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15 November 2019

Mr Kendrick Yim
Tax Council Network
Law Design and Practice Group
Australian Taxation Office

Online: Kendrick.Yim@ato.gov.au

Dear Mr Yim,

Draft Law Compliance Ruling LCR 2019/D3 and Draft Practical Compliance Guide PCG 2019/D6

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

CPA Australia has a number of concerns in relation to the implementation of this interpretation. These are summarised as follows:

- We believe that the line between individual capacity and trustee capacity has not been explored throughtly enough, and that such exploration should be exhaustive.
- We are concerned about the lack of a materiality threshold or *de minimis* statement in relation to assessments.
- There are likely to be extraordinary actions taken by trustees who are professionals in order to comply with the provision of basic services to themselves.
- The substantiation burden in the event of contesting an assessment is likely to be difficult.

Our submission is designed to provide insight into a number of areas which we believe require additional attention. These are provided in the attachment to this submission. However, we recommend that the drafts be revised and re-issued. Our recommendations are summarised on the first page of the attachment.

If you have any queries do not hesitate to contact Richard Webb, Policy Advisor Financial Planning & Superannuation at CPA Australia on richard.webb@cpaaustralia.com.au or 03 9606 9607.

Yours sincerely

Dr Gary Pflugrath CPA

Executive General Manager, Policy and Advocacy
CPA Australia

Recommendations

We make the following recommendations:

- The Australian Taxation Office (ATO) should prepare revised drafts of both Draft Law Compliance Ruling 2019/D3 (LCR 2019/D3) and Draft Practical Compliance Guide 2019/D6 (PCG 2019/D6), which should be subject to extensive consultation with stakeholders. Representatives from Treasury should be present, alongside representatives from the ATO, to hear stakeholder concerns.
- The revised version of LCR 2019/D3 should contain further examples to ensure that clarity exists in relation to services provided to funds that are subject to the non-arm's length income (NALI) provisions.
- The ATO should reconsider and amend the factors listed in paragraph 39 to ensure that circumstances involving trustees who are professionals providing services to their funds in their capacity as trustees are not inappropriately captured.
- Guidelines regarding materiality including a statement around whether a *de minimis* approach will be adopted and other low risk circumstances should be inserted in PCG 2019/D6.
- Guidance as to the Commissioner's approach to PCG 2019/D6 from 1 July 2020 should be inserted.
- A safe harbour for compliance should be inserted into PCG 2019/D6 as well as guidance for trustees on how to avoid inadvertent breaches of the trustee remuneration prohibitions contained in the *Superannuation Industry (Supervision) Act 1993* (SIS Act).
- Clearer details on documentation needed to substantiate self-managed superannuation fund (SMSF) records should be provided in PCG 2019/D6.

Our submission predominantly deals with the issues raised by the Draft Law Compliance Ruling 2019/D3 (LCR 2019/D3, the "Draft Ruling") in relation to the guidance on services provided to a complying superannuation fund by professionals in their capacity as trustees. It is our contention that the guidance in LCR 2019/D3 goes further than what was intended in law, and arguably creates a situation where it is impossible for a professional to demonstrate to the satisfaction of the Commissioner that services provided do not give rise to non-arm's length income.

We discuss the Draft Practical Compliance Guide 2019/D6 (PCG 2019/D6, the "Draft Guide") sporadically throughout.

The key issue in relation to the Draft Ruling is that trustees may have to satisfy an overwhelming burden of proof in order to disprove any non-arm's length income (NALI) assessments, once the ATO has made such an assessment.

By way of background, we refer to the requirements set out for taxpayers who believe that an assessment is either excessive or incorrect. Section 14ZZK of the *Taxation Administration Act 1953* (the TAA) explains that a taxpayer must firstly prove that an assessment was either excessive or incorrect, and once this has been done, must then show what the assessment should have been.

