31 January 2025

Ms Bonita Tsang
Australian Taxation Office

By Email: PAGSEO@ato.gov.au

Dear Ms Tsang,

SMSF ASSOCIATION SUBMISSION – LCR 2021/2DC: NON-ARM'S LENGTH INCOME - EXPENDITURE INCURRED UNDER A NON-ARM'S LENGTH ARRANGEMENT

The SMSF Association welcomes the opportunity to provide a submission on LCR 2021/2DC: Non-Arm's Length Income - expenditure incurred under a non-arm's length arrangement (the LCR).

We recommend that this submission be read in conjunction with our submission on Draft Taxation Ruling TR 2010/1DC2 Income tax: superannuation contributions (the Ruling), as the issues are highly interrelated. We have intentionally avoided replication to provide a cohesive analysis; both submissions collectively address the issues arising from the interaction of the contribution and NALI provisions and should not be considered in isolation.

While we acknowledge the ATO's efforts to clarify the application of the non-arm's length expenditure (NALE) provisions, significant uncertainties remain, particularly concerning the:

- delineation between trustee and individual capacities
- nexus between non-arm's length expenses (NALE) and income
- disproportionate impact on SMSFs due to minor compliance breaches.

Thus, we reiterate that the SMSF Association and its members remain committed to seeking further change and improvement to the law and ATO guidance materials on NALI and NALE and our submission should not be construed as endorsing the current law or ATO materials. As previously submitted, we consider that the current ATO views reflected in the LCR can, among other things, result in disproportionate tax outcomes and would welcome further practical compliance guidelines from the ATO on how it might deal with minor and honest and inadvertent oversights that may otherwise invoke NALI/E.

Our submission highlights key issues, including the ambiguity surrounding common compliance-related expenses, the lack of clear guidance on specific capital versus revenue expenditure, and the need for practical approaches to mitigate substantial tax liabilities.

We also address inconsistencies in the ATO's guidance, such as the treatment of professional skills and the use of licences in providing fund-related services, and emphasise the need for explicit

clarification to ensure trustees can comply with both NALE provisions and their professional obligations.

We urge the ATO to refine its guidance to align with the legislative and policy intent, provide practical compliance pathways, and ensure SMSF trustees are not disproportionately subject to penal tax rates.

By addressing these concerns, the ATO can better promote clarity, fairness, equity and sustainability in the SMSF sector.

Services provided under a non-arm's length arrangement

1. NALE and nexus to income of the fund

For the NALE provisions to apply, there must be a sufficient nexus between the non-arm's length expense and the ordinary or statutory income of the fund, as outlined in paragraph 17 of the LCR. Without this nexus, the NALE provisions will not apply, even if the fund's expenditure is less than it would have been under arm's length dealings.

We consider the ATO view of what a 'sufficient nexus' is, is too broad and lacks the necessary precision with incurring a particular expense to the related ordinary or statutory income that flows from such an expense that becomes tainted. We therefore request the ATO to reconsider its "nexus" theory following passage of the 2024 amendments.

We understand why the ATO would submit that there was a very broad nexus with a general expense prior to the 2024 amendments. However, general expenses have now been dealt with by the 2024 amendments and therefore the ATO should revise its view as a specific expense can taint an asset forever in a fund if there is a sufficient nexus (eg, see the Trang example in example 9 of the LCR where the second rental property is tainted while owned by her fund).

In this regard we ask that the ATO outline any case law and authority (apart from ATO materials) that it can provide for advisers and taxpayers to better understand the nexus needed and when a specific or general expense will have the requisite nexus to ordinary and statutory income.

As you would be aware, providing a viewpoint on nexus, without supporting it with valid and persuasive authority can leave advisers and taxpayers without the clarity they need to navigate the issue effectively.

In particular, the LCR still fails to provide clear guidance to address common expenses such as legal, adviser and accounting fees.

