2 May 2024

Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Sir/Madam,

SMSF ASSOCIATION SUBMISSION – TREASURY LAWS AMENDMENT (BETTER TARGETED SUPERANNUATION CONCESSIONS AND OTHER MEASURES) BILL 2023 AND A RELATED BILL

The SMSF Association thanks the Committee for the opportunity to appear as a witness at the public hearing and for the opportunity to the respond to questions on notice.

We would also like to take this opportunity to provide further information and context to the evidence provided to the Inquiry on the impact this policy will have on farmers, and to provide some simple amendments to address the most egregious aspect of the Bill – the taxation of unrealised capital gains.

We note that two crucial exposure draft regulations consultations which directly impact the operation of the measures contained in this Bill closed just last week on Friday 26 April 2024. These are the *Treasury Laws Amendment Instrument 2024: Better Targeted Superannuation Concessions* and the Attorney-General's Department consultation on the *Family Law (Superannuation) Regulations 2024.* It is crucial that the outcomes of these consultations are considered alongside this Bill.

Our detailed responses to the Inquiry, including proposed amendments, are appended to this letter.

If you have any questions about our submission, please do not hesitate to contact us. We thank you again for the opportunity to participate in this Inquiry.

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.

Appendix 1

Questions on Notice

1. What tax principles does this bill breach, by taxing unrealised gains?

The operation of this tax will impose an income tax liability on unrealised capital gains. This is not a feature of the Australian Taxation System. If an amount is not ordinary income (e.g. rent, interest, dividends) and is not statutory income (e.g. net capital gains), it is **not** assessable income.[1]

This tax will operate to impose a tax on tax, which is not a feature of the Australian taxation system. We also provide further commentary in the response to question 3 following.

Unrealised gains are movements in the market value of an asset or investment. For superannuation funds, this is an important accounting entry, necessary to ensure that a member's balance as closely as possible, represents its realisable value at a particular point in time.

Unrealised gains do not represent actual income earned. No income, cash or proceeds have been received by the fund.

The current capital gains tax laws operate to tax realised gains when the asset is sold. As a result, cash has been received by the fund. The fund will then make the necessary tax provision and set aside the cash needed to pay any taxation liabilities that will arise.

This is why liquidity is such a concern for SMSFs. It is not a lack of preparedness or non-compliance with the statutory and fiduciary duties of an SMSF trustee. It is because of the volatile, and lumpy nature of this tax and the fact that it is being applied to unearned income of the fund. It is completely unreasonable to expect SMSF trustees when formulating their investment strategies to have to predict future tax changes, particularly changes which are such a radical departure from existing tax law.

The University of Adelaide research[2] included with our original submission, highlighted the following:

a) *Taxation on unrealised capital gains is rare among OECD countries, and rarer still in OECD pension systems.*

b) *Australia's tax system clearly delineates between income and capital gain taxes (CGT), and the CGT regime, which has been in place now for almost 40 years, is based primarily on realised gains **evidenced by completed transactions**. [Emphasis added]*

[1] *Income Tax Assessment Act 1997* (Cth), s 6-15(1).

[2] George Mihaylov, Ivan Obaydin and Ralf Zurbruegg, 'Evaluation of the proposed changes to superannuation tax concessions' (Research Report, International Centre for Financial Services, The University of Adelaide, October 2023).

c) *Given both the benchmarking to other OECD nations and Australia's own economic history, we interpret the structure of the current … as a somewhat radical departure from existing taxation policy, with potentially far broader consequences than just those outlined by Treasury in their consultation paper.*

d) *At face value, the new tax mechanism, and in particular the proposal to include unrealised capital gains in earnings estimates, seems at odds with the purpose of superannuation as a long-term investment vehicle aimed at providing financial security in retirement.*

2. Based on your reading of the draft regulations released by Treasury, how will these apply to those defined benefit schemes? Will it be equitable? Should this not be in the primary legislation?

The draft regulations prescribe certain calculations and methods to value a defined benefit superannuation interest for Division 296 purposes. The regulations are intended to provide rules to enable commensurate treatment to be applied to defined benefit interest. Whether or not the regulations will actually achieve this is very difficult to determine. It is our understanding that most defined benefit funds have alternative valuation methods approved by the Minister and we do not have access to this information.

While the valuation methods and factors in the Family Law Regulations will provide a default valuation method for the purposes of Division 296, the Family Law Regulations are due to sunset on 1 April 2025 and are currently being reviewed. Therefore, it is difficult to form an opinion on the suitability of the valuation method, and whether or not they will provide commensurate treatment, as the relevant factors have not been published.