It is this issue with which we will concern ourselves in this submission: Examples provided in LCR 2019/D3 relate to situations where professional practitioners provide services to their own funds using their own expertise. However, the Draft Ruling treats these as falling conveniently into two categories, where one relates to services provided in a person's individual capacity, and where services are rendered in a trustee's capacity. The reality is not so clear cut.

The line between individual capacity and trustee capacity

Examples 2, 6 and 7 provide the clearest insight as to the line which is being drawn between services provided to the fund by trustees (or directors of corporate trustees) or entities associated with those trustees or directors. For clarity, this submission will assume that all directors referred to from this point onwards are directors of corporate trustees unless otherwise stated.

Paragraphs 36 to 42 of the Draft Ruling make it clear that the intention of the NALI measure is not to capture services provided by those trustees or directors if those services are performed in their trustee capacity, only if they are being provided in those individuals' individual capacity. However, despite what appears to be very clear and unqualified language in paragraph 40 regarding certain services required to provide trustee services to a superannuation fund, this delineation is not a clear one, and a number of questions are raised about the treatment of such services in LCR 2019/D3.

Paragraph 40 specifies certain services that an entity operating in a trustee's capacity may provide where the NALI provisions will not apply, namely bookkeeping or accounting services for no remuneration. Example 6 provides a situation where an accountant, Leonie, is administering her own fund and does not charge for the services or duties undertaken by her in relation to services provided by Leonie in her capacity as a trustee.

On the other hand, Example 2 discusses Mikasa's firm (where she is a partner) providing accounting services to the fund for no charge. It is not difficult to see the issue where the facts would indicate that the firm may not be operating at arm's length from the fund sufficiently enough for this to be considered an ordinary commercial transaction. Under the criteria given in paragraph 39, a similar example where the trustee (or director) of the fund also happens to be the partner of the firm responsible for services provided to the fund might also potentially consider that partner to have provided services in their individual capacity, as (paraphrased from the dot points in paragraph 39):

- The individual would normally charge for providing the services;
- Equipment or other assets of the firm may have been used in performing the services;
- The services may be performed subject to a licence required by that individual's normal practice or profession, and/or their qualification; and
- Insurance covering the firm for services rendered may also be covering this work.

This situation is nearly identical to the situation in example 7, where Sharon, who is a licensed real estate agent is personally involved in the property management services being provided to the fund for which she is the trustee. Although Sharon is charging the fund half of what she would ordinarily charge, the remaining circumstances appear to be the same. However the similarity ends when one considers the wording of paragraph 40, which, devoid of any additional context, would suggest that special consideration comes into effect whenever accounting or bookkeeping services are the object of the situation.

