Comments on the Government's proposed new Superannuation Tax

The Government is set to introduce a new tax on superannuation funds with assets above $3 million. While the decision to increase taxes on large superannuation funds is widely supported, the way in which the tax has been structured is inconsistent with the principles of existing Australian taxation, is contrary to the stated objective of the changes, and has the potential to inflict some erratic outcomes. The most extreme of these could damage the capacity of some superannuation funds to support retirement income. Ironically, a relatively simple adjustment to the Government's proposed tax structure would remove these anomalies.

The stated objective of the new tax is to make Australia's superannuation system "more sustainable and fairer".[1] In practical terms, the objective is to reduce (although not necessarily to eliminate) the extent of the tax "concession" afforded to high-wealth superannuants. That concession, which has been estimated by Treasury to be in the order of $50 billion per annum, arises from the taxation of earnings in superannuation funds at either 15% (in accumulation funds) or 0% (in retirement funds), both of which are well below the top marginal tax rate of 45% on ordinary taxable earnings. The Government's desire to claw back some of this lost revenue is understandable and widely supported, even by many high-wealth superannuants.

In terms of context, it should be remembered that the impact of this tax will fall (at least initially) on a generation that has been both forced and incentivised to accumulate superannuation over the past 40 or more years. It did so while also been asked to fund the public pensions for older generations who had no superannuation. Importantly, it did so under a set of rules that has recently started to change materially, to the detriment of those recently retired or facing retiring. These considerations do not rule out a tax increase at the upper end. **They do, however, demand that any changes made to the tax structure be both consistent with the Government's stated objective and demonstrably fair. Anything less would be a betrayal of the older generation of Australians**.

That the changes be consistent with the Government's stated objective requires that the additional tax paid by any superannuant should result in a total tax that is somewhere between that paid under the current concessional rate and the amount that would have been paid had the fund's assets been held outside the fund. That is, any change to the tax structure should reduce the revenue lost due to the existing tax concessions; it should not generate excess tax (i.e., tax greater than would have been raised if the assets were held outside super); nor should it fail to collect tax in situations where some extra tax should reasonably be paid. That the changes be demonstrably fair requires that the additional taxes apply evenly to different types of income and do not have the potential to impair the fundamental ability of an individual's superannuation fund to provide an adequate income in retirement or force distressed sales of assets accumulated over time in good faith.

The Government's proposed tax changes fail both of these requirements.

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[1] See paragraph 1.7 on p. 4 of the Exposure Draft Explanatory Memorandum.

The Proposed New Tax Structure for Superannuation

The Government's proposed new tax on superannuation funds is set out in Treasury's Consultation Paper[2] and the draft Law[3]. It can be summarised as follows:

- Taxable earnings on superannuation funds will be measured in two ways:
  - **Measure 1** follows the same methodology currently used for calculating taxable earnings on superannuation assets. That measure is based on realised income. This measure includes some concessions; for example, realised capital gains on properties held for longer than 12 months are given a 33.3% discount when included in taxable earnings.
  - **Measure 2** is calculated conceptually as the difference in the market value of the fund's assets (called Total Superannuation Balance or TSB) at the end of the period compared with the TSB at the beginning of the period. In calculating taxable earnings under measure 2, the TSB at the end of the period includes the mark-to-market value of the end-of-period assets (regardless of whether or not they have been realised), and is adjusted up for any distributions from the fund during the period (e.g., due to payment of a pension if the fund is in retirement mode) and down for any contributions to the fund during the period (e.g., if the fund is in accumulation mode).
- Tax paid by superannuation funds on Measure 1 will be unaffected by the proposed changes. That is, funds in accumulation phase will continue to pay 15% on Measure 1 of taxable earnings, while funds in retirement phase will continue to pay no tax on Measure 1.
- The second measure of taxable earnings is only triggered when the adjusted TSB of the fund at the end of the period ($TSB_{t+1,a}$) is above the TSB "cap" of $3 m. In this case, the fund will pay 15% tax on Measure 2[4]. Thus, for example, if TSB_t is $4 m and $TSB_{t+1,a}$ is $5 m, Measure 2 of taxable earnings would be $1 m and the tax payable by the fund would be $60,000 (.15 x $1 m x 40%).
- There are two small additions to this basic summary:
  - First, in cases where the starting TSB is below the $3 m cap, Measure 2 of taxable earnings is limited to the change in asset value above $3 m (i.e., $TSB_{t+1,a}$ - $3 m, rather than the full amount of $TSB_{t+1,a} - TSB_t$).
  - Second, the Discussion Paper proposes that individuals may be permitted to pay the additional tax under Measure 2 either from the superannuation fund's assets or from assets held outside the superannuation fund.

