The Tax Institute

26 April 2024

Alan Raine
Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email economics.sen@aph.gov.au

Dear Mr Raine,

Treasury Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023

On behalf of The Tax Institute, we thank the Senate Economics Legislation Committee (the **Committee**) again for the opportunity to appear as a witness regarding its inquiry and report on the:

- Treasury Laws Amendment (Better targeted Superannuation Concessions and Other Measures) Bill 2023 (the **Bill**);
- Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023 (the **Imposition Bill**); and
- accompanying explanatory memorandum (the **EM**).

During the public hearing on 18 April 2024, Senator the Hon Dean Smith asked me questions regarding the Treasury's response to certain proposals The Tax Institute had made in its submission during the consultation for the exposure draft of the legislation. I confirm that I provided a response to these questions by email on 23 April 2023. A copy of the questions asked along with my response to Senator Smith is extracted in **Appendix A**.

Further, on 23 April 2024, Senator the Hon Andrew Bragg, Deputy Chair of the Committee sent by email a number of questions on notice. Details of the questions, along with my response to Senator Bragg, are contained in **Appendix B**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

If you would like to discuss any of the above, please contact me on [redacted].

Yours faithfully,

[redacted]

Julie Abdalla

Senior Counsel – Tax & Legal

APPENDIX A

I have set out below my response to Senator Smith's questions that were asked during the public hearing held on Thursday 18 April 2024 and provided to the Committee by email on 23 April 2024.

Questions

Senator Smith's questions may be summarised broadly as follows:

- How has the Treasury responded to TTI's comments regarding the treatment of disability, medical and related insurance payments? Is the Treasury alive to those matters?
- How has the Treasury responded to the deferral mechanism recommended in the TTI submission? What level of engagement and interest has the Treasury shown?

While I answered in part during the public hearing, Senator the Hon Jess Walsh, Chair of the Committee, requested that the questions be taken on notice in the interest of time.

The Tax Institute's response

We did not receive a response from Treasury regarding either of these matters, or indeed any of the issues put forward in our submission to the Treasury dated 19 October 2023, a copy of which is attached.

Until we heard Treasury's responses to Senator Smith's questions yesterday, it was not clear to us whether Treasury had considered these issues, or whether there was any appetite to accommodate our recommendations. As the Committee would be aware, they were not reflected in the draft Bill.

We do not agree with the reasoning put forward by the Treasury in distinguishing structured settlement payments from total and permanent disability (**TPD**) proceeds or terminal medical condition (**TMC**) payments, simply because they are distinguished in relation to the transfer balance cap. Given that all of these categories of payments ultimately relate to compensation for loss or serious injury, or terminal illness, we consider that it is not inconsistent with the policy of the proposed measure to treat them equally. We would expect that alignment across the treatment of these payments would not be a significant cost to revenue but would have a significant impact on the recipients of such payments. We also note other differences between the transfer balance cap and the proposed measure, namely that the transfer balance cap is subject to indexation whereas the proposed measure is not. It is, in our view, inadequate to cherry-pick certain aspects on the basis of consistency, while disregarding others, particularly where they may impact Australians in difficult life circumstances.

In relation to the deferral mechanism we had proposed, Senator Smith asked the Treasury why they considered it was not suitable. The Treasury's response suggested that an ability to defer would be a type of tax concession and referred to the 84-day period in which an affected taxpayer must pay their liability as providing flexibility. While we acknowledge that a deferral may be in a way concessionary, given the various concerns we have raised throughout our submission, including the potential for taxpayers to have to liquidate assets to pay their Division 296 liability, an 84-day period is, in our view, insufficient.

The Treasury acknowledged that the 84-day period was an arbitrary choice, and we would urge the Committee to recommend a longer period to alleviate the pressure on affected taxpayers.

If it would assist the Committee to provide any further information about the treatment of TPD, TMC and related insurance payments, the deferral mechanism, or any other aspects of the proposed measure, please do let me know.

APPENDIX B

I have set out below my response to Senator Bragg's questions that were sent via email on 23 April 2024.

