



COOPER GRACE WARD
LAWYERS

Non-Arm's Length Income

Webinar
Television Education Network

28 July 2015

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1. INTRODUCTION

- 1.1 The non-arm's length income rules play a significant role in structuring SMSF acquisitions and investments as the rules encompass a wide range of transactions even where the income derived by the SMSF reflects an arm's length amount.

As a result, this area is a potential minefield for advisors as the penalties can be extremely disproportionate to the gain received by the SMSF.

Despite this, the non-arm's length income rules do not occupy a critical step in the SMSF decision making process, often only being considered at the last minute or after the fact.

- 1.2 All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

2. WHAT IS NON-ARM'S LENGTH INCOME?

- 2.1 Non-arm's length income received by a SMSF trustee is taxed at the top marginal rate (currently 45%), rather than at concessional rates which apply to other income of a complying SMSF. This includes income that would otherwise be exempt current pension income where the SMSF is in pension phase.¹

It is 'designed to prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers.'²

- 2.2 The relevant legislation is section 295-550, which provides:

295-550 Meaning of non-arm's length income

- (1) An amount of ordinary income or statutory income is non-arm's length income of a complying superannuation fund... (other than an amount to which subsection (2) applies or an amount derived by the entity in the capacity of beneficiary of a trust) if:
- (a) it is derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme; and
 - (b) that amount is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme.
- (2) An amount of ordinary income or statutory income is also non-arm's length income of the entity if it is:
- (a) a dividend paid to the entity by a private company; or
 - (b) ordinary income or statutory income that is reasonably attributable to such a dividend;
- unless the amount is consistent with an arm's length dealing.
- ...
- (4) Income derived by the entity as a beneficiary of a trust, other than because of holding a fixed entitlement to the income, is non-arm's length income of the entity.
- (5) Other income derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is non-arm's length income of the entity if:

¹ Sections 295-385 and 295-390.

² Explanatory Memorandum, *Superannuation Legislation Amendment Bill (No. 2) 1999* at paragraph 2.13.

- (a) the entity acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm's length; and
- (b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length.

2.3 This section was introduced as part of the 'Simpler Super' amendments in 2007. Prior to this, non-arm's length income was known as 'special income' and covered in section 273 of the *Income Tax Assessment Act 1936*.

Under section 273, amounts received were deemed to be 'special income' unless the ATO determined that the receipt was consistent with an arm's length dealing. The Commissioner set out the factors that would be applied in determining whether to exercise its discretion in Taxation Ruling 2006/7.

However, under section 295-550, the taxpayer is now required to self-assess whether the SMSF has derived non-arm's length income.

Despite this change, the rewrite was not intended to alter the meaning of the provisions.³ As a result, the Commissioner has confirmed that its position as outlined in TR2006/7 is still applicable.⁴

2.4 This is especially relevant as there has been no judicial or ATO guidance on the application of section 295-550 yet. Therefore, advisors can rely on the decisions and guidance provided in relation to section 273 of the *Income Tax Assessment Act 1936*.

2.5 Under section 295-550, there are three main categories of non-arm's length income:

- (a) dividend income from private companies;
- (b) trust distributions; and
- (c) other ordinary or statutory income (that does not result from dividends or trust distributions).

This paper will not explore the last category, as all the elements tested are dealt with in the section on Trust Distributions at paragraph 4.17 to 4.23 of this paper.

3. DIVIDEND INCOME

3.1 Dividends received (and ordinary or statutory income received that is reasonably attributable to a dividend) by a SMSF from private companies are non-arm's length income unless the amount received is consistent with an arm's length dealing.⁵

This section also applies to non-share equity interests, an equity holder in a private company and non-share dividends.⁶

3.2 This test has to be applied to each stage of a given transaction. In particular, the acquisition of the shares, the maintenance of the shareholding and the payment of the dividends must all be on an arm's length basis.

3.3 In determining whether an amount is consistent with an arm's length dealing, the SMSF is to have regard to the factors set out in section 295-550(3). These are:

³ Explanatory Memorandum, *Tax Laws Amendment (Simplified Superannuation) Bill 2006* (Cth) at paragraph 3.14.

⁴ Taxation Ruling 2006/7A1 – Addendum.

⁵ Section 295-550(2).

⁶ Section 295-550(6).

- (a) the value of shares in the company that are assets of the entity;
- (b) the cost to the entity of the shares on which the dividend was paid;
- (c) the rate of that dividend;
- (d) whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend;
- (e) whether the company has issued any shares to the entity in satisfaction of a dividend paid by the company (or part of it) and, if so, the circumstances of the issue; and
- (f) any other relevant matters.

3.4 The Full Federal Court confirmed in *Darrelan*⁷ that:

- (a) no single factor is given precedence over another; and
- (b) paragraph (f) 'any other relevant matters', is sufficiently wide enough to consider the rate of return on investment or dividend yield and the acquisition price.

In this case, the trustee of the SMSF acquired four shares (being 4% of the shares on issue) in Vercot Pty Ltd, a passive holding company, for \$51,128 from an existing shareholder.

Vercot in turn held 25,609,320 shares in Abigroup Limited, a listed public company, valued at \$14,853,405.60. Effectively, the trustee of the SMSF acquired an indirect interest in Abigroup shares worth \$594,136.