The Logical Flaw in the Government's Proposed New Tax Structure

The logical flaw in the Government's proposed tax changes arises from its use of two entirely different concepts of taxable earnings for Measure 1 and Measure 2.

The basis of Australian taxation applied to individuals (and, indeed, of taxation applied in virtually all countries) is that graduated tax rates are applied to a single, consistent measure of taxable earnings that includes realised income and realised capital gains and losses, but not

[2] Better targeted superannuation concessions, Consultation paper, Commonwealth Treasury, 31 March 2023.
[3] Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023.
[4] In the case of an accumulation fund, the tax on Measure 2 would be 'additional' to the 15% tax it pays on Measure 1, although the two taxes of 15% are likely to be very different in magnitude since they are based on completely different measures of taxable earnings.

unrealised income (whether gains or losses), that is, Measure 1 above. The principal underlying the use of realised income in calculating taxable earnings for individuals is well established and widely understood; namely, that capital gains and losses are largely irrelevant in calculating taxable earnings until they are crystalised. The normal measure of taxable earnings includes (allowable) deductions, and legislated concessions (such as concessional recognition of certain capital gains).

Importantly, this normal concept of (realised) taxable earnings is currently applied to earnings that are generated by assets held in superannuation funds and earnings that are generated by assets held outside superannuation funds. Treasury's estimate of the cost of superannuation tax concessions was presumably based on applying different tax rates to taxable earnings measured in this way.

The tax changes for superannuation proposed by the draft tax law diverge from this principle of good taxation by introducing two different concepts of taxable earnings that apply in tandem to any given fund. The proposed changes continue to apply the 'normal' concept of taxable earnings on superannuation assets for funds with TSB below the $3 m. However, for funds with TSB above the $3 m cap, an additional concept of taxable earnings (Measure 2) is introduced – one that is fundamentally at odds with Measure 1. Critically, Measure 2 includes Measure 1 (since realised earnings contribute to ending TSB) plus unrealised capital gains and losses.

While the distinction between the two measures is not material for earnings generated from employment, it is potentially very material for superannuation funds which are composed entirely of investments in assets, the market value of which may fluctuate significantly from period to period.

This change in the definition of taxable earnings from a single, consistent measure to two conflicting measures introduces anomalies that demonstrably fail both the requirements of fairness and consistency with the Government's objective.

The inconsistency of the new tax with the Government's objective is illustrated by the following example.

Example 1

A current worker has initial assets (TSB_t) of $2.8 m in a SMSF accumulation fund (of which he is the only member).[5] During the year the fund earns income of $84,000 (i.e., 3% on funds invested).

Under current arrangements, the concessional tax rate of 15% would result in the fund paying $12,600 in tax on the fund's assessed taxable earnings of $84,000 (Measure 1). Those same assets, if held by the individual outside the superannuation fund would incur a maximum of $37,800 in tax (at the maximum 45% rate on the same measure of taxable earnings).[6]

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[5] For simplicity, all of the examples in this paper focus on a single individual who is the member of a self-managed superannuation fund (SMSF). While SMSFs are more likely than other funds to experience the anomalies raised in the paper (because of the greater concentration and low liquidity of many of their investments), the conclusions of the analysis are by no means limited to SMSFs.

[6] For simplicity, I ignore the possibility that an individual may pay less tax on income earned outside the fund. This would be the case if other earnings were below the level at which the top marginal tax rate becomes

Under the new tax proposal, the super fund will still pay $12,600 on Measure 1 of taxable earnings. Whether any additional tax is payable depends on whether the fund's TSB at the end of the period exceeds $3 m.