Paragraph 19 of the LCR confirms that expenditure incurred in complying with or managing an SMSF's tax affairs and obligations lacks a sufficient nexus to the derivation of the fund's income. This aligns with TR 93/17, which recognises that expenses for preparing and lodging the SMSF Annual Return (SAR) are compliance-related and not tied to income generation. Similarly, ATO guidance (QC 53481) supports this view, also extending it to costs incurred in preparing financial statements.

Recommendation

To significantly reduce the compliance burden for trustees and ensure consistent application of the NALE provisions, the ATO should consider a complementary paragraph to paragraph 19, listing

common expenses where no sufficient nexus to the fund's income exists. In addition to the expenses referred to earlier, this could also be used to provide clarity on other common expenses including, but not limited to, trust deed amendments, acquisition or upgrades of administration software plus expenses incurred in preparing and lodging the SAR.

Example 6 of the LCR focuses on the capacity in which the service is undertaken, ignoring the absence of a required nexus to the fund's income. This example is misleading and should be amended to acknowledge that section 295-550 of the ITAA 1997 does not apply in such cases, making the question of capacity irrelevant.

2. NALE & the service provider

In accordance with the LCR, where a service is provided to the SMSF, if there is sufficient nexus to the income of the fund, the NALE provisions may apply if the amount charged is less than that which would be expected if parties were dealing at arm's length.

Where the service is provided by the trustees (or directors of the corporate trustee), the capacity in which the activity is performed needs to be determined.

If performed in the capacity as an SMSF trustee, the NALE provisions do not apply (paragraph 42 of the LCR) due to statutory restrictions which do not permit a trustee to be remunerated.

However, the ATO suggests that if performed in a non-trustee capacity, i.e. in an individual capacity, the NALE provisions may apply (paragraph 43 of the LCR).

In an effort to align guidance with statutory limitations, the ATO's position in the LCR is that services are presumed to be provided in a trustee capacity unless evidence indicates otherwise (paragraph 47 of the LCR).

However, the ruling provides limited guidance on how this presumption can be rebutted, particularly in scenarios where trustees/directors possess professional skills and licences that could benefit their funds but do not meet all of the requirements of s17B of the SIS Act.

Furthermore, the LCR oversimplifies the interaction of the NALE provisions with the operation of the Corporations Act and financial services law. For example, there are nuances with licensed advisers providing personal financial advice to themselves or their SMSF and charging a fee, as these laws require the adviser and client to be distinct parties.

Without the appropriate guidance addressing these statutory restrictions, the Commissioner places trustees in a difficult position where compliance with both the NALE framework and their professional and legal obligations could be practically unachievable without contravening the law.

Furthermore, recent Private Binding Rulings (PBRs), such as PBR 1052132378413 and PBR 1052155666298 highlight several areas where the ATO's approach in the LCR needs refinement.

The threshold test that needs to be applied by trustees in their circumstances needs to be clearly stated and supported with a clear explanation. Noting that the issue of materiality likewise is not clearly stated or discussed.

Minor and Incidental Use of Equipment

Both PBRs recognise that minor, infrequent, or irregular use of business equipment (e.g., tax agent software or computers) does not, of itself, indicate that an individual is acting in their professional capacity rather than in their capacity as a trustee. This practical position should be explicitly addressed in the LCR to provide certainty to trustees.

Example 6 of the LCR, which assumes no use of professional equipment or licences, does not reflect common scenarios where trustees may use such resources incidentally for fund purposes.

Use of Professional Licences

In PBR 1052155666298, the ATO concluded that the trustee's use of their tax agent registration number, while incidental and for cost efficiencies, did not constitute NALE.

This contrasts with the rigid approach implied in the LCR (eg, Leonie in example 6 of the LCR does not use the equipment or assets of her employer, nor does she lodge the annual return using her tax agent registration), which lacks guidance on whether the use of a professional licence can ever be considered immaterial.

The ATO is required to administer the law in a consistent manner. The details in PBR 1052155666298 should be consistent and reflected in the LCR.

