI) rules (for example, see **Appendix A** for links to previous submissions).

In particular, we have examined the Bill and explanatory memorandum materials in detail and remain opposed to the government's proposed NALE rules for superannuation funds. Our reasons for reaching this conclusion can be found in detail in our submissions made to Treasury on 7 July 2023 (see **Appendix B**) and 21 February 2023 (see **Appendix C**).

For ease of reference, we have summarised our key concerns and our recommended alternative proposals below.

**Our concerns with the NALE rules**

By way of background, the NALE amendments came about to deter superannuation funds from entering into uncommercial (low interest and no interest) limited recourse borrowing arrangements (LRBAs) to increase member balances through non-arm's length arrangements that result in the superannuation fund receiving more income through charging lower than an arm's length expense (ie, low interest or no interest) (see Appendix C, pages 13 – 14 for more information). However the drafting of the NALE legislation, combined with the ATO's approach in Law Companion Ruling LCR 2021/2, will operate beyond the policy intent and disproportionately impact Australians compared to the mischief it was intended to discourage.



In fact, the explanatory memorandum to the Bill<sup>1</sup> that introduced the NALE provisions makes it clear that the government was attempting to deal with the issue of zero or low interest rate related party loans. The forward estimates expressly state the revenue the government expected to collect was in relation to the interest that would have been collected on zero or low interest rate loans had they been on arm's length terms. For this reason, our association believes the NALE changes were not intended to be, and should be, as broad and far reaching as what has eventuated.

In any event, there was a solution in place for low interest, no interest LRBA loans before the NALE provisions were introduced. The ATO's Taxation Ruling TR 2010/1 on superannuation contributions indicates that should there be an amount that has been undercharged or not charged to a fund, the shortfall amount will be deemed to be a contribution to the fund as the member(s) have benefitted from the transaction and have therefore indirectly increased the capital of the fund. Having an amount classified as a contribution has its own disadvantages as it could lead to excess contributions and with excess contributions tax built into the system, the end tax outcome can be quite excessive. In our opinion, there was no need to make the rules more complex by extending NALI to include expenses.

### **Our suggested recommendations**

We believe that a number of changes should be made, including:

#### **1. The NALE rules should be abolished**

We propose that the NALE rules be repealed so the law (295-550 ITAA 1997) is brought back to its pre-1 July 2018 terms, and instead use existing regulatory tools to deal with non-arm's length dealings, including:

- Amend the pre-1 July 2018 rules to make proportionate NALI tax assessment (discussed below) and use the current tax penalty regime as a proportional deterrent.
- Treating non-arm's length dealings as contributions per Taxation Ruling TR 2010/1.
- Amend section 109 of the SIS Act to prevent superannuation funds entering into non-arm's length transactions (ie, amend section 109 to capture NALE).
- Rely on an annual audit to review an SMSF trustee's compliance with the SIS Act and the SIS Regulations.
- The power to issue fines and give rectification directions and education directions (Part 20 of the SIS Act).
- The power to disqualify trustee/directors and to make SMSFs non-complying.

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<sup>1</sup> *Treasury Laws Amendment (2018 Superannuation Measures No.1) Bill 2019*







In light of the extensive powers listed above, it is unnecessary to use a 90% NALI/NALE tax rate as a regulatory tool.

## **2. SMSFs should also be exempt from the NALE regime**

Exempting large APRA-regulated funds for both general expenses and specific expenses NALE but subjecting SMSFs and SAFs for both general and specific expenses of the fund is unfair. The proposal as it stands will result in an unlevel playing field between APRA-regulated funds and smaller funds and does not promote tax neutrality/equality across the superannuation sector. To be clear, the proposed NALE rules do not work for any fund – SMSFs or large APRA-regulated funds. Thus, we propose that SMSFs be granted the same carve-out as that of large APRA-regulated funds, and also that the NALI tax penalty should only apply to the extent of any undercharge or non-charge amount of NALE (discussed below).

## **3. The two times multiple concept should not be legislated**

Although the proposed legislative changes to the NALE rules are an improvement to the initial proposal to tax NALE at a rate of 225% (ie, a five times multiple), we remain opposed to the concept of a multiple. Under the proposed changes, SMSFs and small-APRA superannuation funds (SAFs) will be taxed on a general expense NALE at a two times multiple (ie, an effective tax rate of 90%) on the undercharging/non-charging amount of NALE. We don't believe it is necessary to introduce a new tax penalty regime (ie, the two times multiple) to act as a disincentive from using non-arm's length arrangements as there are already many other regulatory measures available to deal with non-arm's length dealings (as explained above).

## **4. Consistency is needed between general and specific expenses**

We do not believe that different NALI tax treatment should apply to different expenses as having a different NALI tax regime will further complicate the rules. Rather than using a two times multiple for general expenses and the "existing" NALI treatment apply for specific expenses (ie, NALI is taxed at 45%), it is our view that general and specific expenses be treated the same. That is, that the NALI tax rate of 45% should only apply to the amount of underpayment/non-payment of the expense and that it should apply on a proportionate basis (discussed below).