Over the next eight financial years, Vercot paid dividends (being the on payment of the Abigroup dividend) totalling \$950,136. Although the dividends were paid proportionately to all shareholders in Vercot, the rate of the dividends were 'unquestionably enormous'.

The trustee of the SMSF argued the acquisition of the shares was irrelevant and all the Commissioner was required to consider was whether the receipt of the dividends was consistent with an arm's length dealing. They argued in this case that the dividends received were consistent with an arm's length dealing as Vercot merely paid dividends equal to those it received from an arm's length third party.

The Full Federal Court agreed with the Commissioner and held that the dividends were special income. To support the argument advanced by the taxpayer 'would undermine the policy underlying section 273(2)'.⁸

3.5 Although taxpayers now self-assess under section 295-550, the Commissioner's approach outlined in Taxation Ruling 2006/7 also provides useful guidance in applying these factors to whether dividend income is non-arm's length income.

4. TRUST DISTRIBUTIONS

4.1 There are two circumstances where a trust distribution can give rise to non-arm's length income:

- (a) if the income is derived 'other than because of holding a fixed entitlement',⁹ and
- (b) where the income is derived under a non-arm's length dealing where there is a fixed entitlement.¹⁰

⁷ *Darrelan Pty Ltd (trustee of the Henfam Superannuation Fund) v FCT* [2010] FCAFC 35.

⁸ *Darrelan Pty Ltd (trustee of the Henfam Superannuation Fund) v FCT* [2010] FCAFC 35 at [31].

⁹ Section 295-550(4).

¹⁰ Section 295-550(5).

4.2 If a 'fixed entitlement' does not exist, the trust distribution is automatically non-arm's length income. Whereas an objective assessment must be undertaken if a fixed entitlement does exist.

4.3 The predecessors to these two sections have been the subject of a number of recent cases.

'Income derived'

4.4 The taxpayer has argued in two recent cases that the special income rules did not apply as the trustee of the SMSF had not 'derived' any income; it had merely been the recipient of a trust distribution.¹¹

4.5 The Full Federal Court confirmed in both these cases that a trust distribution is income derived by a SMSF for the purposes of these rules.

4.6 In *Allen's case*, a hybrid trust was established in 2001. In 2002, a related entity of the Allen's Asphalt Staff Superannuation Fund established a fixed trust by way of declaration of trust. This declaration nominated the SMSF as the absolute beneficiary of the fixed trust. On the same day, the trust deed of the hybrid trust was amended to add a discretionary beneficiary class which included the fixed trust.

In the 2003 financial year, the hybrid trust made a \$2.5 million capital gain which was wholly distributed to the fixed trust, which resulted in the SMSF receiving a \$2.5 million distribution from the fixed trust.

The SMSF argued that it did not derive any income from the arrangement as they were merely the recipient of the distribution.

The Court held the taxpayer's argument is a 'distinction without a difference' and that income 'attributed or imputed to the beneficiary... is the functional equivalent of derivation'.¹²

The Court commented in dismissing the taxpayer's argument, that if it was accepted, the provisions 'can have no operation at all if the expression 'income derived' excludes the receipt of trust distributions'.¹³

The taxpayer's special leave application to appeal this point was dismissed by the High Court.¹⁴

4.7 In *SCCASP*, the taxpayer attempted to distinguish the decision in *Allen* on the basis the distribution (which had been determined by the trustee) had not yet been paid to the SMSF.

In this case, *SCCASP Pty Ltd* was the trustee of the H&R Super Fund (SMSF). A related entity, the Rowe Family Trust, conducted a business trading as Super Cheap Auto.

As a result of a group restructure and subsequent listing on the stock exchange, the Rowe Family Trust derived a significant capital gain 2004 financial year. The trustee of the Rowe Family Trust decided to distribute 100% of its income for the 2004 financial year to the SMSF.

Out of the \$14 million capital gain, only \$2.89 million was actually paid to the SMSF, although the entire capital gain was included in the SMSF's assessable income.

In dismissing the Taxpayer's argument, the Court held 'the purpose of the word 'derived'...is to identify the source, not the receipt'.¹⁵ Therefore, the SMSF will derive income when it 'becomes entitled to the income in its capacity as a trustee for that beneficiary'.¹⁶

¹¹ *Allen and Another v FCT* [2011] FCAFC 118 and *SCCASP Holdings Pty Ltd v FCT* [2013] FCAFC 45.

¹² *Allen* at [56].

¹³ *Allen* at [57].

¹⁴ *Allen v FCT* [2012] HCATrans 25.

¹⁵ *SCCASP* at [66].

¹⁶ *SCCASP* at [68].

The taxpayer's special leave application to appeal this point was dismissed by the High Court.¹⁷

Ordinary and Statutory Income?

- 4.8 It was also argued in both *Allen* and *SCCASP* that section 273 only applied to ordinary income, not statutory income. This argument was based on the fact that section 273 referred only to 'income', which was not defined in the Tax Act.

The Court confirmed in *Allen* that 'income' for the purposes of section 273 referred to assessable income and therefore included any capital gain distributed to the SMSF. This has been clarified in section 295-550 to remove any confusion:

It should be noted that s 273 of the ITAA 1936 has since been replaced by s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), which was evidently enacted to put paid to the arguments advanced by the taxpayers in this case.¹⁸

Gross Income or Net Income?

