Legislative Update

Why is everyone talking about Non-Arm's Length Expenses?

There has been a lot of chatter about non-arm's length expenses in the industry lately and sometimes it is hard to keep up with it all, so let us summarise it all up for you as simply as we can.

Firstly, what you need to know is that back in the 2017/18 Federal Budget the Government expanded on their definition of Non-Arm's Length Income (NALI) to include a new term called 'Non-Arm's Length Expenses (NALE)'. They then went on to propose new provisions relating to NALE in the 2023/24 Budget. They have now drafted legislation to amend the Income Tax Assessment Act 1997 to include additional rules that will relate to NALE. So what is the difference between NALI and NALE you may ask? And what is changing? Let's break it down.

What is Non-Arm's Length Income (NALI)?

It is a provision to prevent superannuation funds from conducting transactions on a non-market basis. NALI arises when income is more than what would be expected on an arm's length dealing or when expenditure is less than (or nil) what would be expected on an arm's length dealing. For example, if Joe Blow's SMSF sold a property to his wife for $1 million when the property has a market value of $900,000 then that would be considered non-arm's length income.

What is Non-Arm's Length Expenses (NALE)?

NALE is where expenses incurred from producing income from an asset are not dealt with on an arm's length basis. It can either be one of two things; a specific expense or a general expense. A general expense is not related to gaining or producing income from a particular asset of the fund. Examples of general expenses would be actuarial costs, accountant fees and administrative costs in managing the fund. A specific expense will be an expense relating to gaining or producing income for a particular asset. Examples of specific expenses would be maintenance expenses for a rental property or investment advice fees for a particular pool of investments.

What are the proposed new laws?

The Government have released draft legislation under 'Treasury Laws Amendment (Measures for Consultation) Bill 2023: Non-arm's length expense rules for superannuation funds'. They are proposing to make three amendments to the Income Tax Assessment Act 1997 which will relate to NALE. The three new laws are:

1.For SMSFs and small APRA funds, general non-arm's length expenses result in a maximum of twice the difference between the amount that would have been expected at arm's length and the amount actually incurred being non-arm's length income, with no deduction applying against that amount. The total amount taxed at the highest marginal rate is then capped to income minus deduction, excluding assessable contributions and deductions against them.

That's pretty wordy hey?! The best way to get your head around it is to run through a simple example.

Consider an SMSF where Sally is the sole member. The SMSF earned $20,000 in income and has $5,000 in eligible deductions, resulting in $15,000 taxable income for the year. Sally is also an accountant and provides accounting services to her SMSF free of charge, rather than at her market rate of $3,000. This would be considered a NALE between Sally and her SMSF. The 2 factor approach would apply resulting in $6,000 ($3,000 x 2) of non-arm's length income.

To determine the non-arms length cap, it is the total income other than assessable contributions, minus deductions other than deductions against assessable contributions. Therefore, $20,000 in income less $5,000 in deductions totals $15,000. As the cap is higher than the non-arm's length income ($6,000), the non-arm's length component stays at $6,000 which will be taxed at the highest marginal rate.

2..The NALE rules will not apply to large APRA-regulated funds and exempt public sector superannuation funds.

Large APRA funds and exempt public sector super funds have a get-out-of-jail free card for this one. They will be able to continue to calculate their non-arm's length component in the same way they do now.

3. Prior to 1 July 2018, expenses that were incurred or expected to be incurred cannot result in the application of the NALE rules.

If this Bill is passed, the changes will apply to income gained in the 2023/24 financial year and onwards, and expenses incurred on or after 1 July 2023.

What's next?

The consultation process for the draft legislation closed on 7 July 2023 and now it is the good ol' game of wait and see.

Rebecca Oakes B.Bus, Adv Dip FP, SSA
SMSF Technical Manager
1800 230 737rebecca@act2.com.au