## **5. NALI and NALE should be made proportionate**

We also believe that NALI and NALE should be made proportionate – that is, only the additional income (over and above an arm's length income) or the underpayment of expenses (ie, below the arm's length expense) should be subject to the NALI tax rate of 45% (plus penalties, as applicable).



Examples of proportionate application include:

- If under non-arm's length dealings, a superannuation fund acquires an asset for 10% below market value, then NALI should apply to 10% of the income and gains from that asset (ie, not 100%)
- If a related party of a superannuation fund fails to charge an arm's length fee of \$10,000 in management fees for managing a superannuation fund asset, then NALI should apply to \$10,000 (ie, not all of the income and gains from that asset).

#### **6. Trustees should be able to rectify breaches without the application of NALI.**

The NALI provisions provide no opportunity to rectify. This sits at odds with, for example, the SMSF compliance rules where trustees are given the opportunity to rectify breaches brought to their attention in the annual audit. Trustees should be given the opportunity to make good rather than having all of the fund's income taxed at 45% (or 90% if the proposal for general expenses is adopted).

#### **Closing comments**

Please find the details of our previous 7 July 2023 and 21 February 2023 submissions which provide detailed commentary on the issues with the proposed NAL rules and further information regarding our recommended legislative changes.

If you have any questions in relation to this submission, please contact Phil Broderick on [REDACTED] or [REDACTED] or Natasha Panagis on [REDACTED] or [REDACTED]

Yours faithfully,

[REDACTED]

**Phil Broderick**  
Institute of Financial Professionals Australia  
Board Member  
Chair, Superannuation Technical and Policy  
Committee

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**Natasha Panagis**  
Head of Superannuation and Financial  
Services

#### **About the Institute of Financial Professionals Australia**

The Institute of Financial Professionals Australia is a not-for-profit membership association (originally known as Taxpayers Australia, then more recently Tax & Super Australia) and has been serving members for over 100 years. With a membership and subscriber base of over 15,000 practitioners, our association is at the forefront of educating and advocating on behalf of independent tax, superannuation and financial services professionals. This submission is made by us on behalf of our members' interests.







## Appendix A

Links to various NALI and NALE submissions and media releases over the years

[Joint bodies submission – 3 September 2021](#)

[Our budget submission \(including NALI\) – 28 January 2022](#)

[Our budget submission \(including NALI\) – 12 September 2022](#)

[Our budget submission \(including NALI\) – 24 January 2023](#)

[Our submission 21 February 2023](#)

[Our press release 21 February 2023](#)

[Joint bodies submission 22 February 2023](#)

[Joint bodies press release 23 February 2023](#)

[Our submission 7 July 2023](#)

[Our press release 7 July 2023](#)





## Appendix B

7 July 2023

Retirement, Advice and Investment Division  
The Treasury  
Langton Crescent  
Parkes ACT 2600

Dear Sir/Madam,

### Submission on non-arm's length expense rules for superannuation funds

The Institute of Financial Professionals Australia is a not-for-profit membership association (originally known as Taxpayers Australia, then more recently Tax & Super Australia) and has been serving members for over 100 years. With a membership and subscriber base of over 15,000 practitioners, our association is at the forefront of educating and advocating on behalf of independent tax, superannuation and financial services professionals.

This submission is made by us on behalf of our members' interests.

### Our association does not support the proposals and proposes alternative measures

On 21 February 2023, the Institute of Financial Professionals Australia put forward a submission on the non-arm's length expense (NALE) rules for superannuation funds to the government for its consideration. That submission remains substantially the same (see Appendix C) but with additional items for your consideration, including:

#### 1. The two times multiple should not be legislated.

Although the proposed legislative changes to the NALE rules are an improvement to the initial proposal to tax NALE at a rate of 225% (ie, a five times multiple), we continue to oppose the concept of a multiple. Under the proposed changes, self managed superannuation funds (SMSFs) and small-APRA superannuation funds (SAFs) will be taxed on a general expense NALE at a two times multiple (ie, an effective tax rate of 90%) on the undercharging/non-charging amount of NALE.

This means that small funds will still have the obligation to prove that all their expenses are at market rates or pay extra tax. This will require SMSF trustees to obtain benchmark evidence to prove that the amounts to be charged or that the amount paid to another party is at arm's length/market rates to minimise the risk of the non-arm's length income (NALI) provisions applying. Benchmark evidence can be difficult to obtain as expenses/costs can be subjective and can vary widely between providers.