- 4.9 There is some debate as to whether the non-arm's length income rules relate to the gross income or the net income received by a SMSF. I believe this confusion primarily arises as the amount distributed by a trust to the SMSF (distributable income) is often quite different to the amount the SMSF is required to pay tax on under section 97 of the *Income Tax Assessment Act 1936* (assessable income).

*Bamford*¹⁹ confirmed trust deeds can define what is 'income' for the purposes of distributions to a trust's beneficiaries and this quite often does not align with the definition of income for the purposes of the Tax Acts.

The non-arm's length income rules are concerned with the 'assessable income' that the SMSF has to include in its tax return as a result of the trust distribution. Not the actual amount (distributable income) received by the SMSF beneficiary. This position was confirmed in *Allen* and *SCCASP*.

As a result, we are not only concerned with how the trust derives its income, but also whether all the expenses incurred by the trust are also on an arm's length basis. For example, if the trust income received by or due to the SMSF beneficiary is increased as a result of expenses that are less than what it would have been in an arm's length arrangement, the income received by the SMSF will be non-arm's length income under section 295-550(5).

This position is different under the first limb (other ordinary or statutory income) of the non-arm's length income rules. In this case, the section only relates to whether the ordinary or statutory income received is more than had there been an arm's length dealing. Therefore, when applying this limb, the expenses incurred by the SMSF in deriving that income are irrelevant.

'Fixed entitlement'

- 4.10 Establishing whether a SMSF has a fixed entitlement to income is a critical step in applying the non-arm's length income rules to trust distributions. This is because an amount distributed from a trust to a SMSF is automatically non-arm's length income if the SMSF does not have a fixed entitlement. The Commissioner does not have any discretion.
- 4.11 There has been significant conjecture as to the meaning of 'fixed entitlement' as there are two competing views:
- (a) The strict approach - that 'fixed entitlement' is defined in section 995-1.

¹⁷ *SCCASP Holdings Pty Ltd v FCT* [2014] HCATrans 17

¹⁸ *Allen* at [7].

¹⁹ *FCT v Bamford and Anor* [2010] HCA 10.

(b) The watered down approach – ‘fixed entitlement’ is not defined in the legislation.

- 4.12 The preferred view adopted by the ATO is the watered down approach. The ATO’s position is that a SMSF has a fixed entitlement if its ‘entitlement to the distribution does not depend upon the exercise of the trustee’s or any other person’s discretion.’²⁰

In adopting this view, the ATO argue that the definition of ‘fixed entitlement’ in section 995-1 does not apply to the non-arm’s length income rules as the words ‘fixed entitlement’ do not have an asterisk immediately preceding them in that section.

Support for this argument can be found in section 2-10 which provides ‘*most defined terms in this Act are identified with an asterisk*’. Section 2-15 then goes on to explain when defined terms will not be identified with an asterisk. The ATO’s position is that as the words ‘fixed entitlement’ do not fall within the exclusions listed in section 2-15, it is therefore not a defined term and thus takes its ordinary meaning.

This approach is the favoured by the ATO as, in the Commissioner’s opinion, the strict approach ‘would give rise to adverse and unintended impacts on superannuation funds that hold arm’s length trust investments.’²¹

- 4.13 The alternative view is that ‘fixed entitlement’ is defined in section 995-1. That definition provides:

an entity has a fixed entitlement to a share of the income or capital of a company, partnership or trust if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the *Income Tax Assessment Act 1936*.

Establishing whether a beneficiary has a ‘fixed entitlement’ to a share of income or capital of a trust under this approach is dependent upon whether, under the trust instrument, the beneficiary has a ‘vested and indefeasible interest’ in a share of the capital or income.²²

In summary, to have a ‘vested and indefeasible interest’, the SMSF’s right to income and capital of a trust must be automatic, not subject to any restrictions or intervening events and cannot be taken away. To determine whether a SMSF has a vested and indefeasible interest and therefore a fixed entitlement, it is necessary to examine the terms of the trust deed.

This approach was preferred by the AAT in the recent case of *The Trustee for MH Ghali Superannuation Fund v FCT*.²³ The AAT concluded that ‘fixed entitlement’ is defined in section 995-1 for the purposes of fixed entitlement.

- 4.14 Despite the decision in *Ghali*, the ATO’s view remains that ‘fixed entitlement’ is not defined and takes its ordinary meaning.

The ATO indicated in the Decision Impact Statement that as *Ghali*’s case was ultimately decided in the ATO’s favour and the meaning of ‘fixed entitlement’ was not determinative, the ATO could not appeal the case to obtain further guidance on this issue.

In support of their view, the ATO has correctly pointed out that their preferred approach is more favourable to taxpayers.

- 4.15 In light of the decision in *Ghali*’s case, my view is that it is dangerous to rely on the ATO’s position when structuring SMSF investments without a private ruling. The ATO’s position is not supported by the current case law, therefore your clients will remain exposed to adverse tax consequences should the ATO see fit to change their approach in a given situation.

²⁰ TR 2006/7 at [102].

²¹ Decision Impact Statement, *The Trustee of the MH Ghali Superannuation Fund v FCT*.

²² Section 272-5(1) of Schedule 2F of the *Income Tax Assessment Act 1936* (Cth).

²³ [2012] AATA 527

When considering the competing views in this case, it is important to remember the lessons taught from past experiences. With *Bamford*²⁴ still fresh in minds of all advisors, it is critical that we do not make the same mistakes. For years the ATO consistently applied a watered down administrative approach (with no foundation in the law) to the operation of discretionary trusts. However, when it came to the crunch time, the ATO adopted a strict interpretation of the law regarding trusts which consequently resulted in a lot of pain for advisors.

