

Webinar:

Not so NALI



Aaron Dunn
CEO, Smarter SMSF





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Prepared as of 25 August 2021

Today's session

Understanding NALI

Finalised legislation

ATO Ruling & Guidance

Examples

NALI definition

- Section 295-550, ITAA 1997 was introduced from 1 July 2007 (formerly known as 'special income').
- [TR 2006/7](#) is still relevant with no intended change to provisions.



PRIVATE COMPANY DIVIDENDS

A dividend paid by a private company, or ordinary income or statutory income reasonably attributable to such a dividend, is NALI unless the amount is considered consistent with an arm's length dealing.



CERTAIN DISTRIBUTIONS FROM A TRUST

A distribution from a trust is NALI if the Fund does not have a fixed entitlement to income, and some circumstances where income is derived under NALI where there is a fixed entitlement.



NON-ARM'S LENGTH TRANSACTIONS

Other types of income where the parties to a scheme are not dealing at arm's length, and income derived from the scheme is greater than might have been expected have they been dealing at arm's length.

Re: Hains (deceased); Barnsdall v FCT 88 ATC 4565

*“What is required in determining whether parties dealt with each other in respect of a particular dealing at arm’s length is an assessment whether in respect of that dealing they dealt with each other as arm’s length parties would normally do, so that the outcome of their dealing is a **matter of real bargaining.**”*

Davies J



Decision endorsed by:

Hill J in the Trustee for the Estate of the late AW Furse No.5 Will Trust v FC of T 91 ATC 4007

Full Federal Court in Commissioner of Taxation v AXA Asia Pacific Holdings Ltd [2010] FCAFC 134

NALI legislative amendments

- Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 was re-introduced into Parliament and **received Royal Assent on 2 October 2019**
- Whilst retaining current laws (s.295-550, ITAA 97), amendments **remove the ambiguity** in the application of the NALI provisions where a fund incurs a loss, outgoing or expenditure (or does not incur a loss, outgoing or expenditure) in certain circumstances.
- **Amendments to current laws took effect from 1 July 2018**





LCR 2021/2

- ATO has finalised position with the release of LCR 2021/2 on the application of the NALI provisions in s.295-550 of ITAA 1997, where expenditure is incurred under a non-arm's length arrangement.
- NALI provisions will apply where a scheme operates in which the parties are not dealing at arm's length as it relates to:
 - Acquiring assets at less than market value (ordinary & statutory income)
 - Non-arm's length expenditure (revenue or capital account)
 - Net capital gains (incl. impact of market value substitution rules)



Focus for today's session:

Implications of ruling with expenditure that is incurred (or not incurred) under a non-arm's length arrangement.

Timeline of events to finalise LCR 2021/2



Draft ruling issued in 2018 (before Government finalised changes to s.295-550, ITAA 1997)



Revised draft in 2019 (due to introduction of law changes)



Commissioner release compliance guidance (PCG 2020/5) for arrangements where there is a sufficient nexus of the non-arm's length expenditure (NALE) to all of the fund's income –available from 1 July 2018 to 30 June 2022.



LCR 2021/2 finalised after being referred to public rulings & advice panel for guidance, post industry consultation.

End of the road?



Not so NALI

Acquiring for less than market value





Non-arm's length asset acquisition

- Where fund purchase an asset at < \$MV under a scheme not at arm's length, the fund incurs NALE for the purposes of applying 295-550(1), ITAA 1997.
- Any shortfall **cannot** be treated as an in-specie contribution (TR 2010/1) where sold under terms of a contract
 - being difference between consideration and market value
- Contract would specify the component of the acquisition that is:
 - Purchased under the terms of the contract; and
 - The amount of the in-specie contribution for the remaining interest
- NALE provisions would apply, regardless of whether the shortfall was recorded within financials as an in-specie contribution
- Results in all income from the asset, including capital gains subject to NALI

Purchase < \$MV & no in-specie contribution

- During 2018-19, Russell purchased listed shares in his SMSF from a related party for \$500,000
- Market value at time of transfer was \$900,000, with no in-specie contribution being made as part of arrangement
- Fund has entered into scheme resulting in less capital expenditure that would otherwise have been incurred.
- The capital expenditure was incurred in gaining or producing dividend income
- **RESULT = any dividend income received by the SMSF is NALI**
- **And... NALE incurred in acquiring the shares will also result in NALI when CGT event arises**