However, for impacted members what is clear is that the fund, or the fund's appointed actuary, will be responsible for valuing a defined benefit interest on an annual basis for the purposes of Division 296, and this will increase costs for all members.

For consistency, we would have preferred the calculations and methods for valuing a defined benefit superannuation interest were contained in the primary legislation. The fact that this important detail was released many months after the Bill, and just prior to the Senate Inquiry, made it very difficult for industry to properly consider the detail and likely impact of Division 296.

One observation is that women will be required to pay more tax under this measure compared to a male counterpart. This is due to the operation of the Australian Bureau of Statistics' life expectancy tables which consistently show women's life expectancies exceed that of men. These factors will directly impact the valuation of defined benefit fund interests for Division 296 purposes.

3. Does this new tax constitute double taxation?
If you view the existing 15% earnings tax and the new 15% Division 296 tax, together as one tax (i.e. an effective 30% tax on earnings), then there is no double taxation. However, we believe this approach is misguided. The existing 15% earnings tax is a tax on the fund's taxable income and the Division 296 tax is an individual member tax liability that will be applied to the increase in the impacted member's total super balance for the income year. They are both fundamentally different taxes and should be regarded as separate taxes. In our view, the correct interpretation is to say an amount of earnings that constitutes taxable income (as defined in the *Income Tax Assessment Act 1997* (Cth)) will be subject to two different taxes at two different points. Once on the operation of the specialist liability rules for capital gains in chapter 3 of the *Income Tax Assessment Act 1997* (Cth) and then again under Division 296. The operation of Division 296 in its current form can result in the payment of a tax premium to the headline tax rate on values that are never realised. While this measure allows for the calculation of losses which can be applied to offset future gains, it does not adequately consider the impacts where the value of fund assets fall below the arbitrary threshold that has been set, or where a decline in value occurs but does not again increase. Tax is applied on the rise in value, but compensation or adjustments are not guaranteed under the loss provisions. We note recent Treasury consultations which sought feedback on mechanisms to encourage members to increase the consumption of their superannuation balances in retirement. Under Division 296, any amounts withdrawn, regardless of when or how they are taken will be added back and included in the earnings calculation in the year withdrawn. Including the payment of this tax. This seems particularly punitive. A movement in a member's superannuation account balance will include many different elements. Not all of which relate to taxable income. Various accounting provisions and book entries and adjustments are required of prudent trustees and in accordance with accounting standards and policies. Aside from unrealised gains, provisions for other contingent liabilities or events are also made and adjusted for. Movements to taxes and tax adjustments will also directly impact the movement of a member's total superannuation balance. In Australia, tax is not paid on income taxes.

Appendix 2

Supplementary Information

Number of SMSFs with primary production land

We are not aware of any reliable ATO statistical data that could be used to estimate the number of SMSFs which hold primary production land and will be impacted by this tax. There are no labels on the SMSF annual return which would allow this source of income to be identified. It is not data that the ATO records or otherwise requires to be provided. Conclusive, or detailed ATO data is simply not available.

Similarly, any attempt to extrapolate this information from personal tax return data is likely to underestimate the number of SMSFs which hold primary production land. Primary production businesses may be structured in a variety of ways, using various structures available. This may include some or a mix of companies, trusts or SMSFs. As such, the income farmers receive may not appear in their personal income tax returns as primary production income. It may appear, for example, as wages, director fees, or dividends. Noting producers may not personally receive income each year.

Statistical data provided by the largest specialist SMSF auditing firm in the country, ASF Audits, shows 1,062 SMSFs audited by ASF Audits in 2021/22, out of a population of approximately 37,000 SMSFs, held primary production land and 20 per cent of those funds were likely to be impacted by this tax. Extrapolated across the entire population of 610,000 SMSFs, this equates to over 17,000 SMSFs who in 2021/22 held primary production land with just over 3,500 SMSFs holding primary production land that were likely to be impacted by this tax.

It should be noted the absences of indexation on the $3m threshold, and the historical movement in primary production land values, is very likely to result in many more of the remaining 13,500 SMSFs which in 2021/22 held primary production primary but may not initially be impacted by this tax, being impacted in the very near future.

The statistical data provided by ASF Audits also shows 24 per cent of SMSFs audited by ASF Audits in 2021/22, and which will be impacted by this tax, owned business real property. Extrapolated across the entire SMSF population this equates to over 13,000 SMSFs which hold business real property who are likely to be impacted by this tax.

