
SISFA 2019 SMSF FORUM

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MELBOURNE



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NON-ARM'S LENGTH INCOME – TABLE OF ABBREVIATIONS

NAL	Non-arm's length
NALE	Non-arm's length expenses
NALI	Non-arm's length income
AL	Arm's length
ITAA36/97	<i>Income Tax Assessment Act 1936 or 1997</i>
SF	Superannuation fund
ADF	Approved deposit fund
PST	Pooled superannuation trust
UT	Unit trust
TP	Taxpayer
LRBA	Limited recourse borrowing arrangement
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
LVR	Loan value ratio

NON-ARM'S LENGTH INCOME



- Topics to be considered:
 1. Background and recent developments
 2. Ordinary and statutory income
 3. Dividends from private companies
 4. Distributions from trusts
 5. Application to capital gains
 6. Messages

NON-ARM'S LENGTH INCOME



- Background and recent developments
 - **Mischief?** S 273 ITAA36 (predecessor of s 295-550 ITAA97) an anti-avoidance provision.
 - “...Section 273 is designed to prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers”

[Explanatory Memorandum to Superannuation Legislation Amendment Bill (No 2) 1999, para 2.13].

NON-ARM'S LENGTH INCOME



- Background and recent developments
 - The silent assassin? NAL provisions still remain obscure/unknown to some
 - Taxable income of complying SF's, ADF's and PST's divided into NAL component and low tax component: s 295-545(2) ITAA97
 - NAL component = NAL income less deductions to extent attributable to that income
 - NAL component taxed at 45% (instead of 15% or 0%)

NON-ARM'S LENGTH INCOME



- Background and recent developments
 - **Dire tax consequences of NALI:**
 - 😓 Cases?
 - 😓 ATO reviews/audits?
 - 😓 Penalties?
 - 😓 GIC/SIC
 - Odious: once an amount of income is NAL, whole amount tainted...

NON-ARM'S LENGTH INCOME



- Background and recent developments
 - Prior to 1 July 2008, law contained in s 273 of ITAA36 ('special income')
 - Current law: since 1 July 2008, contained in Subdiv 295-H of ITAA97 ('non-arm's length income') – most cases to date involve s 273 but see *GYNW and C of T* [2019] AATA 4262
 - From 2019 income year onwards, s 295-550(1) and (5) repealed and rewritten to ensure that NAL income rules apply where a complying SF, complying ADF or a PST incurs NAL expenses in gaining/producing that income
 - *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019* received Royal Assent on 2 Oct 2019

NON-ARM'S LENGTH INCOME



- Background and recent developments
 - Several categories of NALI within s 295-550 as follows:

Ordinary/statutory income	S 295-550(1)
Private company dividends	S 295-550(2) & (3)
Trust distributions	S 295-550(4) & (5)

NON-ARM'S LENGTH INCOME



- Background and recent developments – arm's length
 - Concept of AL referred to in all categories of NALI
 - Not defined in ITAA36; defined by direction only in s 995-1 of ITAA97:

“In considering whether parties deal at arm's length, consider any connection between them and any other relevant circumstance”
 - Lee J in *Granby Pty Ltd v FCT* 95 ATC 4240 at 4243:

“What is asked is whether the parties behaved in the manner in which parties at arm's length would be expected to behave in conducting their affairs”

NON-ARM'S LENGTH INCOME



- Background and recent developments – arm's length
 - Davies J in *Re Hains (dec); Barnsdall v FCT* 88 ATC 4565:

“What is required... 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”
 - Weinberg J in *APRA v Derstepanian* [2005] FCA 1121:

“...whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment”
 - DP McCabe & SM Hespe in *GYNW and C of T* [2019] AATA 4262 at [109]:

“how unrelated parties, each acting in his or her own best interest, would carry out a particular transaction”

NON-ARM'S LENGTH INCOME



- Background and recent developments – arm's length
 - Full Court in *C of T v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134: no presumption that parties at AL deal with each other at AL; conversely, parties that are not at AL can still deal with each other at AL
 - See summary of principles by Dowsett J in *AXA* at [26]
 - Careful regard to be given to presence of collusion – parties not deal with each other at AL where they collude to achieve a particular result: *Granby*

NON-ARM'S LENGTH INCOME



- Background and recent developments – arm's length
 - However, majority in *AXA* noted that the pursuit of one party for its own benefit of a “collateral advantage” cannot without more lead to a conclusion that parties to transaction not dealing with each other at AL