Market substitution rules

- Where a fund acquires a CGT asset at less than its market value, the **market value substitution** rules in s.112-20 of ITAA 1997 may apply to modify the cost base / reduced cost base.
- Fund is required to adjust the first element of the cost base of the CGT asset that is acquired to its market value
- Will affect amount of subsequent capital gain on a later CGT event but does not affect the application of the NALE provisions in determining whether acquired at market value.
- **Any capital gain made by the fund from the subsequent CGT event of that asset will be NALI.**





Purchase < \$MV

- Continuing the previous example...
- Russell's SMSF sells the shares acquired for \$500,000 for \$1.0M two year's later
- For CGT purposes, the cost base of the shares is modified by the MV substitution rule (s.112-20, ITAA 97) as the parties did not deal with each other at arm's length for the acquisition
- Result = cost base of \$900,000, capital gain of \$100,000 (\$1.0M - \$900k), taxed as NALI
- **NB.** MV substitution rules would have also applied initially to taxpayer on transfer of shares into SMSF



Non-arm's length acquisition using LRBA

- Kellie's SMSF acquired a commercial property for \$2.0 million on during 2018-19, using a LRBA
- LRBA terms included 100% LVR, interest rate of 1.5% and repayments annually over 25 year period
- The SMSF derives rental income of \$12,000 p/mth
- Terms do not satisfy that of an LRBA on arm's length terms – e.g. P&I monthly, lower LVR
- Scheme entered into has resulted in SMSF incurring expenditure in gaining or producing rental income that would be less if dealing at arm's length.



Non-arm's length acquisition using LRBA

RESULT:

- The income derived from the non-arm's length scheme is to be treated as NALI:
 - \$144,000 rental income (less deductions attributable to the income) forms part of the fund's non-arm's length component and taxed at highest MTR
 - The deduction for interest will reduce the amount assessed as NALI
- Non-arm's length interest on borrowings to acquire an asset will result in any eventual capital gain on disposal **also** being treated as NALI.



Part purchase / part in-specie contribution

- During 2018-19, Nadia owns a commercial premises, leased to a third party to carry on a business
- Current market value of the property is \$500,000
- She wants to transfer the asset into her SMSF but only has \$400k
- Nadia's SMSF agrees to purchase 50% of property under a contract from her for \$250,000 and makes a NCC for the remaining 50%
- The acceptance of the in-specie contribution is recorded and reported within the fund's accounts and to the ATO.
- Continues to lease the premises on same terms
- **NALI does not apply (as at arm's length)**



Not so NALI

Non-arm's length expenditure



Application of the NALE provisions

- To determine if the NALI provisions apply, need to identify the relevant 'scheme' under which the parties were not dealing at arm's length.
- A '**scheme**' is defined as any arrangement, or any scheme, plan, proposal, action, course of action or course of conduct, where unilateral or otherwise (s. 995-1(1), ITAA 1997)



Approach required

It is necessary to **identify** both the:

1. Steps of the relevant scheme; and
2. Parties that deal with each other under those steps of the scheme

Once steps identified, necessary to **determine** whether:

1. The fund incurs NALE in gaining or producing ordinary or statutory income, or
2. Acquired a fixed entitlement to the income of a trust

Application of the NALE provisions

- Instances exist where the non-arm's length expenditure will have a **sufficient nexus** to ALL of the ordinary and/or statutory income derived by the fund.
- For example, a fund may incur expenditure that does not specifically relate to a particular amount being derived by the fund, but still has a sufficient nexus more generally to all income derived by the fund to be deductible (under section 8-1, ITAA 1997)
 - actuarial costs, accountancy fees, audit fees, investment adviser fees, other admin costs in managing the fund, etc.



Where the fund incurs non-arm's length expenditure of the nature as outlined above the nexus between the expenditure and all the income derived by the fund is sufficient for **all** the income to be caught under the NALI provisions.

Recurrent nature

If NALE is of **recurrent nature** (that does not relate to the acquisition of an asset) under a scheme that only has a nexus with the fund deriving ordinary or statutory income during a particular year, and subsequently ceases to incur NALE in a later year, income in later years are not NALI.

e.g. interest expense of an LRBA is an example of recurrent expenditure that is in relation to the acquisition of an asset (*always taints CGT position*)

Example – NALE

Nexus to all income of the fund - NALI

- For 2020-21, Mike as trustee for his SMSF engages his accounting firm, where is a partner to provide accounting services for the fund (i.e. SMSF compliance & tax return).
- The accounting firm does not charge for those services as a result of non-arm's length dealings between the parties (and not as part of a discount policy).
- Scheme entered into acquiring accounting services under non-arm's length arrangement (s.295-550(1) of ITAA 1997).
- The NALE (being \$0 incurred for services) has a sufficient nexus with all of the ordinary & statutory income derived by the SMSF for the income year.



