SMSF Association

Submission – Part 3

Better Targeted Superannuation Concessions

Case Studies

17 April 2023

About the SMSF Association

The SMSF Association is the peak body representing the self-managed superannuation fund (SMSF) sector which is comprised of over 1.13 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.

Our Beliefs

- We believe that every Australian has the right to a good quality of life in retirement.
- We believe that every Australian has the right to control their own destiny.
- We believe that how well we live in retirement is a function of how well we have managed our super and who has advised us.
- We believe that better outcomes arise when professional advisors and trustees are armed with the best and latest information, especially in the growing and sometimes complex world of SMSFs.
- We believe that insisting on tight controls, accrediting and educating advisors, and providing accurate and appropriate information to trustees is the best way to ensure that self-managed super funds continue to provide their promised benefits.
- We believe that a healthy SMSF sector contributes strongly to long term capital and national prosperity.
- We are here to improve the quality of advisors, the knowledge of trustees and the credibility and health of a vibrant SMSF community.
- **We are the SMSF Association.**

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Important Note

The SMSF Association's submission in response to the *Better Targeted Superannuation Concessions* consultation paper[1] is set out in three parts:

PART 1 – Introductory letter and overview

PART 2 – Consultation Questions and Recommendations

PART 3 – Case Studies

This paper is Part 3 of this submission.

It is intended that all three parts of this submission are read in conjunction with one other. This will be essential in understanding the issues identified and matters discussed.

Introduction

The following case studies represent real life, client-based scenarios. They illustrate the unintended consequences and complexities emerging from the proposed model.

These represent just some of the issues and scenarios identified. The short consultation period has not provided sufficient time to examine and compile all scenarios.

We would encourage Government and Treasury to undertake further consultations before proceeding to the exposure draft stage.

We would be pleased to further discuss the case studies included in this submission and would welcome the opportunity further consult and work with Government and Treasury.

[1] 'Better targeted superannuation concessions' (Consultation Paper, The Treasury, 31 March 2023) <https://treasury.gov.au/consultation/c2023-373973>.

Case Studies

Case Study 1 – Investment performance triggers balance exceeding $3m

Kelvin is the sole member an SMSF.

Over the years he has contributed when he can into superannuation and made prudent investments.

Kelvin's SMSF is invested in a diversified investment portfolio using a mix of listed Australian and international shares, and exchange traded funds.

Some investments are self-directed as he likes to research and follow the share market. He also uses a broker for advice, and the placement of trades.

He has seen sustained growth in his portfolio over the years.

Kelvin currently has $1.2 million in his SMSF.

It is important to Kevin that he has sufficient income to fund his retirement and can met his extra medical expenses as he has an underlying medical condition. He hopes to retire soon but has a personal bank debt, a legacy of a failed business venture and personal guarantee.

He worries about his future financial security and whether he will have enough funds to pay for his future aged care and medical needs, taking into account the final loan repayments.

An opportunity arises to invest in an initial public offering (IPO) for a new ASX listing through his broker.

Shares are issued at $0.50. Kelvin invests $20,000 via his SMSF (1.6% of the fund value).

Shares are issued in early March and the share price rises. This continues to 30 June. On the back of positive announcements and sound performance, the shares are now with $5. The holding is valued at $200,000.

A significant company announcement sees a rapid spike in the value of the shares. After a period of strong, sustained growth, the shares reach $75 by 30 June in year 2. The holding is now worth $3 million. As a result, Kelvin's member account is valued at $4,500,000.

A proposed takeover of the company fails, and the share price suffers a sharp decline in value, stabilises, and falls again. By 30 June of year 3, Kelvin's member account is valued at $1,900,000.

Kelvin's TSB does not exceed $3 million again.