“...there may be real risks.... by ‘dissecting’ the dealing into segments or aspects and submitting that the parties ‘colluded’ or ‘yielded judgment’ one to the other on some aspect of the dealing”
 - A dissection of the transaction into segments may inaccurately colour the overall assessment

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - S 295-550(1) now provides that an amount of ordinary income or statutory income (of a complying SF, ADF or PST) is NALI if, as a result of a scheme the parties to which were not dealing with each other at AL in relation to the scheme one or more of the following applies:
 - a. the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at AL in relation to the scheme;
 - b. in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of the loss/outgoing/expenditure that the entity might have been expected to incur if those parties had been dealing with each other at AL in relation to the scheme; or
 - c. in gaining or producing the income, the entity does not incur a loss/outgoing/expenditure that the entity might have been expected to incur if those parties had been dealing with each other at AL in relation to the scheme

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - Restructure of s 295-550(1) does not affect application to income that would have been captured as NALI prior to amendment (now in 'chapeau' to s-section 295-550(1)(a))
 - Three requirements still to be met:
 1. Must be a “scheme” (“transaction” under s 273) - broadly defined in s 995-1 of ITAA97, requires at least two parties (EM at [3.15]) – exact parameters of scheme may be disputed (like Part IVA)
 2. Parties to the scheme must not have been dealing with each other at AL in relation to the scheme
 3. Income derived from the scheme must have been more than the amount the entity might have been expected to derive if those parties had been dealing with each other at AL (in relation to the scheme)

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - Subsections 295-550(1)(b) and (c) both new
 - Requirements – ordinary/statutory income will be NALI (of a complying SF, ADF or PST) if:
 1. There is a scheme in which the parties were not dealing with each other at AL; and
 2. The fund incurs a loss/outgoing or expenditure of an amount in acquiring the entitlement or in gaining or producing the income; and
 3. The amount of the loss/outgoing or expenditure is less than the amount that the fund might have been expected to incur if those parties had been dealing with other at AL; or
 4. The fund does not incur a loss/outgoing or expenditure that the fund might have been expected to incur if those parties had been dealing with other at AL

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - Amendments target “technical deficiency” and seek to “remove any ambiguity” by ensuring that (EM at [3.9]):

“...superannuation entities cannot circumvent the provisions by entering into schemes with non-arm’s length expenditure (including where they do not charge expenses)”.
 - Law Companion Ruling (LCR) 2019/D3 released 2 Oct 2019 – stated to be a draft for public comment
 - Contains 9 examples – some draconian outcomes
 - Comments invited by 15 Nov 2019

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - “in gaining or producing the income...”- must be a sufficient nexus, reflective of s 8-1 analysis, between NALE and the relevant ordinary/statutory income: EM at [2.38]
 - Nexus construed widely by Comsr in LCR 2019/D3:
 - NALE incurred to acquire an asset will have a sufficient nexus to all ordinary/statutory income derived by the SF in respect of that asset (including any capital gain on disposal): at [17] (see also EM at 2.41)
 - In some instances, NALE will have a sufficient nexus to all ordinary/statutory income derived by fund: at [18]
 - Expenses may be of a revenue or capital nature in same way that NALI may be ordinary or statutory income: at [16]
 - NALE not have to be deductible under s 8-1 for NALE to apply: at [16]

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - MV substitution rules in s 112-20 ITAA97 can apply in respect of an asset acquired that is subject to NALI rules: EM [2.46] to [2.48]
 - To calculate NAL component, necessary to identify deductions attributable to NALI – may or may not include NALE
 - NALI rules not intended to apply to arrangements that are purely internal (not undertaken with another party and not a scheme): EM at [3.33]
 - For example a SMSF trustee may undertake bookkeeping activities for no charge – not constitute a scheme
 - But beware of trustee not acting as trustee but providing services as third party to SMSF for no amount or less than amount that fund might have been expected to incur if parties had been dealing with other at AL – capacity in which acting critical

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income – NALE examples
 - Example 1 - LCR 2019/D3
 - A owns commercial property worth \$800,000
 - A sells the property to himself as trustee of A's SMSF for \$200,000
 - SMSF leases property to third party
 - All rental income NALI - sufficient nexus between NALE incurred in acquiring property and the income derived from leasing
 - Will be a sufficient nexus between NALE and eventual capital gain on disposal to be NALI

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income – NALE examples
 - Example 2 – LCR 2019/D3
 - M as trustee of SMSF engages an accounting firm, where she is a partner to provide accounting services to the fund
 - Accounting firm does not charge the SMSF for services it provides
 - NALE has sufficient nexus with all ordinary and statutory income derived by SMSF for year(s) services provided!!