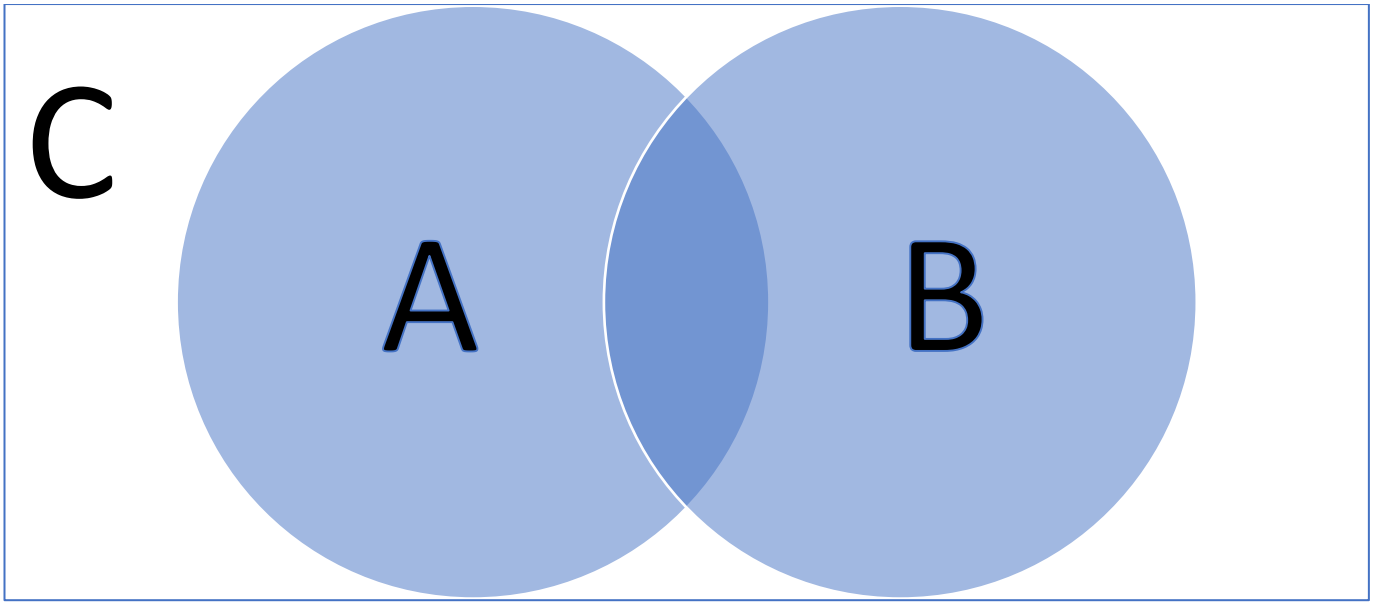
We suggest that this must be clarified: To what extent does the provision of accounting or bookkeeping services by a trustee (or director) shield them from the effects of the Draft Ruling? Or are such services not intended to be captured at all? And why would a similarly required service for a fund such as property management services not be eligible for such special consideration?

Additionally, what actually is outsourcing, for the purposes of the final sentence of paragraph 41, where if a trustee who is an accountant by profession outsources the bookkeeping or accounting services to their accounting firm, which charges non-arm's length rates?

LCR 2019/D3 suggests that activities – accounting/bookkeeping or other activities as appropriate – which are provided, can only be provided in either the capacity of an entity performing these duties as a trustee (or a director) or by an entity performing these duties in their individual capacity. Paragraphs 37 and 38 quite specifically refuse to entertain the possibility that a trustee (or director) can be operating in both capacities. This strict dichotomy is not correct in all circumstances.

For example, in the total set of activities C that can be provided to a superannuation fund by a trustee (or director), some of these will be in subset A which are activities which can be performed by an individual in their capacity as a trustee (or director) and some will fall into subset B which can be performed in their individual capacity.

Subset A might be considered activities that are necessary to the ordinary day to day function of the fund, whereas subset B may be services rendered by professionals to a complying superannuation fund for a variety of purposes, some of which may be considered optional. The total set of activities C which can be provided to a trustee of a complying superannuation fund can be illustrated by the following diagram.



Where the subset A of activities that are necessary to be provided to the fund by trustees is given by:

$$A \in C$$

And the subset B of activities which can be performed by a trustee in an individual capacity is given by:

$$B \in C$$

Given that a number of services that can be provided would fall into the overlap between subsets A and B, there can be no doubt that the service which will not give rise to NALI can be summarised as:

$$A - (A \cap B)$$

This reveals an enormous grey area in between examples 2 and 6, with a number of key considerations which practitioners might need to consider if they are to undertake services for the funds of which they are trustees (or directors). To put this another way, the overlap between subsets A and B (the "grey area" referred to previously) is only partly explored in this Draft Ruling, and we believe this needs to be rectified. The wording of paragraphs 37 and 38 would appear to contend that example 7 – or example 2 in circumstances where Mikasa was the responsible partner – would fall into the grey area.

We are not entirely clear what additional information the ATO needs to understand when a service which is being rendered both in an individual capacity and in the capacity as a trustee (or director) of a fund, and believe that the catch-all of "include" contained at paragraph 39 of LCR 2019/D3 is not sufficient to assist practitioners to understand where the ATO is likely to assess an activity as incurring NALI.