Some evidence of the ATO's desire to pick and choose the approach that best suits the circumstances in this area already exists. Despite continually insisting publically that 'fixed entitlement' is not defined in the legislation, in Private Ruling No. 1012585947911 the ATO adopted the approach of the AAT in *Ghali's* case that 'fixed entitlement' is a defined term and has the meaning in section 995-1.

Given the potential risks associated with a SMSF not having a 'fixed entitlement', my view is that it best to comply with the strict approach when structuring SMSF investments. Although this definition of 'fixed entitlement' is more complicated and restrictive, it is not impossible or impractical to comply with.

4.16 **Trusts deeds and fixed entitlements**

- (a) Regardless of which definition of fixed entitlement you apply, in no circumstances will an ordinary discretionary or family trust result in a beneficiary having a fixed entitlement.
- (b) The ATO has also made it clear that, in its view, unitholders in most private unit trusts do not have a 'fixed entitlement' as required by the loss trust rules. This is the primary reason the ATO is favouring the view that a SMSF has a fixed entitlement provided the trustee has no discretion in determining distributions.
- (c) Most unit trusts allow units to be redeemed and further units to be issued. Usually, these provisions allow the trustee or the unitholders to determine the price.

This potentially results in the units held by an existing unitholder being defeasible (and not 'vested and infeasible') and therefore, all unitholders not having a fixed entitlement.

However, a unitholder's interest will not be defeasible merely because existing units can be redeemed and new units can be issued provided the relevant price is determined on the basis of net asset value according to Australian accounting standards.²⁵

- (d) Also, unitholders do not have a 'fixed entitlement' if there are powers and discretions in the deed that can terminate, invalidate or annul the unitholders' entitlements to their 'share' of the income or capital without their consent.²⁶
- (e) In addition, it is likely that a unitholder's interest may be defeasible if:
 - (i) the trust deed allows for different classes of units;
 - (ii) the trustee has the power to make gifts;
 - (iii) the trustee has the power to establish and support charities; or
 - (iv) the trust deed can be amended without the unanimous consent of all unit holders.²⁷

These issues have been explored in detail in a number of cases which are beyond the scope of this paper.²⁸

²⁴ *FCT v Bamford and Anor* [2010] HCA 10.

²⁵ Section 272-5(2) of Schedule 2F of the *Income Tax Assessment Act 1936* (Cth).

²⁶ *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 at [100].

²⁷ See ATO Interpretative Decisions 2002/749 (Withdrawn) and 2002/750 (Withdrawn) and NTLG, Minutes of Meeting.

- (f) Therefore, most 'off the shelf' unit trust deeds will not comply with the strict interpretation of the meaning of fixed entitlement.
- (g) Applying the non-arm's length income rules to hybrid trusts can be a little more complicated. This is mainly due to the fact that each hybrid trust is different and can look like an 'off the shelf' unit trust deed or a family discretionary trust with some fixed income split.

Under the ATO's view, any income received from a hybrid trust will be non-arm's length income if the trustee had a discretion as to how to pay the income. This is a problem even where the trust is divided into units but the trustee has a discretion to pay disproportionately to the unit holdings.

However, assuming the strict interpretation is correct, all hybrid trusts will not be fixed trusts and therefore the income from such trusts received by a SMSF will be non-arm's length income.

- (h) Although uncommon, it is also possible for this issue to arise for limited recourse borrowing arrangements.

Most LRBA's are established with some form of specially drafted bare trust deed. It is critical that the SMSF beneficiary is entitled to all the income and capital of the LRBA and that the SMSF's entitlement is not dependant on the exercise of any discretion.

This was an issue in Private Ruling No. 1012600494171. In that ruling, the Commissioner found that the SMSF did not have a fixed entitlement under the bare trust deed. This was because:

- (i) the trust deed did not include any specific provisions entitling the SMSF to the income and capital of the trust; and
- (ii) the trustee was required to follow the beneficiary's instructions/directions.

As a result, the Commissioner was of the view that the SMSF's entitlement to income was dependent on the SMSF providing an appropriate instruction/direction to the bare trustee.

In my view, this conclusion is extremely harsh and I do not believe that you would necessarily have the same result if this matter was litigated before a court.

However, this ruling demonstrates the need for extreme caution when preparing or choosing an LRBA deed provider as it is not a mere formality that it is drafted appropriately.

- (i) Despite the strict approach in the loss trust provisions, the Commissioner also has a discretion to deem a beneficiary to have a fixed entitlement.²⁸ In determining whether to exercise this discretion, the Commissioner must have regard to:
 - (i) the circumstances in which the entitlement is capable of not vesting or the defeasance can happen; and
 - (ii) the likelihood of the entitlement not vesting or the defeasance happening; and
 - (iii) the nature of the trust.³⁰

²⁸ *Dwight v FCT* (1992) 23 ATR 236, *Saunders v Vautier* (1841) 49 ER 282, *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)* [2005] HCA 53, *Soubra v FCT* [2009] AATA 775 and *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16.

²⁹ Section 272-5(3) of Schedule 2F of the *Income Tax Assessment Act 1936* (Cth).

What is an arm's length dealing?

