



Law Council  
OF AUSTRALIA

*Legal Practice Section*

22 February 2023

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

By email: [superannuation@treasury.gov.au](mailto:superannuation@treasury.gov.au)

Dear Treasury,

## **NON-ARM'S LENGTH EXPENSE RULES FOR SUPERANNUATION FUNDS— CONSULTATION**

This memo has been prepared by the Superannuation Committee of the Law Council of Australia's Legal Practice Section (**the Committee**). The Committee welcomes the opportunity to make a submission to the Treasury in relation to the Consultation paper on 'Non-arm's length expense rules for superannuation funds' (**Consultation Paper**) published in January 2023.

### **NALE Consultation Paper**

#### General observations

The Committee broadly agrees with the noted observation of other industry stakeholders that the non-arm's length income (NALI) and non-arm's length expenditure (NALE) provisions have the potential to operate so that there are disproportionately severe outcomes for breaches of the rule. The Committee also agrees that the impact is particularly severe in relation to general expenses of superannuation funds, where there is an onerous compliance burden placed on funds.

The Committee considers that there is limited comfort provided by the Commissioner's Law Companion Ruling 2021/2 (LCR 2021/2) requiring large superannuation funds to have 'appropriate internal controls and processes in place', and 'reasonable attempts to have been made' for determining arm's length expenditure in the case of self-managed superannuation funds (SMSFs).

The extent of compliance resources that will need to be devoted to the NALE provisions is evident from LCR 2021/2: for example, for expenses charged to or by related parties on a cost-recovery basis, trustees will need to ensure that they have evidence to 'justify' those charges as being arrived at on 'commercial terms' within the overall context of the business operations of the fund and the related-party service provider.

Further, as the Committee understands LCR 2021/2 statements as to how the Commissioner proposes to limit the direction of compliance resources, the transitional compliance approach will only apply to general expenditure incurred prior to 1 July 2023. It is noted that, pursuant to Practical Compliance Guidance 2020/5 (PCG 2020/5), the NALE provisions will commence with full effect, including with respect to general expenditure, from 1 July 2023.

### Potential amendments

The Committee notes that the potential amendments would be designed to apply to general expenses that have a sufficient nexus to all ordinary and statutory income derived by the fund. For large APRA-regulated funds the potential amendments would exempt all income from the operation of the NALE provisions in respect of general expenses.

A more nuanced approach would apply to SMSFs and small APRA-regulated funds (SAFs), where there would be a factor-based approach setting an upper limit on the amount of fund income taxable as NALI due to a breach relating to 'general expenses'. The maximum factor being five times the level of the general expenditure breach—calculated as the difference between the amount that would have been charged as an arm's length expense and that amount that was actually charged to the fund. If all income is greater than the income deemed to apply from the application of the maximum factor, all income is treated as NALI and taxed at the highest marginal rate.

The Committee understands the focus of the amendments would be limited to addressing the tainting effect of the NALE provisions which potentially expose all income of a fund to the top marginal rate of tax due to a relatively minor expense being on non-arm's length terms (ie the 'tainting effect'). As such, the NALI rules will apply where NALE is asset-specific and expose income (including capital gains) of that asset to tax at the highest marginal rate.

### Consultation questions

The Committee responds to each of the consultation questions in the Consultation Paper below.

*Question 1: Are there any potential unintended adverse consequences for superannuation funds, their members and stakeholders from adopting a sector-specific approach to the NALI provisions related to general expenses which applies different treatment to large APRA-regulated funds and SMSFs and SAFs?*

The Committee notes there may be perceived issues of fairness between the different proposed approaches for each sector, particularly as between SAFs and large APRA-regulated funds. However, the Committee does not think there are any particular legal issues that pertain specifically to the differing treatment between sectors.

*Question 2: Would the approach outlined of setting an upper limit on the amount of fund income that is taxable as NALI due to a general expenses breach be sufficient to mitigate the 'tainting effect', where all income of the fund is potentially subject to the top marginal tax rate due to a relatively minor breach of the rules due to a general expense?*

The Committee queries whether the imposition of an upper limit operates to mitigate the tainting effect in circumstances where the total income of the fund will operate as a cap: that is, where the amount determined by the application of the factor of five exceeds total

fund income. In those circumstances, the fund is in no better position as a consequence of the tainting effect than it would have been without the operation of the potential amendments (ie Example 1B in the Consultation Paper). As such, despite the potential amendments, a relatively minor breach of the NALE provisions by the trustee of a SAF or SMSF may still be viewed as having a disproportionate adverse NALI consequence.