To underline the uncertainty which exists, consider the following examples:

Example A:

Ana Lucia is a stockbroker who owns and operates a small firm. The firm allows staff to enter trades for themselves or related party accounts on a special terminal during working hours and provides a staff discount of 50% on normal brokerage incurred. Ana Lucia takes advantage of this staff benefit to conduct trades on behalf of a fund for which she is the trustee, and the fund is accordingly invoiced for the discounted trades.

Ana Lucia's fund's trust deed has an investment strategy which requires listed equities to be held by the fund.

Example B:

Bernard is an accountant who has recently started up his own practice. At this stage, he works from home, using his own home computer. As he is in the initial stages of the practice, Bernard's work is sporadic, mostly consists of tax work, and can take place at unusual times. Bernard takes advantage of some of his downtime to complete the tax returns on behalf of the fund for which he is a director.

Bernard does not charge the fund for completing the tax returns, which he lodges through the mail rather than using his tax agent registration.

Example C:

Charlotte is a partner with a law firm located in the city where she specialises in conveyancing. Charlotte's SMSF is presently in the process of selling a property, and in her lunch break, she prepares sale documents for which her firm does not charge the fund.

The sale takes place and the documents that Charlotte has prepared are used.

Example D:

Desmond is a financial planner who is able to access a special wrap service solely due to his occupation as a financial planner. The wrap service is unable to charge advice fees and charges reduced administration fees. Desmond is allowed to use the service to administer the SMSF for which he is the joint trustee, together with his partner Penelope. Desmond is a representative for a licensee which only allows execution-only transactions involving wrap services under extremely limited circumstances, as they would normally provide personal advice in the form of a Statement of Advice to any of their clients using a wrap service to administer their funds.

Desmond accesses the wrap for his fund on an execution-only basis and provides neither a Statement of Advice, nor charges the fund the licensee's normal advice fee.

Example E:

Eko, a chartered financial analyst, is provided with an iPad and an accompanying Bluetooth keyboard as part of his job as an asset consultant specialising in small to medium wealth management firms. Eko uses his iPad to model portfolio risk using a combination of sophisticated risk-modelling tools and Excel spreadsheets. The consultant for whom Eko works provides their services on a fee for service basis.

Eko does not like onscreen keyboards and occasionally takes his Bluetooth keyboard home where he uses his own iPad to undertake portfolio risk modelling for the purposes of an SMSF for which he is a director. Eko's fund's investment strategy requires a reasonably strict approach to risk to be maintained.

Example F:

For a number of years Franca was a representative at a financial planning firm which worked under a licensee which was responsible for a number of different firms. The licensee provided all representatives and their eligible spouses with a staff superannuation fund which owned an attractive group life policy offering death, total and permanent disability and income protection. The group cover was well priced compared to the market and eligible for high levels of automatically accepted cover. When Franca suggested to her husband Sayyid, a bricklayer, that he might also like to take advantage of this, he joined Franca's fund as an eligible spouse.

When Franca left the firm, she and Sayyid were informed that under the terms of the continuation option for the policy, a feature unique to this staff superannuation fund allowed her and her husband to continue their cover under

a new policy owned by them as trustees for their SMSF, with cover continuing to be provided by their insurer at the same discounted terms. Franca, who has been recently diagnosed with cancer, and Sayyid, who might potentially be uninsurable as a blue-collar worker, took advantage of the option and the new policy was put in place.

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In the above examples, we have the combined issues where the features of each transaction when assessed against the criteria in paragraph 39 of LCR 2019/D3 are likely to result in the fund being assessed as having incurred NALI. Yet in all cases, there are problems in capturing these for a number of reasons, mostly being that they do not readily slot into any of the neat categories discussed in the Draft Ruling. We agree that the intention of LCR 2019/D3 is to capture professional services being rendered in such a way as to avoid ordinary commercial circumstances[1]. However, none of the examples above are ordinary commercial circumstances, and all involve transactions necessary for executing day to day operations for which the trustees (or directors) would be responsible.

