18 October 2023

Director
Superannuation Tax Unit
Retirement, Advice and Investment Division
Treasury
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Email: superannuation@treasury.gov.au

Dear Sir/Madam,

SMSF ASSOCIATION SUBMISSION – TREASURY LAWS AMENDMENT (BETTER TARGETED SUPERANNUATION CONCESSIONS) BILL 2023

The SMSF Association welcomes the opportunity to provide this submission in response to the Government's exposure draft legislation on the Better Targeted Superannuation Concession.

We would like to express our concerns on the short consultation period afforded to this exposure draft legislation. The changes proposed are significant, complex and in need of careful, detailed review. Further, elements of the proposed measures are heavily reliant upon regulations. Those regulations have not been made available as part of this consultation. This affects our ability to properly consider all aspects of these proposed measures.

The proposed measures will add further complexity, red tape, cost, and unintended outcomes to what is an already complex superannuation legislative framework. What is proposed is counter to both horizontal and vertical tax equity principles.

When Government first began positing the idea and need for these measures, reference was made to the relatively small number of individuals, with total superannuation balances exceeding $50 million and $100 million. We agree that balances of this size are outside of the original policy intent but are an unintended consequence of historical policy settings. It should be noted that these individuals complied with the law as it stood at that time and invested in good faith, as encouraged by previous Governments.

These are legacy issues that will be addressed over time through existing policy settings.

It must also be recognised that the ability to build significant wealth of this kind within the superannuation system is no longer possible. Strict limitations such as the contribution rules and caps operate to control the amounts that can be moved into the superannuation system.

Despite the original stated objective of this policy, being the targeting of those with substantial wealth inside superannuation, we note that the proposed threshold has been struck at a considerably lower level. The shift from $100 million to $3 million, and a measure of earnings that captures unrealised capital gains, utterly reframes the policy position, from one that targets ultra-high net wealth individuals, to one that starts to capture elements of middle Australia, small business owners and farmers. It has very different policy intentions and outcomes.

The lack of indexation of the threshold will over time, because of inflation and increasing wages (and therefore increased compulsory superannuation guarantee payments), see this measure impact many more ordinary Australians.

The policy does not consider a person's home ownership status, the combined balances of a couple or the level of wealth held outside of superannuation. It will impact many small business owners and farmers who have invested in their businesses through property acquisitions. Of deep concern is that despite being raised previously, the measure will impact some who suffer a total and permanent disability event.

The role that superannuation savings play in providing security in retirement should not be overlooked. It is a fiscal and resourcing benefit to Government where individuals are more self-reliant, self-managing and funding their individual care and accommodation needs.

Several concerns and unintended consequences were identified and raised with Treasury in our submission in response to the consultation paper earlier this year. We thank Treasury for the proposed modification with regards to limited recourse borrowing arrangements. However, these amendments do not go far enough, and significant concerns remain. In particular, the inclusion of unrealised gains in the measurement of earnings will impose financial stress on a meaningful number of SMSF members.

Recent studies show a substantial number of SMSFs that will be affected by this tax change hold property and, given many will be small business operators and farmers who hold their premises and land in an SMSF, it is not difficult to see how disruptive this new measure will be not only for the SMSF sector but for small business operators and the broader community.

An alternative measurement of earnings which reduces uncertainty and the severity of including unrealised capital gains, is needed as a matter of priority. We therefore strongly encourage Government to cease the progress of the proposed amendments and instead continue to engage with stakeholders and industry to ensure that the resulting policy and legislation delivers the right outcomes, which are fair and equitable.

Please refer to the Addenda to this submission for further details on the issues and unintended consequences arising from this proposed measure, including our proposed simplified measurement of earnings.

We welcome the opportunity to further consult and work with Treasury and Government on this draft Bill. If you have any questions about our submission, please do not hesitate to contact us.

We thank you again for the opportunity to provide this submission.

Yours sincerely,

Peter Burgess
Chief Executive Officer

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing the self-managed superannuation fund (SMSF) sector which is comprised of over 1.1 million SMSF members and a diverse range of financial professionals. The SMSF Association continues to build integrity through professional and education standards for practitioners who service the SMSF sector. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial advisers, tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them with access to independent education materials to assist them in the running of their SMSF.

Addendum A – Better Targeted Superannuation Concessions

Liability for tax

Child Recipients

We support the exception to the liability for tax outlined in proposed subsection 296-20 (child recipients).

However, if the policy intent is to completely exempt children from Division 296 tax, for income years in which that child is in receipt of a death benefit income stream, the draft legislation does not always achieve this.

That is, subject to how an income stream is structured, there may be a period between when the income stream ceases and when any residual benefits are cashed. In this case, a child recipient may be liable for Division 296 tax in the year the income stream ceases.