We don't believe it is necessary to introduce a new tax penalty regime (ie, the two times multiple) to act as a disincentive from using non-arm's length arrangements as there are already many other regulatory measures available to deal with non-arm's length dealings. Refer to Appendix C on pages 15 – 16 for more information regarding the existing regulatory tools available to deal with non-arm's length dealings.

Despite our view that the two times multiple should not be legislated, if the government maintains its current position, we would like to see the government provide a benchmark for superannuation funds to compare their expenses against. Similar to the Australian Taxation Office's (ATO) [small business benchmarks](#), a benchmark for expenses will enable SMSFs and SAFs to work out how the fund compares to other superannuation funds and decide if the trustee/directors of the fund need to make any changes.

## **2. Exempting large APRA-regulated funds from the NALE regime is unjust.**

Exempting large APRA-regulated funds for both general expenses and specific expenses but subjecting SMSFs and SAFs for both general and specific expenses of the fund is unfair. The proposal as it stands will result in an unlevel playing field between APRA-regulated funds and smaller funds and does not promote tax neutrality/equality across the superannuation sector.

We do not agree with having different rules for different funds and disagree that large APRA-regulated funds have less incentive to enter into schemes of the kind which result in a tax advantage. Refer to our response to consultation paper question 1 in Appendix C on page 19 for more information regarding our views on this matter.

## **3. There must be consistency between general and specific expenses and NALI/NALE should be proportionate.**

We do not believe that different NALI tax treatment should apply to different expenses. As shown in example 1.4 of the exposure draft explanatory memorandum, where members have both general and specific NALE (ie, a general accounting expense and a renovation expense related to a particular asset/property), having a different NALI tax regime will further complicate the rules. Rather than using a two times multiple for general expenses and the "existing" NALI treatment apply for specific expenses (ie, NALI is taxed at 45%), it is our view that general and specific expenses be treated the same. In particular, that the NALI tax rate of 45% should only apply to the amount of underpayment/non-payment of the expense.

We also believe that NALI and NALE should be made proportionate – that is, only the additional income (over and above an arm's length income) or the underpayment of expenses (ie, below the arm's length expense) should be subject to the NALI tax rate of 45% (plus penalties, as applicable). Further information regarding this recommendation can be found in Appendix C on pages 16 – 17.

Further, the interaction with other tax provisions is unclear, particularly the capital gains tax regime and the contributions rules. It is noted that industry have raised not only our concerns with the NALE rules but also NALI more generally. In our view, this is the opportunity to fix the NALI regime and deal with all of these issues in one go.

**4. The proposed legislation is overly complex.**

The proposed amendments will make the NALI/NALE rules (even) more difficult to interpret. Legislation should be able, where possible, to be interpreted by the general taxpayer. With respect, the proposed changes are overly complex and will be very difficult for taxpayers (and their advisors) to interpret. Especially, without the background to why the changes were enacted and their purpose.

As noted below, we believe the NALE rules should be abolished rather than amended. However, if the proposed changes are retained, we suggest that the rewrite be redrafted in a simpler style. We are happy to provide you with suggestions.

**5. The examples in the exposure draft explanatory memorandum lack diversity and important details.**

It would have been beneficial if there was more variety and diversity of examples, rather than focussing on professionals such as accountants, lawyers and financial/investment advisers. Many of the examples, for example, lacked the following information which would have been useful in understanding the government's position on NALE:

- i. The examples involved activities performed by members in their individual capacity rather than activities performed in their trustee/director capacity.

Further, some of the examples are questionable, such as example 1.3 which includes a couple named Andrew who is a lawyer and his spouse Stephanie who is an investment adviser. Both members provide general legal (Andrew) and investment (Stephanie) advice to their fund where the market value of these services is \$2,000 each (ie, \$4,000 in total). In particular, we question the outcome here as Andrew and Stephanie are using their own skills, knowledge and experience to perform their trustee roles

This example, along with many others, do not address the issue of which "hat" a trustee is wearing when they provide services to their fund. That is, whether services provided are performed in a person's trustee or individual capacity. Generally speaking, most "general services" such as accounting or investment advice services are performed by members who have the necessary "skills and knowledge<sup>2</sup>" to

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<sup>2</sup> Paragraph 46 of LCR 2021/2



perform the service. The ATO's Law Companion Ruling LCR 2021/2, paragraph 46 states:

*46. An individual's business, profession, life experiences or employment may result in the individual having skills and knowledge that can assist the individual perform their duties in their capacity as trustee, or as a director of a corporate trustee, of a SMSF. Utilising such skills and knowledge of itself does not indicate that the individual is not acting in their capacity as trustee or as a director of a corporate trustee. For example, a financial adviser who is a trustee of a SMSF can utilise their skills and knowledge in deciding the investment strategy of the SMSF in their capacity as trustee.*

Accordingly, LCR 2021/2 confirms that skills and knowledge do not suggest services are performed in a person's individual capacity, rather, the default position is to presume a trustee is acting in their capacity as trustee. Based on the ATO's view in LCR 2021/2, it can be seen that Andrew and Stephanie are using their own skills, knowledge and experience to perform general services to their fund. The intention is not to circumvent the contribution caps or to obtain a tax advantage by engaging in such "schemes" as it is nonsensical to pay yourself as an individual or pay another person to perform a minor and general service that you could do yourself for your own SMSF.

