

**SMSF MASTERCLASS**  
**Breaking down LCR 2021/2**  
A case study approach to the NALI traps

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## But first....what you need to know

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# What you will learn from this session

- History of section 295-550
- What is the impact of NALI and NALE on a fund's taxable income
- Restructuring of section 295-550
- What LCR 2021/2 says
- What are general expenses for NALI purposes
- Comparing the provisions of the SIS and Tax Act for non-arm's length transactions

# Evolution of non-arm's length income provisions

- Originally designed to prevent an 'undue amount of company profits being diverted to the superannuation fund'. (sections 23F (16) to (18) of ITAA '36)
- Amended to prevent income from being 'unduly diverted to superannuation to shelter income from normal tax rates such as personal tax rates'. (s273 of ITAA '36)
- Now designed to prevent 'inflating super fund earnings through non-arm's length dealings'. (s295-550 of ITAA '97)

## What is non-arm's length income

Income exceeds  
amount expected  
from an arm's length  
dealing

or

Expenses less than  
amount expected  
from an arm's length  
dealing

= NALI

# What is treated as Non-arm's length income?

- All income from discretionary trusts
- Private company dividends unless satisfy requirements in s.295-550(3)
- A scheme where parties are not at arm's length but the income is greater than arm's length
- Income from fixed trusts where parties are not at arm's length and income is greater than arm's length

# Meaning of non-arm's length income s295-550

- Income that is ordinary or statutory income
- A scheme must exist where the parties were not dealing with each other at arm's length
- One of the following applies:
  - The amount of income is more than what the entity expected to derive had it been dealing at arm's length
  - Any loss, outgoing or expense is less than what would have been expected had the parties been dealing at arm's length
  - The entity did not incur a loss, outgoing or expenditure that may have been expected if the parties had been dealing at arm's length.

# What is a scheme or arrangement?

- Scheme is any arrangement or plan, proposal, action, course of action or conduct, whether unilateral or otherwise.
- Arrangement means any arrangement, agreement, understanding, promise or undertaking whether express or implied and whether or not enforceable or intended to be enforceable by legal proceedings.

# Dividends as non-arm's length income

- A dividend paid by a private company to the fund, or
- ordinary or statutory income reasonably attributable to the dividend
- is non-arm's length income, unless the amount is consistent with an arm's length dealing

# Dividends consistent with arm's length dealing

## Considerations:

- Value of the shares in the company
- Cost of the shares on which the dividend was paid
- The rate of the dividend
- The rate of dividends paid on other shares in the company
- Whether the shares were issued in satisfaction of a dividend and the circumstances
- Any other relevant matters

# Case Study 1

- On 1 June 2020 the Right Superannuation Fund acquires 100,000 shares in a private company (Building Products Pty Ltd) for 50 cents each (total value \$50,000)
- The members of the Right Superannuation Fund are related to Building Products Pty Ltd
- At the time of acquisition the value of a share in Building Products Pty Ltd was \$1 and paid by others who also purchased 100,000 shares
- On 1 July 2021 Building Products Pty Ltd pays a dividend equal to 5 cents per share (total dividend \$5,000 for 100,000 shares)

Is the income received by the Right Superannuation Fund non-arm's length income?

# Case Study 1

## Considerations:

- Value of the shares in the company - not known as at 1 July 2021 but the issue price was \$1
- Cost of the shares on which the dividend was paid – 50 cents per share
- The rate of the dividend – 5 cents per share
- The rate of dividends paid on other shares in the company – 5 cents per share
- Whether the shares were issued in satisfaction of a dividend and the circumstances - No
- Any other relevant matters

Dividends are non-arm's length income as they are not consistent with an arm's length dealing.

## Case Study 2

- Mineland Pty Ltd was established in 2015 to purchase land for development.
- Once the developed land was sold the company was to be wound up.
- There were 9 original investors who purchased 100,000 shares in the company for \$1 per share and a related superannuation fund, the Daisy Super Fund which purchased 10,000 shares for 75 cents per share.
- Land was acquired by the company, developed and then sold at a profit to an arm's length party.
- On 1 July 2020 a dividend of \$5 was paid on each share and \$1 capital was returned to all shareholders when the company was wound up.