The latest edits to Example 10 of the LCR only underscore contradictions within the NALE framework. If Jean were a retired electrician yet maintained his licence and performed work for the SMSF, he would be unable to charge a fee as per s17B of the SIS Act as he no longer performs similar services for the public. It is illogical that Jean's retirement status determines whether he must charge a fee, despite performing identical work to maintain the SMSF's property.

Capacity and Intention Documentation

Both PBRs emphasise the importance of trustees documenting their intention and capacity when providing services to the fund. This practice could be formally incorporated into the LCR as a compliance safeguard, allowing trustees to demonstrate that their actions are within the scope of their trustee duties.

Recommendations

To reduce ambiguity and compliance risk, the ATO needs to provide clearer guidance to trustees on the delineation of roles, where members with relevant skills (e.g., advisers, accountants, lawyers) perform fund-related tasks.

Industry requires explicit guidance on the treatment of financial advice fees to align the LCR with existing legal frameworks and ensure it provides workable and realistic compliance pathways for SMSF trustees who are also licensed advisers.

Ensure the LCR provides comprehensive examples reflecting practical realities, such as those outlined in the referenced PBRs. An LCR promotes transparency, consistency and reduces compliance costs associated with having to seek and rely on individual rulings.

Consider the introduction of safe harbour provisions to introduce materiality thresholds to guide trustees on acceptable incidental use of professional licences and resources, reducing uncertainty and compliance burdens.

3. NALE and fixed trusts

Non-arm's length dealings conducted within a fixed trust, in which the SMSF is a unit holder, can give rise to NALI under section 295-550(5)(a) for income received by an SMSF from the unit trust. This extends to services provided to a trustee of a fixed trust, for which there is no remuneration.

While the ATO has not explicitly commented on this scenario, it can be inferred that similar principles as outlined in paragraphs 44 – 47 of the LCR apply, acknowledging that trustees and directors have duties arising from statute, fiduciary obligations, and the powers provided by governing documents.

Recommendation

Greater clarity is required with respect to whether trustees of fixed unit trusts may also use their professional skills or knowledge to perform their duties, and that such use does not inherently indicate they are acting outside their trustee capacity.

An example, which addresses the provision of guarantees by directors of a corporate trustee of a unit trust would also be useful, particularly in light of the ATO's views expressed in *SMSFRB 2020/1*: Self-managed superannuation funds and property development.

We suggest that additional examples are also added to understand the difference between an individual versus a trustee capacity is involved including where an SMSF trustee/director/member might also be acting in an entity in which an SMSF invests, e.g., a private company or unit trust.

We suggest THE following draft sentence be added at the end of paragraph 48:

> ***48.*** *Similar considerations as noted in paragraphs 44 to 47 above apply where a person is acting as a director of a company or the trustee of a unit or fixed trust (and the directors of a corporate trustee) in which an SMSF invests.*

Taxpayers should not be required to seek private rulings on such matters, as doing so consumes significant resources for both the ATO and taxpayers.

Specific NALE – revenue or capital

We welcome the ATO taking on board industry's previous comments to remove reference to expenses of a 'recurrent nature'. However, we do not believe edits to paragraph 21 of the LCR are sufficient to provide the clarity industry needs to understand when NALI could apply to any future capital gain on disposal of an asset.

When read in conjunction with edits made to Example 9 (Trang's example), we believe the rationale for the change aligns with the concept of revenue versus capital expenses. If this is correct, this should be explicitly outlined in the LCR.

We believe adopting the established revenue versus capital distinction will promote compliance as it is well understood within the industry. For example, industry is familiar with the difference between improvements and repairs/maintenance in the context of LRBAs and adopting these concepts, as set out in SMSFR 2012/1, could provide a practical framework for understanding NALE impacts with respect to specific expenses.

Recommendation

The ATO should explicitly clarify the rationale for the removal of the term 'recurrent expense' in paragraph 21 of the LCR, particularly as it relates to tainting future capital gains.

