Tel: +61 2 9251 4100
Fax: +61 2 9240 9821
www.bdo.com.au

Level 11, 1 Margaret St
Sydney NSW 2000
Australia

By email: superannuation@treasury.gov.au

21 February 2023

Retirement, Advice and Investment Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Madam/Sir,

NON-ARM'S LENGTH EXPENSE RULES FOR SUPERANNUATION FUNDS - BDO SUBMISSION

BDO refers to the invitation by Treasury to provide comments on the Government's **Consultation paper ('the Consultation Paper') considering options to amend the non-arm's length income (NALI) provisions which apply to complying superannuation funds.**

BDO is pleased to provide comments on the options to amend the NALI provisions which apply to complying superannuation funds as outlined in the Consultation Paper. In summary, our main concern is the options contained in the Consultation Paper are disproportionate in their impact in relation to the perceived mischief addressed. The proposed changes perpetuate a significant disparity between the treatment of non-arm's length income (of a complying superannuation fund) on the one hand and expenses on the other. Additionally, we note other concerns with the measures for your consideration.

BDO's detailed comments in this regard are in the attached appendix.

Should you have any questions or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 8221 2285 or shayne.carter@bdo.com.au.

Yours sincerely

Shayne Cater
BDO Partner Tax

Appendix

BDO Submission to Treasury
Non-arm's length expense rules for superannuation funds: Consultation paper

BDO has considered the options to amend the non-arm's length income (NALI) and non-arm's length expense (NALE) rules for superannuation funds contained in the Consultation Paper which addresses the potential for severe outcomes for breaches in relation to general expenses (i.e., accounting fees, actuarial costs, audit fees, investment adviser fees and compliance costs) that have a sufficient nexus to **all** income derived by the fund. We provide the following comments on the consultation paper.

1) Background – Non-arm's length income (NALI)

In Australia, the legislature has a long history of having taxation provisions designed to ensure that income which would otherwise have been assessable at non-concessional rates of taxation, is not (broadly expressed), channelled into a superannuation fund to avoid that higher taxation impost. This is achieved by having measures which identify such non-arm's length income and ensure it is taxed at the top marginal rate. Certainly, these provisions existed, in one form or another, in the former section 23F of the Income Tax Assessment Act 1936 (the 36 Tax Act), former sections 23FC, 23FD and Part IX of the 36 Tax Act, and, with effect from 1 July 2007, Division 295 of the Income Tax Assessment Act 1997(the 97 Tax Act).

The provisions in Part IX of the 36 Tax Act were then known as the Special Income provisions and exist in substantially the same form as the NALI provisions contained in Division 295 of the 97 Tax Act. To this end, and as was noted in the Administrative Appeals Tribunal decision; GYBW and Commissioner of Taxation [2019] AATA 4262;

> *"87. The Explanatory Memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006 enacting s 295-550 stated that the rewritten provisions of Division 295 did not change the law as it currently operated under Part IX of the ITAA 1936 (at [3.14]) except that in Part IX of the ITAA 1936, the Commissioner had a discretion to decide that it was unreasonable that a dividend from a private company be treated as 'special income' (or 'non-arm's length income') where it was derived by a complying superannuation fund. This was replaced with an objective test that the amount be consistent with an 'arm's length dealing' [Schedule 1, item 1, subsections 295-545(2) and (3)]."*

The case law has established that the special income provisions apply to both income according to ordinary concepts and statutory income. The provisions do not make an amount assessable but rather apply to determine the rate of tax an otherwise assessable receipt may suffer by determining whether that amount forms part of the non-arm's length component of the taxable income of a complying superannuation fund. That is the taxable income of a complying superannuation fund may be bifurcated into two components, ordinary (or low tax component)

income, and non-arm's length component. The Income Tax Rates Act 1986 (the 86 Rates Act) taxes the non-arm's length component at 45%.

An objective test must be satisfied in order for the NALI provisions to have application. The provision essentially requires the Commissioner to posit an alternative scenario, a hypothetical scenario, to be compared with what actually occurred in ascertaining whether non-arm's length income has been derived. This is an extremely important aspect of the measures, a sanity check if you will, concerning the application of the provisions. That is, even if the parties have not been dealing at arm's length, has more money been channelled into a superannuation fund than otherwise would have been the case? If this question cannot be answered in the affirmative the provisions have no application, in effect no mischief has been occasioned by the non-arm's length dealings.

Relevantly in Allen's Asphalt Staff Superannuation Fund v FC of T [2011] FCAFC 118 (Allen's Asphalt) it is stated:

> *'But the statute cannot be stultified because of the very conduct at which it is aimed. The comparison required by s 273(7)(b) postulates a hypothetical arm's length dealing which may be compared with what actually occurred: that there was not, in fact, an arm's length dealing does not make the comparison impossible.'*

With NALI, it is both entirely appropriate and necessary that the legislation impose a very significant hurdle to be overcome for these provisions to have application. If the income derived by a fund where dealings were considered at arm's length, is not less than the income derived on a putative non-arm's length basis, there is no mischief occasioned and the NALI provisions have no application.

In essence with the NALI provisions, the Commissioner is required to determine the non-arm's length income (not five times the non-arm's length income) which is then subject to the top marginal tax rate pursuant to s.26 of the 86 Rates Act.

2) Background - NALE

Of course, from an economic perspective, it follows that the undercharging of an expense to a complying superannuation fund delivers the same economic outcome as channelling excessive income to that fund. In this sense BDO welcomed the 2017/2018 budget measures expanding the ambit of s. 295-550 of the 97 Tax Act as appropriate and fair. Having said this in our view the execution of these new measures, as introduced by the Treasury Laws Amendment (2018 Superannuation Measures No 1) Act 2019, were flawed.

3) The Consultation Paper

This Government has the opportunity to right the wrongs with the NALE provisions - The proposed remedial measures outlined in the Consultation Paper are, in our view, fundamentally misconstrued. As outlined above, and as confirmed by the Courts, the NALI provisions require the identification of non-arm's length income – and it is that amount which is then made subject to tax at the top marginal rate. How is it then that a NALE amount should be subject to tax at an effective 225% (see page 9 of the Consultation Paper)?

> *'At the current highest marginal tax rate of 45 per cent, a maximum effective tax rate of 225 per cent (5 multiplied by 45 per cent) would be applied to the general expenditure breach.'*

As a basic proposition there should be symmetry between the taxation treatment of NALI and NALE. To do otherwise introduces significant distortions in the tax system that have no basis in rationale tax policy decision making. In our view the NALE amount should be the absolute amount of the undercharged expense, not some arbitrarily determined multiple of that amount.

We have other concerns.

The proposed measures will mean that in certain circumstances, s.295-550 will, not only determine the rate of tax but rather become a de facto taxing provision.

Is this proposal constitutionally permissible? Does it amount to an unlawful exaction of property from a complying superannuation fund?

How is it that a fund deriving an amount of NALE (in respect of say an undercharged audit fee) is inherently more offensive from a policy perspective than a fund breaching prudential standards becoming non-complying and taxed at 45%, rather than 225%?

If NALI becomes an effective taxing provision, then how do the new provisions sit with Taxation Ruling TR 2010/1 which case law held not to have application as s.295-550 was (in effect) a rate determining, rather than assessing, provision?

Conclusion

BDO submits that the Government needs to fundamentally rethink the approach to NALE whereby the measures are not disproportionate relative to the perceived mischief addressed and that at a minimum symmetry with the NALI provisions is achieved.