Is the income received by the Daisy Super Fund non-arm's length income?

# Case Study 2

## Considerations:

- Value of the shares in the company - not known as at 1 July 2020 but the issue price was \$1
- Cost of the shares on which the dividend was paid – 75 cents per share
- The rate of the dividend – \$5 per share plus a capital return of \$1
- The rate of dividends paid on other shares in the company – \$5 per share
- Whether the shares were issued in satisfaction of a dividend and the circumstances - No
- Any other relevant matters
  - Members arm's length to the decisions of the private company
  - Business dealings of company has no relationship with the super fund or its members
  - The rate of the dividend

**Dividends are at arm's length as they are consistent with an arm's length dealing.**

# Can franking credits be non-arm's length income?

- A dividend from a private company may consist of a dividend and a franking credit
- The franking credit will be non-arm's length income if it is derived from a transaction or a series of transactions where:
  - The parties were not dealing at arm's length, or
  - The income from the transaction was greater than if the parties were dealing at arm's length.

## Case Study 3

- John and Maria are members of the Hitech Super Fund and directors of Hitech Pty Ltd
- They hold 1 share in Hitech Pty Ltd.
- Due to COVID – 19 the company made over \$5 million and it has \$1 million in its franking account.
- Hitech Pty Ltd issues 100,000 shares to the Hitech Super Fund for 10 cents per share on 1 January 2021.
- On 1 July 2021 Hitech Pty Ltd pays a dividend of \$10 for each share which is fully franked.

Is the income including the franking credit received by the Hitech Super Fund non-arm's length income?

# Case Study 3

## Considerations:

- Value of the shares in the company - not known as at 1 July 2020 but the issue price was 10 cents
- Cost of the shares on which the dividend was paid – 10 cents per share
- The rate of the dividend – \$10 per share
- The rate of dividends paid on other shares in the company – \$10 per share
- Whether the shares were issued in satisfaction of a dividend and the circumstances - No
- Any other relevant matters
  - Members not arm's length to the decisions of the private company
  - Business dealings of company has close relationship with the super fund or its members
  - The rate of the dividend is significant to the fund within a very short period of acquisition

**Dividends are at arm's length as they are consistent with an arm's length dealing.**

# Income from trusts as non-arm's length income

- Income received by the fund as a beneficiary of a trust, other than as a fixed entitlement to income is non-arm's length income
- Income received by the fund by a fixed entitlement to income is non-arm's length income where the parties were not dealing with each other at arm's length in relation to the scheme and one or more applies:
  - The amount of income is more than what the entity expected to derive had it been dealing at arm's length
  - Any loss, outgoing or expense is less than what would have been expected had the parties been dealing at arm's length
  - The entity did not incur a loss, outgoing or expenditure that may have been expected if the parties had been dealing at arm's length.

# Case Study 4 Paying full market value for a fixed entitlement to a trust distribution

- Mike and Nancy are members of the MN SMSF
- Nancy's brother owns 75% of the units in a company which is trustee of a unit trust
- The unit trust has 10 unit holders including the MN SMSF who own 10,000 units in the unit trust which were acquired at their market value.
- The holdings of the MN SMSF in the unit trust are less than 5% of the value of the fund's total assets.
- Mike and Nancy's private company lease a commercial premises from the unit trust on an arm's length basis.
- Distributions from the unit trust are determined on an arm's length basis.

