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Dear Director

Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023 – Submissions in response to consultation by Treasury

Introduction

We refer to the exposure draft legislation *Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023* (**Exposure Draft**) released for public comment on 3 October 2023 and the invitation by Treasury for submissions on the Exposure Draft and the accompanying explanatory material (**Explanatory Material**).

King & Wood Mallesons welcomes the opportunity to make a submission on the proposed measure. As a firm, we have extensive experience in relation to the operation and tax treatment of superannuation funds, both for investors and for the funds.

Based on our experience, we consider the Exposure Draft may have unintended significant consequences for both individual taxpayers and superannuation funds.

Executive summary

Our main concerns with the Exposure Draft, which are elaborated on below, include:

- the proposed current threshold ($3 million) is not indexed, and could lead to significant intergenerational inequity issues having regard to inflation, as well as wage and investment growth over time;
- the proposed taxation of unrealised gains generates significant risk of double taxation on the same underlying source of income;
- the Federal Government has not provided any reason justifying the taxation of unrealised gains;
- the proposed measures assume that all individuals that would be subject to the additional tax are readily capable of satisfying the relevant tax liability. This may not be the case for many individuals having regard to the types of assets which are not uncommonly held in superannuation funds (e.g. illiquid assets such as unlisted securities and real property); and

- for taxpayers whose superannuation is not in retirement phase, there is no mechanism for those taxpayers to withdraw amounts from their superannuation fund and restructure their affairs in light of the proposed measures. This issue is compounded by the lack of grandfathering available.

Therefore, we submit that the Exposure Draft should not be legislated in its present form.

Background

The proposed measure was first announced by Treasury on 28 February 2023, and flagged as being part of the Federal Government's "*need to make responsible budget choices to ensure generous superannuation tax breaks are better targeted and sustainable*." The fact sheet accompanying the announcement indicates that it was expected the proposed reforms would affect less than 0.5% of individuals with a superannuation account, and by the 2025-26 income year, it is expected the measures will apply to less than 80,000 taxpayers. The proposed measures were then formally announced in the May 2023 Federal Budget.

Under the Exposure Draft, a new Division 296 will be inserted into the *Income Tax Assessment Act 1997* (Cth) and impose additional tax (the **Division 296 Tax**) on a percentage of earnings equal to the percentage of an individual's "total superannuation balance" (**TSB**) exceeding $3 million for an income year. The Division 296 Tax is proposed to be imposed at the rate of 15% of an individual's taxable superannuation earnings (**TSE**). Broadly, the TSE is calculated by determining the difference in the value of a taxpayer's TSB (which takes into account all Australian superannuation interests held by that taxpayer, except for foreign superannuation funds and other constitutionally protected funds) over the income year.

To the extent that there are negative superannuation earnings in an income year, these may be carried forward to future income years and applied against a taxpayer's TSE (which depends upon the individual's TSB remaining above $3 million).

Concerns

Since the proposed measure was released for consultation, industry groups have expressed concerns that the measure would go beyond what Treasury intended. We share these same concerns.

In particular, we consider the measures will have the following unintended consequences:

(a) The lack of indexation mechanism will embed intergenerational inequity.

The stated aim of the proposed Division 296 Tax is to better target superannuation concessions to ensure fairness and sustainability of the system as a whole. As Treasurer Dr Jim Chalmers stated, it is intended to address the concern that "*ordinary working people subsidise incredibly generous tax breaks for people with millions and millions of dollars in superannuation*".

When the measures commence in 2025, Treasury estimates that only 0.5% of Australia's wealthiest individuals are expected to have superannuation balances exceeding $3 million.

However, unless the $3 million threshold is adjusted on an indexed basis (consistently with the concepts such as the concessional contribution cap and the transfer balance cap), the reach of this additional tax will increase over time to ultimately capture the superannuation savings of "*ordinary working Australians*" – a considerable change from its intended scope.

