Hottest topics and latest info in SMSFs

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2023 ADELAIDE NOVEMBER 20–22

Today's session

🔥 Division 296 tax

- How the new laws intend to apply from 1 July 2025
- How the rules will impact SMSF members

🔥 NALE / NALI provisions

- How the new measures will apply from 1 July 2023
- How the new laws will impact SMSFs

Division 296 tax laws

- Exposure draft released for consultation (now closed) to insert a **<u>new</u>** Division 296 into ITAA 1997 to impose additional 15% tax on super earnings where individual's super balance exceeds $3.0m.
- Government only provided a 2-week consultation period – totally insufficient, and several technical problems with the draft laws.
- Further consultation has occurred with Treasury, and active dialogue happening with the crossbench Senators.
- **Primary concerns remain…** inclusion of unrealised capital gains <u>and</u> no indexation of the threshold (amongst other technical issues)

Reference: https://treasury.gov.au/consultation/c2023-443986

Calculating taxable super earnings

- A person has ***taxable superannuation earnings*** for an income year if their TSB at the end of that year is greater than LSB threshold ($3.0m) **<u>and</u>** the amount of their superannuation earnings for the year is greater than nil.

Step 1: TSE = ((TSB at the end of the year - LSB threshold) / TSB at the end of the year) x 100 #

Step 2: Proportion = TSE % x Amount of superannuation earnings* for the year

Step 3: Tax liability = 15% x Proportion

Formula is rounded to two decimal places

TSB value

- TSB is central to the concept to the scope of Div 296 tax
- Relevant for % of earnings > $3.0m
- Earnings calculated with reference to TSB at start and end of the year, ***adjusted*** for withdrawals and contributions
- New laws propose the introduction a <u>new concept</u> of **TSB value -** removes the link to a member’s transfer balance account (TBA) in the retirement phase value.

TSB value

Existing TSB

= Accumulation phase value (APV)

+ Retirement Phase Value

(adj. for mkt value of account-based income streams)

+ In transit rollovers

+ certain outstanding LRBA amounts

- Structured settlement contributions

From 30 June 2025

= Combined TSB value, includes:

** Accumulation + Retirement Phase – cessation at that time*

** Death Benefit Income Streams*

** Defined Benefit interests – Value/method in Regulations*

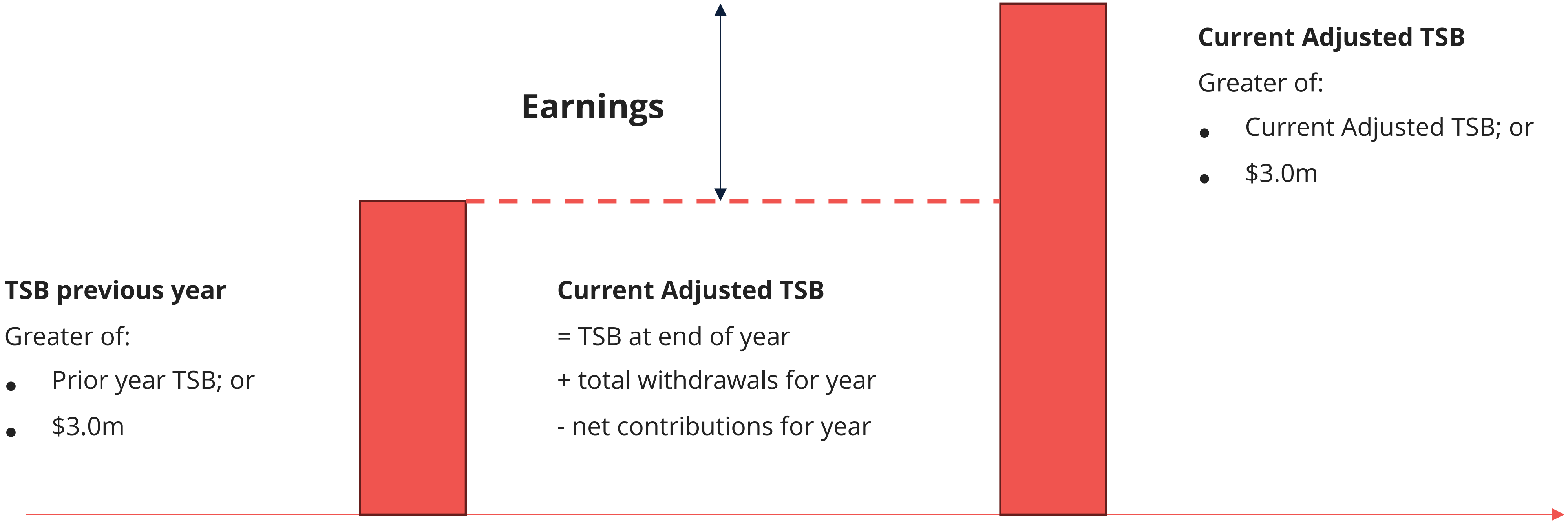
+ In transit rollovers

~~+ certain outstanding LRBA amounts~~ #

- Structured settlement contributions

Removed for Div. 296 purposes only

Earnings calculation



Calculating super earnings

Basic superannuation earnings = Current adjusted TSB – TSB (previous year)

- What is an individual's adjusted TSB?
  - Modified closing balance of ***withdrawals*** and ***contributions*** that would otherwise overstate or understate the investment earnings generated within super.

Withdrawals (+ add back)
Super benefit payments (lump sum & pensions)
Contribution splitting (paid to spouse)
Family law splitting payments (paid to spouse)
Amounts withheld from an excess untaxed rollover amount
Amounts released under a valid requested release authority
Any amounts prescribed by the regulations
FHSSS valid release authority (using formula)

Not withdrawals
Rollover super benefits
Continuous disability policy payments
Withdrawal arising due to fraud / dishonesty
Amounts paid under unclaimed money act
Amounts paid from a foreign super fund
Amounts prescribed in the regulations

Calculating super earnings

Contributions (- deduct)
Contributions - 85% of CCs, downsizer & CGT cap
Contribution splitting (received from spouse)
Family law splitting payment (received from spouse)
TSB value of super death benefit income stream
Death or TPD insurance proceeds
Allocated amounts from reserves – captured under s.291-25(3)
A transfer from a foreign super fund
Remediation payment / compensation for loss because of fraud or dishonesty
Any amounts prescribed by the regulations

Not contributions
Rollover super benefits
Contributions to foreign funds
Amounts received under unclaimed money act
Any amounts prescribed by the regulations