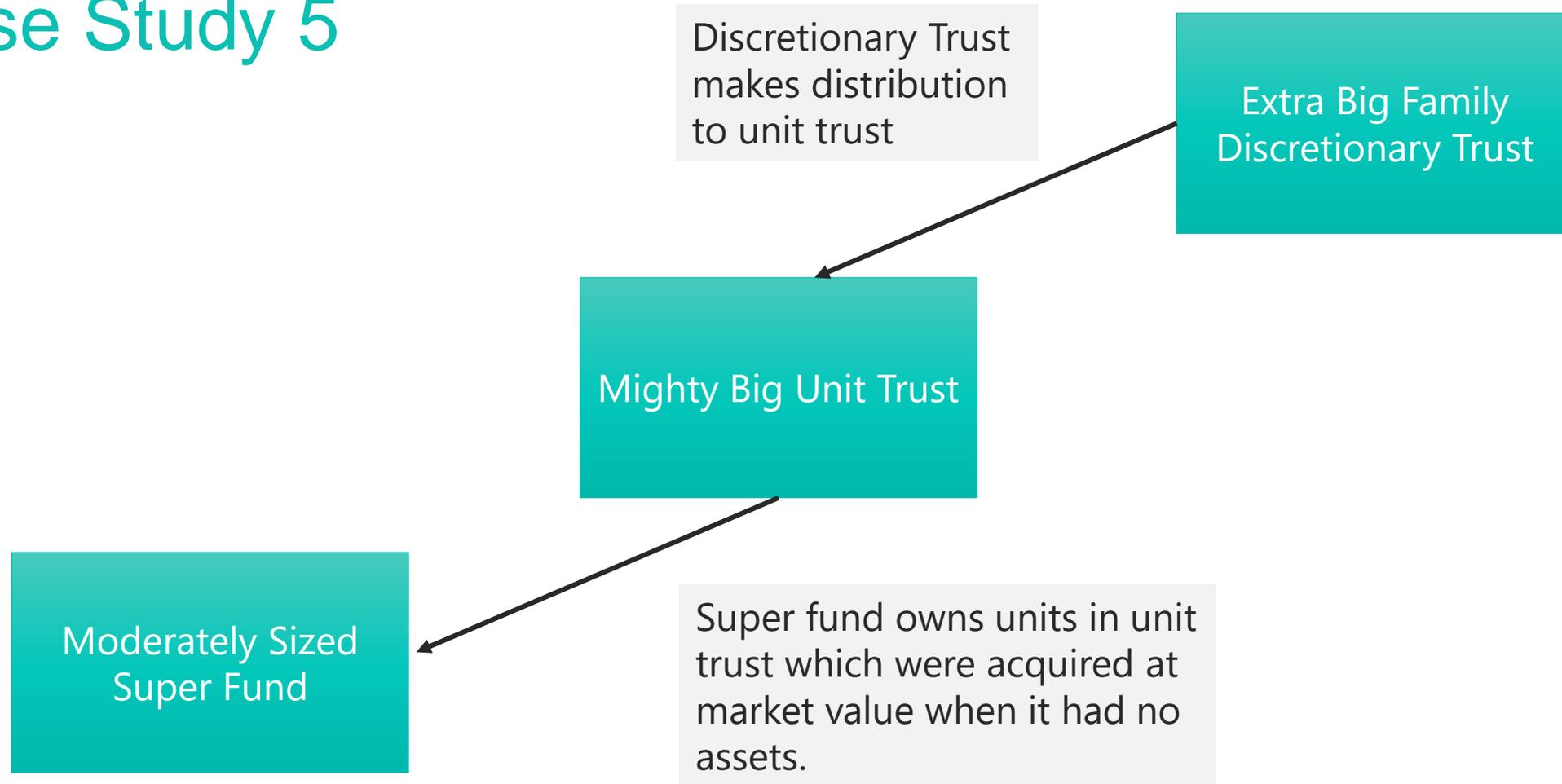
Are the distributions received from the unit trust by the MN SMSF non-arm's length income?