Important:

Section 295-550(1) will cease to apply if the arrangement changes in a subsequent year if the arrangement changes to an arm's length transaction between the parties.



Capacity in which activities are performed

It may be necessary for an individual to ascertain whether they are performing an activity in the capacity as either:

- **Trustee of the SMSF**
- **Individual capacity**



Statutory scheme

Section 17A of SISA prevents a trustee or director of an SMSF from receiving remuneration for any duties or services performed in their **capacity** as trustee of the fund.



Individual (or other) capacity

Section 17B of SISA provides exceptions to allow remuneration for duties & services performed by them if they:

- Perform the duties or services other than in capacity as trustee/director; **and**
- Are appropriately qualified, and hold all necessary licences, to perform the duties or services; and
- Perform the duties or services in the ordinary course of business, carried on by them, or performing similar duties or services to the public; and
- Receive remuneration that is no more favourable to them than which it is reasonable to expect would be on an arm's length basis.

Capacity in which activities are performed

- NALI provisions **will not** be enlivened due to trustee/director not charging for services in relation to the fund when acting in a trustee capacity.
 - e.g. NALE provisions will not apply where a trustee, **acting in that capacity**, performs accounting services to the fund for no remuneration.
- However, when trustee is acting in **another capacity** and either:
 - does not receive remuneration for those services; or
 - receives remuneration in accordance with the s.17B exceptions

paragraph 295-550(1)(b) or (c) may apply where the fund incurs non-arm's length expenditure (NALE).



Statutory obligations

Trustee/director is required to perform particular actions to satisfy various obligations under the deed, statute (e.g. SISA) or other fiduciary conditions imposed under law.

Individual may have skills or experience that allows them to perform specific tasks – e.g. financial adviser to prepare investment strategy.

Utilising such skills of itself does not indicate that the individual is **not** acting in capacity as a trustee or director.

Capacity in which activities are performed

Commissioner's view for NALI provisions is that it is appropriate to presume that trustee/director operating under s.17A of SISA, **unless there are factors that suggest a contrary conclusion**. These include:

- Individual charging the SMSF for services performed – however, there can be circumstance where the individual can be acting in an individual capacity even though they do not charge the fund for performing the services
- The individual uses the equipment and other assets of their business, or equipment and other assets used in their profession or employment in a material manner.
 - Consideration of whether asset or equipment use is minor, infrequent or irregular? E.g. Use of business computer at the office by an individual would not, of itself, indicate a person is acting in an individual capacity.
- The individual performs the activities pursuant to a licence and/or qualification relating to their business, or their profession or employment – i.e. the activity can only be performed due to the individual or business holding the relevant licence or qualification.
- The activity is covered by an insurance policy relating to their business, profession or employment (e.g. indemnity insurance)



Need to weigh up all relevant facts, circumstances and factors in deciding in what capacity the individual is acting – either as trustee or other than as trustee?

Example

Internal arrangement – SMSF trustee provides services to the fund



Leonie is a trustee of an SMSF of which she is the sole member.

She is a chartered accountant and registered tax agent who is employed in an accounting and tax agent business. Leonie (in her capacity as trustee) prepares the accounts and annual return for the SMSF. She **does not** use the equipment or assets of her employer, nor does she lodge the annual return using her tax agent registration.

As she performs these duties or services as trustee of the SMSF, she does not charge the SMSF for this work.

The **NALE provisions do not apply** as the duties or services performed by Leonie are in her capacity as trustee rather than under an arrangement in which parties are dealing with one another on a non-arm's length basis.

Example

SMSF trustee carries out duties – trustee capacity



Levi is the trustee of his SMSF of which he is the sole member.

He is also a financial advisor and director of Levi and Co Financial Services Pty Ltd (Levi & Co). Levi operates the business of Levi & Co from a commercial office and on regular occasions from his home. At home, Levi uses the computer and office equipment supplied by and paid for by the business.

When at home, but not while working or billing clients, Levi undertakes the bookwork and **occasionally** makes online investments for his SMSF using the computer and office equipment supplied by the business.

Levi performs these activities as trustee of his SMSF and **does not charge** the SMSF for this work. Levi's use of the computer and office equipment at home is minor and incidental in nature and will not, of itself, indicate that he is undertaking these services in any capacity other than as trustee for his SMSF.