A proposed fix would be to amend the wording in s296-20 to:

*"You are not liable to pay *Division 296 tax for an income year if you are a child recipient of a superannuation income stream* ***at any time during the year****."*

Death of an individual

Similarly, we note the proposed subsection 296-30 provides that an individual is not liable for Division 296 tax for an income year if they die 'before the last day of the year'.

If the policy intent is to exempt individuals from Division 296 tax for an income year if they die before the end of the income year, the draft legislation does not achieve this in the case of an individual who dies on 30 June of an income year.

A proposed fix would be to amend the wording in s296-30 to:

*"You are not liable to pay *Division 296 tax for an income year if you die before* ***the end of*** *the last day of the year."*

Death Benefits – Reversionary Pensions

We welcome the exclusion of a member who is deceased from the proposed tax. There are strong practical and policy rationales for doing so. However, the outcome is quite different for a recipient of a reversionary pension. The receipt of a reversionary pension will capture couples who individually fall below the threshold, but on the death of one, will cause the surviving spouse to exceed the threshold and be subject to Division 296 tax.

A reversionary pension becomes immediately payable to the beneficiary on the date of death of the original pension member. The minimum pension payments required also must be paid during the income year. This is necessary to ensure that the pension continues to comply with the associated pension rules.

To ensure policy alignment and consistency, the recipients of reversionary pensions must be excluded from Divisions 296 tax to the extent of the reversionary pension benefit. This exemption needs to apply in the first and second year of income. Doing so ensures policy alignment and consistency with

the operation of the transfer balance cap rules and the equitable treatment of a deceased member's benefits under these proposed measures.

Pursuant to *Income Tax Assessment Act 1997* (Cth) section 295-25(1) items 1 and 2, if you are a reversionary beneficiary, the value of the reversionary benefit is not included in your transfer balance cap until 12 months after the income stream becomes payable. The policy behind this deferral was to ensure that a surviving spouse had sufficient time, considering the grieving process and time to obtain and action professional advice, to restructure their affairs and comply with the transfer balance cap.

To comply with the TBC, a member may do one, or a combination of the following:

1. Fully or partially commute their personal pension superannuation interest and transfer the benefits to their accumulation interest.
2. Receive a lump sum commutation as a benefit payment from their personal superannuation pension interest.
3. Receive a lump sum commutation as a benefit payment from the superannuation interest supporting the reversionary pension.

The 12-month period allotted will inherently transverse two financial years. Specifically, if any adjustments to comply with the Transfer Balance Cap involve the payment of a lump sum benefit to the member, these amounts will be added as earnings under this proposed measure. This treatment is another point of concern that requires reconsideration.

While the proposed measure would exclude the balance of the reversionary pension from being classed as earnings in the year allocated, an individual's TSB is not adjusted, subjecting other fund earnings including changes in asset values, to the proposed tax. This includes any pension benefits paid to the member during the course of the financial year, including those paid from the member's interest before they became the recipient of a reversionary pension.

We strongly urge Treasury and Government to critically re-evaluate the current treatment of reversionary beneficiaries within the framework of death benefits. As it stands, the inclusion of reversionary pension interests in the first and second year of income leads to markedly disparate outcomes, serving to amplify inequities within the system. This is not merely an oversight; it fundamentally contradicts the existing policy settings designed to ensure equitable treatment of reversionary pensions

The inequitable treatment of reversionary pensions in the initial 12-month period from the date of death of the primary pensioner is expected to be amplified with the proposed change to the definition of Total Superannuation Balance. We believe there is an opportunity to harmonise the treatment of reversionary pensions with the introduction of a modification provision, to exclude the value of such pensions from the definition of Total Superannuation Balance in the year of the death of the primary pensioner.

Disability Benefits

We also support the exception to the liability for tax outlined in proposed subsection 296-25 (recipients of structured settlement contributions). We note, however, there is no exception for individuals who receive a disability payment.

In the same way that structured settlement contributions can be large payments, disability payments can also involve sizeable amounts commonly paid to compensate the individual for current and future loss of earnings. We acknowledge exempting individuals who receive a structured settlement contribution from a liability to pay tax under Division 296 is consistent with the treatment of structured settlement contributions under the Transfer Balance Cap provisions. However, it is not obvious to us why an individual who has their superannuation balance increased by the proceeds of a disability payment, is not afforded the same treatment.

From a consistency and equity perspective, the proposed provisions should be improved by including new subsection ***Exception – disability insurance proceeds*** (see suggestion below). Similar to the exception for structured settlement contributions, this subsection would exempt an individual from a liability to pay Division 296 tax if an amount representing proceeds from a total and permanent disability policy has been received, in respect of that member in that year, or in any income year.