4.17 Where a SMSF trustee has a 'fixed entitlement' in a trust, the income received will still be 'non-arm's length income' if:

- (a) the income is more than the amount the SMSF trustee might have expected to derive if those parties had been dealing at arm's length; and
- (b) either:
 - (i) the SMSF trustee acquired the entitlement under a scheme, the parties to which were not dealing with each other at arm's length; or
 - (ii) the income was derived under a scheme, the parties to which were not dealing with each other at arm's length.³¹

4.18 This element has been the subject of much of the case law on non-arm's length income. Dowsett J summarised the propositions from the cases dealing with this expression in *AXA Asia Pacific Holdings Ltd* as follows:

- in determining whether parties have dealt with each other at arm's length in a particular transaction, one may have regard to the relationship between them;
- one must also examine the circumstances of the transaction and the context in which it occurred;
- one should do so with a view to determining whether or not the parties have conducted the transaction in a way which one would expect of parties dealing at arm's length in such a transaction;
- relevant factors which may emerge include existing mutual duties, liabilities, obligations, cross-ownership of assets, or identity of interests which might enable either party to influence or control the other, or induce either party to serve a common interest and so modify the terms on which strangers would deal;
- where the parties are not in an arm's length relationship, one may infer that they did not deal with each other at arm's length, and that the resultant transaction is not at arm's length;
- however related parties may, in some circumstances, so conduct a dealing as to displace any inference based on the relationship;
- un-related parties may, on occasions, deal with each other in such a way that the resultant transaction may not properly be considered to be at arm's length.³²

4.19 The Full Federal Court in *Allen's* case also confirmed that the income does not need to be derived from an arrangement where the SMSF has an active role.³³

In that case, the SMSF was established and later made the sole beneficiary of a fixed trust. At the same time, the fixed trust was also made a beneficiary of a hybrid trust. Mr Allen was the sole director of the trustee of both the fixed trust and the hybrid trust and a trustee of the SMSF.

The SMSF received a \$2,500,000 distribution in accordance with units it owned in the fixed trust. The fixed trust's only income was a \$2,500,000 distribution from the hybrid trust.

The taxpayer argued that it did not 'acquire the entitlement' as the SMSF's role in receiving the distribution was entirely passive. As the SMSF took no steps, there could be no 'dealing' between the parties.

³⁰ Sections 272-5(1)(b)(i)-(iii) of Schedule 2F of the *Income Tax Assessment Act 1936* (Cth).

³¹ Section 295-550(5) of the *Income Tax Assessment Act 1997* (Cth)

³² *FCT v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134.

³³ *Allen and Another v FCT* [2011] FCAFC 118 and *SCCASP Holdings Pty Ltd v FCT* [2013] FCAFC 45.

The Full Federal Court rejected this argument, stating:

This is a remarkable submission; it cannot be accepted. It could only be accepted if one were to ignore the separate legal personalities of the corporate trustees involved and treat as shams the carefully orchestrated series of trust structure and sequence of distributions. And that is a course which the taxpayers do not invite the Court to take.³⁴

Further, the Court provided:

The steps undertaken by Mr Allen...led to the results that the Super Fund received both the fixed interest in the trust...and the relevant distributions.³⁵

In concluding the arrangement constituted a non-arm's length dealing (and therefore, the \$2,500,000 was special income to the SMSF), the Court acknowledged that although the SMSF did not pay an active role in the receipt of the distribution in question the SMSF 'was the recipient of a distribution which it might have disclaimed, but chose not to do so.'³⁶

4.20 The Court also concluded a 'dealing' is significantly wider than a 'transaction'. Unlike a transaction, a 'dealing' does not:

require the parties to actually deal with each other at all. It is intended to catch distributions in which there has been some non-arm's length dealing between the parties. It is not a condition of the operation that there should have been a dealing by the recipient of the distribution.³⁷

4.21 The recent case of *MH Ghali Superannuation Fund v FCT*,³⁸ provides another example of when the parties were found not to be dealing at arm's length, although this case is probably a better authority for maintaining proper record keeping.

In this case, the trustee of the SMSF held units in a related unit trust. The records showed the only other unitholders to be Dr Ghali personally, MH Ghali Pty Ltd and a second SMSF. Although other family members were also directors of some of the entities, the Tribunal found that Dr Ghali was in fact the controller of all of the entities in question as there was no evidence that suggested the other directors participated in the decision making processes.

The Tribunal looked at the definition of arm's length in section 995-1 and concluded that it contains a direction on how to determine whether parties are dealing at arm's length. It provides:

In determining whether parties deal at arm's length, consider any connection between them and any other relevant circumstance.

The Tribunal held that the connection between the parties in this case suggests a non-arm's length dealing:

Given my finding that Dr Ghali was the person directing the dealings between the Unit Trust and the Superannuation Fund, and that in fact he acted on both side of any such negotiations, one might reasonably be forgiven for coming to the conclusion that any such dealings could not be at arm's length.³⁹

Despite this, the Tribunal acknowledged there may be transactions between related parties that are consistent with an arm's length dealing. To do this, it is necessary to look at the detail of the arrangement between the parties.

³⁴ *Allen* at [65].

³⁵ *Allen* at [66].

³⁶ *Allen* at [73].

³⁷ *Allen* at [72].

³⁸ [2012] AATA 527.

³⁹ *Ghali* at [55].