Kelvin's TSB for the years in question is as follows:

Starting TSB	$1,200,000
Year – 1	$1,400,000
Year – 2	$4,500,000
Year – 3	$1,900,000

<u>Calculation:</u>

Year 2 Earnings = ($4,500,000 + 0 – 0) - $3,000,000 = $1,500,000

Proportion of earnings = ($4,500,000 - $3,000,000) / $4,500,000 = 33%

Tax Liability = 15% x $1,500,000 x 33% = **$74,250**

Issues:

- Tax is being levied on unrealised gains.
- The value on which the tax is calculated is never realised.
- Carrying forward the losses on the decline in value can never by applied, as his TSB stays below $3 million.
- Kelvin's TSB valuation is a point in time value based on market performance. It does not reflect Kelvin's level of personal wealth outside of superannuation.

Case Study 2 – Treatment of tax provisions and addbacks

Any adjustments to tax provisions will directly impact a member's balance in a super fund. This will therefore be included in an individual's TSB.

Joan has a TSB of more than $3 million at the end of the prior financial year. The growth in Joan's superannuation balance has been through good advice and a long-term investment strategy, investment in strong performing investments through a diversified investment portfolio.

At the end of the current financial year, Joan decides to retire. She elects to commence an account-based pension using her full $1.9m transfer balance cap.

A large portion of her remaining accumulation balance will be needed to payout the mortgage on her home once the fixed interest period ends. This will be paid out as a lump sum in a future year when the proceeds are required.

Joan's SMSF has been accounting for deferred tax liabilities for future capital gains on her SMSF investments. This is a provisional book entry that accounts for the capital gains tax that would arise if the investments were sold at 30 June. It provides Joan with the realisable value of her member account at that date.

In June, when Joan commences her pension, an adjustment is required to the deferred tax liabilities. The assets supporting her pension are now no longer subject to income tax on earners or capital gains tax on disposal.

The accountant who administers her SMSF performs the necessary calculations for the tax adjustment required. Joan has had a long-term investment strategy for her fund which includes property and shares. Large amounts of unrealised gains are present in her SMSFs investment portfolio. This includes a property originally purchased for $300,000 which is now valued at $970,000. The portfolio of shares includes bank shares acquired at IPO for $5.40 which are now trading at $110, and mining shares acquired at IPO for $0.01 which are now trading at $26. Both are ASX 200 companies.

An amount of $80,000 is added back to Joan's member account because of the adjustment to the provision for deferred tax liability.

Joan has made no contributions or withdrawals during the year of income. No pension payment is required for the year where a pension commenced in June.

The addback of the deferred tax liability on the commencement of Joan's pension will be included in the earnings calculation along with the growth in asset values and fund income.

Case Study 3 – Farming Property Valuation

Marco and Rosa, both aged in their 50’s, are husband and wife and engaged members in their SMSF.

The SMSF holds a 50% share in farmland, a residential property, listed shares and cash.

The farm was originally acquired in 2017 for $1.2 million.

In 2021, the property was valued at $1.77 million, and the members balances were $2 million each.

In 2022, the farmland suddenly increased in value to $3.94 million. This is triggered by significant corporate acquisitions and amalgamation of similar properties in the region. The member’s balances increase to $3.4 million each for the year.

The market leasing rate remains relatively unchanged for properties in this location, of similar size and same agricultural activity. Over the years, market rates have either remained unchanged or not seen any material increase in value.

In the 2025/26 year, cropping quality is high as is demand for properties in the area. Based on sales activity in the region, the property is now worth $4.8 million. The property is leased to a neighbour who is looking to expand their operations and compete with the larger properties in the region.

In the 2026/27 year, the region suffers a devastating drought and locust plague. The immediate outlook is dire. It is some of the worst conditions experienced in the region for many years. Market conditions determine that is appropriate to defer lease payments. The fund receives reduced then no lease payments under a deferred lease arrangement with lessee. No contributions are received for Marco or Rosa. Business conditions are too difficult, so the couple are not paid wages or superannuation from their rural based business.