Question 1

What are some of the unintended consequences you are concerned with?

The Tax Institute's response

The Tax Institute is concerned that the implementation of Division 296 as currently drafted in the Bill will result in several unintended consequences, including:

- **Increased liquidity pressures on superannuants** – the taxation of unrealised gains results in a mismatch between the cash flow from the realisation of an asset by the superannuation fund and the tax liability arising from the unrealised gain. Superannuants with low cash balances and/or illiquid assets will be placed under significant financial pressure to pay their Division 296 liability. A mechanism that allows taxpayers to defer their tax liability would result in a more equitable outcome by allowing these taxpayers a more reasonable period to pay their Division 296 tax liability.
- **Not allowing taxpayers who die to utilise losses** – the current approach of allowing taxpayers to only carry forward losses inequitably prevents taxpayers who die with a carried forward loss from being able to recognise the reduction in value of their superannuation assets. This means that taxpayers may be put in a position where they incur a tax liability based on an unrealised value that is higher than the realised value of an asset, effectively resulting in the overpayment of tax. A loss carry-back mechanism would mitigate this and better ensure that the tax collected is an accurate reflection of the realised value of the relevant assets and therefore the 'taxable superannuation earnings' used to calculate the Division 296 tax liability.
- **Liability to taxation based on the date of death** – if a taxpayer dies on any day in the income year, other than 30 June, they will not be subject to Division 296 tax for that income year. However, taxpayers who die on 30 June will be liable to Division 296 tax for that income year. We consider this to be a grossly unfair and unnecessary outcome that inappropriately levies a tax based on factors beyond the control of the taxpayer. There is, in our view, no reasonable basis why a taxpayer who dies on 30 June should have a different tax outcome to someone who dies on 29 June. We consider that a taxpayer should not be liable to Division 296 tax for an income year in which they die, irrespective of the day on which they die in that income year.
- **Impacting a larger number of taxpayers than intended** – the Government's announcement regarding Division 296 stated that approximately 0.5% of Australians, or around 80,000, will be impacted by the additional 15% tax. However, the proposed threshold of $3 million is not proposed to be indexed or subject to a regular legislative review. As a result, Division 296 will likely suffer from bracket creep, impacting a larger number of taxpayers than intended over time. This will affect an increasing number of taxpayers year on year and is not merely a problem arising decades into the future.

- **Inconsistent taxation of amounts relating to compensation for serious injuries or medical conditions –** currently, amounts received from structured settlements are exempt from being included in any manner for the purposes of determining a Division 296 tax liability. However, only proceeds from total and permanent disability (**TPD**) or terminal medical condition (**TMC**) payments are excluded from the contributions total. TPD and TMC payments will not be subject to Division 296 tax only in the income year they are received by the superannuation fund. However, TPD and TMC payments will be subject to Division 296 tax in the income years following the income year in which the payment is made. As stated in my response to Senator Smith's questions in Appendix A above, The Tax Institute does not agree with Treasury's stated rationale for this differentiated approach. We consider that TPD and TMC payments should be equally exempted from the operation of Division 296.
- **Incurring a Division 296 tax liability on funds withdrawn to pay tax liabilities –** under the relevant formulas used to calculate the total superannuation balance (**TSB**), amounts withdrawn from a superannuant's account are added back when calculating the Division 296 liability. In principle, this step is necessary to ensure that taxpayers do not avoid a Division 296 liability simply by withdrawing funds. However, there are some exceptions to the withdrawals principle to recognise that not all withdrawals are made to support a taxpayer's lifestyle or retirement. However, currently under the Bill, amounts validly withdrawn to pay certain tax liabilities through a release request (such as under Division 293 and proposed Division 296 of the *Income Tax Assessment Act 1997* (**ITAA 1997**)) are proposed to be added back. This means that taxpayers will be effectively required to pay Division 296 tax on amounts they are explicitly permitted by the legislation to withdraw from superannuation to pay tax liabilities. We consider that these withdrawals should not be added back into the calculation of the TSB as those amounts are not used to support the taxpayer's lifestyle or retirement. Those amounts can be used only to pay certain tax liabilities.
- **A lack of sector neutrality –** feedback from our members indicates that the approach proposed under the Bill is not likely to achieve the desired objective of sector neutrality. Due to their inherent features and associated compliance obligations, self-managed superannuation funds (**SMSFs**) and defined benefit plans are likely to be more adversely impacted in various ways ranging from their liability to Division 296 tax to the associated compliance costs. The proposed approach may benefit from reconsideration to ensure that the final approach is capable of achieving sector neutrality.