In particular for Stephanie, we question what the difference is between setting up an investment strategy for her fund where it is deemed to be NALE of a general nature versus the example provided in paragraph 46 of LCR 2021/2 where a financial adviser who is a trustee of a SMSF can "utilise their skills and knowledge in deciding the investment strategy of the SMSF in their capacity as trustee" and not be deemed as NALE of a general expense? Both services involve the same work, that is, setting up or deciding the investment strategy for the fund but yet both have different NALI outcomes. We originally thought this was considered NALE as Stephanie is only a member of the fund and not a trustee, which would mean that she could not have performed this service in her capacity as trustee. However this cannot be correct as all members of a SMSF must be trustees and vice versa, unless an exception applies (ie, a legal personal representative is acting as trustee on behalf of a member, which does not appear to be the case in this example). As such, we would like to understand the government's position on this matter as there are inconsistencies in its guidance to the general public.

- ii. The examples that relate to accountants providing "general accounting services" do not go one step further and provide guidance on what the outcome would be if an accountant lodged their own SMSF tax return. The examples in the exposure draft explanatory memorandum are similar to the examples in LCR 2021/2, particularly example 6 regarding Leonie the accountant. In this example, Leonie prepares the





accounts and annual return for her SMSF but does not use the equipment or assets of her employer, nor does she lodge the annual return using her tax agent registration. Despite the NALE provisions not applying to Leonie, there is still no clarity for professionals doing work for their own SMSF. For example:

- Accountants – it is understood they can do the bookwork, prepare the accounts and the annual return for their own SMSF (including on their work computer) and use their expertise gained via their work, but can they also lodge their SMSF's tax return using their own tax agent registration, or under their firm's corporate tax agent registration? Although it's unlikely they could, both LCR 2021/2 and this exposure draft explanatory memorandum have not clarified this situation.
  - Financial/investment advisers – it was originally thought that advisers could decide the investment strategy and place investments for their SMSF but this is now questionable due to example 1.3 (Stephanie). A further grey area is where the SMSF portfolio is invested on the same platform as the adviser's other clients. Can the adviser use their work dealer code to manage their SMSF portfolio? Again, both LCR 2021/2 and this exposure draft explanatory memorandum have not clarified this situation.
- iii. A number of the examples contain a single individual trustee of an SMSF. Given this is not permitted by the SIS Act, your examples should be altered to ensure that there are either two individual trustees or a corporate sole director trustee.

### Closing comments

The exposure draft explanatory memorandum, as well as other guidance (ie, LCR 2021/2 and the previous Treasury NALE consultation papers) imply that the *Superannuation Industry (Supervision) Act 1993* (SIS Act) is not an appropriate regulatory tool to deal with non-arm's length dealings.

In our view, the purpose of the SIS Act is to regulate behaviour whereas the *Income Tax Assessment Act 1997* (ITAA 1997) is designed to extract an appropriate level of tax from a taxpayer. Aside from having to abide by the sole purpose test, we believe the SIS Act already prohibits trustees from entering into non-arm's length dealings by virtue of section 109, which requires that investments must be made and maintained on arm's length basis.

As mentioned in our February 2023 submission, an alternative option to deal with a NALE breach would be to repeal the NALE rules so the law (295-550 ITAA 1997) is brought back to its pre 1 July 2018 terms, and instead capture non-arm's length dealings via the contribution rules (as per Taxation Ruling TR 2010/1) and slightly amend section 109 of the SIS Act to prevent superannuation funds entering into non-arm's length transactions (ie, amend to capture NALE).





It must be remembered that the NALE amendments came about due to non-arm's length related party loans (see Appendix C, pages 13 – 14) and the drafting of the legislation, combined with the ATO's approach in LCR 2021/2, will operate beyond the policy intent and disproportionately impact Australians compared to the mischief it was intended to discourage.

It is therefore unnecessary to introduce a new penalty tax regime of using a 90% NALI/NALE effective tax rate as a regulatory tool as the superannuation system already has sufficient regulatory tools to deal with non-arm's length dealings. If enacted, the legislation will make the NALI provisions more complicated in absence of the explanatory memorandum.

To be abundantly clear, the proposed NALE rules do not work for any fund – SMSFs or large APRA-regulated funds. Thus we propose that SMSFs be granted the same carve-out as that of large APRA-regulated funds, and also that the NALI tax penalty should only apply to the extent of any undercharge or non-charge amount of NALE.

