



Non-Arm's Length Expenditure (NALE)

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

The ATO has released Law Companion Ruling LCR 2021/2 'Non-arm's length income – expenditure incurred under a non-arm's length arrangement', which is a guide to how the provisions apply. They have also released Practical Compliance Guideline PCG 2020/5 'Applying the non-arm's length income provisions to non-arm's length expenditure', which indicates that the ATO will not allocate compliance resources in relation to certain general expenses, as identified below, for the period from inception up to and including the 2021/22 Financial Year.

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

What does arm's length mean to an SMSF?

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

What is NALI and NALE?

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

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

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

How do we identify NALE?

To identify NALE we need to look at identifying if there is a scheme. In LCR 2021/2, the ATO state that "A scheme is defined as any arrangement, or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise".

There must also be a connection between the expenditure and the ordinary or statutory income a fund receives. The expenditure must have been incurred in gaining or producing the relevant income (or acquiring an entitlement to the income of a trust). The expenditure can be of a revenue or capital nature. Expenditure linked to specific income is easily identified, such as rental property expense and rental income. Where NALE arises on expenditure to acquire an asset, there is a sufficient nexus to all ordinary and statutory income of that particular asset and any capital gain on disposal of the asset. The following example, taken from LCR 2021/2 indicates how NALI would apply to specific expenditure.

Example from LCR 2021/2 – No. 1 Specific Expenditure – NEXUS to SPECIFIC INCOME

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

The issue is that in some cases, such as accounting and audit fees, the NALE will have a sufficient connection to ALL of the ordinary and statutory income of a fund and that is where SMSFs need to be careful.

The finalised LCR confirms at paragraph 19 that a fund may incur expenditure that does not specifically relate to a particular amount of income being derived by the fund. This expenditure still has a sufficient nexus more generally to all income derived by the fund where it is deductible under section 8-1 of the Income Tax Assessment Act 1997; such as the following:

- Actuarial costs - except those incurred in complying with, or managing, the fund's income tax affairs and obligations (for example, Subdivision 295-F) which are ordinarily deductible under section 25-5
- Accountancy fees - except those incurred in complying with, or managing, the fund's income tax affairs and obligations (for example, Subdivision 295-F) which are ordinarily deductible under section 25-5
- Audit fees
- Costs of complying with a 'regulatory provision' as defined in section 38A of the Superannuation Industry (Supervision) Act 1993 (SISA) (unless the cost is a capital expense)
- Trustee fees and premiums under an indemnity insurance policy
- Costs in connection with the calculation and payment of benefits to members (but not the cost of the benefit itself); for example, interest on money borrowed to secure temporary finance for payment of benefits and medical costs in assessing invalidity benefit claims
- Investment adviser fees and costs in providing pre-retirement services to members, and
- Other administrative costs incurred in managing the fund.

Where NALE of the nature outlined above are incurred, the nexus between the expenditure and ALL income derived by the fund is sufficient to be NALI.

Example from LCR 2021/2 – No. 2 General Expenditure – NEXUS TO ALL FUND INCOME

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

Another important consideration is the situation where an SMSF enters into arrangements that result in receiving discounted prices. Paragraph 51 of the LCR states that arrangements can still be on arm's-length terms where they are consistent with normal and commercial practices. An example of this is where an individual is acting in their capacity as trustee being entitled to a discount under a discount policy offered where the discount policy applies to all employees, partners, shareholders or office holders.

From 1 July 2022 the ATO will apply compliance resources towards general fund expenses for an SMSF only to ascertain whether the parties to the scheme have made a 'reasonable attempt' to determine the arm's length expenditure amount for services provided to the fund. This is for services provided by an individual acting in their individual capacity. PCG 2020/5 still applies with the compliance approach of the ATO for NALE where there is a nexus between the expenditure and ALL income derived by the fund prior to 30 June 2022.

Trustee v individual capacity

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

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

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

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

A concept noted in the LCR in example 9 is where an individual is using their tools of the trade to undertake a repair to an asset owned by their SMSF. Where the use of the tools is 'minor, infrequent or irregular in nature' and will not of itself, indicate that services are provided in any other capacity other than trustee of an SMSF. Whereas the use of the tools for a substantial renovation to another property owner by the SMSF is not considered 'minor, infrequent or irregular in nature', they are considered to be undertaken in their individual capacity. The rental income and subsequent capital gain from the property is deemed to be NALI.

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

Example from LCR 2021/2 – No.6 – NOT NALI/NALE

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

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

Trustee remuneration

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

What does your administrator need to focus on?

We need to know where income is sourced from to determine if it is arm's length. We also need confirmation of all SMSF related expenses to ensure transactions are appropriately account for.

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