Ultimately when the property is sold, a significant capital gains tax liability will arise in the fund.

As the property has been held for a period of more than 12 months, the fund is entitled to a 1/3 CGT discount. The effective tax rate on the taxable gain is 10%. The taxable gain will also be net of disposal costs including sale and settlement costs.

CGT payable will be in addition to the additional tax levied under the proposed model. The proposed tax is levied on the individual members personally during the holding period to which this measure applies.

The additional tax calculated on the growth in value of fund assets and is levied at a flat rate of 15%. The CGT discount and disposal costs are not considered.

Where a decline in value occurs, although losses are calculated, these are only of benefit if an increase occurs again in the future. The result is the excess payment of tax on a value that has not been realised.

Case Study 4 – Small business Comprehensive Example

Mick (45) and Daniella (39) run a plumbing business. The business had contracts in the building sector but also provided maintenance and general plumbing services. Over the years they saw the opportunity to tap into the home renovation market and expanded to provide bathroom renovations. They have had to move business premises twice in the last 6 years. Moving is not only inconvenient, it is expensive, and time lost also has a cost.

Like many small business owners, they want stability and certainty. After getting advice, they decide to invest in their future by using their SMSF to purchase business premises.

- A common strategy for a wide variety of business owners is to hold the business premises in their superannuation fund.
- Doing so provides long term stability and certainty for the business.
- The added bonus, the lease payments made by the business to the SMSF are providing for Mick and Daniella's retirement. (As well as capital growth)
- The business is everything to Mick and Daniella. It not only provides income today, but also factors into their future retirement plans when they plan to sell the business.
- The business and the property can be sold separately at different times.

Like many small business owners, the family home is at risk. Not only is there the private mortgage, but the property will also be used as security for borrowings for the business, and director guarantees.

They will often pay themselves last. In difficult years, employees and contractors are always paid. So Mick and Daniella's income will be the ones to be cut when times are tough or cash flow is tight.

During COVID, Government restrictions made it difficult to operate. Worst still, the supply chain interruptions meant that Mick and Daniella did not have access to essential supplies. To make matters worse, post Covid, fixed priced contracts impacted profit margins as the cost of supplies and other costs increased.

One of the major builders they have contracts with has collapsed. This represents a significant portion of their business income and cash flow. Large amounts remain unpaid. It looks like they will receive nothing through the liquidation process.

The business premised they purchased is in a quality, well located and in demand area. Year on year the property value has continued to increase. It has been a smart investment.

Summary of Issues

- Measures don't consider wealth external of superannuation. Presumption is significant personal wealth as well as a high super balance.
- Many more people are retiring with mortgage debt. For small business owners, their homes are often used as security for business debt – business loans, overdrafts, vehicle and equipment finance, director guarantees for trade agreements, leases.
- Many small business owners contribute to super when they can. Some years may see low or no contributions made, in good years, larger contributions (subject to the contribution caps and rules) tend to be made.

- Mick and Daniella know the importance of superannuation and contribute when they can. There have been some years where they have not been able to contribute due to difficult business conditions.
- Good investment strategies and strong performing investments can provide people with an opportunity to grow their superannuation next egg.
- The SMSF is required to report all fund assets at their market value on 30 June each year. As the property increases in value, the SMSF's value will increase. Therefore, the member's balances will adjust accordingly. This will include:
    - Taxation of paper gains
    - Currently growth in the value of an asset is taxable as a capital gain when the asset is sold.
    - If a loss occurs under the calculation, the loss can be carried forward to reduce any future earnings calculated.
    - Tax is not refunded.
    - If the member's TSB value falls below $3m, it appears that no adjustment or tax refund will be made.
- Limited recourse borrowings, often used to purchase property, will in certain circumstances be added back when calculating a person's TSB. Effect is a calculation of earnings based on gross assets rather than net assets.
    - Applies to LRBA's commenced from 1 July 2018 where:
        - Loan is from a related party; OR
        - Member has met a condition of release.