Please find the details of our previous February 2023 NALE submission which includes our recommended/suggested legislative changes at Appendix C, pages 12, 14 – 19.

If you have any questions in relation to this submission, please contact Phil Broderick on [REDACTED] or [REDACTED] or Natasha Panagis on [REDACTED] or [REDACTED]

Yours faithfully,



**Phil Broderick**  
Institute of Financial Professionals Australia  
Board Member  
Chair, Superannuation Technical & Policy  
Committee



**Natasha Panagis**  
Head of Superannuation and Financial  
Services





## Appendix C

21 February 2023

Retirement, Advice and Investment Division  
The Treasury  
Langton Crescent  
Parkes ACT 2600

Dear Sir/Madam,

### Submission on non-arm's length expense rules for superannuation funds

The Institute of Financial Professionals Australia is a not-for-profit membership association (originally known as Taxpayers Australia, then more recently Tax & Super Australia) and has been serving members for over 100 years. With a membership and subscriber base of over 15,000 practitioners, our association is at the forefront of educating and advocating on behalf of independent tax, superannuation and financial services professionals.

This submission is made by us on behalf of our members' interests.

### Our association does not support the proposals and proposes alternative measures

While we do not believe that a factor-based approach is the correct way to deal with a general expense breach, we nonetheless acknowledge that the government is looking at options which aim to break the link between the general expense breach and the income of the fund as a whole.

However, we believe that a number of changes should be made to the law, which we have outlined in our submission below, including:

1. The five time multiple concept should not be legislated – the proposal is inappropriate, extremely disproportionate, too high a penalty and is not consistent with other areas of the tax law. Non-arm's length income (NALI) and non-arm's length expenditure (NALE) should not be used as a regulatory measure. As noted below, there is already plenty of other regulatory measures to deal with non-arm's length dealings.
2. It is our strong view, that NALI and NALE should be made proportionate – that is, only the additional income (over and above an arm's length income) or the underpayment of expenses (ie, below the arm's length expense) should be subject to the NALI tax rate of 45% (plus penalties, as applicable).
3. A de minimis rule should be legislated.
4. Trustees should be able to rectify breaches without the application of NALI.
5. NALE should not apply retrospectively.





## Background – issues to be addressed

The introduction of the NALE rules and the Australian Taxation Office (ATO) interpretation of these rules as published in Law Companion Ruling LCR 2021/2, have far reaching and harmful consequences.

It is difficult to imagine that such outcomes were intended as the ATO's interpretation of the law and Treasury's recent consultation paper on the NALE rules has gone beyond addressing the original mischief at which the government policy was intending to address.

To recap, the NALI<sup>3</sup> rules in section 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997) were amended in 2019 to extend the scope of the rules to deter superannuation funds from entering into non-arm's length limited recourse borrowing arrangements (LRBAs) to increase member balances through non-arm's length arrangements that result in more income or charging lower than an arm's length expense.

For example, the Treasury [consultation paper](#) dated 11 January 2018, that preceded the amending legislation, refers to how the measures will affect LRBAs (see paragraph 30) and its only two examples relate to LRBAs (see examples 2 and 3). The consultation paper made no reference to "general expense" non-arm's length expenses.

Further, as noted in the second reading speech to the *Treasury Laws Amendment (2018 Superannuation Measures No.1) Bill 2019 (the Bill)*, the purpose of the changes was to:

*'ensure that superannuation funds can't circumvent the contribution caps by using non-arm's-length expenditure to inflate their overall income – for example, by borrowing money from a member at a reduced interest rate.'*

The explanatory memorandum to the Bill also indicated that the financial impact of this measure was *"estimated to result in a gain to revenue of \$30 million over the forward estimates period, reflecting the additional tax paid by non-arm's length lenders on interest income earned on loans"*. That is, it was contemplated to be small in revenue impact, further supporting that the measure was only aimed at non-arm's length LRBAs.

Thus, the drafting of the legislation, combined with the ATO's approach in LCR 2021/2, will operate beyond the policy intent and disproportionately impact Australians compared to the mischief it was intended to discourage. As can be seen, the explanatory memorandum to the Bill that introduced the NALE provisions makes it clear that the government was attempting to deal with the issue of zero or low interest rate related party loans. The forward estimates expressly state the revenue the government expected to collect was in relation to the interest

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<sup>3</sup> Section 295-550 *Income Tax Assessment Act 1997* (Cth) (ITAA 1997)

that would have been collected on zero or low interest rate loans had they been on arm's length terms.

For this reason, our association believes the NALE changes were not intended to be as broad and far reaching as what has eventuated.