That is, NALE that materially and permanently enhances the value or functionality of an asset, or significantly alters it for the better, could taint future capital gains as NALI. Conversely, NALE that merely maintains or repairs an asset to ensure its continued functioning should only result in NALI for the income year in which it was incurred, assuming exceptions for trustee capacity do not apply.

We also suggest that further guidance be included in the LCR so the ATO's view is more clearly expressed on how the NALI/E provisions apply in respect of:

- The difference between a general and a specific expense.
- The difference between a capital and revenue expense.
- The difference between a pre-acquisition and post-acquisition expense relating to an asset, eg, Sharon's discounted management fee in example 11 of the LCR. This is particularly important given the NALI provisions do not apply to pre–July 2018 NALE unless the NALE relates to the acquisition of an asset.
- The difference between a general expense and a specific expense that are tax related expenses deductible under s 25-5 of the ITAA 1997.

There are likely to be different combinations of the above expenses that will need to be analysed from time to time. It would be helpful for the ATO to outline some guidance in these situations as well.

NALE and CGT - Scope and Proportionality of Penalties

The 2024 legislative amendments limited the penal rate of 45% tax for general NALE to twice the expense shortfall, addressing to some extent disproportionate outcomes in relation to general expenses.

However, specific NALE provisions, remain problematic.

For existing assets, the ATO view appears to be that specific NALE of a capital nature, can taint all income and any future capital gain linked to the asset permanently, irrespective of how minor the expense is. This is a disproportionate outcome. For example, a small NALE, like an underpayment for renovations, could subject the asset's income and capital gains to a 45% tax, permanently.

Given the long-term nature of superannuation, this exposes an SMSF to penalty tax for potentially decades, vastly disproportionate to the severity of the initial lower expense. Moreover, in the absence of a realisation event, it taints all capital gains derived from the asset's original acquisition date by an SMSF even though a specific NALE capital expense is incurred years after the asset is acquired.

There is a clear disconnect between a minor capital expense and the tainting of all capital gains, which are driven primarily by capital appreciation resulting from market conditions. The market appreciation has no relevant nexus to the NALE which is related to an appreciation in market value.

Finally, while the NALE provisions are technically forward looking from 1 July 2018, the impact on capital gains is retrospective because the ATO view applies to the entire gain realised upon disposal, regardless of the period over which the asset appreciated. This creates an inequitable outcome as trustees are, for instance, taxed on gains attributable to assets acquired prior 1 July 2018 but where a post-acquisition NALE capital expense is incurred after that date based on the ATO view.

Recommendation

The Commissioner should consider the exercise of his General Powers of Administration (GPA), in accordance with PS LA 2009/4, to mitigate the disproportionate CGT outcomes for capital improvements under the NALI/NALE provisions.

For example, the ATO could use these powers administratively to consider:

- allowing a transitional relief period during which trustees can address or rectify NALE breaches of a capital nature, before tainting the asset becomes permanent;
- establishing a de-minimis rule to introduce a materiality threshold where a capital NALE below a certain percentage of an asset's value, does not result in tainting all income and capital gains forever;
- a safe harbour for gains attributable to appreciation that occurred before 1 July 2018 that allows for apportionment of capital gains based on the periods of ownership relative to the introduction of the NALE provisions.

Similar to the Commissioner's minimum pension underpayment GPA, SMSF trustees should also be able to apply for administrative relief to prevent disproportionate outcomes where evidence can be presented showing an innocent or inadvertent oversight.

Market Valuation Matters

1. Establishing market value

Although amendments made by Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019 were superseded by the 2024 changes, we believe the Explanatory Material (EM), with respect to the need for an arm's length market value remains very relevant.