In particular, failing to provide for indexation of the $3 million TSB threshold will mean increasingly greater number of younger Australians being subject to the changes over time, due to the effect of wage/investment growth, without accounting for the diminishing purchasing power that accompanies inflation. That is, while $3 million in 2023 might be seen to represent a level of wealth to which the proposed changes are appropriately applied, $3 million in ten years' time (i.e.

2033) may not represent an appropriate threshold, taking into account the likely increases to the cost of living in the intervening period. Treasury's own modelling has acknowledged that Division 296 Tax is forecast to apply to at least 10% of superannuates by 2052.[1] Some industry modelling suggests that younger Australians who are on average salaries throughout their careers may accumulate superannuation in excess of the $3 million threshold, and be caught by the proposed Division 296, by the time they retire.

The risk of the proposed new tax applying disproportionately to younger generations is a compelling reason to index the $3 million threshold and ensure that equity is built into the design of the tax from its inception. It should be recognised that younger Australians currently in the midst of their accumulation phase will have no choice but to continue making contributions in a less concessional environment, in circumstances where:

(i) the likelihood of triggering the non-concessional effect of the $3 million TSB threshold grows, due to wage / investment growth over time; and

(ii) the real value (measured in purchasing power) of their superannuation balances continues to diminish relative to the increasing cost of living.

In our view, these concerns regarding intergenerational inequity are readily addressed by an appropriate indexation mechanism to the $3 million TSB threshold.

(b) The taxation of unrealised gains may result in exposure to double taxation.

Applying an additional tax calculated by reference to the unique metric of "taxable superannuation earnings" exposes individuals to double taxation in a number of circumstances. Two basic examples of this double tax exposure are set out below.

(i) Capital gains that are realised during the income year may effectively be taxed twice. The gain will be taxed at 10% (if it is a discount capital gain) or 15% inside the superannuation fund. Further, the net proceeds of the disposal will also be included in the TSB at the end of the income year and will be taxed at 15% to the individual member under Division 296. This potential double taxation is again compounded by a potential future tax at 17% (inclusive of the Medicare levy) if the discount capital gain is passed as a death benefit to an adult child.

(ii) In circumstances where an individual member dies and their superannuation is passed to their adult children as a death benefit, that part of the benefit that represents earnings taxed inside the fund may also be taxed multiple times. The earnings will be taxed inside the superannuation fund at up to 15%. The earnings will then be taxed to the individual member under Division 296. The earnings will also be taxed to the member's adult child beneficiary at a further 17% (inclusive of the Medicare levy).

It is important to consider the effective tax rate that will be imposed on superannuation earnings in circumstances such as the above. The aggregation of the various taxes may mean that earnings are taxed at a higher rate than would have applied if the asset was held outside of the superannuation fund. For example, a discount capital gain realised by an individual directly will be currently taxed at a maximum rate of 23.5%.

(c) The taxation of unrealised gains gives rise to other adverse outcomes.

The proposal to impose Division 296 Tax on a tax base that captures unrealised gains is inconsistent with generally accepted tax policy. It has the capacity to give rise to unintended consequences and

[1] Hansard at pg 70.

cause genuine hardship, particularly in light of the expanded scope of Australian individuals who will be caught by this tax over time.

(i) *Inequity in taxing amounts that may never be derived*

By taxing unrealised gains, Division 296 is not only accelerating the taxing point for increases in the value of assets, but also potentially taxing something that will never actually be realised.

Take the following example:

> *Jen has a TSB of $2 million in her superannuation fund on 30 June 2025. $200,000 of that balance reflects a minority interest in an unlisted start-up company (**Company**). The balance of her fund's assets, valued at $1.8 million, comprise commercial property used in carrying on her small business. The Company does well over the financial year, and her minority interest increased in value to $2.2 million by 30 June 2026. The value of her minority interest then crashes the following year and has a nominal value of $200. The commercial property holds its value throughout this period. Jen's TSB is $4 million as at 30 June 2026, but down to $1,800,200 as at 30 June 2027. Jen's TSB never exceeds $3 million again.*

In the case of the above example, Jen will have taxable superannuation earnings of $250,000 (being $1 million x 25%), and will pay Division 296 Tax of $37,500 (being 25% of $1 million x 15%), in respect of the 2026 income year. Despite the fact that Jen's superannuation fund has made a loss on the start-up investment overall, Jen will not be entitled to any refund for the Division 296 Tax.