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income – NALE examples
 - Example 3 (EM example 2.1)
 - SMSF acquires commercial property from third party for MV price
 - SMSF rents out the property for MV rent
 - SMSF finances purchase under LRBA on terms consistent with s 67A SIS Act
 - LRBA terms includes no interest, borrowing full purchase price & no repayts until end of 25 yr term
 - SMSF was in a financial position to enter a LRBA on commercial terms with interest rate of 5.8%
 - Income derived from NAL scheme is NALI
 - Eventual capital gain on disposal will be NALI

NON-ARM'S LENGTH INCOME



- Ordinary and statutory income
 - **Note:** s 295-550(1) not applicable if s 295-550(2) applies or amount derived by entity in capacity as beneficiary of a trust
 - S 295-550(1) often not apply since dividends & trust distributions excluded from s 295-550(1) – see s 295-550(2) to (5)
 - But s 295-550(1) applied to direct investments made by SF's, such as property developments (ATO concern), contractual agreements or supplies for services between SF and another entity where SF derives more income than if acting at AL
 - In *GYNW*, AAT noted at [124]:

“... it is difficult to conceive of circumstances where a dividend paid by a private company to a complying superannuation fund would not be non-arm's length income under s 295-550(2) yet constitute non-arm's length income for the purposes of s 295-550(1)”.

NON-ARM'S LENGTH INCOME



- Dividends from private companies
 - A dividend (or ordinary/statutory income reasonably attributable to a dividend) paid to a complying SF will be NAL income *unless* amount consistent with AL dealing: s 295-550(2)
 - In deciding whether an amount is consistent with an AL dealing have regard to (s 295-550(3)):

• Value of shares in the company	• Whether dividend paid on other shares in company & if so, rate
• Cost of the shares (to the entity)	• Whether company has issued shares to entity in satisfaction of a dividend & if so, circumstances
• Rate of the dividend	• Any other relevant matters

NON-ARM'S LENGTH INCOME



- Dividends from private companies
 - S 295-550(2) and (3) remain unchanged
 - Full Federal Court in *Darrelen Pty Ltd v C of T* [2010] FCAFC 35 provided guidance as to how factors in s 295-550(3) are to be construed
 - Court in *Darrelen* upheld assessments which treated private company dividends as 'special income'
 - The acquisition by the SF in *Darrelen* of shares in company for significantly less than MV proved critical

NON-ARM'S LENGTH INCOME



- Dividends from private companies

- In *Darrelen*, fact SF derived distribution at rate equal to other shareholders did not alter court's conclusion (at para [34]):

“If the price at which the four shares in Vercot were sold to the Fund had been set at their market value, the price at which they were sold would not have secured the sale of even one share; the dividends on those four shares would have continued to accrue to the transferor, a non-concessional taxpayer”

- Sub-para (f) (any other relevant matter) of s 295-550(3) is expansive - court in *Darrelen* regarded yield/rate of return on investment as a factor that could be considered under para (f)

NON-ARM'S LENGTH INCOME



- Dividends from private companies
 - Court also concluded that market value of shares may be considered under sub-para (a) or (f) of s 295-550(3)
 - Comsnr in TR 2006/7 lists matters he will consider relevant in relation to sub-para (f) to inc:
 - Extent to which members who are at AL to the private company have an interest in the SF/ADF/PST
 - Relationship between SF/ADF/PST and private company or entity with which private company has dealings
 - Who SF/ADF/PST acquires shares from & circumstances
 - Rate of return on SF's investment

NON-ARM'S LENGTH INCOME



- Dividends from private companies
 - *GYNW* is first NALI case in several years
 - First NALI cases to deal with s 295-550
 - In issue was whether dividends/franking credits received by SMSF were NALI and if so, whether penalty (50% for recklessness) was correctly imposed
 - SMSF acquired 20% of the shares in a company, B Holdings Pty Ltd for MV (\$200) at that time on premise that B Holdings to become holder of shares in BE Pty Ltd: at [97]
 - Next day, B Holdings acquired all shares in BE Pty Ltd from Mr K, a related party (controller of B Holdings and BE Pty Ltd) for \$200