It is also arguable that there was a solution in place before the NALE provisions were introduced. The ATO's Taxation Ruling TR 2010/1 on superannuation contributions indicates that should there be an amount that has been undercharged or not charged to a fund, the shortfall amount will be deemed to be a contribution to the fund as the member(s) have benefitted from the transaction and have therefore indirectly increased the capital of the fund. Having an amount classified as a contribution has its own disadvantages as it could lead to excess contributions and with excess contributions tax built into the system, the end tax outcome can be quite excessive. In our opinion, there was no need to make the rules more complex by extending NALI to include expenses.

In addition, superannuation fund trustees were prohibited from entering into non-arm's length dealings by section 109 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

Finally, there has always been a structural issue with NALI (even before the NALE changes) in that NALI has a disproportionate effect as the 45% tax rate is applied on all of the income tainted by NALI rather than applying the 45% tax rate on the excess income (ie, the income over and above what the superannuation fund should have received had there been arm's length dealings).

### **Recommended/suggested legislative changes**

#### **1. Remove the factor-based approach which leads to an effective tax rate of 225%**

The factor-based approach, which sets an upper limit on the amount of fund income taxable as NALI to a general expenses breach, is inappropriate, extremely disproportionate, too high of a penalty and is not consistent with other areas of the tax law.

When a general expenditure breach is multiplied by five times, an effective tax rate of 225% will apply on the value of any undercharging or non-charging. As a result, the penalty is excessive and will still result in disproportionately severe outcomes for breaches of the NALI rules.

If we look at the normal taxing principles, individuals are generally taxed at their applicable marginal tax rate plus penalties for any wrongdoing. However, this tax outcome will usually still be less than the income that an individual has earned. In our experience of NALI audits,





the NALI tax rate of 45% is generally the starting point, however, penalties can also apply. That is, a 45% tax rate applies to begin with and is multiplied by a penalty of around 25% - 75%. For example, applying a penalty of 25% for failure to take reasonable care or a penalty of 75% for intentional disregard of the law.

Unlike the blunt disproportionate application of the five times multiple, the penalty tax regime takes into the account the circumstances of the arrangement. That is, from a culpability point of view, if egregious breaches occur, there are already provisions in the penalty regime to punish individuals for their actions. For example, if a member makes an inadvertent error, this action may attract a 0 – 25% penalty, whereas more reckless and intentional actions may attract a 50% – 75% penalty.

The penalty regime is already tailored and proportionate, reflecting the seriousness of any breach. It is therefore not necessary to apply a five multiple at 45% on all individuals who make mistakes, be they inadvertent or intentional. Even for the most egregious of actions, where a 75% penalty is applied to a 45% tax rate because of intentional disregard of the tax law, the effective tax rate is only 78.75%.

In contrast, the effective rate of 225% compares unfavourably not only to the penalty tax regime but also to other anti-avoidance measures including Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936), the diverted profits tax (40%) and intentional disregard penalties (75%). It's even greater than one of the highest tax penalties being Part 7 penalties under the superannuation guarantee system for non-lodgement of superannuation guarantee statements (200%).

### **There are already regulatory tools to deal with non-arm's length dealings**

We understand the rationale for such a high penalty rate is that government wishes to use the NALI/NALE rules as a disincentive for non-arm's length dealings. In our view, this is an inappropriate use of the tax system. The tax system is designed to extract an appropriate level of tax out of a taxpayer. Even the harshest tax rates and penalties in the current tax system do not exceed 100% of the income or expense.

It is noted that the superannuation system already has sufficient regulatory tools to deal with non-arm's length dealings, including:

- Treating non-arm's length dealings as contributions per Taxation Ruling TR 2010/1.
- Using the current tax penalty regime (on top of a proportionate NALI tax assessment).
- The SIS Act and the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regs), including the sole purpose test (section 62) and section 109 of the SIS Act.



- An annual audit to review an SMSF trustee's compliance with the SIS Act and the SIS Regs.
- The power to issue fines and give rectification directions and education directions (Part 20 of the SIS Act).
- The power to disqualify trustee/directors and to make SMSFs non-complying.

This can be seen in example 1A from the consultation paper. In that example, the non-charging for accounting services could be treated as a concessional contribution and, if that causes members to exceed their concessional contributions cap, the excess would be released with its associated earnings. Alternatively, the non-charged amount (\$5,000) could be taxed proportionately at the NALI tax rate (eg, tax of \$2,250), plus penalties (0% to 75%), plus interest.

Likewise, example 2 would cause the SMSF trustee to breach section 66 of the SIS Act (eg, prohibition against acquiring assets from related parties not at market value) and section 109 of the SIS Act. This could result in the ATO issuing SIS Act penalties, rectification orders, disqualification of the SMSF trustees and/or making the SMSF non-compliant. The under-value transfer could also trigger the excess contribution regime.

In light of the extensive powers listed above, there is no need, and it is inappropriate, to use a 225% NALI/NALE tax rate as a regulatory tool.

