

## SMSF non-arm's length rules extended to include expenditure

The recent enactment of Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019 has resulted in important changes to the operation of the non-arm's length income rules with new provisions relating to expenditure applying retrospectively from 1 July 2018 which can lead to fund income being taxed at the top marginal rate.

The non-arm's length rules require SMSF activities to be undertaken on commercial terms with all assets purchased at market value.

### What is non-arm's length income (NALI)

Broadly, income is NALI for a complying SMSF if it is:

- derived from a scheme in which the parties were not dealing with each other at arm's length; and
- more than the SMSF might have been expected to derive if the parties had been dealing with each other at arm's length.

Income derived by an SMSF as a beneficiary of a discretionary trust is NALI, as are dividends paid to an SMSF by a private company (unless the dividend is consistent with arm's-length dealing).

Income derived by an SMSF as a beneficiary of a trust through holding a fixed entitlement to the income of the trust will also be NALI where:

- the SMSF acquired the entitlement under a scheme or the income was derived under a scheme in which the parties were not dealing with each other at arm's length; and
- the income is more than the SMSF would have been expected to derive if the parties had been dealing with each other at arm's length.

Tax Ruling TR 2006/7 Special Income outlines the Australian Taxation Office (ATO) approach to NALI (special income was the predecessor to NALI).

### How is NALI taxed

Superannuation fund income which is NALI is subject to income tax at 45% (not the usual 15%).

Additionally, the exempt pension income concession does not apply to NALI with this income still taxed at 45% whilst exempt pension income is taxed at 0%.

Where NALI applies to the income of an investment any capital gain on that investment in a subsequent year will also be NALI.

### Extension of the rules to include non-arm's length expenditure (NALE)

From 1 July 2018, the definition of NALI has been extended to also include ordinary or statutory income where there is a scheme in which parties were not dealing with each other at arm's length and:

- an SMSF incurs a loss, outgoing or expense that is less than might have been expected if the parties had been dealing at arm's length; or
- there is no loss, outgoing or expense incurred by an SMSF where one would have been expected if the parties had been dealing at arm's length.

From 1 July 2018 the law has also been amended to ensure that income derived by an SMSF in the capacity of beneficiary of a trust through holding a fixed entitlement to the income of the trust will be NALI where:

- the SMSF acquired the entitlement under a scheme or the income was derived under a scheme in which parties were not dealing with each other at arm's length; and
- the SMSF incurred expenses in acquiring the entitlement or deriving the income that are less than, including nil expenses, what the SMSF would otherwise have been expected to incur if the parties were dealing on an arm's length basis.

Generally, where no such link can be found between the activity undertaken and a particular asset, NALI will apply to all income of the fund in that financial year.

[\(Cont'd over page\)](#)



### Also in this issue...

SMSF investment strategy obligations	2
New Super Guarantee opt rules for high income earners with multiple employers	3
New Super Guarantee salary sacrifice integrity measure	4

## Extension of the rules to include non-arm's length expenditure (cont'd)

The ATO has published LCR 2019/D3 which provides examples of how the new legislation applies. Three examples are below:

### Example 1 - Asset purchased less than market value

A property is purchased for \$200,000 while the market value is \$800,000. This provides sufficient connection between the NALE incurred in acquiring the property such that all rental income is NALI and any capital gain from the disposal of the property is also NALI.

### Example 2 - Trustee uses their professional services firm (non-asset related)

The partner of an accounting firm who is the trustee of their SMSF uses the firm to provide accounting services to the fund, but no fee is charged. In this case, the trustee is not acting as a trustee but has provided services that are undertaken by a third party.

The SMSF has acquired the services under a non-arm's length agreement, providing a connection between the NALE and fund income that classifies all of the SMSF's income for the financial year as NALI.

### Example 3 - Trustee uses their professional services firm (asset related)

The trustee of a fund is a licensed real estate agent and provides property management services to the SMSF as a licensed real estate agent. The fund is charged 50 per cent of the fee than would be otherwise charged to a non-related party.

There is sufficient nexus between the NALE and rental income derived from the residential property such that all rental income will be NALI as long as the non-arm's length deal remains in place.

## Other matters

With the new addition to the NALI rules considering fund expenditure, SMSF trustees and advisers will need to scrutinise their investments to ensure all expenses are the same as if there had been a dealing on an arm's length basis.