We recommend that the list of factors in paragraph 39 be amended to ensure that these examples are properly targeted.

Materiality

We note that there is no part of the Draft Ruling, nor PCG 2019/D6, dedicated to materiality. How close to the arm's length rate for a service is deemed to be enough? If the situation involving Franca above was only a discount of $5 per annum in relation to her insurance premium, would this be acceptable to the Commissioner, or would the discount need to be substantial?

We recommend that guidelines regarding materiality and whether a *de minimis* approach is to be adopted, be inserted into PCG 2019/D6.

Compliance

PCG 2019/D6 is only in place until 30 June 2020, and it is not clear what is likely to follow from this, if anything. If PCG 2019/D6 is sunsetted without replacement at that date, one might expect that the ATO could take a severe approach to assessments.

We note later in this submission that false positives giving rise to incorrect assessments will be close to impossible to address by affected trustees. Given this, we would recommend that PCG 2019/D6 contain guidance as to the Commissioner's approach after this date. We also strongly recommend that a safe harbour be specified to ensure that extraordinary actions are not required in relation to ordinary compliance.

"Extraordinary actions" is not a term which we use lightly. For example, some of the measures which would need to be taken in the examples cited above in order to ensure compliance, include:

- In Example A , Ana Lucia may be prevented from utilising the discount available to staff for making trades, as this may result in NALI being assessed in relation to the assets traded. However, this may require additional processes to be created for staff of the stockbroker to conduct trades, simply to satisfy the rules in relation to their SMSF. Regardless of whether the trades need to be conducted manually because the handful of trades does not justify building new automated processes, or whether the existing process can be modified, this will present costs to the stockbroking business. Is it appropriate that the stockbroking business should foot the bill for a cost attributable to employees' superannuation fund tax compliance?

[1] See paragraph 2.6, Explanatory Memorandum to the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

- In Bernard's case, it is unclear whether he can comply at all, since he may be unable to demonstrate a disconnect between his trustee work and his new practice. Is avoiding use of his tax agent registration enough, or should he also have gone to the extent of using his wife Rose's computer to avoid any possible confusion? Should Bernard be required to get another tax agent just to ensure compliance? And if so, would this be a first time that a taxpayer is required to incur fees from another taxpayer in order to comply with the law?

The other examples are no less extreme, and in some cases wasteful and inefficient. We can summarise these with the following questions:

- Should Charlotte be billing her own fund for her own expertise using work that was completed during her own unpaid breaks?
- Should Desmond be made to use a retail version of the wrap service to administer his fund, compile a Statement of Advice for himself and charge his fund for this?
- Does Eko really need to buy a second Bluetooth keyboard in order to undertake risk modelling on his own fund's asset portfolio in his spare time?
- Is it necessary that Franca and Sayyid decline what would now be vitally important insurance and risk underinsurance by refusing the continuation option?

We have concerns that where a trustee bills the fund in attempting to comply with the ruling, they will set themselves up for failure to comply with the prohibitions on trustees remuneration as specified by the *Superannuation Industry (Supervision) Act 1993.* There must be guidance on how to comply with this requirement as part of this, and we recommend that this be inserted into PCG 2019/D6.

However, compliance is only part of the issue. Substantiation is required to address issues associated with incorrect and excessive assessments.

Substantiation

Earlier, we noted the level of evidence needed to satisfy the legal obligations necessary to contest an incorrect or excessive assessment. The actions to be taken to substantiate claims could be themselves excessive.

We saw in Example 6 of the Draft Ruling a situation where Leonie does not use the assets of her employer, nor does she lodge her return using her tax agent registration. Paragraph 37 of the Draft Ruling concludes that whether Leonie is performing these duties in her capacity as a trustee is fact dependent and requires an objective consideration of the circumstances in her case.