# Case Study 4

## Considerations

- The amount of income is more than what the entity expected to derive had it been dealing at arm's length – **distribution received by the MN SMSF was determined on an arm's length basis**
- Any loss, outgoing or expense is less than what would have been expected had the parties been dealing at arm's length – **the property leased by the private company was arm's length**
- The entity did not incur a loss, outgoing or expenditure that may have been expected if the parties had been dealing at arm's length – **transactions seem to have been determined arm's length**

# Case Study 5



# Case Study 6

Investments issued at a discount

Woolworth's shares issued at less than market price as part of a dividend reinvestment plan

Employee share plans in ANZ

Employee share plans in Hitech Pty Limited

Which of these arrangements could be non-arm's length income or a contribution



Super  
Concepts

# Non-Arm's Length Expenses

## PCG 2020/5 and LCR 2021/2

Recent publication of LCR 2021/2 (previously Draft LCR 2018/D10) for non-arm's length income – expenditure incurred under a non-arm's length arrangement.

- Sufficient nexus between expenditure and income.
- A sufficient nexus may exist between the expenditure and all fund income.
- ATO will not allocate compliance resources for the 2018/19, 2019/20, 2020/21 and 2021/22 financial years for expenditure of a general nature that has a nexus to ordinary or statutory income.

# PCG 2020/5

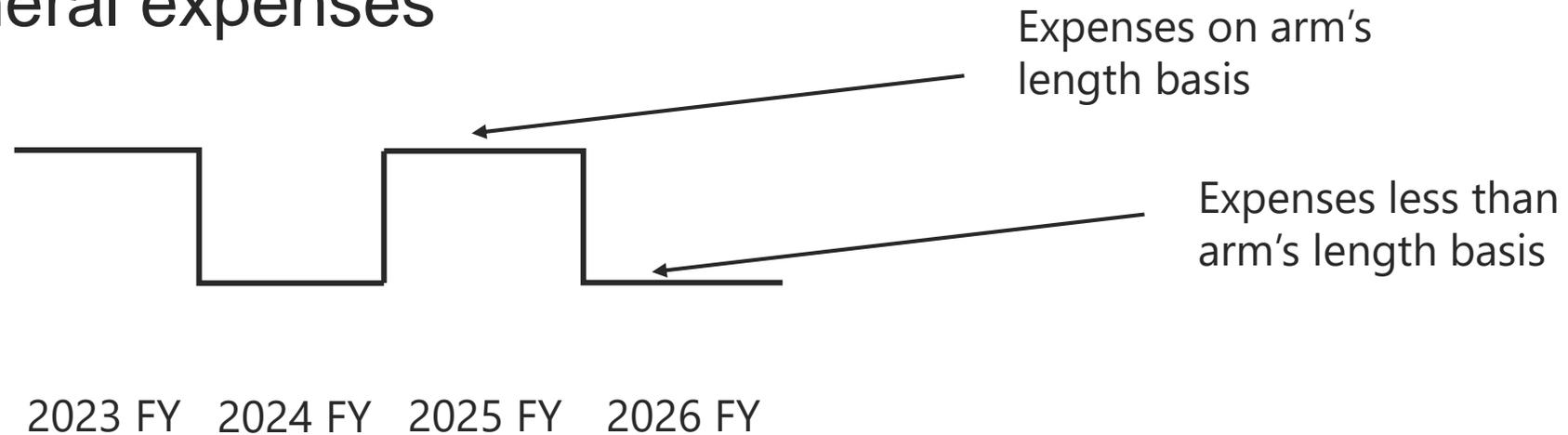
- Examples:
  - related party accounting services which are used but not charged to the fund.
- It does not apply where the fund incurred non-arm's length expenditure which relates specifically to particular ordinary or statutory income.
  - related party real estate agent foregoing commission for a property purchase by the fund

## LCR 2021/2

- Sufficient nexus between NALE and relevant income of the SMSF.
- Applies to ordinary or statutory income derived by the fund from the relevant asset.
- Where general expenses are lower than on arm's length all income may be treated as NALI