Current financial planner scenario

- James is a trustee of his SMSF, in which is he also a member.
- He is a financial planner and uses Hub24 as main platform within his financial planning business.
- James has access to Hub24 for his own fund and can invest directly without any requirement for a Statement of Advice (SoA) and therefore not charging a fee for that advice.
- Hub24 does charge administration fees to the SMSF for use of the platform, however there are no other fees incurred by the SMSF to undertake these investments



POLL:

What capacity is James acting within his SMSF for the purposes of non-arm's length expenditure (NALE) requirements?



Is James acting as trustee of his SMSF?

OR



Is James acting in his individual capacity as financial planner?



Analysis

Let's work through the following questions to better understand the issues...

Question	Analysis
<ul style="list-style-type: none">• Can James undertake work on his fund's investment strategy without charging a fee?	<ul style="list-style-type: none">• Yes, just because he is a financial planner, it does not prevent him from acting in a trustee capacity to meet the statutory requirements of formulating and monitoring of his SMSF investment strategy.
<ul style="list-style-type: none">• Is James using equipment or other assets of the business in a material manner? or is it infrequent or irregular use?	<ul style="list-style-type: none">• He may be utilising business equipment, but arguably through infrequent or irregular use for own fund.
<ul style="list-style-type: none">• Is James performing activities pursuant to a licence in relation to his financial advice business?• Can this activity be performed without holding the relevant AFSL licence (or as an authorised representative)?	<ul style="list-style-type: none">• Yes, James is performing an activity pursuant to holding an AFSL licence or as an AR of a licensee.• James does not have access to the Hub24 platform generally without the holding of the AFSL licence or as an AR of a licensee (no retail access available to Hub24).

Analysis

Question	Analysis
<ul style="list-style-type: none">Is the activity covered by the PI policy of James' financial planning business?	Yes, it would be a requirement of the AFSL licence or licensee as an AR.
<ul style="list-style-type: none">Is there a staff discount policy in place within the business that applies the same discount to all employees, partners, shareholders or office holders?	Would need to show evidence of a staff discount policy.



Result = James is acting in his individual capacity

Whilst generally can prepare the investment strategy of his fund, he wouldn't have access to Hub24 without acting as a financial planner that requires him to perform activities pursuant to holding a relevant licence. As a result, an arm's length fee would need to be charged over and above the Hub24 platform fee, otherwise the NALI provisions would apply.

The only exception to this would be if a staff discount policy was in place that entitled James' SMSF to a discount to invest via Hub24 through the financial planning business.

Non-arm's length dealings

- Where trustee/director provides services in a **non-trustee capacity** for remuneration, the NALE provisions will apply where the remuneration is incurred by the fund in gaining or producing ordinary or statutory income and the expenditure is non-arm's length expenditure – this also includes where **no remuneration** is provided.
 - **e.g.** Trustee (being accountant or bookkeeper) contracts accounting services to their firm, which charges non-arm's length rates



If arm's length charges are paid – NALE provisions do not apply.

Look for commercial pricing policy to support amount being charged.

- [PCG 2020/5](#) currently in force to allow non-arm's length arrangements to be adjusted by 30 June 2022.



Discounts & pro-bono

- An SMSF may enter into arrangements that provide the fund with a **discounted fee**.
- Will still be on arm's length terms where they are consistent with normal commercial practices
 - E.g. trustee being entitled to a discount under a discount policy where they are provided to all employees, partners, shareholders or officeholders.
- **Pro-bono:** will still be on arm's length terms whether the trustee/director is not able to influence the service provider's decision to supply the services on a pro-bono basis.



3rd party providing services - discount

Sasha is the trustee of her SMSF of which she is the sole member. She is also an employee of Eren & Co Accountants ('Eren & Co').

Sasha engages Eren & Co to provide accounting services to her SMSF. Sasha is entitled to a staff discount rate that is available to all staff of Eren & Co. Sasha is charged the discounted rate for these services.

As the discount is available to all staff of Eren & Co and is not able to be influenced by Sasha, the discounted rate has been provided on an arm's length basis.

Accordingly, the non-arm's length expenditure provisions will not apply.

Example

SMSF trustee carries out duties – different capacities



Trang is the trustee of her SMSF of which she is the sole member. She is also a plumber by trade and runs her own business as a sole trader in which she also employs an apprentice, Nova.

Trang's SMSF has two investment properties which are leased for a commercial rate of rent.

After finishing work for the day, Trang stops by one of the SMSF's investment properties to connect a stand-alone water filter provided (and to be taken away at lease end) by the tenant. She uses some of her tools of trade to complete the installation.

Trang performs this activity as trustee of her SMSF and does not charge the SMSF for this work. Trang's use of the tools of her trade in respect of this property is minor, infrequent or irregular in nature and will not, of itself, indicate that she is undertaking these services in any other capacity other than as trustee for her SMSF.