For example, suppose the assets in the above fund appreciated in value by $1,000,000 over the course of the year (due to asset price movements, currency movements, etc.).[7] The increase would result in an adjusted TSB at the end of the year (including the realised income earned and the asset revaluation) of $3,884,000. Under the Government's proposed tax changes, the superannuant would be liable for 15% "additional" tax on Measure 2 of taxable earnings; namely, the change in value of the fund above $3 m (but only on the percentage of TSB above $3 m – i.e., 23%). Measure 2 of taxable earnings would be $884,000 and the additional tax payable would be $30,180 (15% x $884,000 x 23%).

Thus, the fund would pay total tax of $42,780.[8] Since unrealised gains are not taxed on assets held outside the fund, the fund would pay $4,980 **more** in tax than the individual would have paid if the assets had been held outside the fund.[9] The **effective tax rate** on the fund's **realised earnings** of $84,000 would be 51%, which is beyond the upper bound of Australia's current tax scales.

The fact that the tax on a super fund under the Government's proposed changes might exceed the tax that would be payable if the same assets were held outside the fund runs counter to the Government's stated objective of reducing the gap between current superannuation tax concessions and the tax that would be raised if the assets were held outside superannuation.

The potential anomalies that could arise from the proposed tax changes are not limited to over-taxation (as in the example above). There are parallel situations where the Government's proposed tax would fail to gather any of the "lost revenue" that the Government is seeking to capture. Such a situation is illustrated in Example 2 below.

Example 2

In this example the individual has an entitlement of $20 m in a SMSF accumulation superannuation fund. Taxing such high-wealth individuals was a big driver behind the Government's proposed tax changes.

Suppose realised earnings in the year are high (e.g., 12%), yielding Measure 1 taxable earnings for the individual of $2.4 m. Under current arrangements, the super fund would pay $360,000 in tax on behalf of the member, compared with $1,080,000, which the member would pay if the assets were held in his own name outside the fund. The "lost" revenue in this case is a whopping $720,000.

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applicable. Allowing for such situations (e.g., for individuals who have retired) would make the anomalies highlighted in this paper even more dramatic.

[7] The increase in asset value in this example is 35%. While this is arguably large, it is not outside the realms of historical experience. In any case, the potential for the new tax to increase the overall tax take beyond what would be paid on assets outside the fund can still be illustrated at much lower increases in asset values.

[8] As noted above, the Government's proposal allows the individual to either pay the extra tax from the super fund or from assets held outside the super fund. Regardless, the cost to the individual is still additional tax of $30,180.

[9] As noted above, the "excess" tax paid by the individual will be even greater if the individual's other earnings generated taxable earnings that are below the level at which the 45% maximum tax rate for normal earnings applies.

Suppose that, in this case, the unrealised market value of the member's share of the assets in the fund falls by $2.4 m (net of any contributions), thereby leaving his adjusted TSB at the end of the period the same as his TSB at the beginning. In this case, Measure 2 taxable earnings would be zero and the new tax would raise zero in additional tax from this member.

Thus, despite the fund generating $2.4 m in taxable earnings for the individual, the new tax would raise no additional tax from him and would capture no part of the lost revenue that the Government is supposedly targeting with its new law.

While an effective tax rate in excess of 50% in the first example, and no more than 15% in the second, is a strong indication that the new tax is likely to fail the test of fairness, the potential extent of the unfairness is better illustrated in Example 3.

Example 3

A somewhat hidden, but clearly intentional feature of the new tax, is that it effectively double taxes capital gains in large funds. That is, realised capital gains are taxed as part of Measure 1, while unrealised capital gains are taxed as part of Measure 2.[10]

The impact of this double taxation is clearest in years where a capital gain is realised.

For example, consider a farmer who has included his farm within his accumulation phase SMSF. Suppose the farm was valued at $500,000 at the time it was included within the fund and that, over the course of say a decade, the market value of the farm has increased to $2 m. The farm is part of the farmer's overall SMSF which has TSB_t of $3 m. [11]

Suppose that, during the current year, as a result of a shortage of prime rural land, the value of the farm doubles to $4 m. Suppose the fund is currently leasing the farm to a third party at a yield of 1.5 % p.a. on its market value of the previous year. Suppose the fund is earning 3% on the farmer's other $1 m of superannuation investments. Before any consideration of asset sales, the fund is therefore currently generating Measure 1 taxable earnings of $60,000 p.a., on which it would pay $9,000 in tax.