From an audit perspective, NALI is not a compliance breach but a tax issue. It most likely will result in the Auditor providing a management letter comment notifying trustees that the tax calculation has been misstated. Where it has been materially misstated, Part A of the audit report will be qualified, which must now be reported to the ATO on the fund's annual return.

The retrospective amendments could result in all income derived by a fund during the 2018-19 and 2019-20 income years being classified as NALI where it has incurred non-arm's length expenditure of a general nature. The ATO has advised it will apply a transitional compliance approach for these income years by not allocating compliance resources to determine whether NALI applies:

- where the fund incurred NALE of a general nature that has a sufficient nexus to all ordinary and/or statutory income derived by the fund in those respective income years (for example, non-arm's length expenditure on accounting services); and
- where the fund incurred NALE that directly related to the fund deriving particular ordinary or statutory income during the 2018-19 and 2019-20 income year.

Given the ATO has high-level data-matching capabilities, it is likely the new NALI legislation will catch out those SMSF trustees who choose ignore the non-arm's length rules including expenditure.



## SMSF investment strategy obligations

In August 2019 the ATO wrote to approximately 17,700 SMSFs as part of a campaign to ensure trustees are aware of their investment strategy obligations.

Of key concern was ensuring that trustees have considered diversification and liquidity of their assets when formulating and executing their fund's investment strategy.

### What is required

SMSFs are required to have in place a documented investment strategy and ensure it is regularly reviewed.

The strategy must take into account:

- *risk/return* – the risk involved in making, holding and realising, and the likely return from the fund's investments having regard to its objectives and its expected cash flow requirements;
- *diversification* – the composition of the fund's investments as a whole including the extent to which the investments are diverse or expose the fund to risk from inadequate diversification;
- *liquidity* – the liquidity of the fund's investments having regard to its expected cash flow requirements. This would encompass the ability of your fund to pay benefits/pensions to members and other costs incurred by the fund;
- *liabilities* – the ability of the fund to discharge its existing and prospective liabilities; and
- *insurance* – whether to hold insurance cover for one or more members of the fund.

Diversification involves spreading the investments over a number of individual assets, asset classes (including property, fixed interest, cash and equities), countries and/or investment managers. Diversification may also be achieved within each asset class (for example, investing in commercial and residential property, domestic and foreign equities, and long and short-term fixed-interest investments).

An investment strategy should be considered the SMSF's blueprint when dealing with the fund's assets to ensure the SMSF's investment objectives and members' goals are met. It provides the parameters to ensure trustee/s invest money in accordance with that strategy.

Of equal importance is the investment objective and strategy is not set in stone. Trustees can choose to change the investment objectives they have set for their SMSF at any time.

### The ATO Correspondence

The funds that the ATO wrote to held 90 per cent or more total investments in a single asset or asset class.

The ATO noted that these funds may be at risk of not meeting the diversification requirements and that ultimately trustees were responsible for ensuring their investment strategy meets the requirements of Superannuation Law.

SMSFs' auditors for these funds have also been contacted by the ATO, emphasising the need to consider the fund's compliance with the investments strategy requirements.

It should be noted that the ATO letters were not an attempt to regulate and limit the control and freedom that SMSF trustees have but rather ensuring that if trustees wish to invest their assets in a certain way that they must clearly articulate their reasons for doing so.

While there is no specific requirement to be diversified the investment strategy must consider diversification. If a SMSF's value is concentrated in a particular asset class, the auditor will most likely be looking to see the rationale for this investment decision reflected in a fund's investment strategy.

It is not uncommon for SMSFs with lower member balances to find diversification a challenge as there is limited money to invest. Nonetheless, trustees are still required to demonstrate that they adequately understand and mitigate the associated investment risks.

For example, if an SMSF has invested in a large illiquid asset such as real property which may form the majority of the fund, it is timely to ensure the strategy reflects the concentration and liquidity risk associated with this investment.

Where you have in place an adequate investment strategy that deals with these risks and can provide the necessary evidence to support your investment decisions, no further action is expected.

Where your fund has not complied with its investment strategy requirements under superannuation law, you may be liable to administrative penalties being imposed by the ATO, as Regulator of the SMSF sector.

Your investment strategy does need to be reviewed at least once a year and this will be evidenced by your approved SMSF auditor. It is also important to review your strategy whenever the circumstances of any of your members change or as often as you feel it is necessary.