An example of such a result is an accountant with their own SMSF providing their own accounting services, at what might be determined to be a discounted rate, potentially exposing the entire income of the SMSF to NALI if the total income of the fund is relatively low in quantum (ie similar to Example 1B in the Consultation Paper). The Committee notes that the kinds of circumstances where a trustee is likely to be motivated to seek discounted fees, or more favourable terms for expenses, are likely to be when the fund is in a more parlous state with lower returns and liquidity concerns. It is therefore reasonably foreseeable that the retirement savings of members that may have already been exposed to poor returns will then be further adversely impacted by the NALE measures, and will unlikely be assisted by the potential amendments.

*Question 3: Are there any potential unintended adverse consequences for SMSFs or SAFs from setting an upper limit on the amount of fund income taxable as NALI due to a general expenses breach? Would there be unintended consequences from calculating the upper limit using a factor of 5?*

The Committee refers to its comments above.

*Question 4: Would carving out large APRA-regulated funds from the NALI provisions for general expenses appreciably lower the compliance burden for large APRA-regulated funds?*

In the opinion of the Committee it is likely that the potential carve-out of general expenses for large APRA-regulated funds will result in less compliance resources being devoted to the management of NALE. It will be important that the legislation gives a clear definition of 'general expense' so that determining whether or not certain expenditure can be categorized as general expenditure does not become a new compliance burden for funds.

The Committee also notes that trustees of regulated superannuation funds must also ensure that they comply with various statutory covenants under the Superannuation Industry (Supervision) Act 1993 (Cth) (SIS Act)—including to exercise their powers in 'the best financial interests of the beneficiaries'<sup>1</sup> and to 'promote the financial interests of the beneficiaries'.<sup>2</sup> In seeking to ensure that the interests of members and other beneficiaries are always at the forefront of any decisions made by trustees, it is not uncommon (though probably not strictly required) for the trustee to pursue the best possible financial outcome for the fund in negotiating with service providers (sometimes including related-party service providers). As such, it seems that there is a natural tension between the SIS Act provisions and the NALE provisions, which will continue to vex the compliance function of trustees—even with the implementation of the potential amendments.<sup>3</sup> The Committee merely wishes to note the existence of this tension, and is not, at this stage, suggesting any particular change that ought to be made to address it.

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<sup>1</sup> S 52(2)(c) and s52B(2)(c) of the SIS Act.

<sup>2</sup> S 52(12) of the SIS Act (not applicable to SMSFs).

<sup>3</sup> The extent to which such tension may ultimately affect the construction of s 295-550 ITAA 1997 is presently unknown and open to conjecture.

Question 5: Are there any unintended adverse consequences for large APRA-regulated funds, their members and other stakeholders from carving out large APRA-regulated funds from the NALI provisions for general expenses?

The Committee is concerned that the trustee decision-making and associated processes concerning the classification of an expense as either a general expense, or an expense that is directed towards a particular asset or investment, will become more significant under the potential amendments. Trustees—particularly of large funds—will be incentivised by the potential amendments to ensure that any expenditure that might be classified as general expenditure is properly and fully caught by the fund’s accounting systems within that description.

Rules or guidance around appropriate classification may need to be developed having regard to the definition of ‘general expense’ for the purposes of the NALE provisions. Also, consideration may need to be given to whether any anti-avoidance measures might be necessary to ensure the integrity of the measures; all trustees ought to be required to classify expenditure according to the same suite of rules, with the same expenses across funds having the same taxation treatment.

Finally, the Committee queries whether the carving out of general expenses may have a further behavioural impact in the way in which service providers are retained by trustees so that the details of the expenditure in invoicing are made less transparent in order that an expenditure might be grouped or otherwise expressed so as to be classified as a ‘general expense’, rather than an expense that relates to a particular investment project or asset. We have raised this possible behavioural concern for the completeness of our response to this question, which is directed to ‘unintended adverse consequences’ of the potential amendments. For the avoidance of doubt, the Committee considers that the potential amendments will have an overall positive impact for superannuation trustees and the industry.

The Committee would welcome the opportunity to discuss this submission with you. In the first instance, please contact the Committee Chair, Natalie Cambrell at [ncambrell@khq.com.au](mailto:ncambrell@khq.com.au) or on 0439 950 968.

Yours sincerely



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