NON-ARM'S LENGTH INCOME



- Dividends from private companies
 - SMSF (through its controller) aware that dividends were sourced from BE Pty Ltd and of relationship between Mr K and BE
 - BE Pty Ltd declared large fully franked dividends to B Holdings for the 2012 (\$3,365,000), 2013 (\$5,300,000) and 2014 (\$500,000) years
 - B Holdings declared and paid fully franked dividends for those years to the SMSF
 - SMSF argued that subject of inquiry was dividends paid by B Holdings to SMSF and that amount of dividends and franking credits consistent with its 20% stake
 - Heavy regard given to *Darrelen* in considering s 295-550(3)

NON-ARM'S LENGTH INCOME



- Dividends from private companies
 - AAT found that factors in s 295-550(3)(b), (c), (d) and (e) either not infringe AL requirement or not applicable
 - However, lengthy consideration given to “any other matters” in s 295-550(3)(f) and in particular the underlying transaction that gave rise to the dividends
 - AAT concluded that MV of shares in BE Pty Ltd were not worth a nominal amount: at [121]
 - If shares in BE Pty Ltd had been sold at MV, amount paid by B Holdings would not have resulted in it acquiring all of the shares and dividends would have largely accrued to transferor, a non-concessional TP

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - Income derived by a beneficiary of a trust other than because of holding a fixed entitlement to the income of the trust is *automatically* NALI: s 295-550(4)
 - Conversely, income derived by a beneficiary of a trust through holding a fixed entitlement to the income of the trust will only be NAL income if other conditions are met: s 295-550(5)
 - Accordingly, distinction between a fixed and non-fixed entitlement to income of a trust is critical – likely to remain a contested threshold issue in litigation
 - S 295-550(5) repealed and rewritten to include NALE; s 295-550(4) remains unamended

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - “Fixed entitlement” not defined in s 273 – nor is it asterisked as a defined term in s 295-550(5)
 - ITAA97 states that “most” defined terms are identified by an asterisk: s 2-10(2)
 - “Fixed entitlement” defined in s 995-1 by reference to Div 272 of Schedule 2F of ITAA36 (trust loss provisions)
 - Until decision in *MH Ghali Superannuation Fund v FCT* [2012] AATA 527, no suggestion that Div 272 definition of fixed entitlement applicable to NAL income provisions

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - In *Ghali* a threshold issue was whether SF held a fixed interest in the income of the Ghali Unit Trust
 - Cl 12.3.11 of Ghali UT deed granted the trustee a discretion to determine which class of unit holder shall be presently entitled to income of the trust... “and in default of such determination the unit holders were to be presently entitled in the same proportions as they hold units”
 - Was common ground between parties that fixed entitlement meant an interest that was “vested in interest”

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - TP contended that 'vested in interest' is one where the holder has an immediate fixed right of present/future enjoyment: *Glenn*
 - TP acknowledged that existence of a substantive condition precedent would preclude relevant interest being vested
 - However: TP contended was a distinction between a contingent interest and a defeasible interest – a vested but defeasible interest would be taken to be a fixed entitlement to income
 - In *Ghali*, no discretion required for this entitlement – SF's interest existed unless a determination made to defeat its existence

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - AAT agreed – found that to be a fixed entitlement, interest need only be vested, not vested in interest and possession and unit holder's interest in income/capital was vested irrespective of whether discretion exercised
 - However: AAT found that “fixed entitlement” for s 273 purposes took its meaning from trust loss provisions in Sched 2F of 272 of ITAA36 – a beneficiary has a fixed entitlement if:

“...under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of the income of the trust...”
 - But still found SF held a fixed entitlement to income of the trust

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - Decision in *Ghali* not appealed
 - Comsnr's *Ghali* DIS acknowledged that Div 272 test more stringent – and will not be applied unless/until issue tested further in courts
 - Comsnr did not amend TR 2006/7
 - Comsnr's view well settled – at the very least, the interest in the income of the trust had to be “vested in interest if not in possession” immediately before the amount as derived by the trustee: TR 2006/7, para [208]
 - Comsnr considers that “vested in interest” means “it is bound to take effect in possession at some time and is not contingent upon any event occurring that may not take place: para [209]

