ATO ruling on SMSFs could slug big super

Expenses claims

Shaun Cartoon

A much-anticipated ruling, finalised this week by the ATO, has the potential to trigger billion-dollar tax liabilities that would ultimately be borne by ordinary members of large superannuation funds.

The Law Companion Ruling 2021/2 concerns the application of so-called non-arm's length income (NALI) and non-arm's length expense (NALE) rules and, while it primarily focuses on self-managed superannuation funds, the principles apply equally to Australia's largest APRA-regulated superannuation funds.

And therein lies a very serious potential problem that needs to be recognised by the federal government and addressed as a matter of urgency.

Under the new ruling, and by way of example, if a superannuation fund incurs non-arm's length expenses in purchasing an asset, the income subsequently derived from that asset – and any future gain made on its disposal – will be taxed at the top marginal rate of 45 per cent.

The real worry, though, is that if a superannuation fund incurs a general expense that is not connected with any particular asset, the ruling confirms the ATO's position that all of the income of the fund will be taxed at the top rate.

So, how might that play out? Take a SMSF where the trustee and sole member is an accountant at a small firm. If the firm provides accounting services to the SMSF for free, the ATO view is that this general expense causes all of the income of the SMSF to be non-arm's length income and thus taxable at the top rate.

Other "general" expenses identified by the ATO in the new ruling – actuarial costs, accounting fees, audit fees, investment advisor fees and other administrative costs – suggest that a relatively immaterial expense item can taint the income of the whole fund.

This is an incredibly punitive and harsh outcome, and its impact will be exponentially more significant in the large APRA-regulated fund sector, where related parties routinely provide services such as asset management and other administrative services.

For large funds, the ATO notes that it may be commercially justifiable to provide particular services on a simple cost-recovery basis because of the economies of scale it achieves within the business.

The example featured in the ruling is where services are provided to a large APRA fund, either by the trustee acting in a separate capacity or by a related third party. In this context, the ATO says that the trustee charging the fund on a cost-recovery basis will not trigger action under the new non-arm's length expenditure provisions.

The risks associated with the ruling are not lost on the ATO, which concedes that "the commissioner is alive to concerns that a finding that general fund expenses are non-arm's length is likely to have a very significant tax impact on the complying superannuation fund, even where the relevant expenses are immaterial".

The ATO has sought to reassure SMSFs by stating in the ruling that it will only seek to ascertain that they have made a "reasonable attempt" (whatever that means) to determine an arm's length expenditure amount for services provided to the fund.

For large funds, provided that supporting documentation demonstrates that appropriate internal controls and processes are in place and that "reasonable steps" were taken to determine an arm's length expenditure amount, the ATO states that it will not allocate compliance resources to determine whether expenses are, in fact, arm's length expenses.

Tax governance is the zeitgeist of the times so it's hardly surprising to see the ruling advising funds that appropriate controls and processes should form part of their tax risk management and governance framework.

The reality is that this ruling will place enormous additional pressure on the already complex internal controls required of superannuation funds, their boards, and the employees who manage them. One inadvertent, immaterial slip up and the fund could have a monumental tax problem on its hands.

It is not enough for the fair application of these new rules to rely on the commissioner's promise not to look too closely. In our view, the ruling renders this tax law untenable for large funds and legislators should immediately move to carve them out.

Shaun Cartoon is a tax partner at law firm Arnold Bloch Leibler

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