## New super guarantee opt out rules for high income earners with multiple employers

From 1 January 2020, eligible individuals with multiple employers can apply to opt out of receiving super guarantee (SG) from some of their employers. This measure will help prevent individuals unintentionally exceeding their concessional contributions cap.

Individuals may be eligible to opt out if they:

- have more than one employer; and
- expect their employers' mandated concessional super contributions to exceed their concessional contributions cap for a financial year.

To apply for an SG employer shortfall exemption certificate it will be necessary to submit to the Australian Taxation Office the *SG opt out for high income earners with multiple employers form* (NAT 75067).

The certificate if approved releases one or more employers from their SG obligations for up to four quarters in one financial year. Individuals will still need to receive SG contributions from at least one of their employers for each of those quarters.

The exemption certificate means the employer will not be liable for the super guarantee charge (SGC) if they do not make SG contributions for the employee for the quarters covered by the certificate.

An employer can choose to disregard an exemption certificate and continue to make SG contributions.

## Applying for an exemption certificate

An application for an SG employer shortfall exemption certificate:

- must be made by the employee to be covered by the certificate – an employer cannot apply for an exemption certificate;
- can only be made in respect of current employers;
- must be lodged in the approved form at least 60 days before the first day of the first quarter that the application relates to.

## When you need to apply

To give eligible employees time to make an application following the commencement of this measure, the ATO will accept applications for the 2019–20 financial year as follows:

- third quarter commencing 1 January 2020 – lodge on or before 18 November 2019.
- fourth quarter commencing 1 April 2020 – lodge on or before 31 January 2020.

An exemption certificate can be for a period of up to four quarters in one financial year. A separate application is required for each financial year.

## Issuing an exemption certificate

The ATO will only issue you with an exemption certificate if:

- an individual is likely to exceed their concessional contributions cap for the financial year that includes the relevant quarters for which an exemption is sought; and
- after issuing the certificate, they will still have at least one employer obliged to make mandated SG contributions for their benefit in each quarter covered in the exemption certificate.

If the ATO decides to issue an exemption certificate, they will issue a written notice to:

- the employee that made the application; and
- each employer that is covered by the certificate.

Once issued, the exemption certificate cannot be varied or revoked.

## Consult with your employer

This measure may not benefit everyone who is eligible. Employees will need to talk to their employers before making an application as any changes to their pay and other entitlements need to be negotiated between the employee and their employers. It will also be necessary to consider employment arrangements, such as how pay and other entitlements may change and the effect of any relevant award or workplace agreement. Your financial adviser, accountant or tax agent may provide you with further advice based upon your circumstances.

## New super guarantee and salary sacrifice integrity measure

In late October 2019 the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No 1) Bill 2019 passed both Houses of Parliament.

This bill closes off a loophole which allowed unscrupulous employers to count employees' salary sacrifice superannuation contributions against their own superannuation guarantee obligations.

From 1 January 2020 the formula for calculating superannuation guarantee contributions has been amended to add back any salary sacrifice contributions.

This will ensure Superannuation Guarantee is based on any pre-salary sacrifice remuneration.

### About Bastion Superannuation Solutions

Bastion Superannuation Solutions specialises in the provision of administration and compliance services to self-managed superannuation fund trustees and advisers.

For further information on our range of services please see our web site.

Our range of services include:

- Fund Administration including preparing financial accounts and maintaining member records
- Superannuation compliance and technical guidance
- Self-managed superannuation fund establishment
- Assistance with updating self-managed superannuation fund trust deeds

Bastion Superannuation Solutions Pty Ltd  
AFSL 278 280 ABN 70 105 016 984  
Level 3, 400 Queen Street, Brisbane  
GPO Box 1859 Brisbane Qld 4001



Phone: (07) 3004 1100  
Facsimile: (07) 3221 9811  
Email: [info@bastionsuper.com.au](mailto:info@bastionsuper.com.au)  
Website: [www.bastionsuper.com.au](http://www.bastionsuper.com.au)

### Important Information

Any advice contained in this newsletter is general advice only. The reader's particular objectives, financial situation and needs have not been taken into account. To avoid making a decision not appropriate to you, the content should not be relied on or act as a substitute for receiving financial advice suitable to your circumstances. When considering a financial product the reader should obtain the relevant Product Disclosure Statement and read it