Under the Government's proposed tax, Measure 2 taxable earnings for the fund would be $2 m, on which the fund would be required to pay an additional $120,000 in tax. The combined tax on Measure 1 and Measure 2 is $129,000, which is $69,000 more than the total cash earnings of the fund for the period (indeed, the effective tax rate on realised earnings would be 215%).

As others have observed, situations like this could cause a liquidity problem for the fund, which could force the sale of the farm.

Suppose that, in order to provide the liquidity needed to pay the tax, the farmer sells the farm at the end of the period at its market value of $5 m. In this case, Measure 1 taxable earnings would be increased by 2/3 of the realised capital gain of $3.5 m, while Measure 2 would be

[10] While the focus of Measure 2 is on unrealised capital gains, it also captures realised capital gains, since they will be reflected in the ending value of TSB.
[11] The farm example is well stated by Peter Burgess, "$3m super tax cap will hit farmers' finances", AFR, 15 June 2023.

unchanged. The additional tax on the realised capital gain under Measure 1 would be $350,000 (15% x $2,333,333).

In this case, where the capital gain is realised during the tax year, the farmer pays a total tax on his capital gains of $470,000, which is an effective capital gains tax rate of 13.4% (($350,000 + $120,000)/3,500,000). While the actual effective tax rate will be different for each situation (depending, for example, on the size of the find and the original purchase price of the assets in question), where a capital gain is crystalised during the year the outcome is reasonably consistent with the Government's objective for the new tax.

However, the situation can change materially where the asset subject to capital gain is not sold within the tax year.

If the farmer does not sell within the tax year, the Measure 2 tax of $120,000 is still due and payable, regardless of the fact that it exceeds the realised earnings of the fund for the tax year. If, in the following year, the value of the farm falls back to its historical level (due to a change in market conditions), the tax will lower the value of the fund, notwithstanding that the increase in value that generated the tax may no longer be realisable.

There are any number of assets that could experience such erratic valuation movements over time. In addition to farms, residential and commercial properties have experienced sharp fluctuations in value. Equities, especially those in limited sectors, such as small caps and technology stocks, have shown historical price volatility, and any foreign investments that incorporate currency risk are doubly exposed to sharp fluctuations in value. More recently, crypto assets, which are held in a number of large public offer superannuation funds, as well as some SMSFs, have shown the potential to increase by multiples of their value in a short period and then to drop to zero.

In the case of superannuation funds in retirement mode, there is the potential that volatile asset values could lead to taxes being paid on unrealised capital gains in one period, while any offset to future capital gains from a subsequent price collapse may be totally unusable if the value of the fund falls below the $3 m cap. If the fluctuations in asset values were sufficiently large, there is a risk that Measure 2 taxes on unrealised capital gains could erode the value of the fund and therefore its capacity to sustain retirement income.

Can the Government's Proposed Super Tax be Salvaged?

The examples chosen above are not the only examples of anomalies that could arise under the proposed tax. The point is that the introduction of a completely new measure of taxable earnings for superannuation earnings on assets above $3 m has the potential to create anomalies that lie outside the objectives of the proposed tax and that could violate any concept of fairness to the retired generation.

The solution for restoring the integrity of the new tax is relatively simple. The simple fix would be to use the proposed asset benchmark to set a higher tax bracket on the same measure of taxable earnings that is used for all other taxation purposes.

For example, the Government's proposed tax appears to be attempting (in a very erratic and potentially damaging way) to introduce a graduated tax (including the base taxes of 15% for accumulation funds and 0% for retirement funds) that increases from 15% (for accumulation

funds to just under 30% and from 0% for equivalent retirement funds, to just under 15% for funds that are enormous.