> ***Exception — disability insurance proceeds***
>
> > *You are not liable to pay *Division 296 tax for an income year if proceeds from a policy of insurance, in respect of you suffering a permanent incapacity, have been received into a superannuation interest of yours in that year or in any earlier income year.*

The treatment of disability benefits and insurance proceeds is in need of broader policy review and must be brought in line with the treatment of structured settlement payments contributed to superannuation. Structured settlement contributions are excluded from the calculation of a person's total superannuation balance, and transfer balance cap.

Your adjusted total superannuation balance – your withdrawals total (s296-50)

Excess Contributions

Where an individual exceeds their non-concessional contributions cap (potentially due to a member giving a trustee a notice to vary down the amount of deduction they intend to claim for a personal contribution, or a member's downsizer contribution failing the eligibility requirements and being reclassified as a non-concessional contribution), in most cases the excess amount plus 85 percent of an associated earnings amount is released under Division 131 in Schedule 1 to the *Taxation Administration Act 1953*. One hundred percent of the associated earnings amount is then assessable to the individual and taxed at their marginal tax rate, less a 15 percent offset (which offsets the tax payable by the individual's superannuation fund on actual earnings relating to the excess contribution).

The effect of proposed subsection 296-50(1)(e) is to include in the definition of ***your withdrawals total*** the amount of a payment made during the year by a superannuation provider:

> *(i) from a superannuation interest of yours; and*
>
> *(ii) in relation to a release authority issued under Division 131 or 135 in Schedule 1 to the Taxation Administration Act 1953, other than a release authority that relates to a *first home saver determination.*

This provision results in the whole amount paid under a release authority, in respect of an excess non-concessional contributions determination (including 85 percent of the associated earnings), being added to the individual's earnings for the purposes of Division 296 tax. Where an individual is subject to Division 296 tax, this would mean a potential tax rate of up to 62 percent (i.e. the individual's associated earnings are taxed at the individual's marginal tax rate plus a proportion of those earnings will also be subject to Division 296 tax).

To correct this, subsection 296-50(1)(e) should be amended so that the amount of a release authority (in respect of an excess non-concessional contributions determination) included in the definition of ***your withdrawals total,*** excludes the amount released representing associated earnings. This could be done in a similar way to the treatment of releases under the FHSS scheme in s296-50(1)(f) and (2).

Excess Transfer Balance Cap

A similar situation also arises where an individual exceeds their transfer balance cap. That is, individuals who exceed their transfer balance cap are liable for excess transfer balance tax. Excess transfer balance tax is generally calculated on the individual's excess transfer balance earnings for the period commencing when the individual starts to have an excess transfer balance account to when their transfer balance account is no longer in excess. The tax rate is 15 percent for the first time an individual has an excess transfer balance, increasing to 30 percent for any subsequent times the individual has an excess transfer balance.

The effect of subsection 296-50(1)(e) is to include in the definition of ***your withdrawals total*** the total amount commuted under an excess transfer balance determination. This includes not only the excess transfer balance amount, but also the notional earnings on this amount – which are either subject to 15 percent or 30 percent tax. Where an individual is subject to Division 296 tax, this would mean the notional earnings on the excess transfer balance amount are subject to double taxation.

To correct this, subsection 296-50(1)(e) should be amended so that notional earnings withdrawn to correct an excess transfer balance, are excluded from the definition of ***your withdrawals total***. Alternatively, regulations could be prescribed under subsection 296-50(1)(h) to this effect.

We note the inclusion of subsection 296-50(5) is intended to avoid the double counting of amounts for Division 296 tax purposes. However, it would appear this provision would not apply to the above scenarios because the amount that is subject to double taxation is only taxed once under Division 296.

Your adjusted total superannuation balance – your contributions total (s296-55)

Under subsection 296-55(f) an amount allocated by a trustee to a member's account in accordance with conditions specified by the regulations for the purposes of subsection 291-25(3) will be included in the total of a member's contributions and will therefore be subtracted from the member's adjusted total superannuation balance for the purpose of calculating earnings.

Subsection 291-25(3) specifies that an amount in a complying superannuation plan is covered under this subsection if it is allocated by the superannuation provider in relation to the plan for you for the year in accordance with conditions specified in the regulations.

We note Income Tax Assessment (1997 Act) Regulation 291-25.01 confirms that if an amount meets the conditions of this regulation, it will be an amount covered under subsection 291-25(3) of the

Income Tax Assessment Act 1997. Such amounts are counted in determining an individual's concessional contributions for a financial year.

Regulation 291-25.01(3) goes on to confirm that an amount will meet the conditions of this regulation, and therefore count towards the member's concessional cap, where neither sub-regulation (4) or (5) applies to the amount.