Question 2

How could this adversely affect those with SMSFs? Is there a liquidity risk for those with farms in their SMSF?

The Tax Institute's response

We note that:

- as of June 2022, approximately 76% of people with superannuation accounts had only one account;[1] and
- although SMSFs may have up to six members, approximately 68% of SMSFs are two-member funds and 25% are single-member funds.[2]

This means that approximately only 7% of SMSFs have more than two members. Further, our understanding from our members is that most SMSF members do not have additional, separate superannuation funds.

Feedback from our members suggests that the proposed taxation of unrealised gains under Division 296 is expected to have a disproportionately greater impact on SMSFs. The feedback also indicates that the concentration of members in single-member or two-member funds results in higher portfolio volatility at the member level, including in relation to the attribution of unrealised capital gains. Such volatility is in part due to the small number of members in an SMSF. For this reason, we consider that SMSFs are disproportionately more likely to be adversely impacted by Division 296.

The liquidity concerns for SMSFs with farms as the primary asset are likely to be the same as for any superannuation fund with an illiquid portfolio. That is, these taxpayers may have to sell their assets at prices lower than market value due to the timing constraints for payment of a Division 296 liability, while also incurring the costs of re-investing the lesser value of sale proceeds into a different (and potentially sub-optimal) investment strategy. This issue is even more concerning where the assets required to be sold form the basis of a taxpayer's livelihood as in the case of farmland held by farmers in SMSFs.

Further, the Bill proposes a 60-day period for individuals to elect to release a certain amount from one or more of their superannuation funds for the purpose of paying the tax. This leaves only 24 days from when the trustee of the superannuation fund receives the release request for the superannuation fund to release the funds so the individual can pay their liability by the due date. This is also, in our view, a grossly inadequate period.

Question 3

Does this tax constitute double taxation?

The Tax Institute's response

Division 296 sets an additional tax that a certain category of taxpayers will be required to pay which gives effect to the Government's policy intent to tax certain superannuation earnings at a higher rate. The Tax Institute recognises the Government's right to determine the rate of taxation for different sectors of taxpayers in a progressive system.

In our view, and as reflected in our responses to Questions 1 and 4, we consider that the paramount issue is that the mechanism utilised to determine the amount of a Division 296 tax liability contains a number of inequitable elements and sets an undesirable precedent in relation to the taxation of unrealised gains.

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1 ATO, 'Trend towards single accounts', available here.

2 ATO, 'SMSF quarterly statistical report, September 2023', available here.

Question 4

What tax principles does this Bill breach, by taxing unrealised gains?

(a) How does the TSB calculation work? Is there anything else like this in the tax system?

(b) Is this a wealth tax?

(c) Is this an example of essentially overpaying tax on income you never earnt?

The Tax Institute's response

No explicit principle in Australia's taxation or superannuation system precludes the taxation of unrealised gains. However, it is contrary to one of the fundamental principles of good tax policy and law design: equity. It is inequitable to tax an unrealised gain.

Taxing unrealised gains is also contrary to well-established practice within our taxation and superannuation system. Specifically, the taxation of unrealised gains is contrary to the approach taken across the vast majority of Australia's capital gains tax (**CGT**) regime, where the relevant tax liability arises only when the asset is sold, disposed of, or otherwise realised.

