Navigating NALI with trusts and private company dividends

JULIE STEED - Wednesday, 12 October 2016   0 COMMENTS

While non-arm's length income in relation to limited recourse arrangements has received a great deal of attention recently, the other three income classes where NALI can apply are less understood.

Following the release of two interpretive decisions, ATO ID 2014/39 and ATO ID 2014/50, establishing the ATO's view that loans on non-commercial terms lead to NALI, practitioners have paid close attention to the LRBA aspects of NALI. This article, however, will look at some of the other income classes in the NALI definition that are not classified as income from non-arm's length transactions.

Non-arm's length income

As most practitioners are aware, the NALI provisions are an anti-avoidance measure designed to prevent income, that would otherwise be taxed at personal marginal tax rates, from being diverted to a super fund.

The non-arm's length component of taxable income is a super fund's NALI less allowable deductions. NALI is taxed at the top personal marginal tax rate (MTR) which is currently 47 per cent. NALI is excluded from exempt current pension income for assets that are supporting income streams.

Non-arm's length income definition

The definition of NALI is contained in section 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997) and involves four classes of income:

- Income from non-arm's length transactions;
- Private company dividends;
- Trust distributions where there is no fixed entitlement; and
- Trust distributions where there is a fixed entitlement.

Private company dividends

Dividends paid by private companies or income reasonably attributable to such dividends (for example, franking credits), are NALI, unless the amount is consistent with an arm's length dealing.

Definition of arm's length:

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

Accordingly, the definition of arm's length is very broad.

In considering whether a dividend amount is consistent with an arm's length dealing, it is necessary to have regard to:

- The value of shares in the company;
- The cost of the shares on which the dividend was paid that are held by the super fund;
- The rate of the dividend;
- Whether the company has paid a dividend on other shares and if so, the rate of that dividend;
- Whether the company has issued any shares to the super fund in satisfaction of all or part of a dividend and if so, the circumstances of the issue; and
- Any other relevant matters.

The rate of the dividend paid to the super fund will be compared to the rate paid to other shareholders. Different share classes offering different dividend rates will generally indicate non-arm's length dealings unless the rate reflects a different level of risk and is therefore consistent with arm's length dealings.

If the super fund receives shares in lieu of a dividend, the shares will not automatically be NALI. However, it is necessary to consider the individual circumstances. For example, shares which are issued to all shareholders on the same basis may be acceptable.

The 'any other relevant matters' is a catch-all provision, however, the following matters are likely to be relevant:

- The extent to which members who are at arm's length to the private company have an interest in the super fund;
- The relationship between the super fund and the private company;
- The relationship between the super fund and any party with which the private company has dealings;
- Who the super fund acquired the shares from and the circumstances of that acquisition; and
- The rate of return on the super fund's investment.

Trust income – no fixed entitlement

Income from a trust where the beneficiaries do not have a fixed entitlement to income is always NALI. If the trustee has discretion as to how income is to be distributed to beneficiaries, then there is no fixed entitlement. Accordingly, income from a discretionary family trust will always be NALI.

Trust income – fixed entitlement

Where the distribution of income from a trust to the beneficiaries is based on a fixed entitlement, the income will be NALI if:

- The income is derived from a scheme;
- The parties were not dealing on arm's length terms; and
- The income is more than the super fund would be expected to derive if the parties had been dealing at arm's length.

Case law

The Allen's Asphalt case considered whether an entitlement to trust income was a fixed entitlement. The super fund received a distribution of $2,500,005 in 2002-03 which was received as a result of being the sole beneficiary of a fixed trust. The fixed trust received the distribution from a hybrid trust which sold an asset and made a $2,500,005 capital gain.

The commissioner determined that the fixed trust was a scheme and the $2,500,005 distribution was derived from a discretionary trust and therefore NALI. Accordingly, the income was taxed at 47 per cent.

Assessment of non-arm's length income

The determination of income being NALI is a self-assessment process. If trustees are unsure, they may request a private binding ruling from the ATO.

Auditors will also review related party transactions and ensure any units or shares acquired have been acquired at market value. It is important for clients to keep records of such transactions that substantiate an arm's length arrangement. Such records may include copies of trust deeds of unit trusts. In addition to the trust deed specifying whether distributions are fixed or discretionary entitlements, it is essential that the trustee behaves in accordance with the terms of the trust deed.

Conclusion

As with all private investment arrangements, it is important to ensure that the investment provisions of relevant superannuation law are complied with. SMSF trustees must thoroughly review all income received from dividends from private companies and distributions from trusts to determine whether it should be treated as NALI.

Julie Steed, senior technical services manager, IOOF