Sub regulation (4) outlines that an amount will not meet the conditions of the regulation where:

a) the amount is allocated, in a fair and reasonable manner:
    (i) to an account for every member of the complying superannuation plan; or
    (ii) if the member is a member of a class of members of the complying superannuation plan, and the amount in the reserve relates only to that class of members--to an account for every member of the class; and
b) the amount that is allocated for the financial year is less than 5% of the value of the member's interest in the complying superannuation plan at the time of allocation; and
c) the amount would not be assessable income of the complying superannuation plan if it were made as a contribution.

That is, where a trustee allocates an amount from a reserve on a proportional basis to all members of the fund, and the allocation did not cause the member's benefits to increase by 5 percent or more, the amount allocated would not count as a contribution. This means it would increase the member's adjusted total superannuation balance and therefore their earnings for Division 296 purposes.

Given that the member does not have any right or entitlement to the reserve allocation, it seems inequitable that a decision by the trustee to "allocate" an amount to their account should potentially increase their tax liability under Division 296.

In addition, sub-regulation (5) applies if the amount that is allocated from a reserve is used solely for the purpose of enabling the complying superannuation plan to discharge all or part of its liabilities (contingent or not), as soon as they become due, in respect of superannuation income stream benefits that are payable by the complying superannuation plan at that time, and any of the following applies:

a) the amount has been allocated to satisfy a pension liability of the plan paid during the financial year;
b) on the commutation of a superannuation income stream, except as a result of the death of the primary beneficiary, the amount is allocated to the recipient of the superannuation income stream, to commence another superannuation income stream, as soon as practicable.

As a result, where a member commutes a complying lifetime or life expectancy pension, and the amount held in the pension reserve is allocated to the recipient of the superannuation income stream to commence a Market Linked Income Stream (MLIS), this could result in a double counting of part of the reserve allocation.

For example, in this situation the amount allocated from the reserve to commence the MLIS would not be treated as a contribution and therefore would increase the member's adjusted total superannuation balance in that income year. In addition, the amount of any pension payments made

from the MLIS (which would consist entirely of the amount allocated) would then be treated as a withdrawal and would be added back into the calculation of the member's adjusted total superannuation balance – resulting in that amount being double counted.

This means if either sub-regulation (4) or (5) apply, the amount will not be treated as a contribution and therefore would increase the value of a member's adjusted total superannuation balance. This would then increase the amount of earnings for Division 296 purposes.

A simple amendment to address this issue would be to treat all allocations from a reserve to a member's account as a contribution for the purposes of Division 296, not just those that count towards the member's concessional contributions cap.

Under the proposed methodology it is also conceivable that some unintended and undesirable outcomes could arise where a member commutes a complying defined benefit pension, and the proceeds are used to commence a MLIS. Depending on the valuation of the defined benefit pension at the start of the income year, and the market value of the MLIS at the end of the income year, it could have a positive or negative impact on earnings for Division 296. This could arise not due to actual positive or negative earnings, but rather due to differences in the valuation methodologies of the two pensions.

Finally, any changes to the treatment of reserves relating to capped defined benefit incomes streams, should be considered in conjunction with the Government's 2021-22 Federal Budget announcement to allow members in an SMSF, a two-year period, to exit certain legacy pension products. With what is being proposed under these concessions, this amnesty is even more important, as SMSF members remain trapped in outdated products and are unable to exit their SMSF. SMSF members need to be afforded the choice to enter more modern, flexible arrangements without the risk of any reserves relating to these legacy pensions, being subject to double taxation.

Your superannuation earnings and basic superannuation earnings (s296-40)

The calculation of earnings for the purposes of Division 296 tax is intrinsically linked to the change in the member's total superannuation balance (TSB) during an income year. The difference between the member's TSB just before the start of the income year, and the member's TSB at the end of the income year, adjusted for contributions and withdrawals, constitutes ***basic superannuation earnings*** for the purposes of Division 296.

A member's TSB broadly represents the member's withdrawal benefit at that time. It is a legislative requirement that the value of the assets underpinning a member's TSB represent market value on 30 June each year. This means the change in a member's TSB during the income year is not only reflective of the ordinary, exempt, and statutory income allocated to the member's balance during the income year, but also the appreciation of asset values during the income year. The outworking of the proposed definition of superannuation earnings is that the sum of the income received, and the change in the paper value of the assets (i.e. unrealised capital gains) during the income year, as outlined in subsection 296-40(2), is then proportioned using the formula in subsection 296-35(2) to derive the amount that will be subject to tax under proposed Division 296.