In Bernard's case from example B, however, the fact that he is now a self-employed sole practitioner working from home raises complications which Leonie does not have. If Bernard was assessed as having provided tax agent services to his fund in an individual capacity, what records would he need to contest this? In Leonie's case, what if there was an assessment made in error that she had undertaken her work in her accounting business during ordinary working hours? How would she demonstrate that she had been incorrectly assessed?

Demonstrating that she had worked from home may appear to support Leonie's case. What records would support this?

- Documents stored on Leonie's home computer may support this claim, but what if they were built on templates that show as having been created using a computer in her office?
- Work undertaken on her computer may show up in the computer's logs. But what if Leonie undertakes basic recommended hygiene on her personal computer such as reinstalling the operating system once every six to 12 months?
- How does Leonie retain these records?

- How much work needs to be done and where?

For Bernard, would appropriate document retention extend to requiring him to partition his home computer, or run a virtual machine to ensure that the records needed to contest an assessment were retained? Is it reasonable for Bernard to be required to purchase duplicate software licences to substantiate that he has acted in his capacity as a trustee rather than dealing with himself on a non-arm's length basis? And if Bernard needed to use Rose's computer instead, does this not now mean that her computer records and logs also have to be retained.

The ordinary compliance paperwork for an SMSF may have once been to retain receipts, financial statements and tax returns and have properly completed set-up documentation including trust deeds and investment strategies retained on file. However, we now appear to have a requirement that home computer files and backups be retained, even from a third party's computer.

More broadly, if we look at the other examples, other questions need to be addressed:

- If it is acceptable for Charlotte to use the equipment at her disposal during her lunch break, how does she establish that this was, indeed, her lunch break? What if her lunch break is not at the same time every day? Does she need to retain copies of her work Outlook diary? How do acts such as accidentally hitting save on a word file at 3 PM in the afternoon not be used against her fund?
- How can Desmond, a qualified financial planner, demonstrate to the satisfaction of the Commissioner that he doesn't need to advise himself as a trustee prior to entering into a new wrap service?
- If Eko chose not to take the Bluetooth keyboard home that he has been provided with, do tablets retain records showing whether the onscreen keyboard was used?

The details above however only address what is needed to ensure that the first limb of the requirements under section 14ZZB of the TAA are addressed. The other limb requires taxpayers to demonstrate how much the correct assessment should have been. This is problematic. For example, for such a rare feature as a continuation option allowing Franca's SMSF to extend this into a new policy, how would Franca be able to demonstrate the normal arm's length rate?

We believe that this detail needs to be made clearer in PCG 2019/D6. We further recommend that the number of examples contained in LCR 2019/D3 be extended to ensure that all doubt regarding substantiating transactions involving assets or other matters involving the fund is exhausted.

Other comments

CPA Australia has a number of other comments in relation to the drafts and outline the folllowing areas where better explanation needs to be provided:

- The nexus between expenses and income for the purposes of NALI appears to be overly simplistic in parts, and conceivably renders income assessable as NALI in more than one period, not only the period in which the expense was (or was likely) incurred. This would be considered by most to be not only severe, but also raises questions about when the nexus becomes too remote.
- The materiality of the non-arm's length expenditure where this may have a nexus to the fund's entire assessable income, compared to if the expenditure only has a narrow nexus to one item.
- That any discussion of the capacity in which trustee duties are performed would be helpful if similar requirements in the SIS Act were described.
- Comments relating to capital gains throughout the LCR relate to capital gains forming part of NALI, when in practice, only the net capital gains form part of ordinary and statutory income. Consideration should be given to amend this section.

References

Explanatory Memorandum to the *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019* (Cth).

Superannuation Industry (Supervision) Act 1003 (Cth).

Taxation Administration Act 1953 (Cth).