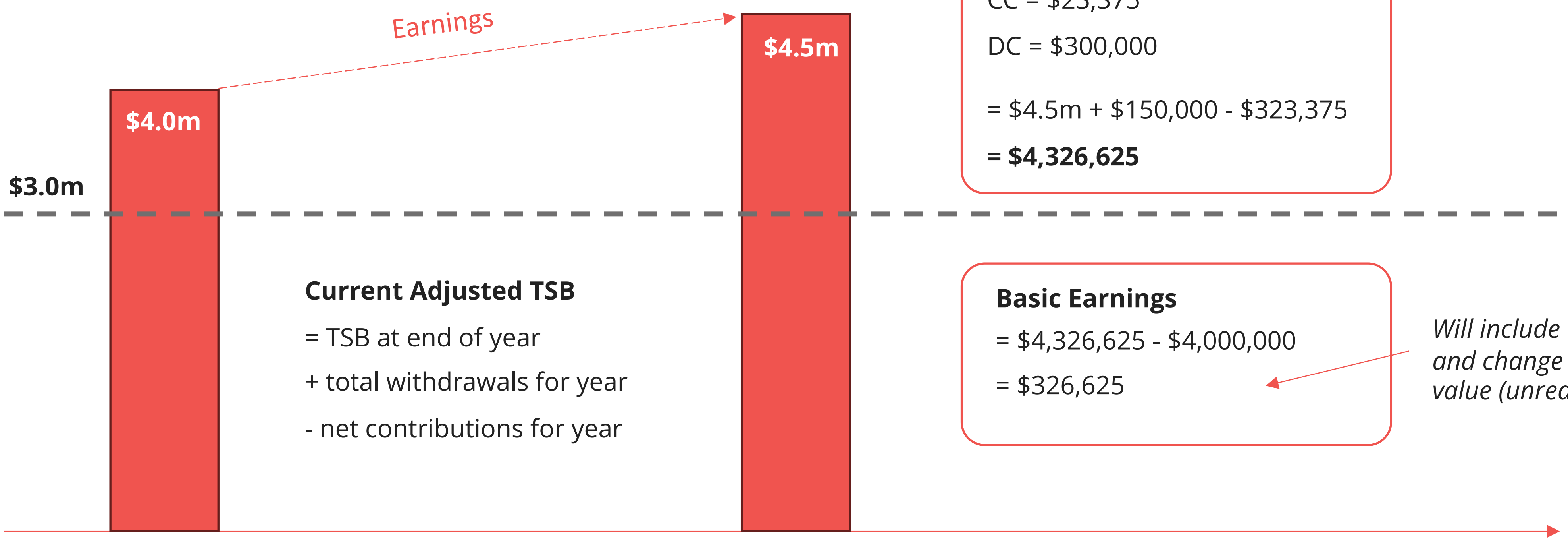
Div. 296 tax analysis

Case study

- Jan is a member of her SMSF
- At 30 June 2025, her TSB is $4.0 million
- During the 2025-26 year:
    - $27,500 of concessional contributions
    - $300,000 as a downsizer contribution
    - $150,000 in pension payments
- At 30 June 2026, Jan's TSB is $4.5 million

How does Div. 296 tax apply to Jan's circumstances?

Earnings calculation



Current Adjusted TSB

= TSB at end of year

+ total withdrawals for year

- net contributions for year

30 June 2025

Jan has TSB = $4.0m

30 June 2026

Jan has TSB = $4.5m

Current Adjusted TSB

Withdrawals (+)

Pension = $150,000

Net contributions (-)

CC = $27,500 x 85%

CC = $23,375

DC = $300,000

= $4.5m + $150,000 - $323,375

= $4,326,625

Basic Earnings

= $4,326,625 - $4,000,000

= $326,625

Will include both income and change in market value (unrealised gains)

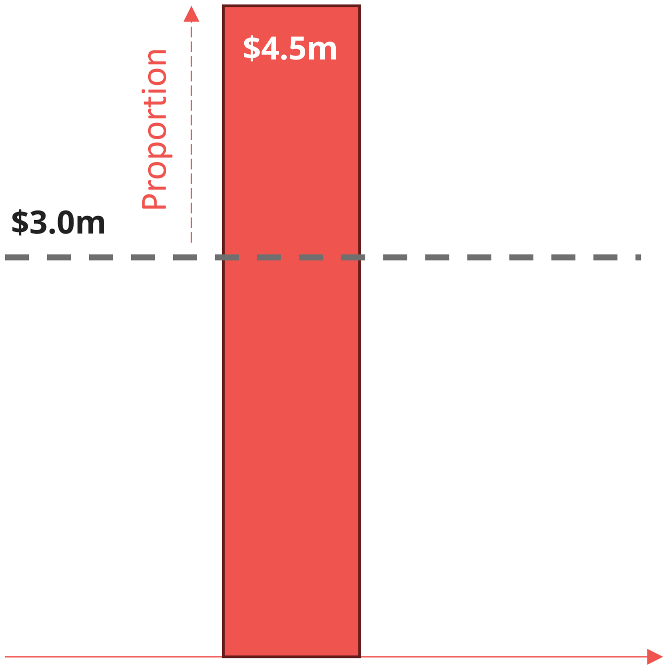
Div. 296 tax analysis

Case study

- At the end of the year:
  - Jan's TSB is > than LSB threshold ($3.0m) **AND**
  - Her basic super earnings for 2025-26 are > nil
- **Jan will have taxable super earnings for Div. 296 tax purposes under s.296-35(1) ITAA 1997**

How much of the super earnings is subject to Div. 296 tax?

Div. 296 tax calculation



30 June 2026

Jan has TSB = $4.5m

Proportion:

= ($4.5m - $3.0m) / $4.5m

= 33.33% *(rounded to 2 decimals)*

Taxable Superannuation Earnings:

= 33.33% x $326,625 (basic earnings)

= $108,864

Div. 296 tax (2025-26 year)

= $108,864 x 15%

= $16,330

How does this compare to the alternatives for Jan?

Considerations

How does this compare to Jan's personal tax position?

i.e. move $1.5m to Jan's personal name.

- earn 5% interest: $75,000 x 30% tax rate (up to $200k) = $22,500
- Unrealised gains not taxed until sold, but at higher rate personally (even with 50% discount)
  - SMSF will pay no more than 10% (> 12mths); less with ECPI claim
- Likely to be a breakeven point with Div. 296 tax annual liability through to future realisation of assets > $3.0m in SMSF.

SMSF may be in a refundable position with franking credits?

- Cashflow impact of Div. 296 tax may be minimal due to tax refund

Alternative tax structures, transaction costs and investment strategy are going to influence the pros & cons of restructuring SMSFs assets outside of super.