(ii) *Hardship to fund tax*

Imposing a tax on an individual in respect of the unrealised profits and gains of their superannuation fund has the capacity to cause genuine hardship on individuals.

This will be particularly the case where individuals do not have disposable cash outside of their superannuation to fund the tax. The proposal for amounts to be released from the superannuation fund to pay the tax does not necessarily resolve this issue, as there is no nexus between the quantum of the tax and the actual income derived by the fund.

This outcome is also demonstrated in the example of Jen above. The assets in Jen's superannuation fund are illiquid. She does not have the option of selling the unlisted stock, as there is no present market for those assets. If Jen is unable to fund the extra $37,500 tax from her personal savings, her only options would be for her fund to either sell the business assets (jeopardising her ability to run her business) or be in default of the assessment and be exposed to penal GIC charge.

However, even if there was a market to dispose of an asset in an individual's superannuation fund, this gives rise to a number of other concerns including the valuation of such assets, timing matters and the obligations of trustees to comply with relevant superannuation laws notwithstanding the competing interest to release cash to fund the tax liability of the individual. Matters such as determining an appropriate market value in a relatively short period of time may be challenging and may also negatively impact the transactions undertaken to dispose of such assets.

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(iii) *Inability to recoup future tax benefits*

Whilst the Exposure Draft provides that negative superannuation earnings from balances above $3 million will be carried forward and used to reduce the amount of superannuation earnings subject to Division 296 Tax in future income years, there may be instances where an individual never recoups this future tax benefit – sometimes due to factors outside of their control. In the example in paragraph (c)(i) above, Jen should have transferable negative superannuation earnings of $1 million for the 30 June 2027 income year. However, as Jen's TSB never exceeds $3 million again, she will receive no future tax benefit with respect to the transferrable negative superannuation earnings.

Some of the above outcomes would be mitigated to some extent if taxpayers were entitled to a refund for the tax referable to their negative superannuation earnings.

The current proposed approach has been adopted due to its perceived simplicity and on the basis that it will not cause substantial additional compliance or administrative requirements for superannuation funds. In reality, the costs of complying with and administering the new measure are likely to be a substantial additional impost on funds, particularly for self-managed superannuation funds which are more likely to hold illiquid property, like farm assets and commercial property. This will include the costs of obtaining (and potentially defending) annual valuations.

(d) There is no ability for taxpayers who are still working and whose fund is not in retirement phase to restructure their arrangements to adequately prepare for the incoming measures.

The potential adverse tax outcomes under the proposed new Division 296 Tax mean that for those affected it may often be more tax effective to hold and invest their wealth above $3 million outside the superannuation system.

For those affected individuals who have met a "condition of release" (such as having reached preservation age and retired, or being over the age of 65), they may move their retirement savings out of the superannuation system.

For younger Australians, this is not currently an option. These individuals have invested their savings into their superannuation fund – accepting that these savings will consequently be subject to the conditions of preservation and significant superannuation regulation – in exchange for the promise of long-term concessionary tax rates. Given that the Federal Government has now changed the nature of the tax concessions without grandfathering available, it is appropriate for affected individuals to be afforded an option to move excess funds out of superannuation on a tax-free basis and allow them to be taxed on the earnings at the relevant rate that applies to their alternative holding structure.

Our submissions and contacts

We make these submissions on behalf of our firm, and the views expressed are our own and not those of any clients.

We would welcome the opportunity to discuss these submissions with Treasury.

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Yours faithfully

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