For good reason, the taxation of unrealised capital gains is rare among OECD countries, and rarer still in OECD pension systems[1]. Taxing unrealised capital gains involves taxing a capital gain that has not been realised, and may never be realised, by the investor. It also assumes investors have the necessary cash reserves or assets that can be realised to cover the cost of the tax liability. In the context of the "better targeted superannuation measure", and the $3 million threshold, the reality is very different.

A recent research study undertaken by the University of Adelaide found over 13 percent of SMSF members (almost 7,000 SMSF members) affected by Division 296 would not have had sufficient liquidity in their fund to cover the tax liability if Division 296 had been introduced on 1 July 2020[2].

This problem is only likely to worsen over time, as unrealised capital gains accrue while tax payments from previous years diminish liquidity. While affected members will have the option of funding a Division 296 tax liability with funds external to their superannuation fund, this is unlikely to be possible for all affected members. An individual's superannuation balance may not be indicative, or an accurate proxy, of their personal wealth.

Farmers and small business operators with land and business premises owned by their SMSF may encounter significant liquidity pressures. Changes in property values do not automatically correlate to an increase in leasing income or rental yields. Market forces driving property prices differ to those driving yield. Broadly, yield is driven by the use, size, quality, and location of the property asset.

We do not subscribe to the view that liquidity stress brought on by the introduction of Division 296 is a failing of the SMSF trustees to properly formulate the fund's investment strategy. In our view it is unreasonable to expect SMSF trustee to envisage future tax changes when formulating the fund's investment strategy – particularly of the magnitude of the Division 296 tax increases which, for affected members, could result in an average annual tax liability exceeding $80,000[3].

It is also worth noting that selling illiquid assets typically incurs substantial transaction, and other, costs associated with market timing and other macroeconomic factors. The liability to pay Division 296 tax will, in some cases, be more than 9 months after the end of a financial year. The shift in market movements in that time may force the sale of assets in a declining market to pay a tax assessed on an artificial value at an earlier point in time. This will be detrimental to members, as the potential losses and transaction costs will be further exacerbated by the financial burden of a Division 296 liability.

Recent research undertaken by a major SMSF software provider, found almost one in four SMSFs administered on their software, with at least one member with a balance over $3 million, are invested in direct property[4]. With over $81 billion[5] of commercial property owned by SMSFs, it is not difficult to see how disruptive this new measure could be not only for the SMSF sector but also for small business operators, farmers, and the broader community.

Given the substantial risk of liquidity and financial stress, it is not surprising that both domestically and overseas, the only argument that could be found for taxing unrealised capital gains comes from

[1] 'Evaluation of the proposed changes to superannuation tax concessions', The University of Adelaide, October 2023.
[2] Ibid. To model the impact of proposed Division 296, the research assumed Division 296 was introduced effective 1 July 2020, and applied for the 2020/21 and 2021/22 income years.
[3] Ibid.
'2023 Annual Benchmark Report', Class, September 2023.
[5] 'SMSF quarterly statistics report' Australian Taxation Office, June 2023.

the United States in the context of taxing individual "super-wealth". As observed by the University of Adelaide:

"Given the rather substantial difference between a Forbes 400 billionaire and an Australian farmer who holds their $3.5 million farm in a SMSF, we question whether Australia's mandatory retirement savings system is the appropriate vehicle to address super wealth and wealth inequality."[6]

Linking the measurement of earnings under subdivision 296-40 with movement in capital markets, will produce substantial year-on-year volatility in the superannuation taxation environment. This is evident in the University of Adelaide research which found large differences in the number of funds that would have been impacted by Division 296 in 2020/21 when compared to 2021/22.[7] This volatility was directly related to the performance of capital markets in those years. Clearly, including unrealised capital gains exacerbates this volatility making it more difficult for members to plan for their tax liabilities and manage their investments and liquidity needs. Ultimately, this is likely to have negative implications for the financial performance of impacted funds.

There will also be other unintended consequences which relate directly to the inclusion of unrealised capital gains in the definition of ***basic superannuation earnings***. For example, there will be scenarios where the effective tax rate incurred by a member on their taxable superannuation earnings will exceed the highest marginal tax rate. Imposing an effective tax rate which not only claws back the superannuation tax concessions for individuals with balances over $3 million, but also levies an additional tax, appears to be at odds with the stated purpose of this measure.

Case Study 1: Effective rate of tax exceeds highest marginal tax rate.

John Smith has a superannuation balance of $3 million in the accumulation phase. During the year investment earnings totalling $80,000 are allocated to his account. Under current arrangements, the fund would pay $12,000 in tax based on the concessional tax rate of 15 per cent. Those same assets, if held by John outside superannuation, would incur a maximum $36,000 in tax (assuming a maximum 45 per cent rate).

