

## NALI -- unit trusts and draft LCR 2019/D3

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20/12/2019

### Overview

Draft Law Companion Ruling LCR 2019/D3 ('LCR') covers the ATO views on how the amendments to s 295-550 (of the *Income Tax Assessment Act 1997* (Cth)) operate where parties to a scheme do not deal with each other at arm's length and an SMSF incurs non-arm's length expenditure in gaining or producing assessable income. Broadly, a 45% tax is imposed on an SMSF's non-arm's length income ('NALI') as compared to the usual 15% concessional tax rate.



### NALI -- fixed entitlements to trust income

An important change to s 295-550 is the addition of paragraphs (b) and (c) in s 295-550(5). Broadly, these changes are aimed at taxing distributions from 'fixed trusts' or certain unit trusts as NALI where a lower (or nil) expense is incurred in relation to acquiring the entitlement in a unit trust.

These two new paragraphs (ie, (5)(b) and (c)) catch 'income' derived by an SMSF as a beneficiary of a trust through holding a fixed entitlement to the income of a trust as a result of a non-arm's length scheme where an amount of a loss, outgoing or expenditure (relating to acquiring that entitlement) is less than what would have been incurred had the parties been dealing at arm's length.

The Tax Institute's submission on the LCR suggested that the ATO revise the LCR to include the following clarification in the LCR on when these paragraphs apply.

*The new paragraphs (b) and (c) in subsections 295-550(5) focus on the 'income' derived by the superannuation fund as a beneficiary of a trust through holding a fixed entitlement to the income of the trust if as a result of the non-arm's length scheme between the parties where the amount of the loss, outgoing or expenditure relating to acquiring that entitlement was less than (including nil) if those parties were dealing at arm's length. That is, there must be a nexus*

*between the income and the acquisition of the entitlement in the trust concerned. For example, this will include where units in a unit trust are purchased for lower than the market value.*

## Is there a relevant nexus?

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The submission questions the ATO's analysis in the LCR on whether a sufficient nexus is established between the lower expense and a net capital gain on an asset that is acquired at market value.

In particular, the submission provides detailed analysis on when a scheme involving a lower revenue expense will taint a net capital gain for NALI purposes. The submission refers to *Ronpibon Tin NL v FCT; Tongkah Compound NL v FCT* (1949) 78 CLR 47 (**Ronpibon Tin Case**) per Latham CJ, Rich, Dixon, McTiernan, and Webb JJ:

*"For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end. The words 'incurred in gaining or producing the assessable income' mean in the course of in gaining or producing such income ...*

*... it is both ... sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income" (CLR pp 56-57).*

Consider example 8 of the LCR where Scott's SMSF acquires units in a stock exchange listed unit trust at market value (\$50,000) with a flexible related party limited recourse borrowing arrangement.

While the submission accepts the trust distributions of \$8,000 derived from those units would be NALI, The Tax Institute rejects the nexus with the net capital gain. The submission states that if Scott's SMSF had sufficient cash to acquire the units at market value there is no sufficient and necessary nexus in relation to the low interest loan and the derivation of the net capital gain on subsequent disposal of those units. The net capital gain is merely a function of how those units perform on the stock exchange.

## What if an SMSF trustee/director provides services to a unit trust?

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The submission also raises the question of what if an SMSF trustee/director provides services to a unit trust.

For example, consider an SMSF that is invested in a non-g geared unit trust that owned a factory and the SMSF trustee/director attended to bookkeeping, arranged trades people to carry out repairs from time to time and instructed the accountant on an annual basis. Would the ATO treat these services in a similar fashion to internal SMSF trustee services?

## In what circumstance is a right a 'fixed entitlement'?

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The submission also requests the ATO to clarify the meaning of 'fixed entitlement' in relation to unit trusts given prior inconsistent ATO materials.

In practice, there are many 'unit trusts' that do not qualify as fixed trusts and following the LCR, it is an opportune time for the ATO to confirm this position as any income distributed by a non-fixed trust to an SMSF is taxed as NALI.

Will the ATO continue to apply its long standing administrative practice on unit trusts that do not strictly qualify as fixed trusts?

## Conclusions

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SMSFs that invest in unit trusts especially closely held unit trusts need to monitor the outcome of the LCR. Significant changes may be required depending on the ATO's views that will be finally reflected in the LCR after it is finalised and issued as a binding ATO ruling.

## Related articles

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For related articles on NALI:

- [NALI -- warning -- draft LCR 2019/D3](#)
- [NALI - is the ATO's net too wide](#)

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5 December 2019

*By Daniel Butler ([dbutler@dbalawyers.com.au](mailto:dbutler@dbalawyers.com.au)), Director and Bryce Figot, ([bfigot@dbalawyers.com.au](mailto:bfigot@dbalawyers.com.au)), Special Counsel*

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