In this case, a series of unit issues and redemptions were recorded in the register of the Unit Trust with no other evidence supporting the transactions. This lack of record keeping made it difficult to determine the number of units held by each party at any given time. Consequently, the income distributed to the SMSF was not in proportion to its unitholding in the Unit trust.

In addition to this issue, the units held by the second SMSF, which was effectively inactive, were treated as being owned by the SMSF for the purposes of distributing income in the 2005 and 2006 income years.

In arriving at the conclusion that the arrangement was not consistent with an arm's length dealing, the Tribunal commented that:

There are no unit certificates or copies of cheque butts or like documents evidencing payment for issued units of payment by the Unit Trust where units have been redeemed. One might be forgiven for coming to the conclusion that the various transactions have taken place simply by entries in the register and accounts. In my opinion, that is not the purpose of accounting records. They are produced in order to record the transactions which have in fact taken place, rather than constituting a transaction itself. It also amplifies the fact that the issue and redemption of units were not at arm's length.⁴⁰

Income is more than might be expected

- 4.22 Where income is derived as a result of a non-arm's length dealing, the amount is only non-arm's length income if it 'is more than the amount the entity might have been expected to derive if those parties had been dealing with each other at arm's length.'⁴¹

If this applies, then the whole amount received by the SMSF is non-arm's length income, not just the excess over what would have been received in an arm's length transaction.

- 4.23 In *Allen's* case the Full Federal Court stated that this test requires the transaction to be compared with a hypothetical arm's length dealing:

Section 273(7)(b) is speaking of a hypothetical situation that "might have been expected to apply" if the parties to the arrangement had been dealing at arm's length. It requires little imagination to see that if the parties to the movement of funds in this case had been at arm's length, there would have been no distribution at all to the Super Fund. The usual expectation of humankind is that one gets what one pays for, and the Hybrid Trust and the Fixed Trust got nothing in relation to the payments which they made; and there was no purpose to the plan which informed the flow of funds other than the attraction of the favourable tax rate applicable to the income of a CSF.⁴²

5. LIMITED RECOURSE BORROWING ARRANGEMENTS

- 5.1 The non-arm's length income rules suddenly became the subject of renewed interest in late 2012 when the ATO indicated that it was possible for related parties to lend to SMSFs for limited recourse borrowing arrangements (LRBAs) without charging interest.

In all these cases it is clear that there is a 'scheme' and that the parties are not dealing with each other at arm's length. As a result, whether the income received by the SMSF is non-arm's length income turns on whether the amount received by the SMSF is greater than it would have been in an arm's length arrangement.

Commissioner's initial position

- 5.2 Initially, the Commissioner confirmed that the non-arm's length income rules will not apply to a SMSF where it saves on an interest expenses in an LRBA:

⁴⁰ *Ghali* at [62].

⁴¹ Section 295-550(5)(b).

⁴² *Allen* at [59].

The ATO position on low rate loan arrangements and LRBA is that they do not generally invoke a contravention of the SISA, do not give rise to non-arm's length income under section 295-550 of the Income Tax Assessment Act 1997 (ITAA), do not invoke Part 4A of the ITAA 1936 and are not considered to give rise to contributions to the SMSF just from that one fact alone.⁴³

- 5.3 Following the publication of this position, it has been hotly debated whether the non-arm's length income rules are in fact wide enough to 'catch' an SMSF where the SMSF saves on an expense that it would otherwise occur in an arm's length arrangement.
- 5.4 Sections 295-550(1) and (5) are concerned with the 'income derived' by the SMSF. As confirmed in *Allen* and *SCCASP*, this means the amounts received by the SMSF.

Applying this view, on its face, the non-arm's length income rules will not apply where an SMSF receives an interest free or low rate loan from a related party. This is because:

- (a) the SMSF receives distributions from the investment of the 'single acquirable asset' which is held on the terms of the bare trust;
 - (b) the SMSF receives the loan from the related party not the bare trust, as a result, the interest expense is incurred at the SMSF level;
 - (c) as the interest expense is incurred at the SMSF level, the income and expenses of the bare trust remain the same, as a result, the amount distributed to the SMSF remains the same; and
 - (d) as the taxable income received by the SMSF from the bare trust is the same as in an arm's length arrangement the non-arm's length income rules do not apply even though the 'net' position of the SMSF is increased as it has not had to pay interest.
- 5.5 In summary, the main reason stems from the fact that in these arrangements, the expense saving is received by the SMSF rather than the bare trust.

This position should be distinguished from the situation where the expense is saved by the trust, therefore increasing the amount to be distributed to the SMSF.

- 5.6 Despite the approach announced by the ATO, I have always advised my clients to apply for a ruling on this issue. This caution has mainly arisen due to the disproportionate consequences that apply where an SMSF is found to have non-arm's length income.
- 5.7 The early private rulings issued by the ATO on this issue confirm the publically announced position.

In Private Ruling No. 1012414213139, the Commissioner confirmed that the non-arm's length income rules would not apply. In support of this position, the Commissioner stated that:

for subsection 295-550(1) of the ITAA 1997 to apply, the scheme must inflate the level of ordinary or statutory income derived as a result of the non-arm's length dealings. Whether or not the level of taxable income derived by the entity is inflated as a result of a lower level of deduction amounts than would normally be incurred had the parties been dealing at arm's length is not to be taken into account in applying subsection 295-550(1) of the ITAA 1997.