LRBA and TPD Event

- Mick is well below his preservation age (60). What happens if Mick has an accident and is seriously injured? As a result of his injuries, he will no longer be able to work. His super fund holds an insurance policy for Mick and successfully claims on the policy.
    - Although the insurance proceeds received will be excluded from the earnings calculation, Mick will still be liable for tax on earnings if he has a TSB of more than $3m.
        - This is despite his change of status and young age.
        - Mick is 15 years away from attaining his preservation age of 60.
        - Earnings comprising of direct income, capital gains and unrealised gains from fund investments (including insurance proceeds invested) will be assessable.
        - Advice and an appropriate investment strategy are essential in ensuring that the superannuation benefits can fund Mick's ongoing care and needs, as well provide an essential source of income into the future.
    - Any benefits paid to Mick are added back and included as earnings. This includes benefits paid as lump sums and/or pension benefits.

- Mick has now met a condition of release (permanent incapacity):
    - If the LRBA was with a bank and started from 1 July 2018, his share of the loan will now be added back to his TSB

<u>Illustration:</u>

The following is a high level, simplified example to illustrate the impact of the addition of the LRBA to a member's TSB.

Super balances:

	Balances
Mick	$1,020,000
Daniella	$180,000
Total	$1,200,000

Purchase business premises $4m, borrowing $2.8m

Effect on TSB:

	Actual Member Balances	**TSB Adjustment for LRBA**	**Total Super Balance**
Mick	$1,020,000	$2,380,000	$3,400,000
Daniella	$180,000	$420,000	$600,000
Total	$1,200,000	$2,800,000	$4,000,000

Case Study 5a – Structured Settlements v TPD Proceeds

	Structured Settlement	TPD Proceeds
Member component	Tax-free	Taxable
Adjust tax-free element for lump sum benefit paid	Yes	Yes
Exclude from TSB	Yes	No
TBA Adjustment (increase effective TBC)	Yes	No
Classed as a 'contribution' and excluded from earnings	Yes	Yes
Benefit payments excluded as withdrawals	No	No
Growth excluded	No	No

Case Study 5b - Structured Settlements v TPD Proceeds

Adam (42) is seriously injured as a result of an accident. He has sustained life changing injuries and will never be able to work or care for himself unaided again.

Adam is treated differently, depending on whether he receives a structured settlement payment compared to TPD proceeds.

Year 1:

	Structured Settlement	**TPD Proceeds**
Opening TSB	$900,000	$900,000
Sum Received	$3,500,000	$3,500,000
Contribution adjustment	Yes	Yes
Member A/C Component	Tax-free	Taxable
TSB Adjustment	Yes – excluded from TSB	No
TBA Adjustment	Yes	No
Closing TSB	$900,000^	$4,400,000*

^ TSB is not representative of an individual's actual member account balance

**While the insurance proceeds themselves are excluded as income in year one, Adam's TSB exceeds $3 million. The proportion of any growth in Adam's fund will relating to balances over $3 million will still be assessable for the additional 15% tax.*

Adam needs to modify his home to accommodate his needs. The modifications required would be significant and he would be unable to reside in the home during construction. Alternatively, he would need to build a special purpose home.

The rental market is extremely challenging and there is no suitable rental accommodation to accommodate his disability. He doesn't want to be placed in an aged care facility during construction.

Build or renovate, there are significant building delays. He has been told to allow up to two years for the project to be completed.

He decides to stay in his home and look for a suitable site on which to build his home.

Adam has had a small amount of insurance and investments outside of superannuation that has paid out his mortgage and provided a temporary source of income. He doesn't want to start drawing on his superannuation too soon as he knows his money needs to last. He withdraws $150,000 as a lump sum to purchase a special purpose bed, other items and make some simple modifications to make life that bit easier.