Assume John's balance in the above super fund appreciated by $800,000 during the same income year. There were no contributions or withdrawals for the income year so John's TSB at the end of the income year was $3,868,000. Under the proposed tax changes, John would be liable for 15 per cent additional tax on the proportion of earnings attributable to his balance above $3 million, resulting in an additional tax bill of $29,217, taking the total tax bill to $41,217.

Since unrealised gains are not taxed on assets held outside the fund, John would pay at least $5,217 more tax than if the assets had been held outside super. The implicit tax rate on the fund's realised earnings of $80,000 would be 51.5 per cent – exceeding the top marginal tax rate.

The fact that John has paid more tax on his investments then would have been the case if the same assets were held outside the fund, runs counter to the Government's stated objective of "clawing back" the superannuation tax concessions for high-wealth superannuants.

[6] 'Evaluation of the proposed changes to superannuation tax concessions', The University of Adelaide, October 2023.
[7] Ibid.

As this example illustrates, including unrealised capital gains in the calculation of earnings for John has the effect of replacing the concessional super tax rate with an effective tax rate well above than the highest marginal income tax rate.

The inclusion of unrealised capital gains in the calculation of earnings is also highly problematic given the general nature of capital markets. It is common to see a string of bull market years followed by a sharp bear market decline. This means there is a strong possibility a member can effectively be cumulatively taxed on investments that make an overall loss without any real recourse to recover their tax expense.

Case Study 2: Losses with no recourse to recover the tax expense.

Anne, a 75-year-old retiree, has an SMSF with a TSB of $1.5 million at the start of the income year. She has no other assets or income and is totally dependent on her superannuation for retirement income.

Anne keeps about half of her fund in cash and blue-chip shares to provide her with an adequate retirement income, and the other half is invested in higher-risk investments to cover longevity risk and possible medical expenses. Included in the fund's higher risk investments is a $400,000 investment in a newly listed start-up company.

During the income year, the share price of the newly listed start-up rises dramatically, and they now have a paper value in Anne's fund of $4 million. Anne's TSB at the end of the income year is $5 million.

Adjusting for pensions paid, Anne's earnings for the income year for the purposes of this new tax is $2.1 million. Under the current tax settings, Anne's fund pays no tax but, under the proposed new tax, Anne faces a tax bill of $126,000.

Unfortunately, as sometimes happens with start-ups, the value of the shares has now fallen to almost zero. In this case, her capital losses are exacerbated by the tax incurred on the unrealised capital gain from a previous income year. The impact on Anne's future retirement income is devastating. Not only has her fund had to write down the value of the start-up company shares but rubbing salt into the wound is that she will need to liquidate some of the fund's blue-chip shares to cover the $126,000 tax bill incurred on capital gains that were never realised.

Although individuals will have the option of paying their Division 296 tax liability from funds held outside of superannuation, this is little comfort to Anne since she has no non-super assets. Under subsection 296-110, individuals will be able to carry forward negative earnings to offset against future positive earnings, but again this is of little comfort to Anne given her TSB may ever again exceed $3 million.

The potential unintended consequences and anomalies that could arise by including unrealised capital gains in the calculation of earnings is not limited to "over taxation" as illustrated in the previous two case studies. There are also situations where Division 296 would fail to "claw back" the superannuation tax concessions as presumably intended for individuals with very large superannuation balances.

Case Study 3: Very large balance with taxable income pays with no Division 296 tax.

Simon has an SMSF with a TSB of $20 million. During the income year Simon's fund achieves a 10 percent return resulting in $2 million of taxable earnings being added to his account. Simon makes no contributions or withdrawals during the income year.

Also, during the income year, the unrealised market value of the assets in Simon's fund falls by $2 million leaving his TSB at the end of the income year the same as the TSB at the beginning of the income year. Assuming Simon has no transferrable negative superannuation earnings from a prior income year, Simon's ***basic superannuation earnings*** *under subsection 296-40(2) would be nil. Simon would not have a Division 296 tax liability despite having a TSB of $20 million and taxable earnings totalling $2 million for the income year taxed at the maximum superannuation concessional rate of 15 percent.*

Clawing back the superannuation tax concessions for high-wealth individuals like Simon, was the primary driver behind the Government's better targeted superannuation concessions measure. However, as this case study illustrates, including unrealised capital gains in the calculation of earnings, means this measure has the potential to fall well short of the stated objective.

Alternative calculation of earnings (s296-40)

To ensure this measure is able to achieve its stated objectives, while at the same time being fair and equitable in its application across the entire superannuation sector, it is imperative that the measure of "earnings" mirrors, as closely as possible, the traditional measure of taxable earnings. This means reverting to a measurement of earnings which only includes ordinary (excluding contributions), exempt, and statutory income allocated to a member's superannuation account during the income year.