This number will steadily increase as property values continue to rise. Further, this will impact couples whose balances currently fall below the threshold. Receipt of a death benefit pension on the passing of their spouse will result in an increase in their total superannuation balance. This will create additional stress for those trying to grieve their loss and maintain the family business. It is not an appropriate time to be making significant financial decisions on the substantial restructuring of their business and personal financial affairs. Such restructuring will also incur significant transactional costs.

Appendix 3

Alternative Methodology

Simple alternative solution

There are many unintended and inequitable outcomes that arise with a calculation of earnings that includes unrealised capital gains. These unintended consequences and inequitable outcomes could be avoided if the calculation of earning was based on actual taxable earnings or, if that is not possible, a measure of earnings that is a close proxy for actual taxable earnings.

If using actual taxable earnings is not a viable option, a close proxy for actual taxable earnings is the 90-day bank bill rate. Replacing the proposed calculation of earnings with an earning rate equal to the 90-day bank bill rate, would significantly simplify this new tax and substantially remove unrealised capital gains from the calculation of earnings.

Back testing over the past 30 years shows the extremely erratic and unpredictable behaviour of the proposed tax which includes unrealised capital gains in the calculation of earnings. This is because the tax is linked to movements in equity and property markets. In comparison, the 90-day bank bill approach produces much smoother and predictable outcomes, meaning impacted individuals would need to maintain much lower levels of cash reserves. Lower cash reserves mean higher long term investment returns and higher levels of capital investment.

One disadvantage with using the 90-day bank bill rate as a “notional earning rate” is that even in years when investment markets perform poorly, for Division 296 purposes impacted individual’s superannuation interests would still be deemed to have earnt earnings equal to the 90-day bank bill rate. However, the 30-year back testing shows impacted individuals would pay less Division 296 tax over the medium to long-term if, in every year, their superannuation interest was deemed to have received earnings equal to the 90-day bank bill rate rather than an amount of earnings calculated in accordance with the proposed formula in the Bill. This is likely to be the case even over relatively short periods of time which include one or more negative investment return years.

It should be noted, even in years of negative investment returns, a member’s superannuation interest will still receive taxable income (typically in the form of bank interest, dividends, trust distributions, lease income and realised capital gains). Given the 90-day bank bill approach provides greater predictability of future tax outcomes, this would enable SMSF trustees to better structure their investments to ensure this taxable income is always sufficient to cover their liabilities, including any Division 296 tax liabilities.

Replacing the proposed calculation of earnings in the Bill with a calculation of earnings equal to the 90-day bank bill rate will, over the medium to long term, result in less Government revenue than forecasted for this measure. However, the revenue collected will be far more predictable and any loss of revenue is likely to be immaterial over the long term given the amount of tax collected from superannuation death benefits is likely to be higher if amounts are retained in the superannuation environment.

The results of our back testing over the past 30 years were provided as part of our original submission to the Inquiry. We would be happy to undertake further back testing using different scenarios and assumptions if required.

Below are the suggested amendments to the Bill to replace the proposed calculation of earnings with an earning rate equal to the 90-day bank bill rate. These amendments not only substantially remove the taxation of unrealised capital gains, but they also significantly simplify the Bill and the operation of Division 296 by removing the subsections relating to unapplied transferrable negative earnings and the technical adjustments to the calculation of earnings to cater for withdrawals and contributions. These subsections would no longer be required.

Proposed amendments to the Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023.

Schedule 1

Subdivision 296-B – Better targeted superannuation concessions

Subsection 296-10

Omit 296-10, substitute:

296-10 What this Subdivision is about

This Subdivision reduces the superannuation tax concessions for individuals with large total superannuation balances. Subject to certain exceptions, a tax is payable on a proportion of your superannuation earnings for an income year if your total superannuation balance at the end of the year exceeds the large superannuation balance threshold.

[Omit proposed Section 296-40]

Substitute, Section 296-40:

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

Your *total superannuation balance at the end of the previous income year	x	notional earnings rate

Where:

Notional earnings rate, means the annual average of the quarterly base interest rate for the income year.

NOTE: The base interest rate is defined in section 8AAD of the TAA. The base interest rate is adjusted quarterly, as the mean yield on 90-day Bank Accepted Bills for the middle month of the preceding quarter. The base interest rate must be rounded to two decimal places (rounding .005 upwards).

Subdivision 296-45
Omit

Subdivision 296-50
Omit

Subdivision 296-55
Omit

Subdivision 296-60
Omit

Subdivision 296-C
Omit.