Super fund expense deductibility: will anything change?
The application of the general deductibility provision will involve determining the extent to which a loss or outgoing was incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for the purpose of producing assessable income. Generally, but not always, the second limb (in relation to carrying on a business) will be less relevant to SMSF-related expenditure.

An expense that relates solely to gaining or producing assessable income will be fully deductible unless one of the exclusions in s 8-1(2) or a specific exclusion elsewhere in ITAA97 or ITAA36 applies. Alternatively, an expense that relates partly to gaining or producing assessable income is deductible only to the extent that it is incurred in gaining or producing assessable income (see paragraph 8 of the Draft Ruling). Such an expense will need to be apportioned into deductible and non-deductible components.

It follows that identifying those expenses which relate wholly or partly to gaining or producing assessable income is crucial – this requires an understanding of what comprises assessable income as the first step.

WHAT IS THE ASSESSABLE INCOME OF A SUPER FUND?

The determination of assessable income is similar for individuals and superannuation funds, but there are some variations between the two. The assessable income of a taxpayer (individual or superannuation fund) includes ordinary income and statutory income. Ordinary income includes receipts such as interest on deposits, rental payments, etc.

Statutory income may include franking credits, capital gains and, in the case of a complying superannuation fund, certain superannuation contributions.

However, for the purposes of determining the deductibility of expenses only, section 295-95 of ITAA97 specifically includes all superannuation contributions, including those which are not otherwise assessable income of the fund.

As a result, the costs associated with non-concessional contributions (NCCs) and rollover superannuation benefits (other than rollovers within the fund) may be deductible under s 8-1(1). The inclusion of all superannuation contributions in assessable income may also impact on the apportionment of expenses for deductibility purposes – which is the subject of the Draft Ruling.

BASIC PRINCIPLES OF DEDUCTIBILITY

The process of determining the tax deductibility of an expense is largely the same for individual taxpayers and superannuation funds. To be deductible, an expense must fall under either a specific provision of Income Tax Assessment Act 1997 (ITAA97) or the Income Tax Assessment Act 1936 (ITAA36), or the general deductibility provision (ITAA97 s 8-1).

Although specific deductibility is generally beyond the scope of this article, in the SMSF context some examples of specific deductions which may apply include:

- tax-related expenses (ITAA97 s 25-5)
- certain insurance premiums associated with life and disability insurance (ITAA97 s 295-465)
- cost of constructing capital works (ITAA97 Div 43) – in some cases may be relevant to SMSF property investments.

If a specific deductibility provision does not apply, then SMSF trustees should next consider the application of the general deductibility provision.

APPLYING THE GENERAL DEDUCTIBILITY PROVISION

The general deductibility provision allows a deduction for all losses and outgoings to the extent to which they are:

1. incurred in gaining or producing assessable income or
2. necessarily incurred in carrying on a business for the purpose of producing such income.

Sub-section 8-1(2) excludes expense items that are:

- capital or capital in nature
- of a private or domestic nature
- incurred in gaining or producing exempt or non-assessable non-exempt income or
- otherwise precluded from deductibility by ITAA36 or ITAA97.
SMSF trustees should bear in mind that the Draft Ruling is in draft form only and cannot be relied upon, and even if finalised in its current form, is not proposed to apply until 1 July 2014. However, there is an existing taxation ruling which may provide a useful authority for many of the issues raised in the Draft Ruling – see discussion below under Date of effect on page 35.

### TABLE 1: CATEGORIES OF EXPENSES (IN RELATION TO ITAA97 S 8-1(1) DEDUCTIONS)*

<table>
<thead>
<tr>
<th>Expense type</th>
<th>Description</th>
<th>SMSF example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-deductible</td>
<td>The expense is capital in nature, does not relate in any way to the gaining or producing of assessable income, is private or domestic in nature or is subject to a specific exclusion</td>
<td>The costs of trust deed amendments are generally non-deductible, except in certain circumstances.</td>
</tr>
<tr>
<td>100% deductible</td>
<td>The expense is solely related to the gaining or producing of assessable income</td>
<td>An SMSF trustee incurs an interest expense in relation to a limited recourse borrowing arrangement used by the fund to acquire an income producing commercial property.</td>
</tr>
<tr>
<td>Partially deductible</td>
<td>Distinct and severable expenses: A single outlay of which a distinct and severable part is devoted to the gaining or producing of assessable income</td>
<td>A custodian fee of $2,000 of which $1,500 is in respect of segregated current pension assets, and $500 relates to assets which produce assessable income (see para 14-16 of the Draft Ruling).</td>
</tr>
<tr>
<td>Indifferent expenses</td>
<td>An outlay in relation to a thing or service which serves the purpose of gaining or producing assessable income and other non-deductible purposes, where it is not possible to directly determine how much of the expense relates to deductible and non-deductible purposes</td>
<td>Fees for advice concerning the making of several resolutions by the trustees about the ongoing maintenance of the fund (see para 17-21 of the Draft Ruling).</td>
</tr>
</tbody>
</table>

* It is assumed no costs are necessarily incurred in carrying on a business.