In this case, the Fund will derive a greater level of taxable income because the rate of interest payable by the fund is reduced to 0%. That is, the level of taxable income derived by the Fund will be inflated as a result of a lower level of deduction amounts than would normally be incurred if the parties were dealing at arm's length. However, subsection 295-550(1) of the ITAA 1997 does not apply in these circumstances as this subsection applies strictly to amounts of ordinary or statutory income, not taxable income.

⁴³ National Tax Liaison Group, Minutes of December 2012 meeting at [6.1]

Therefore, the income derived by the Fund in these circumstances is not non-arm's length income of the Fund as defined in subsection 295-550(1) of the ITAA 1997

This approach was also supported by the ATO in Private Ruling No. 1012396819768 where they held rental income received from an LRBA would not be non-arm's length income where the SMSF borrowed from a related party on favorable terms.

Commissioner's current position

- 5.8 However, the Commissioner has completely changed his view in relation to how the non-arm's length income rules apply to LRBAs. The recent private rulings issued by the ATO all conclude that income from an LRBA would be non-arm's length income where the SMSF received an interest free loan from a related party.⁴⁴

In these rulings, the ATO rely on the following alternative arguments:

- (a) The income the SMSF would derive from the bare trust in an arm's length would be less than under the proposed arrangement on the basis that the lender might be expected to lend on commercial terms.
 - (b) The SMSF would not receive any income at all from the bare trust if it had to borrow on commercial terms as it wouldn't have entered into the LRBA.
- 5.9 The first argument raised by the ATO in support of the application of the non-arm's length income rules is flawed. As discussed at paragraphs 5.4 and 5.5 of this paper, the income received by a SMSF from the bare trust in LRBAs will not change as a result of the interest saving as the interest saving occurs at the SMSF level, not the at the bare trust level.

To counter this argument in Private Ruling No. 1012582301006, the ATO argued that the income from the bare trust would have been lower as the bare trust would not have been able to acquire such a high income producing asset if the loan were on commercial terms. This position had merit in this case as the related party lender advanced 100% of the purchase price.

- 5.10 The second argument is a little harder to overcome when establishing an LRBA. If the only reason a client is entering into an LRBA is because they can have a related party loan to their SMSF with no interest payable, then this argument will apply.

Therefore it would be important to demonstrate that your client would enter into the LRBA even if they were required to pay interest at commercial rates. In addition to demonstrating this intention, it will also be critical for clients show that they would have been able to practically enter into the LRBA and acquire the identical property if they had received an arm's length loan.

This is one primary distinction between the facts of the unfavourable private rulings and the ruling that was favourable to the taxpayer, Private Ruling No. 1012414213139.

- 5.11 The ATO has also confirmed its position as outlined above in ATO IDs 2014/39 and 2014/40.

Refinances

- 5.12 In Private Ruling No. 1012414213139, the SMSF had an existing loan from a related party lender which was used to establish an LRBA and acquire a property. The loan agreement required interest to be paid at a commercial rate. Following implementation of the loan, the lender agreed to reduce the interest rate payable on the loan to 0%. As a result, it was not possible for the ATO to argue that the same arrangement would not have been entered into had a loan on commercial terms been entered into.

⁴⁴ Authorisation numbers 1012582301006, 101285947911, 1012595001544, 1012591579596, 1012600494171, 1012623016073, 1012627226460, 1012630099511, 1012633428550, 1012634565634, 1012674694054, 1012733720677, 1012744382914

However, the ATO has now also changed its position in relation to refinances. In Private Ruling No. 1012744382914 the ATO adopted the same position as in rulings discussed at paragraph 5.8. In particular, the Commissioner concluded that the SMSF would have derived no further income from the LRBA as a third party would not fund the refinance with an interest rate of 0%. On this basis, the Commissioner concluded that the income would have been more than if the loan was on arm's length terms and therefore the income received by the SMSF from the LRBA would have been non-arm's length income had the refinance taken place.

Despite the position adopted in this private ruling, I do not agree with the conclusion reached by the ATO. This is because the income received from the LRBA would have been the same before and after the refinance as the borrowing is at the SMSF level. Although the net position of the SMSF would have increased, this is irrelevant in determining whether the non-arm's length income rules apply.

Nevertheless, the ATO has made its position clear and any person looking to refinance a related party loan on favourable terms runs a high risk of attracting the attention of the ATO.

Structuring related party loans

- 5.13 The ATO have now also raised concerns with the terms of related party loans even where the parties are charging an arm's length interest rate. Therefore, any party looking to fund an LRBA with a related party loan must take extra care to ensure the related party loan is on arm's length terms in total.
- 5.14 In determining whether the loan is on arm's length terms, the ATO, in a number of the private rulings, also examined:
- (a) the length of the loan;
 - (b) whether there are requirements to make principal repayments and the frequency;
 - (c) the interest payable and the frequency;
 - (d) the amount and loan-to-value ratio of the amount advanced;
 - (e) the rights of the lender in the event of a default; and
 - (f) the security provided for the loan.
- 5.15 In addition to the above issues, the loan will only be considered to be on arm's length terms if it is recorded in a written loan agreement, the loan terms are strictly enforced and the security is registered.
- 5.16 In a number of the private rulings, the ATO commented that above issues were not dealt with in the same way as you would expect a bank financier, therefore resulting in non-arm's length income.