# LCR 2021/2

## General expenses

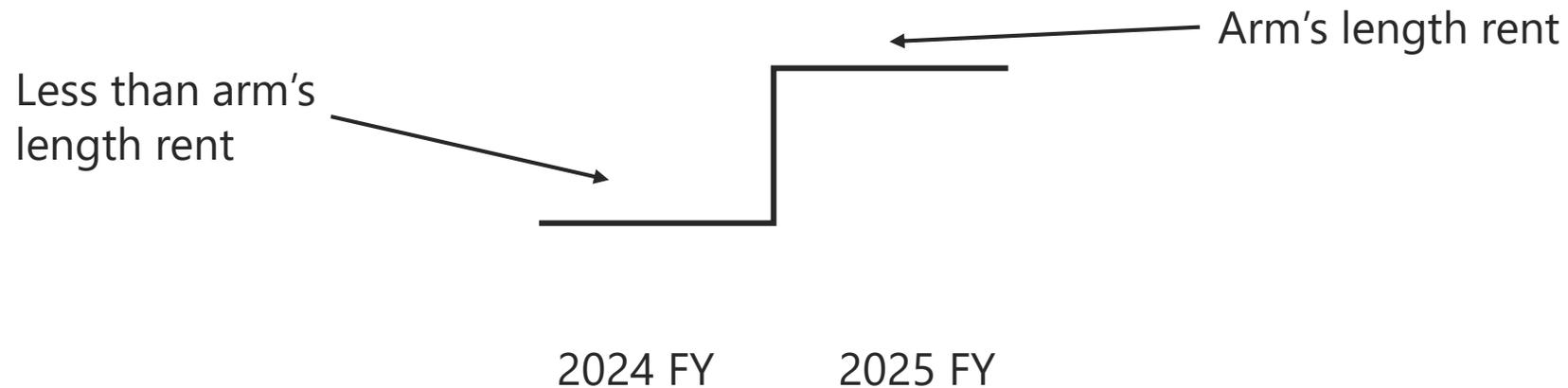


Impact on fund income

Impact on capital gains

# Capital gains and NALE

- Property acquired on an arm's length basis
- No rent paid or less than market rent charged on property
- Rent adjusted to market rent



# Work undertaken by trustee

- Substantial work in renovating a property
- Insubstantial work to undertake minor repairs to property
- Degree of work is important
- Is it work that a trustee would ordinarily undertake
- If trustee is not qualified and can't be paid under section 17B of SIS will this be an issue with NALE?

# Case Study 7

## The Granette SMSF

### The 2022 Financial Year

Annette and Grant are members of the Granette SMSF which commenced on 1 July 2021.

The fund has the following income and assets:

Investment	Income	Cost	Value on 30 June 2022
Woolworths Ltd	\$4,000	\$100k	\$110k
Commercial property	\$50,000	\$1 million	\$900k
Cash	\$500	\$50k	\$50k

Annette's brother Scott is a licensed financial planner and provides advice to the fund at 'mate's rates' at a 20% discount to his normal arm's length clients. Mate's rates are also given to clients who are referred by organisations that Scott's firm sponsors such as the local Townsville Taipan's netball club.

What will be the impact on the tax payable by the Granette SMSF?

# Case Study 7

## The 2023 Financial Year

For the 2023 financial year the fund has the following assets:

Investment	Income	Cost	Value on 30 June 2023
Woolworths Ltd	\$3,000	\$100k	\$nil
Woodside Petroleum	\$0	\$110k	\$110k
Commercial property	\$54,000	\$1 million	\$1.2 million
Cash	\$200		\$60k

Scott and his wife Sonya decided to become members of the Granette SMSF. Scott provides advice to the fund for no cost. Scott's firm continues to give Mate's rates to clients who are referred by organisations that Scott's firm sponsors such as the local Townsville Taipan's netball club.

Grant has his own firm as a town planner and used the work laptop to record the fund accounts which were emailed to their accountant and tax agent.

On 30 June 2023 the Granette SMSF decided to sell its Woolworth's shares for \$120k with a taxable capital gain of \$20,000. The net proceeds of \$110k were used to purchase shares in Woodside Petroleum.

What will be the impact on the tax payable by the Granette SMSF?