## **2. NALI and NALE rules should be made proportionate**

As mentioned above, the consequences of triggering NALI are among the most serious in the tax system (ie, automatic tax at 45% on NALI<sup>4</sup>, which is a larger penalty than Part IVA). Because of the serious consequences of their application, the administration of the NALI rules has been on the basis that they were effectively treated as anti-avoidance provisions and only used for the most serious of cases.

It's the experience of our members that the administration of the NALI rules has been broadened in recent years. This has been brought into particular focus with the introduction of the NALE rules and the ATO release of Law Companion Ruling LCR 2021/2.

We are also part of a larger industry group which is in ongoing consultation with the ATO and Treasury. One of the main aims of this larger working group is to amend the NALI rules generally to make NALI proportionate to the tax imposed, ensuring that an asset is not

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<sup>4</sup> Section 26(1)(b) *Income Tax Rates Act 1986* (Cth)



tainted for life as NALI for all future income and any potential net capital gains upon disposal.

Rather than NALI applying universally to all income tainted by non-arm's length dealings, we believe that NALI should apply proportionately. Examples of proportionate application include:

- If under non-arm's length dealings, a superannuation fund acquires an asset for 10% below market value, then NALI should apply to 10% of the income and gains from that asset (ie, not 100%);
- If a related party of a superannuation fund fails to charge an arm's length fee of \$10,000 in management fees for managing a superannuation fund asset, then NALI should apply to \$10,000 (ie, not all of the income and gains from that asset).

We note the consultation paper states that where NALI is related to a specific asset, the current NALI rules would continue to apply. It is our view that we need consistency between expenses (ie, general and specific) and recommend that specific expenses are treated the same as general expenses. That is, NALI should also apply proportionately to specific expenses.

### 3. Apply a de minimis rule

Rather than applying the NALI tax rate of 45% by five times, other options could be considered, such as applying a 'de minimis' threshold where the excessive amount (ie, the difference between an arm's length expense and the expense that was incurred) above this threshold is taxed at 45%, rather than taxing the entire difference at an effective tax rate of 225%.

The de minimis threshold could be set at an amount of say \$2,000 per annum with amounts over this threshold subject to tax at 45%.

This solution would address the problem of funds having to spend disproportionate time and resources to identify the value of any minor undercharging or non-charging that may have occurred, regardless of the 225% penalty being proposed.

### 4. Allow trustees the opportunity to rectify unintended errors

The NALI provisions provide no opportunity to rectify. This sits at odds with, for example, the SMSF compliance rules where trustees are given the opportunity to rectify breaches brought to their attention in the annual audit. Similarly, with NALI, if a trustee makes an



honest oversight, they should be given the opportunity to make good rather than having all of the fund's income taxed at 45% (or 225% if the proposal for general expenses is adopted).

It is one thing to penalise Individuals for doing the wrong thing by taxing the fund's income and capital gains, but to also deplete the fund's assets over and beyond the mistake is unfair.

This is consistent with the application of the SIS Act, which not only allows rectifications, but it also grants the ATO the power to compel rectifications.

This is also consistent with other parts of the tax system, for example section 109RB in Division 7A of the ITAA 1936.<sup>5</sup>

## 5. NALE should not be retrospective

As the NALI provisions have been hardwired into the tax system for many years, the commencement date for the NALI provisions applies before and after 1 July 2018.

NALE on the other hand applies from 1 July 2018, however, in the ATO's view, NALE can also apply to schemes entered into prior to 1 July 2018.

Having NALE apply on a retrospective basis (ie, as far back to when an asset was originally acquired) can make it extremely difficult for members to account for transactions that occurred many years ago.

For example, one real life case we are dealing with at present involves a member who purchased units in a unit trust over 20 years ago which are now being sold for a capital gain. The documentation surrounding the valuation of the units acquired is being scrutinised by the ATO as the transaction occurred over 20 years ago and the individual is having difficulty providing market valuation evidence at the time of acquisition.

Although the market value substitution rules in section 112-20 of the ITAA 1997 can apply in respect of an asset that is acquired by a superannuation fund at less than its market value, the NALI rules continue to apply to an asset that has its cost base increased by the market substitution rule.

This means that although the market value substitution rule for capital gains tax purposes can obviate any potential tax arbitrage issues, individuals will also be subject to the NALI provisions on any income generated from that asset as well as any resulting capital gain.

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<sup>5</sup> See also PS LA 2011/29







In our opinion, it is suboptimal that cases like this – where assets are originally acquired at market value but the documentation and audit trail is lacking in detail – are now adversely impacted due to retrospectivity of the rules. In this example, if the mischief is that the cost base should have been more than what the ATO believes it should be, then that part of the capital gain should be subject to tax at 45%.

### Consultation paper questions

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?**

The proposal will create different rules for SMSFs and SAFs versus large APRA-regulated funds, as APRA-regulated funds are being exempted from the NALI provisions for general expenses.