In particular, we refer to paragraph 2.49 of the EM which clearly acknowledges that arm's length transactions can fall within a commercial range:

> **Range of transactions may be on arm's length terms**
>
> ***2.49*** *It can be difficult to determine an exact price that is 'non-arm's length'. An 'arm's length' price may be accepted to fall within a range of commercial prices. For example, loans may be available at different interest rates based on a range of factors. Accordingly, an SMSF may be able to apply an acceptable commercial rate of interest to a loan within a band of rates available to it on an arm's length basis.*

However, the ATO's Valuation Guidelines for SMSFs (QC 26343), have not been updated to address the complexities introduced by NALE and fail to clarify whether evidence that falls within an acceptable range of market values is sufficient.

Furthermore, the ATO's update in 2024 to its Market valuation for tax purposes guide failed to lift strict requirements which suggest that taxpayers must nominate a specific market value and justify this choice.

In the recent *BPFN and Commissioner of Taxation (Taxation)* [2023] AATA 2330 case, the Tribunal highlighted the importance of establishing market value in the context of arm's length dealings, further underscoring the need for clear, practical guidelines. The case affirmed that valuations often reflect a range, acknowledging market fluctuations, buyer/seller behaviour, and professional practices.

The Tribunal's approach aligns with the principles outlined in the High Court in Spencer v Commonwealth of Australia [1907] HCA 82, which supports a valuation methodology based on negotiations between informed and independent parties. These principles inherently allow for a reasonable range in determining market value and emphasise the impracticality of pinpoint accuracy.

With no legislative or practical basis demanding pinpoint market valuation precision, the ATO's approach is overly rigid and is inconsistent with established practices. Registered valuers themselves often cite professional liability and market dynamics as reasons for providing valuation ranges, to reflect real-world complexities.

Recommendation

Industry seeks express acknowledgement in the LCR for paragraph 2.49 of the EM and to reflect the process of negotiation. The ATO should provide examples and guidance on some types of assets where an acceptable range of value might apply to show when NALE is not enlivened.

Industry needs the introduction of practical flexibility to ensure that taxpayers are not burdened with justifying a single value point within a range provided by a professional valuer. This requires updates to existing relevant valuation guidelines to show that accepting a value within a range would not, by itself, invoke NALE.

The ATO should also consider the introduction of safe harbour provisions which allow some variance in market value, within an acceptable range. For example, it may be acceptable to the Commissioner if a valuation falls within a 10% margin of a market valuer's opinion, unless there was other evidence suggesting otherwise. This approach will reduce compliance costs and streamline dispute resolutions.

2. Discounted valuations – Employee Share Schemes

The ATO's stance on SMSFs acquiring shares under an Employee Share Scheme (ESS) has long been established, but the LCR and changes to the associated contributions ruling (TR 2010/1-DC2) have introduced significant uncertainty.

Under typical ESS arrangements, an employee nominates their SMSF to acquire shares, and the SMSF pays the company directly, benefiting from a discount provided under the ESS terms. These contractual provisions govern the SMSF's acquisition of the ESS shares.

Historically, based on TR 2010/1, industry practice has treated any discount as a superannuation contribution. Although recently removed, this practice also aligned with the following commentary published on the ATO webpage (QC 26221):

> *A super contribution is anything of value that increases the capital of a super fund and is provided with the purpose of benefiting one or more particular members of the fund, or all of the members in general.*
>
> *For example, when shares acquired under an ESS are transferred to an SMSF at less than market value, the acquisition results in a super contribution because the capital of the fund increases and the purpose of the acquisition is to benefit a member, or members, of the fund.*

The ATO has also issued TA 2010/3: Non market value acquisition of shares or share options by a self-managed superannuation fund, highlighting key concerns with ESS arrangements. This has guided the SMSF industry to establish best practices and treat any discount as a contribution, provided:

- the individual taxpayer properly accounts for the tax liability arising under the ESS provisions; and
- the shares acquired by the SMSF, including any discount, are treated as contributions and reported for excess contributions purposes; and
- the SMSF's investment is acquired and maintained at arm's length; and
- the correct cost base was used by the SMSF to calculate any CGT liability upon the disposal of the shares, and
- the trustee did not breach s 66 of the SIS Act or any other regulatory provision.