Draft Ruling for the apportionment of indifferent expenses, it is open to SMSF trustees to choose from a variety of possible apportioning methods.

However, the Draft Ruling refers to case law (Ronpibon Tin (1949) 78 CLR 47) in suggesting that an overriding fair and reasonableness test applies – that is, the apportionment method must involve a fair and reasonable assessment of the extent to which an expense relates to the gaining or producing of assessable income. A possible apportionment method (referred to here as the ‘asset ratio method’) is by direct relation to the amount of assets in accumulation phase and in pension phase. If 60 per cent of the fund’s assets are held in relation to the members’ accumulation account interests, and 40 per cent to pension phase assets, then the trustee might argue that 60 per cent of an indifferent expense, such as the fund’s auditing fee, is deductible.

The Draft Ruling illustrates another apportionment method, based on the income of the fund (that is, the ‘income ratio method’).

**WHERE:** Deduction = \[
\text{Indifferent expense} \times \frac{\text{Assessable income}}{\text{Total income}}
\]

**Assessable income** is the fund’s assessable income for the year in which the expense is incurred.

**Total income** is the fund’s assessable income and non-assessable income for the year in which the expense is incurred.
An SMSF has the following income and contributions in a particular income year:

- Exempt current pension income: $100,000
- Assessable investment income: $90,000
- Assessable contributions: $10,000
- Total income: $200,000

The fund incurred an expense of $200 for advice relating to various trustee resolutions, which is an indifferent expense.

Using the income ratio method to apportion the expense, the trustee determines that $100 is deductible:

\[
\text{Deduction} = \text{Indifferent expense} \times \frac{\text{Assessable income}}{\text{Total income}}
\]

\[
= \frac{200}{200,000} \times \frac{90,000 + 10,000}{200,000} = \frac{100}{200,000} \times \frac{100,000}{200,000} = 100
\]

Note that the Draft Ruling indicates that section 295-95 of ITAA97 effectively modifies the income ratio method formula, as follows:

\[
\text{Deduction} = \text{Indifferent expense} \times \frac{\text{Assessable income} + \text{non-assessable contributions}}{\text{Total income} + \text{non-assessable contributions}}
\]

WHERE: Non-assessable contributions includes non-concessional contributions and rollovers.

Suppose now that the SMSF in the example above also accepted a non-concessional contribution of $50,000 in the same income year. The impact of that contribution on the apportionment calculation is as follows:

\[
\text{Deduction} = \text{Indifferent expense} \times \frac{\text{Assessable income} + \text{non-assessable contributions}}{\text{Total income} + \text{non-assessable contributions}}
\]

\[
= \frac{200}{200,000} \times \frac{(90,000 + 10,000) + 50,000}{200,000 + 50,000} = \frac{120}{250,000} \times \frac{150,000}{250,000} = 120
\]

It is clear that the inclusion of non-assessable contributions in the income ratio formula will generally increase the amount of deduction claimed under the income ratio method.
IMPACT OF THE ‘FAIR AND REASONABLE’ TEST

Although the trustee may choose the method of apportionment, the method employed must result in a ‘fair and reasonable assessment of the extent of the relation of the outlay to assessable income’.¹

The Draft Ruling provides an example where a straight-forward application of the income ratio formula produces a result which is considered to be not fair and reasonable in the circumstances.

EXAMPLE

A public offer superannuation fund incurs $2 million of expenses relating to a telephone enquiry service to members and prospective members. As there is no way to determine the distinct and severable components of the expense, it is treated as an indifferent expense.