The desired outcome can be achieved without needing to introduce a second concept of taxable income. In this **Alternative Structure** the imposition of the higher tax rates would operate as follows:

- Taxable earnings would be calculated as per Method 1. This would be the **only** concept of taxable earnings applied.
- Following the Treasury's model, fund assets would still be divided into TSB below $3 m and TSB above $3 m. To remain consistent with Treasury's model, the basis for this division would be adjusted TSB_{t+1}. For example, if $TSB_{t+1,a}$ were $4 m, TSB below $3 m would be $3 m (75% of total), and TSB above $3 m would be $1 m (25% of total).
- Using these percentages, taxable earnings would be divided into earnings on TSB below $3 m (**low-TSB earnings**) and earnings on TSB above $3 m (**high-TSB earnings**). A fund with adjusted ending TSB below $3 m will have no high-tax earnings.
- Tax on low-TSB earnings would be taxed at the rates of 15% for accumulation funds and 0% for retirement funds. This is exactly the same way in which those earnings are taxed at present.
- Tax on high-TSB earnings would be taxed at 15%, multiplied by the proportion of high-TSB assets in the fund. Thus, the rate of tax on high-TSB earnings will increase steadily (from 15% for accumulation funds and from 0% for retirement funds) as the size of the fund increases above $3 m.

Under this Alternative Structure, tax would only be levied on realised income, thereby removing the potential for the anomalies identified in the Government's proposed tax structure. In Example 1, the tax payable by the super fund under this Alternative Structure would be $14,568. In Example 2 it would be $666,000 and in Example 3 it would be $12,600. In each case, the total tax would be less than the realised income of the fund. In none of these cases would the new tax result in forced asset sales to meet tax obligations. Nor would it penalise superannuants for erratic (but unrealised) fluctuations in assets values.

Critically, in each case (and any other case that might be considered), the tax payable under this Alternative Structure would lie between the tax that would be paid under existing rules and the tax that would be paid if the assets were held outside the superannuation fund. It would therefore meet the Government's stated objective of reducing the tax revenue lost through existing superannuation tax concessions. It would achieve that objective without introducing random anomalies. Arguably it would be fair to pensioners, both current and prospective.

Addressing Treasury's reasons for not adopting the Alternative Structure

While Treasury's Discussion Paper does not directly consider the Alternative Structure discussed above, the basis for its proposed model provides insights into why it may have been reluctant to do so.

On p.5 of the Discussion paper Treasury observes that:

As the majority of superannuation members are unaffected by this measure, the proposed approach seeks to avoid imposing significant and costly systems and reporting changes that would impact other members.

It goes on to observe that:

The systems and reporting changes that would support calculating taxable income for APRA-regulated funds at a member level present significant challenges.

To avoid imposing these 'challenges' on APRA-regulated funds Treasury proposes using a proxy calculation for earnings, namely Measure 2, which includes unrealised capital gains.

Put bluntly, to avoid imposing administrative costs on APRA-regulated superannuation funds, Treasury has elected to use a proxy measure of taxable earnings that is complex, involves using two fundamentally conflicting measures of earnings for superannuation funds, is capable of producing outcomes that are inconsistent with the objective of the tax changes, and has the potential to produce erratic outcomes that, in some cases, could irreparably damage the integrity of some superannuation funds. In view of the damage the proposed proxy could cause, this bias towards large superannuation funds over small funds (e.g., self-managed) is not defensible.

If taxable earnings are to be measured by proxy, other proxies that could be used with the Alternative Structure outlined above should also be explored. APRA-regulated funds have data on the taxable earnings (based on Measure 1) at the fund level, but not the individual level. If APRA-regulated funds have data on TSB at the individual member level (as suggested by the ASFA submission in response to the Treasury Discussion Paper[12]), a simple proxy might be to allocate the fund's taxable earnings proportionately to TSB at the beginning of the period. The ASFA submission suggests that the funds have the remaining data on ending TSB, withdrawals and contributions needed to break these earnings into low-tax and high-tax earnings as defined in the Alternative approach above. Since low-tax earnings would already have been taxed through the fund's earnings, the only calculation remaining would be to tax the high-tax earnings at 15% x the percentage of assets in the high-tax category at the end of the period.

While such an approach would involve some approximation, and some superannuants could pay more tax (or less) than they might have if earnings were calculated more accurately at the member level, the magnitude of those distortions would be miniscule, compared with the magnitude of the distortions that could occur under the Government's proposed model.

Regardless of whether or not this simply proxy for calculating taxable earnings of APRA-regulated superannuation funds is workable, the flaws in the Government's proposed approach are potentially sufficiently damaging that the onus should be on Treasury and the APRA-regulated funds to suggest a better proxy.

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[12] Submission to Treasury – Better targeted superannuation concessions, ASFA, 17 April 2023.