However, the limitations that some funds have in recording and reporting actual taxable earnings attributable to a member during the income year, means a precise measure of taxable earnings for Division 296 purposes, which is comparable to traditional measures of taxable earnings, is beyond reach.

With this this in mind, we believe a methodology which calculates a member's earnings for Division 296 purposes by multiplying the member's TSB at the end of the previous income year by a notional earning rate, where the notional earning rate represents a reasonable proxy for taxable superannuation earnings (excluding contributions) allocated to member superannuation accounts for the income year, is a more appropriate approach to that contained in this exposure draft legislation.

Critical to the success of this alternative calculation of "earnings" is the careful selection of a proxy (or notional) rate which accurately reflects taxable superannuation earnings (excluding contributions) allocated to member superannuation interests for the income year. To that end, the Australian Government Actuary could be charged with calculating the industry estimate of the annual rate of ordinary income (excluding contributions), statutory income and exempt current pension income, allocated to member superannuation accounts for the relevant income year.

Alternatively, if a notional earning rate which approximates the annual rate of taxable earnings allocated to superannuation member accounts for the income year, is not available or cannot be determined, the 3-month average nominal 90-day bank accepted bill rate published by the Reserve Bank of Australia, could be used as a notional rate to calculate "earnings".

When calculating a member's "earnings", we would recommend that a member's TSB, as measured at the end of the previous income year, be used – rather than using the member's TSB at the end of the income year, or an average of the member's TSB for the income year.

This is because the member's TSB, by its very nature, necessarily incorporates the value of unrealised capital gains, which in turn will inflate the level of notional earnings calculated thereon.

Using a member's TSB at the end of the income year, or an average TSB for the income year, would only further inflate the calculation of earnings and exacerbate the impact of unrealised gains present in a member's TSB. By using a member's TSB at the end of the previous income year, this at least removes the impact of unrealised capital gains derived during the income year in the calculation of "earnings".

Selecting a member's TSB, as measured at the end of the previous income year, is also consistent with the methodology typically used when preparing forecasts of financial investment returns. This aligns to the fundamental principle underpinning this proposed alternative calculation of earnings – that is, this alternative calculation seeks to retrospectively forecast a member's superannuation earnings using a proxy rate of return on a member's starting balance.

While this approach will not produce an entirely precise amount of ordinary income (excluding contributions), statutory income and exempt current pension income, allocated to a member's superannuation interests for the relevant income year, if the notional (or proxy) rate selected reflects a reasonable estimate of such returns, any deviations are expected to be relatively immaterial.

However, if the use of the member's TSB at the end of the previous income year is not the desirable TSB measure, to reduce the timing impact of contributions and withdrawals, the member's average TSB for the income year should be used. This could be calculated by dividing the sum of the member's TSB at the end of the previous income year, and the member's TSB at the end of the income year, by two.

Once a member's notional earnings amount has been calculated, it remains imperative that the proposed provisions of section 296-35 continue to apply to ensure that only the proportion of those earnings that relate to the amount above the threshold will be subject to Division 296 tax.

Adopting this alternative method for calculating earnings will reduce the compliance burden on regulators and industry alike. For instance, this approach does not require the calculation of a member's adjusted total superannuation balance – enabling the removal of proposed sections 296-45, 296-50, 296-55, and 296-60 from the draft Bill. Similarly, Subdivision 296-C, which deals with Transferrable negative superannuation earnings is no longer necessary. This alternate earnings methodology adopts a pragmatic approach and champions simplicity across the superannuation industry.

There may be some concern that this simplified approach may encourage some individuals on the periphery of the $3 million threshold to consider manipulating their TSB to avoid Division 296. We would argue that any such opportunities would be immaterial. That is, any such efforts by a member to withdraw funds from the superannuation environment with the intention of avoiding Division 296 tax will, in effect, amount to that member self-imposing a "hard cap" on their superannuation balance due to their inability to return these amounts withdrawn back into the superannuation system in

future years. We note that individuals impacted by Division 296 tax will not have any available non-concessional contribution cap – as their TSB will clearly exceed the General TBC.

An illustration of the notional earning rate formula is provided as Addendum B.

This approach substantially removes the impact of unrealised capital gains from the calculation of earnings, therefore reducing the severity of unintended consequences and anomalies with the proposed Division 296 approach. While this approach will ensure outcomes are more consistent with the stated policy objectives, it will not remove the taxation of unrealised capital gains entirely. This is because the member's TSB (which incorporates unrealised capital gains) will still be used in the calculation of earnings under Division 296.