There are limited instances where unrealised gains may be brought to tax. Such cases are generally limited to anti-avoidance measures and are usually coupled with deferral mechanisms, unlike proposed Division 296. A key example cited publicly by the Treasury is CGT event I1.

Broadly, CGT event I1 deems a CGT event to happen when an individual stops being an Australian resident for tax purposes. The individual's assets are taken to be sold at the market value at the time they stop being a resident. However, and unlike Division 296, the individual is given the option to defer the tax liability until a CGT event happens in respect of the assets, or the individual again becomes an Australian resident.

Further, CGT event I1 is limited in scope and unlikely to apply to a broad spectrum of taxpayers. Conversely, Division 296 is not limited in scope and can potentially apply to any taxpayer above the defined threshold, which can be raised or lowered based on a future Government's intentions.

The Tax Institute maintains strong concerns regarding unrealised gains being taxed under proposed Division 296, and the potential for this to establish an inappropriate precedent in our tax system.

Question 4(a)

Below is a basic example of how a Division 296 tax liability will be calculated. We note that this example is for illustrative purposes only and real scenarios are likely to be far more complicated.

Facts and assumptions

Peter has an opening total superannuation balance (**TSB**) of $5 million. During the income year, he makes non-exempted contributions of $50,000 and non-exempted withdrawals of $250,000. The superannuation fund earns $300,000 for the income year. Further, the value of the assets increases by $200,000.

As a result, the closing TSB for the income year is $5.3 million. This is calculated as the opening balance + net income + change in the value of the assets + contributions – withdrawals ($5,000,000 + $300,000 + $200,000 + $50,000 – $250,000).

Calculation

Step 1: Calculate earnings percentage

This is calculated using the following formula[3]:

$$\frac{\text{(total superannuation balance at year end – \$3 million)}}{\text{total superannuation balance at year end}} \times 100$$

$$= \frac{\text{\$5.3 million – \$3 million}}{\text{\$5.3 million}} \times 100$$

= 43.40%

Step 2: Calculate the current adjusted TSB

This is calculated using the following formula[4]:

TSB at year end + withdrawals total for the year – contributions total for the year

= $5.3 million + $250,000 – $50,000

= $5.5 million

Step 3: Calculate the total superannuation earnings (**TSE**)

This is calculated using the following formula[5]:

Current adjusted TSB – TSB at the end of the previous income year

= $5.5 million – $5 million

= $500,000

Step 4: Calculate the proportion of earnings subject to Division 296 tax

This is calculated using the following formula:

Percentage calculated under Step 1 × TSE

= 43.40% × $500,000

= $217,000.00

Step 5: Calculate the Division 296 tax liability

This is calculated using the following formula:

Figure from Step 4 × 15%

= $217,000.00 × 15%

= $32,550.00

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[3] Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023 (Cth) – Exposure Draft, Schedule 1, section 296-35.

[4] Ibid, Schedule 1, section 296-45.

[5] Ibid, Schedule 1, section 296-40.

Complex calculations exist across our taxation and superannuation regime, although as noted above, they generally do not have the effect of taxing unrealised gains as Division 296 proposes to do. This will not simply always give rise to merely a timing difference between paying tax on a gain before it is ultimately realised. In some cases, there will be a permanent impost of tax on an amount that may never be realised, such as where:

- an individual dies after paying Division 296 tax on an unrealised gain and then in a later income year has ‘unapplied transferrable negative superannuation earnings’ (**unused carried forward losses**) that are not applied before they die; and
- Division 296 tax is paid on an unrealised gain and the later sale of the asset results in a realised gain for a lesser amount.

Question 4(b)

Division 296 may be regarded as a wealth tax in the sense that a tax is imposed based on the value/worth/assets of an individual, but it encompasses only one component of wealth and does not consider an individual’s wealth holistically. Whether a wealth tax of any kind is appropriate in Australia should be subject to extensive and meaningful consultation.

Question 4(c)

Concerns about tax liabilities arising despite the asset not having yet been sold are essentially concerns about the taxation of unrealised gains.