Year 2:

	Structured Settlement	TPD Proceeds
Opening TSB	$900,000	$4,400,000
Lump Sum Payment	$150,000	$150,000 ~
'Withdrawal' Earnings Addback	N/A	Yes
Closing TSB	$1,300,000^	$4,800,000*

^ TSB is not representative of an individual's actual member account balance

** Adam's TSB exceeds $3 million. The proportion of any growth in Adam's fund will relating to balances over $3 million will still be assessable for the additional 15% tax.*

~Lump sum is added back to the earnings calculation as a 'withdrawal'

In the following year, Adam withdraws $950,000 to pay for home construction and commences a pension.

Year 3:

	Structured Settlement	TPD Proceeds
Opening TSB	$1,300,000	$4,800,000
Lump Sum Payments	$950,000	$950,000 ~
'Withdrawal' Earnings Addback	N/A	Yes
Available TBC	$5,400,000	$1,900,000
Pension Commencement Amt	$3,850,000	$1,900,000
% Fund earnings tax free	~100%	~40%
Tax Component	High tax-free %	High taxable %
Minimum Pension Pmt @ 4%	$154,000	$76,000~
'Withdrawal' Earnings Addback	N/A	Yes
Closing TSB	$350,000^	$4,274,000*

^ TSB is not representative of an individual's actual member account balance.

** Adam's TSB exceeds $3 million. The proportion of any growth in Adam's fund will relating to balances over $3 million will still be assessable for the additional 15% tax.*

~Lump sums and pension payments are added back to the earnings calculation as a 'withdrawal'.

Note:

The treatment of disability benefits for Adam differs greatly, depending on whether he receives either a structured settlement (personal injury compensation payment), TPD insurance benefits, or a combination of both. Yet the definition of permanent incapacity that applies in both circumstances are the same and they are intended to serve the same purpose.

Under the TPD example above, Adam would be paying tax on fund earnings, the taxable component of pension payments as well as be subject to the proposed additional 15% tax. Substantial tax concessions and treatment apply under the rules for structured settlements. These differences significantly impact the longevity of an individual's disability benefits.

Parity is needed, with TPD benefits treated in the same manner as structured settlements.

Case Study 6 – Blue Collar Workers

Salary data in the table below is taken from Hayes *Salary Guide* [2] for the state of Western Australia.

('000)	Electrician	All-Rounder	Leading Hand Maintenance	Excavator Operator	Dump Truck Operator
Salary Range*	$140 - 180	$140 - $175	$150 - $170	$130 -$175	$122 - $160
SG @ 10.5%^	$14.7 - $18.9	$14.7 - $18.37	$15.75 - $17.85	$13.65 - $18.37	$12.81 - $16.8
SG @ 12%	$16.8 - $21.6	$16.8 - $21	$18 - $20.4	$15.6 - $21	$14.64 - $19.2
SG @ 15%	$21 - $27	$21 - $26.25	$22.5 - $25.5	$19.5 - $26.25	$18.3 - $24

* Excluding superannuation, bonuses, and other benefits
~ Based up 8&6 and 2&1 rosters.
^ Current compulsory rate of superannuation guarantee.

Higher rates of superannuation are common in sector as employee retention strategies and for companies to be an employer of choice in a highly competitive market.

Based on an individual's circumstances, long term sector employees may be captured under the proposed measure, and subject to additional tax. Factors include:

- Wages and salaries
- Superannuation guarantee rates paid
- Growth of superannuation assets over time
- Chosen investment strategies or investment options

Superannuation calculators determine an individual's balance at retirement in present value terms. This is important, as it allows consumers to engage with and understand their superannuation balance in today's economic environment.

Many may be unaware that they will be impacted by this proposal in the future.

This highlights the need to ensure indexation is applied to the threshold.

That threshold should be linked to the general transfer balance cap.

Lack of indexation does not account for or consider the effects of inflation.

[2] 'Hays Salary Guide 22/23' (Report, Hays, 7 June 2022) 174-186