Year 1 – the fund derives the following amounts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessable contributions</td>
<td>$39.5m</td>
</tr>
<tr>
<td>Non-assessable personal contributions</td>
<td>$0.5m</td>
</tr>
<tr>
<td>Assessable investment income</td>
<td>$40.0m</td>
</tr>
<tr>
<td>Exempt current pension income</td>
<td>$20.0m</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td><strong>$100.0m</strong></td>
</tr>
</tbody>
</table>

The fund uses the income ratio method to calculate the level of deduction in relation to the telephone enquiry service expense:

\[
\text{Deduction} = \frac{\text{Indifferent expense}}{\text{Total income} + \text{Non-assessable contributions}} \times \frac{\text{Assessable income} + \text{Non-assessable contributions}}{\text{Total income} + \text{Non-assessable contributions}}
\]

\[
= \frac{\$2m}{\$100.0m + \$0.5m} \times \frac{\$39.5m + \$40.0m + \$20.0m}{\$100.0m + \$0.5m}
\]

\[
= \frac{\$2m}{\$100.0m} \times \frac{\$80.0m}{\$100.0m}
\]

\[
= \$1.6m \text{ (this result is suggested as ‘fair and reasonable’ in the Draft Ruling)}
\]

Year 2 – the fund derives the following amounts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessable contributions</td>
<td>$40.4m</td>
</tr>
<tr>
<td>Non-assessable personal contributions</td>
<td>$0.6m</td>
</tr>
<tr>
<td>Assessable investment income</td>
<td>$42.0m</td>
</tr>
<tr>
<td>Exempt current pension income</td>
<td>$22.0m</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td><strong>$105.0m</strong></td>
</tr>
</tbody>
</table>

¹Ronjaban Tin (1949) 78 CLR 47, 59.
In addition the fund receives a $395 million rollover in year 2, as a result of a merger with another fund. Its telephone enquiry service expenses rise to $2.1 million. As a rollover is considered to be a contribution (see ATO Taxation Ruling TR 2010/1), its inclusion in the income ratio formula calculation has the following result:

\[
\text{Deduction} = \text{Indifferent expense} \times \frac{\text{Assessable income + non-assessable contributions}}{\text{Total income + non-assessable contributions}}
\]

\[
= \frac{2.1 \text{m}}{($40.4\text{m} + $42.0\text{m}) + ($0.6\text{m} + $395.0\text{m})}
\]

\[
= \frac{2.1 \text{m}}{478.0\text{m}}
\]

\[
= 2.0076\text{m}
\]

The Draft Ruling states that the inclusion of the $395 million in the calculation leads to a result which is not fair and reasonable. The level of deductibility of the telephone enquiry service expense has jumped from 80 per cent in year 1 to 95.6 per cent in year 2.

The Draft Ruling suggests excluding the ‘extraordinary’ amount of $395 million from the calculation, which will better align the level of deduction (79 per cent) in year 2 with the year 1 result (80 per cent). A deduction of $1.66 million would result in year 2.

**APPLICATION TO SMSFs**

The proposition of excluding an extraordinary amount from the income ratio method calculation because it potentially leads to a result which is not fair and reasonable introduces some uncertainty for SMSF trustees. Issues for SMSF trustees to consider include:

- **How ‘extraordinary’ does an item need to be for it to be excluded?** Generally what is and is not extraordinary is a subjective judgement, and different SMSF trustees may draw different conclusions in essentially the same circumstances.

- **ATO Interpretative Decision ID 2012/47** (published on 25 May 2012) involved several rollover superannuation benefits which the Commissioner of Taxation accepted should be included in assessable income for the purposes of determining the apportionment of s 8-1 deductions.

- **More specifically,** should large non-concessional contributions (NCCs) be treated as extraordinary amounts and excluded from the calculation?

  The two-year bring forward provision arguably encourages larger and less frequent NCCs than would otherwise be the case. But for the two-year bring forward structure, SMSF members may make smaller NCCs (up to $150,000) more regularly (at least annually). It would seem incongruous that a policy to encourage larger and less frequent contributions should be detrimental to the tax position of a fund.

  Further guidance from the ATO on this issue would be helpful. Meanwhile SMSF trustees should seek specific tax advice in regard to their particular circumstances, and the possible application of the income ratio method.

**DATE OF EFFECT**

The Draft Ruling is proposed to be effective from 1 July 2014. However, the existing Taxation Ruling TR 93/17 (originally effective from June 1993) covers many of the same issues that are covered by the Draft Ruling. For example, TR 93/17 explains the difference between ‘distinct and severable’ and ‘indifferent’ expenses, the need for apportionment and the inclusion of all superannuation contributions in assessable income for the purposes of determining expense deductibility.

So it’s not entirely clear what the Draft Ruling introduces that is not already present in the 1993 ruling. Based on TR 93/17, it is arguably open to SMSF trustees to use the income ratio method in income years prior to 1 July 2014, and the calculation could include all superannuation contributions received by the fund, as long as the result is fair and reasonable in the circumstances.
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