# Case Study 7

## The 2024 Financial Year

For the 2024 financial year the fund has the following assets:

Investment	Income	Cost	Value on 30 June 2022
Woodside Petroleum	\$5,500	\$110k	\$nil
Westpac	\$0	\$140k	\$150k
Commercial property	\$75,000	\$1 million	\$1.4 million
Cash	\$500		\$80k

Scott still provides advice to the fund for no cost. Scott's firm continues to give Mate's rates to clients who are referred by organisations that Scott's firm sponsors such as the local Townsville Taipan's netball club.

Grant now uses his personal computer to record the fund accounts which were emailed to their accountant and tax agent.

On 30 June 2023 the Granette SMSF decided to sell its Woodside shares for \$150k with a taxable capital gain of \$40,000. \$110k of the net proceeds were used to purchase shares in Westpac.

What will be the impact on the tax payable by the Granette SMSF?

# Case Study 7

For the 2034 financial year the fund has the following assets:

Investment	Income	Cost	Value on 30 June 2034
Diversified share portfolio	\$0	\$850k	\$1.125 million
Commercial property	\$125,000	\$1 million	\$nil
Cash	\$500		\$3.580 million

In June 2034 the commercial property which had been owned for more than a decade was sold for \$3.5 million which resulted in a taxable capital gain of \$3.4 million after expenses.

What will be the impact on the tax payable by the Granette SMSF?



Questions?

October 2021

## Our team of technical experts



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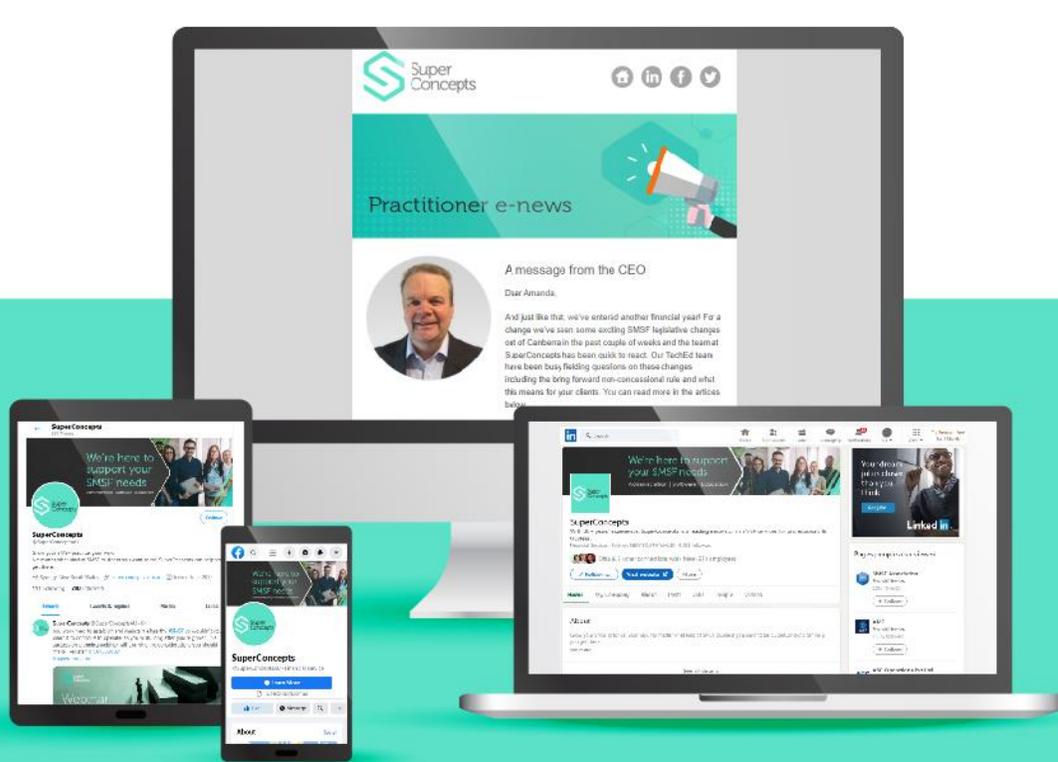
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