However, recent changes in the LCR now suggest that discounts on shares may result in future dividends and net capital gains from the shares, being classified as NALI and taxed at 45%. Additionally, amendments to TR 2010/1DC2 suggest that such discounts may no longer qualify as contributions.

The retrospective application of section 295-550(1)(b) and (c) regardless of when the 'scheme' was entered into, could result in SMSFs exposed to NALI on dividends and net capital gains for shares acquired at a discount under ESSs, despite those shares being acquired and sold several years ago.

The ATO's position on the discount concession outlined in paragraph 51 of the LCR is particularly restrictive, requiring discounts to be offered universally to all employees. However, this does not align with common ESS practices, where discounts are typically offered to specific employee classes, such as senior executives or employees based on years of service.

The strict focus on trustee influence over discount policies is also problematic, especially for small businesses. In small firms, where an SMSF trustee may also be a partner, demonstrating no influence over discount policies is impractical but this is not determinative of commerciality.

Paragraph 53 on cost recovery is far too broad in application and should be removed as cost recovery is used in various industries, eg, architects, builders and other trades and industries use this method. The paragraph is therefore inappropriate and there is no need to link this with paragraph 51. Para 51 can apply to this paragraph without any express reference.

Recommendation

Clarify the application of the LCR and Ruling to ESS arrangements, including both tax and superannuation consequences when an SMSF acquires discounted shares under an ESS.

Provide real-world examples with genuine ESS structures to address ambiguities, including those raised in PBR 1052314103521, which fails to consider s66 of the SIS Act.

Remove or revise references to trustee 'influence' in paragraph 51 and Example 8 of the LCR. A discount policy should be consistent with normal commercial practices with no need to consider the trustee's influence over the policy. If retained, specify permissible levels of trustee input without triggering the NALE provisions through examples.

Clarify the divide between what is a contribution versus NALI/E

As noted under the draft Ruling, there is no clear guidance or divide in the LCR between what is considered a contribution and what is considered NALE. The traditional ATO view was that a payment on behalf of a fund was a contribution.

Thus, we request further clarification as invariably in practice an expense is paid on behalf of a fund is not detected until a subsequent financial year and reported in the financial statements as a sundry creditor. However, there is fear that SMSF auditors and ATO officers might consider these amounts as invoking NALE. Can the ATO please provide further guidance.

Naturally, the guidance added to both the Ruling and the LCR needs to be consistent and appropriate.

Conclusion

The SMSF Association strongly encourages the ATO to refine the guidance provided in the LCR to address the uncertainties and compliance challenges highlighted in this submission.

By introducing clear practical examples, aligning interpretations with legislative intent and established ATO views or case law principles, the ATO can create a more balanced approach that minimises compliance burdens while maintaining the integrity of the NALE provisions.

Unless there is a practical manner of administering NALI/E matters, the costs of administration for all SMSFs is likely to increase, and more ATO resources will need to be allocated to dealing with trifling or minor matters as auditors are likely to qualify more annual reports.

We congratulate the ATO on the guidance previously provided, namely PCG 2016/5, in relation to limited recourse borrowing arrangements (LRBAs) in this regard. This PCG has given clear guidance in relation to related party LRBAs and assisted the SMSF industry and advisers with understanding the interaction between arm's length and non-arm's length LRBAs.

We welcome the opportunity to work collaboratively with the ATO to achieve these outcomes and ensure the SMSF sector remains robust, compliant, fair and sustainable.

If you have any questions about our submission, please do not hesitate to contact us, and we thank you again for the opportunity to provide this submission.

Yours sincerely,

Peter Burgess
Chief Executive Officer

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing the self-managed superannuation fund (SMSF) sector which is comprised of over 1.1 million SMSF members and a diverse range of financial professionals. The SMSF Association continues to build integrity through professional and education standards for practitioners who service the SMSF sector. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial advisers, tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them with access to independent education materials to assist them in the running of their SMSF.