Accordingly, the non-arm's length expenditure provisions will not apply.

Example

SMSF trustee carries out duties – different capacities (cont.)



In respect of the second SMSF rental property, Trang undertakes a complete renovation of the bathroom and kitchen. She schedules time in her work calendar to undertake the work and uses the tools of her trade to undertake all plumbing work on the renovations. She also engages Nova in all works.

Trang does not charge the SMSF for the work undertaken in respect of the second SMSF rental property.

In this instance, Trang's use of the tools of her trade will not be considered minor, infrequent or irregular in nature. Considering all her activities, she will be considered to be undertaking these services in her individual capacity, rather than as trustee for her SMSF.

Example

SMSF trustee carries out duties – different capacities (cont.)



For the purposes of subsection 295-550(1), the scheme involves the SMSF obtaining the services from Trang and deriving the rental income.

Trang **not charging** the SMSF for the services provided constitutes a non-arm's length dealing between the SMSF and Trang, which resulted in the SMSF incurring expenditure in gaining or producing rental income that was less than would otherwise be expected if those parties were dealing with each other at arm's length in relation to the scheme.

As such, there is **sufficient nexus** between the non-arm's length expenditure and the rental income derived from the second SMSF rental property. **The rental income will therefore be NALI.** The non-arm's length expenditure will also result in any capital gain that might arise from the subsequent disposal of the second SMSF rental property being NALI.



Permanently taints the capital gains tax position of the fund as a result of the non-arm's length dealing.



Example

SMSF trustee carries out duties – individual capacity

Jake is the trustee of his SMSF of which he is the sole member. He is also a licenced electrician by trade. The SMSF owns a residential property which it leases for a commercial rate of rent.

Jean undertakes electrical work on the rental property that can only be done by a licenced electrician. In that instance, the work done by Jean is not as trustee of his SMSF but in his individual capacity. Jean charges the SMSF the commercial rate for the work undertaken on the rental property.

Accordingly, the non-arm's length expenditure provisions will not apply.



Example

SMSF trustee carries out duties – individual capacity

Sharon is a director and member of an SMSF. She is a licensed real estate agent and is the director of Ringo Real Estate Pty Ltd ('Ringo RE') which conducts a real estate business, including property management services for rental properties.

The SMSF holds a residential property which it leases for a commercial rate of rent. Sharon provides property management services to the SMSF as a licenced real estate agent. She utilises the equipment and assets of Ringo RE (including the business' website) in performing these services. Her actions are covered by the applicable insurance policies in respect of Ringo RE.

Accordingly, Sharon provides property management services in her **individual capacity** to the SMSF with respect to the residential property. Ringo RE does not have a staff discount policy. She charges the SMSF 50% of the price for her services that Ringo RE would otherwise charge a party.



Example

SMSF trustee carries out duties – individual capacity

For the purposes of subsection 295-550(1), the scheme involves the SMSF obtaining the services from Sharon and deriving the rental income. The price charged to the SMSF constitutes a non-arm's length dealing between the SMSF, Ringo RE and Sharon, which resulted in the SMSF incurring expenditure in gaining or producing rental income that was less than would otherwise be expected if those parties were dealing with each other at arm's length in relation to the scheme.

As such, there is sufficient nexus between the non-arm's length expenditure and the rental income derived from the residential property. The rental income will therefore be NALI for each income year the non-arm's length dealing **remains in place**.

Due to the nature of the non-arm's length expenditure, there will not be a sufficient nexus between the non-arm's length expenditure and any future capital gain made by the SMSF on the disposal of the residential property.



Ability to rectify position to avoid NALI applying on the ordinary income derived from property.



Summary

- Dealing at less than \$MV will result in market value substitution rules applying – impacting taxpayer and SMSF (e.g. off-market transfers)
- Critical that you understand the capacity in which the trustee / director is acting to determine whether the NALI provisions apply
- Benchmark any services to ensure that dealing demonstrate an arm's length arrangement where acting in an individual capacity (not as trustee)
- Are there any staff discount policies in place or can be implemented to avoid the NALI provisions from applying?
- **Review arrangements prior to cessation of Commissioner's relief in PCG 2020/5 at 30 June 2022**



Smart people learn together



Aaron Dunn

CEO & Co-founder

Smarter SMSF

1300 95 94 76

<https://smartersmsf.com>

team@smartersmsf.com



SMSF Association
Accredited
Educator

Thank you!

T 1300 95 94 76

team@smartersmsf.com