27 February 2023

Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Via email: superannuation@treasury.gov.au

To Whom It May Concern,

Non-arm's length expense rules for superannuation funds

The Financial Services Council (**FSC**) welcomes the opportunity to make a submission in response to the Treasury consultation on the non-arms' length expenditure (**NALE**) rules for superannuation funds.

The FSC supports reform to these rules as the NALE rules currently apply disproportionate penalties to minor errors in relation to fund expenditure.

About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, and financial advice licensees.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pools of managed funds in the world.

General comments

The FSC supports changes to the NALE rules to reduce compliance costs on the industry and the potential for punitive penalties. An ATO ruling in 2021 (LCR 2021/2)[1] identified that the existing NALE rules can result in a disproportionate impact on funds, in particular stating:[2]

> *…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.*

Similarly, the Treasury discussion paper notes feedback from the superannuation industry that the existing NALE rules result in "disproportionately severe outcomes for breaches of these rules" (page 4).

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[1] See: https://www.ato.gov.au/law/view/document?DocID=%22COG%2FLCR20212%2FNAT%2FATO%2F00001%22&PiT=99991231235958

[2] See LCR 2021/2 at paragraph 92.

The FSC supports these concerns and agrees with the Treasury paper that any changes to the rules should maintain integrity, provide more certainty for funds, ensure that consequences of breaches are proportionate, and ensure the rules are appropriately focussed (page 4).

However, the FSC considers that arrangements which funds enter into on non-commercial terms are exactly the sort of mischief the law is seeking to prevent.

Your Future Your Super (YFYS) performance testing

Where an APRA-regulated fund pays below arms' length prices to a related party for expenses such as IT, marketing, custody, or general administration, this will obscure the true cost of servicing the fund and the consequent fees charged to fund members (note arms' length prices can legitimately include discounts that are consistent with normal commercial practices, as the ATO acknowledges[3]).

In short, a fund taking this approach will cut measured fees without (noticeably) affecting net performance. The FSC submits this is outcome is not good for consumers.

Further, the level of administration fees charged is consequential to passing the YFYS performance test, which uses administration fees in the current year to determine net investment performance over eight years.

FSC response to proposals

Given the above, in the absence of other YFYS safeguards, the FSC does not agree with Treasury's proposal to provide a full exemption for APRA-regulated funds from the NALE from applying to general expenditure.

Nevertheless, the current NALE rules are very punitive and the FSC submits they require reform. The FSC submits that the NALE rules be amended to reduce exposure to potential penalties and ensure the costs of complying with the rules are low. The FSC considers these changes should apply consistently to all types of expenses for large APRA funds.

The FSC submits there are several specific proposals that should be considered, including:

- Applying a penalty that is proportionate to the extent of any undercharging of expenses. This is similar to the proposal in the Treasury discussion paper – although the FSC submits it is likely that applying a penalty that is five times the extent of undercharging is unlikely to be proportionate.
- Taking a similar approach to other anti-avoidance provisions where the penalty relates to culpability – so that inadvertent errors have minimal penalty (for example the approach currently applying in Part IVA).
- The assessment of compliance with the NALE rules to be verified by the fund's auditors rather than through ATO compliance activities, noting that this approach would see auditors apply a materiality threshold.

As noted above, the FSC considers that any change to the NALE rules for APRA funds should apply equally to general and specific expenses. The punitive approach under the existing rules should not continue to apply to specific expenses only. It does not appear to be reasonable to apply a punitive approach to one type of expense while providing a complete exemption to another type of expense.

The FSC also notes that a consistent treatment of general and specific expenses will ensure that there will be no incentive to convert specific expenses into general expenses to avoid the NALE rules.

By contrast, if general and specific expenses are treated very differently, as is currently proposed, then this will create significant (and unnecessary) pressure on the definition of general and specific expenses. For example, a fund could receive tax or accounting advice that relates to many of the fund's operations, with considerable grey area about which parts of the advice relate to a specific asset or the overall operation of the fund. In some situations, advice on operation of the 45 day rule

[3] See LCR 2021/2 at paragraph 51.

for franking credits could arguably relate to specific assets or to the general operation of the fund. Similar problems could exist with custody fees.

Conclusion

If you would like to discuss this submission or have any questions, please contact Michael Potter on mpotter@fsc.org.au

Yours sincerely,

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