For example, in Private Ruling No. 1012627226460, the members loaned the SMSF the necessary funds to purchase a property. The loans terms were as follows:

- (a) Loan term: 7 years
- (b) Interest rate: 7%
- (c) Repayments: principal and interest in annual instalments
- (d) LVR: 100% of purchase price
- (e) Security: mortgage over the property (although unregistered).

The ATO held that the income received by the SMSF was non-arm's length income as a commercial lender would not have lent 100% of the purchase price to the SMSF and the mortgage would have been registered.

5.17 This can be compared with Private Ruling No. 1012744382914 where the ATO held that the non-arm's length income rules did not apply. In that case, the loan terms were as follows:

- (a) Loan term: 10 years
- (b) Interest rate: 6.7% (or 9.7 if in default)
- (c) Repayments: principal and interest in monthly instalments
- (d) Security: mortgage over the property

5.18 The ATO's current position on related party loans is cause for some concern. If the ATO aggressively pursue this issue further, I would imagine a large number of SMSFs with related party loans may be found to have received non-arm's length income.

Based on my experience, even where a related party is charging interest on a loan provided to a SMSF, a number of these other issues may not be addressed in the same way as an arm's length loan arrangement. For example, I have seen LRBA's established where a second loan has been provided by a related party to enable the SMSF to acquire the property where the LVR offered by the commercial lender was insufficient to fund the acquisition costs.

5.19 When preparing a related party loan, it is critical that you draw your client's attention to these issues and ensure that they are appropriately addressed to avoid the application of the non-arm's length income provisions.

In particular, we always recommend that our clients obtain (formally or informally) from a commercial lender and then ensure that the loan from the related party is on identical terms. If the ATO ever query the terms of these loans, at least the client has contemporaneous evidence to support the position they have adopted.

5.20 For existing related party loans, it would be prudent to review the loan terms to ensure that those loans are consistent with an arm's length arrangement. If they are not, steps should be taken to vary the terms to ensure the non-arm's length income rules do not apply to all future income received by the SMSF from the LRBA.

6. WHERE AN SMSF IS GETTING MORE THAN IT SHOULD - WHAT TO MONITOR

Make sure the SMSF has paid for the right

6.1 Where a transaction involves the acquisition of a right (particularly shares and units), it is essential the SMSF actually pays market value for the acquisition. It will usually not be sufficient for the transaction to be completed by recording the transaction in the accounts unless there is a justifiable reason that is recorded by the parties. In most cases, recording the transaction in the accounts will most likely indicate a non-arm's length dealing.

6.2 If the acquisition of the right or entitlement is not at arm's length, this will most likely taint the income stream even where it (in isolation) is consistent with an arm's length arrangement.

Market value

6.3 It is essential that all transactions occur at market value. A transaction will not give rise to non-arm's length income if it occurs for more than market value, although you need to be careful that this does not cause a breach of the *Superannuation Industry (Supervision) Act 1993* or result in a contribution.

6.4 A transaction will be at market value if it can be demonstrated that the price was arrived at as a result of a bargain struck between parties who each have bargaining power.

6.5 Where the parties are related, negotiations will often be insufficient. In this case, evidence of market value at the time of the transaction is critical. This valuation should be obtained for a person who is reasonably qualified to provide the valuation in the circumstances. It is essential this valuation is retained with the records for the transaction.

Also, the fact that a transaction must take place at market rates does not mean that a discount or a premium cannot be paid. However, if this is the case, it is essential that there is evidence that justifies the discount or the premium payable.

6.6 Alternatively, if a governing document sets out a methodology (for example, a shareholders agreement or a unit trust deed) for valuing that particular asset, it will usually be sufficient to establish that this methodology was strictly followed.

Discretionary amounts

6.7 Any payment that results from the exercise of discretion of a party will be non-arm's length income. In most cases, these payments come from a party related to the SMSF and usually have no other justification than to increase the size of the SMSF.

The courts are suspicious where such amounts are received from unrelated parties as there is usually some undisclosed transaction or dealing that results in the windfall for the SMSF.

Conduct of the other parties

6.8 The cases have made it clear that it is not just the conduct of the SMSF that is relevant. It is necessary to examine the conduct of all the parties involved, including how they derived their income.

Unrelated parties

6.9 The majority of cases deal with arrangements where the parties are related. However, it is important to remember the non-arm's length income rules can apply when a SMSF is dealing with an unrelated party.

In *Granby Pty Ltd v FCT*, the Court held:

That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other.⁴⁵

SIS Act Contraventions

6.10 In circumstances where there is the potential for non-arm's length income, contraventions of the *Superannuation Industry (Supervision) Act 1993* may also exist. Make sure you consider whether the arrangement:

- (a) is consistent with the SMSF's investment strategy;
- (b) results in an in-house asset;
- (c) complies with the arm's length rules; and
- (d) does not breach the sole purpose test.

⁴⁵ (1995) 129 ALR 503 at [22].

7. CONCLUSION

Hopefully this paper provides a useful insight in breadth of transactions that demonstrate the characteristics of a non-arm's length arrangement.

Trustees should ensure that they act prudently in structuring their investments, and maintain appropriate evidence to support the position they have adopted is consistent with an arm's length dealing.

When advising trustees, it is essential that you turn your mind to the non-arm's length income rules as the financial impact of the SMSF can be substantial for your client and your practice if you have not provided sufficient warnings.

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This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.

CKJ10149558 8281772v1