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - What to do?
 - TR 2006/7 not been withdrawn – affords TP protection
 - Given sudden death consequences of non-fixed entitlement, prudent to review deeds to ensure that, applying the Div 272 definition, they do not create non-fixed entitlements
 - If deed is to be amended, consider amendment power (*Jenkins v Ellett* [2007] QSC 154, *Mercanti v Mercanti* [2015] WASC 297, CGT (see *C of T v Clark* [2011] FCAFC 5) and duty implications

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - S 295-550(5) repealed and rewritten in (mostly) similar way to NALE provision in s 295-550(1)
 - S 295-550(5)(a) preserves status quo (rewritten) in relation to income
 - S 295-550(5)(b):

“in acquiring the entitlement or in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each others at arm's length in relation to the scheme”

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - S 295-550(5)(c) same as (b) save that it refers to “...entity does not incur a loss, outgoing or expenditure”
 - s 295-550(5)(b) and (c) refers to “in acquiring the entitlement or in gaining or producing the income...” – subsection (1) equivalent refers to “in gaining in producing the income”

NON-ARM'S LENGTH INCOME



- Distributions from trusts
 - Example (EM example 2.2)
 - Retail SF trustee acquires units in a UT as a beneficiary with a fixed entitlement but pays a substantially lower amount for the units due to a scheme entered into with the broker
 - RSF did not incur expenditure it might have been expected to incur if dealt at AL with broker
 - Income from units would have been the same whether or not acquired under an AL transaction
 - Amount earned is NALI
 - Any capital gain on disposal of units may also be NALI under s 295-550(1)

NON-ARM'S LENGTH INCOME



- Capital gains and statutory income
 - NAL provisions do apply to capital gains, regardless of whether s 273 or s 295-550 is applicable
 - This remains the position unless and until either Full Federal Court finds decision in *Allen (As Trustee of the Allen's Asphalt Staff Superannuation Fund v FCT* [2011] FCAFC 118 to be plainly wrong or HCA overrules it
 - In *Allen and SCCASP Holdings as trustee for the H & R Super Fund v C of T* [2012] FCA 1052, TP's request for special leave to appeal to HCA refused
 - In *GYNW*, was accepted that franking credits attached to the dividends were statutory income for purposes of s 295-550(2)(b): at [83]

NON-ARM'S LENGTH INCOME



- Observations and messages
 - In terms of court and AAT decisions regarding special income/NALI, Comsnr won primary tax on all of them
 - ATO reviews/audits and penalties - live issues: ATO reviews/audits, voluntary disclosures, penalty rates, safe harbour, impacts for tax agents, professional negligence claims?
 - NALE to be carefully considered – can still be NALI if income the same as dealing at AL but expenses not incurred on AL terms
 - Review internal arrangements carefully – capacity trustee acting vital

NON-ARM'S LENGTH INCOME



- Observations and messages
 - Ensure all dealings involving the fund are at AL
 - Where in doubt, AL valuations from reputable and qualified valuers a good idea
 - Provide feedback in relation to LCR 2019/D3 (by 15 Nov 2019)

NON-ARM'S LENGTH INCOME



- Observations and messages
 - Where a SF acquires shares in a company (or units in a trust):
 - The fund should acquire the shares/units for on same terms as any other investor
 - The fund must not receive different treatment in terms of dividends/distributions
 - “Any other relevant matters” in s 295-550(3)(f) will be construed widely (see *GYNW*):
 - Look at underlying transaction
 - The fund should otherwise not be treated differently to any other investor/stakeholder: see *GYNW* at [121]

NON-ARM'S LENGTH INCOME



- Observations and messages
 - Where a SF is a beneficiary of a trust:
 - Ensure as best as possible that the deed creates a fixed entitlement, within meaning of Div 272 of Sched 2F to ITAA36
 - Income that a SF receives from a discretionary trust will automatically be NAL income

NON-ARM'S LENGTH INCOME



- Observations and messages
 - LRBA's should mirror loans from banks/other financial institutions:
 - Market rate interest should be paid
 - LVR's should be consistent with market providers
 - The terms of the loan should be consistent with market providers

NON-ARM'S LENGTH INCOME



- Observations and messages
 - If the SF is audited and litigation follows, the fund will carry the onus:
 - The documentation that surrounds a transaction will be critical
 - Accounting records/other evidence about transaction should be produced at time of transaction and kept: see *Ghali* at [59] to [62]