The benefits of this approach, compared to the proposed approach in subsection 296-40, are as follows:

1. It would achieve actual neutrality, in terms of application and outcomes, across the entire superannuation sector. Given many affected SMSFs have large exposures to direct property, the proposed subsection 296-40 approach would have a disproportionate impact on the SMSF sector. This approach would address this.
2. It would simplify proposed Division 296. For instance, this approach would not require Subdivision 296-C of the draft Bill as transferrable negative superannuation earnings would no longer be required.
3. It would provide more certainty, enable better liquidity management, and improve investment performance and retirement outcomes. Including unrealised capital gains in the calculation of earnings under Division 296, intrinsically links the calculation of earnings to the performance of investment markets. Using a notional earning rate to calculate earnings provides more certainty for members and stability in the collection of tax revenue from one year to the next.
4. Substantially removing unrealised capital gains from the calculation of earnings will alleviate liquidity stress for affected SMSF members. This means many SMSF members will be able to avoid transaction costs (i.e. losses) associated with being compelled to sell illiquid assets solely to meet a Division 296 liability. While a proportion of capital gains will still be subject to Division 296 tax, any potential tax liability will only occur when the capital gain is realised, and the member has access to the sale proceeds to meet their Division 296 liability.
5. While this approach may reduce the total tax revenue generated under Division 296 in the short term, it is very likely to generate greater bottom line total tax revenue for the Federal Government in the medium to long term as unrealised gains are realised over the superannuation lifecycle. This is because a larger asset base within the superannuation system (which should be an outcome of substantially excluding unrealised capital gains from the calculation of earnings) will, in turn grow the overall tax base for future periods[8].

[8] Ibid.

Large superannuation balance threshold (s995-1(1))

The $3m threshold proposed will not be subject to indexation.

Rather than providing certainty to people when arranging their tax and financial affairs, we maintain not indexing the $3m threshold will achieve the opposite. Over time, a greater proportion of the population will exceed the $3 million threshold[9]. This will lead to confusion and uncertainty about future retirement planning strategies, resulting in more people turning to other tax favoured structures which may be subject to lower levels of regulatory oversight.

Indexation of the $3 million threshold could easily be achieved by adjusting the proposed definition of ***large superannuation balance threshold*** in subsection 995-1(1). We propose that the $3 million threshold be indexed to the consumer price index (CPI) in increments of $100,000 in accordance with subsection 960-M.

The proposed definition of ***large superannuation balance threshold*** could be adjusted as follows:

"Large superannuation balance threshold" is:

a) $3 million for the 2025-2026 financial year, or
b) For a later financial year, the amount worked out by indexing annually the amount mentioned in paragraph (a).

Definition of Total Superannuation Balance (TSB)

While the aim of simplifying the definition of TSB is tentatively supported, the proposal will impose an additional administrative burden on superannuation funds, particularly those providing non-account-based pensions.

The proposed change in the definition of TSB will require funds to report an annual value for members with non-account-based pensions which is a significant departure from current requirements. Given the complexities involved with valuing non-account-based pension, it is anticipated that the services of qualified actuaries will, increasingly, need to be engaged – introducing an additional layer of cost that funds will either have to absorb or pass onto their members. It is highly likely that other costs associated with the regular reporting of these valuations, for instance the costs of upgrading administration systems, will also be incurred. These cost implications are expected to disproportionately affect smaller funds, including SMSFs.

Furthermore, the proposed amendments which introduce the definition of TSB value refer to regulations that have yet to be drafted. The absence of specific regulations leaves industry and superannuation funds in a precarious position, as the final regulations could further impose unexpected anomalies, inconsistencies, or consequences, particularly given the complex calculation methodologies currently adopted for different income stream types under the Transfer Balance Cap regime.

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[9] '2023 Annual Benchmark report', Class, September 2023; found 15,788 Class SMSF members have account balances between $2 million and $3 million at 30 June 2023. This represents approximately 4.7 percent of the total number of Class members. Extrapolated across the total number of SMSF members, this equates to around $50,000 SMSF members who soon may be affected by Division 296. This is in addition to Treasury's estimated 80,000 superannuation members who have balances greater than $3 million and are expected to be impacted by Division 296 from 1 July 2025.

Addendum B – Alternative calculation of earnings

The amount of ***your superannuation earnings*** for an income year is calculated using the following formula:

Your TSB at the end of the previous income year	x	*notional earnings rate*

Where:

Notional earnings rate is the rate determined by the Australian Government Actuary as the rate of superannuation taxable earnings (ordinary income (excluding contributions), statutory income and exempt current pension income) allocated to superannuation members for the income year.

Or

Notional earnings rate is worked out by:

Averaging, for the income year, the 3-month average nominal 90-day bank accepted bill rate published by the Reserve Bank of Australia, rounded to the second decimal place.	+ 1 percentage points.

Consistent with the proposed provisions of section 296-35, only the proportion of the earnings that relate to the amount above the threshold will be subject to Division 296 tax.