All superannuation funds should be subject to the same tax rules and concessions. This proposal will create a division in the superannuation sector when what we need is to ensure that outcomes are proportionate, consistent, and fair for all superannuation funds.

From an APRA-regulated fund perspective, the government's view is that APRA-regulated funds would only enter into non-arm's length arrangements that provide general services as the primary intention would be to reduce costs and pass on those savings to their members, rather than for the dominant purpose of obtaining a tax benefit.

We respectfully disagree with this view. All superannuation fund trustees are required to act in the best financial interests<sup>6</sup> of all members. SMSF trustees are also required to reduce costs and pass those savings onto members so it seems unfair that the 'best financial interest duty' is only applicable to APRA-regulated funds and not smaller funds. Smaller funds should be treated the same as APRA-regulated funds and be given the same benefit of the doubt when it comes to looking after their member's best financial interests.

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<sup>6</sup> Section 52(2) *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act)





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?**

As noted above, we do not believe that this proposal is the correct way to deal with a general expense breach.

We recommend the government amend the NALI rules to make NALI and NALE proportionate at a tax rate of 45%. This will ensure that an asset is not tainted for life as NALI for all future income and any potential net capital gains upon disposal.

Alternatively, we suggest that the government introduce a de minimis rule (as explained above) as a way to deal with relatively minor breaches of the rules.

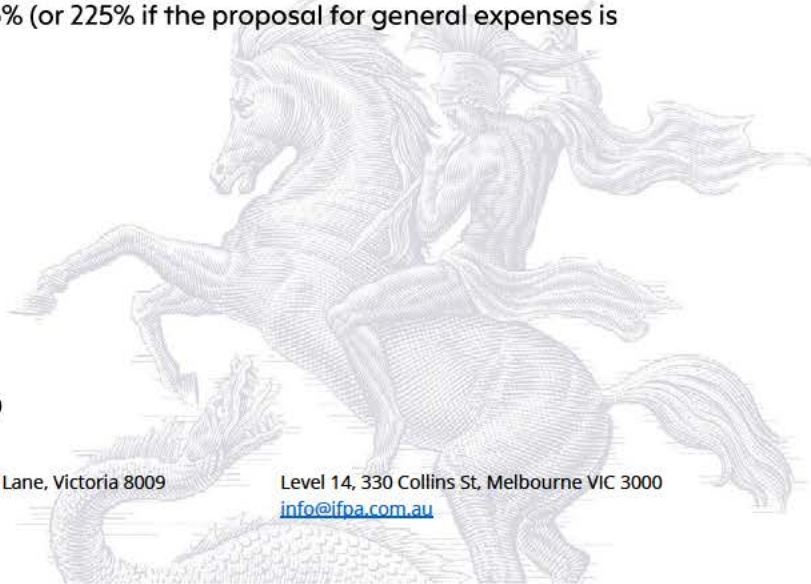
A further alternative could include repealing the NALI rules so the law (295-550 ITAA 1997) is brought back to its pre 1 July 2018 terms, and instead capture non-arm's length dealings via the contribution rules and section 109 of the SIS Act. We understand that other industry bodies will make submissions along this line.

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?**

The 225% effective tax rate will result in excessive and disproportionately severe outcomes for breaches of the NALI rules.

The "punishment" of a 225% tax rate outweighs the "crime", particularly when this effective tax rate is compared to other anti-avoidance measures and other penalties as mentioned in this submission.

Members should be given the opportunity to rectify any unintended errors rather than having all of the fund's income taxed at 45% (or 225% if the proposal for general expenses is adopted).







**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?**

We believe the carve out would lower the compliance burden for large APRA-regulated funds.

It seems unjust that smaller funds will still be subject to the NALI provisions for general expenses, as the proposed method will likely mean an increase in costs for smaller funds, both from an administration and auditing perspective.

This is because SMSF trustees will have to spend more time and resources determining an arm's length price when applying this calculation method, and the ATO may request further information from trustees to support the suitability of the identified arm's length price. This process can be time consuming, particularly if the trustees must obtain a valuation based on objective and supportable data, which is consistent with the ATO's current approach to valuations.

Further, without a legislative fix to the NALI provisions, SMSF auditors will also face more work as they are responsible for checking whether expenses are on arm's length terms. As a result, auditors will be forced to undertake extensive investigations to determine whether any NALI is present. This will result in SMSF auditors asking their SMSF clients more questions which can be painstaking and time consuming, particularly for ordinary expenses that are minor and incurred as a result of low-risk activities. These type of expenses can be extremely difficult for SMSF auditors to detect and can cause the auditor to be sued if the SMSF accounts are not presenting the position fairly.

**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?**

We don't believe there would be any unintended consequences if large APRA-regulated funds are carved out from the NALI provisions for general expenses.

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If you have any questions in relation to this submission, please contact Phil Broderick on [REDACTED]  
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Yours faithfully,



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