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SMSFs, unit trusts and NALI - some lessons for all

18 August 2023 by Matthew Burgess

A recent court decision provides further guidance about the operation of the NALI rules in relation to SMSFs investing via unit trusts.

A key planning issue for self managed superannuation funds (SMSFs) that have invested in a related unit trust is whether any income derived via the structure is in fact 'non-arm's length income' (NALI) under section 295-550 of the Tax Act (see extract at the end of this article).

Where income is NALI it is taxed at the top rate of tax.

One example of where income of an SMSF will be NALI is where the SMSF does not have a fixed entitlement in the trust.

Despite what is often assumed, the mere fact that a unit trust that an SMSF has invested in is not a 'fixed trust' will not of itself mean that the income is deemed to be NALI.

This is because 'fixed entitlement' when used in section 295-550 is not a defined term, unlike (for example) under the trust loss rules of the Tax Act.

The Tax Office is on record (for example see Taxation Ruling TR2006/7) as confirming that it will not deem NALI in relation to standard unit trusts, regardless of whether the structure meets the definition of what is a 'fixed entitlement' under the Tax Act for the trust loss rules.

In particular, the Tax Office has confirmed that for the purposes of the NALI rules, an SMSF will not be caught so long as its 'entitlement to the distribution does not depend upon the exercise of the trustee's, or any other person's, discretion.' Most 'standard' unit trusts will meet this test, even if they do not otherwise meet the strict definition of a fixed trust.

BPFN and Commissioner of Taxation

The decision in BPFN and Commissioner of Taxation (Taxation) [2023] AATA 2330 provides further guidance about the way in which the NALI rules operate for SMSFs investing via unit trusts.

Relevantly the factual matrix involved the following arrangements:

- (a) the SMSF was the sole unit holder of a unit trust (JJUT);
- (b) through a series of loan agreements JJUT lent money through two related entities; namely directly to ABC Pty Ltd
- (c) (ABC) who itself on lent to X Finance Pty Ltd as trustee for the DEF Trust (DEF), a discretionary trust;
- (d) the funds were then ultimately lent by DEF to independent third parties who undertook property development activities;
- (e) JJUT, ABC and DEF (that is all relevant parties to the loan agreements, other than the independent third parties) were essentially controlled by the same person, being a member of the SMSF;
- (f) the interest income derived by JJUT through the loan arrangements was distributed to the SMSF and treated by the fund as exempt current pension income.

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Following an audit, the Tax Office determined that the income was NALI.

In rejecting the Tax Office's conclusion that the income was NALI the court confirmed as follows:

1. Unlike other areas of tax legislation, section 296-550(5)(a) requires initially a consideration of whether the relevant parties were, or were not, dealing with each other at arm's length; and it was clear here they were not.
2. Therefore, the fact that the arrangements might be similar to what could be expected from dealings between parties acting at arm's length was irrelevant for determining whether the NALI regime might be applicable.
3. Given the relationship was one to which NALI may apply, the key test (under section 295-550(5)(b)) became a comparison between the income received and what income might have been derived if there had not been a lack of independence between the parties in dealing with each other in the actual scheme (that is, if the parties to the scheme had been dealing with each other at arm's length - see *Commissioner of Taxation v Glencore Investment Pty Ltd* [2020] FCAFC 187).
4. Relying heavily on the evidence of the accountant and lawyers who had advised the SMSF and valuers called by the SMSF during the proceedings, the court confirmed its view that JJUT did not in fact derive income that was 'more than the amount that the entity might have been expected to derive ... when dealing at arm's length'. In other words, the relevant interest income received by JJUT and in turn the SMSF was not NALI.
5. Furthermore, arguments by the Tax Office that the arrangements were not typical of a standard commercial lending structure (and therefore by implication could not be on an arm's length basis) were rejected.
6. Instead the court accepted the evidence of the advisers to the SMSF that the back to back lending arrangements were analogous with those which might be expected to operate between independent parties dealing independently with one another in the private lending market and that the advisers and all parties took particular care to ensure that each aspect of the structure was on arm's length terms.
7. In particular, the arrangements were structured both for longevity and associated benefits such as not having to redo a loan agreement on multiple occasions. The design of the back to back loans was intended to - and did in fact - limit each parties' loss to what they could have gained, such that a particular party in an on-lending chain was not unfairly disadvantaged or left 'holding the can' in the event of a failed investment down the line.

Conclusion

The decision provides a timely reminder for advisers and SMSF members of methodical and considered strategy development - complemented by valid and enforceable legal and accounting documentation that reflects the suggested objectives.

While undoubtedly an expensive lesson for the SMSF involved, the case (subject to any successful appeal, or 'revisionist history' Tax Office announcements) also serves as a reminder to the Tax Office that the application of the NALI regime has clear limitations.

Section 295-550(5)

For ease of reference, at the relevant time, section 295-550(5) was as follows:

"(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:
(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

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(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.”