From a purely theoretical perspective, the taxation of unrealised gains should produce the same net outcome as the taxation of realised gains, as long as taxpayers are given timely recognition of their losses as well as their gains. However, the theoretical position does not factor in any of the practical difficulties we have raised with the Treasury and the Committee that make it untenable.

Whether tax is ultimately overpaid under Division 296 will likely depend on the taxpayer’s individual circumstances. For example, a taxpayer will have overpaid Division 296 tax if they die while they still have unused carried forward losses. In this instance, the taxpayer has effectively overpaid Division 296 tax as their tax liability has been determined based on an asset value that was higher than the actual value of the asset when it was realised.

Question 5

Can you explain the difference between the approach taken in this Bill compared to standard taxation of super earnings and contributions?

The Tax Institute’s response

The approach that Division 296 takes to taxation is demonstrated in our response to Question 4(a) above. Broadly, the formula attempts to determine a proxy to reflect the growth in the superannuant’s balance that is not attributable to contributions or withdrawals made by the superannuant. This proxy figure is the ‘earnings’ of the superannuant’s account. Division 296 tax is then levied on the proportion of the earnings that reflects the amount of the superannuant’s balance that exceeds $3 million.

Broadly, under the existing system, tax is generally levied on superannuation on one or more of the following:

- contributions when they are made;

- the actual earnings of the superannuation fund once they are realised; and
- the withdrawal of funds from superannuation.

The current system generally taxes employer superannuation guarantee (**SG**) contributions and voluntary (pre-tax) concessional contributions at a flat rate of 15%. Non-concessional contributions are made after an individual has already paid personal income tax on the relevant amounts contributed. Various rules determine the limits and rates of tax for exceeding the relevant caps or thresholds that impose excess contributions tax on the individual (who can request a release from superannuation) on contributions that exceed their concessional or non-concessional contributions cap. Please advise if it would assist the Committee for us to provide further details in this regard.

The actual earnings of superannuation funds are also taxed at 15% (subject to whether the superannuation fund is in retirement phase and the individual has maximised their personal transfer balance cap). If a superannuation fund makes a gain from the sale of a CGT asset, the taxing point arises only once the asset is realised. The amount of the taxable gain included in the fund's assessable income is discounted provided certain conditions are met.

The taxation of withdrawals depends on the superannuation phase of the taxpayer and whether the withdrawal is from a taxed or untaxed element, and from a taxable or tax-free component. Broadly, withdrawals are tax-free if the superannuant is aged above 60 years.

We note that Division 296 does not alter the existing tax regime or change the tax position of superannuation funds. It is proposed to apply in addition to the existing rules.

Question 6

Do you think the Treasury is just hoping to rake in more revenue than it is owed?

The Tax Institute's response

The Tax Institute recognises the Government's right to impose, increase and otherwise modify new or existing taxes. This will necessarily impact the amount of tax collected. We are primarily concerned with the mechanism utilised, and ensuring that the practical outcomes are:

- efficient — reducing, or at the very least not unduly increasing, any associated compliance and administration costs;
- fairly implemented — ensuring that no taxpayers are inequitably disadvantaged;
- consistent with the stated policy intent; and
- administered by the Commissioner of Taxation in a manner that is consistent with the policy and intended legislative outcome.

It is difficult to undertake a thorough analysis of whether the revenue collected will be consistent with the intended policy outcome without access to data and assumptions used by the Treasury in the modelling of future revenue forecasts. As a matter of good governance and transparency, we consider that this information should be made publicly available.

In recent years, changes to Australia's tax and superannuation systems appear to be directed towards either increasing revenue or integrity, or both. Division 296 may generate more revenue than expected under the stated policy intent due to several inherent design features including, but not limited to:

- the lack of indexation capturing more people than intended over time; and
- the inability to carry back losses, potentially resulting in tax being levied on a higher asset value than that at which the asset was actually realised.

Addressing these issues will help to ensure that Division 296 is better targeted and is more likely to collect the intended amount of tax revenue.