Div 296 assessments & tax liability

- Individual is liable for Div 296 tax (not a super fund liability)
- Exceptions apply for:
  - Child recipients of pension at the end of the income year
  - Individuals who have structured settlement contributions made in respect to them
  - Individuals who have died before the last day of the income year
    - dying on 30 June is a problem (subject to Div 296 tax for financial year)!
- Div 296 tax payable – 84 days after Commissioners issues NOA for tax (except DB interests)
  - Any amendments to an assessment will provide additional 84 days for an additional Div 296 tax
- Div 296 GIC rate – 3% + base rate under TAA 1953 (about 4% lower than standard GIC rate)

Div 296 assessments & tax liability

- The individual can choose either:
  - To pay the tax personally; or
  - To release from their super fund (60 days to request)
- Where released from the super fund:
  - If individual has multiple super interests, they can choose which interest(s) to release the money from
    - e.g. highest taxable component (%)

Farmers
Cashflow for the Div. 296 tax may be problematic due to seasonal conditions (e.g. drought)

Start-ups
Valuation increases can create 'paper-profits' that may not eventuate in the future?

Div. 296 tax analysis

Case study – Let's move forward 12 months…

- At 30 June 2026, Jan's TSB was $4.5 million
- During the 2026-27 year:
  - $30,000 of concessional contributions
  - $200,000 in pension payments
- At 30 June 2026, Jan's TSB is $4.2 million

Do we have super earnings subject to Div. 296 tax?

Earnings calculation

Current Adjusted TSB

<u>Withdrawals (+)</u>

Pension = $200,000

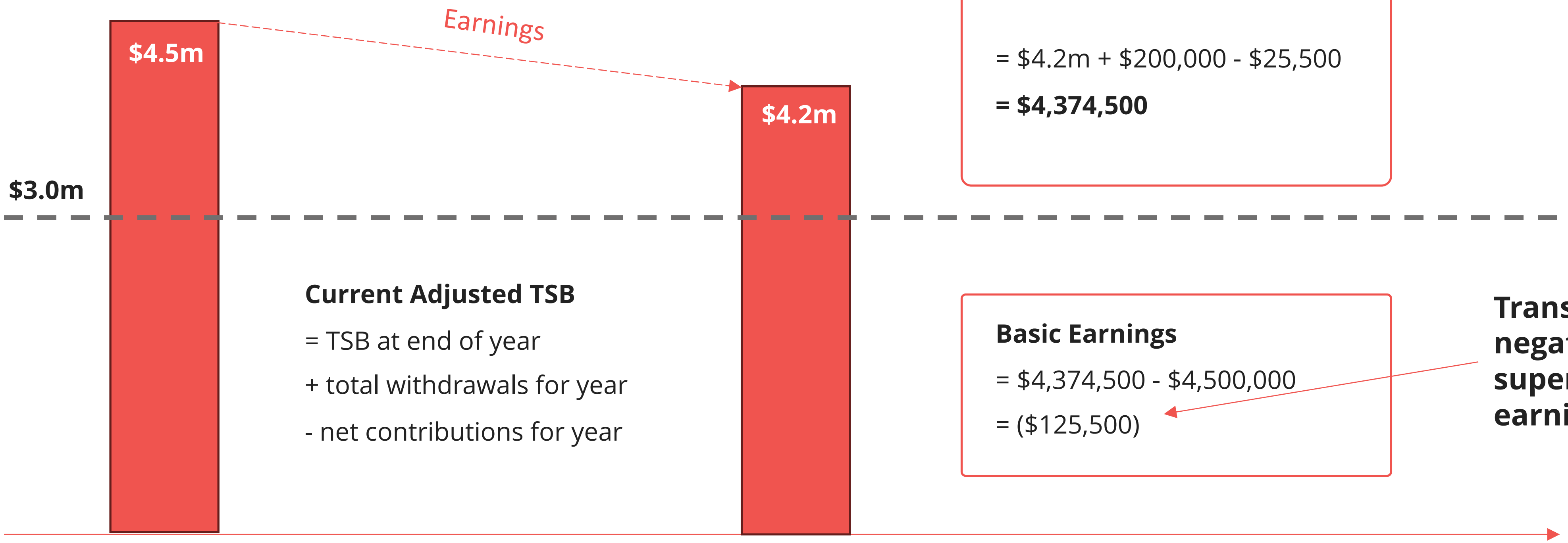
<u>Net contributions (-)</u>

CC = $30,000 x 85%

CC = $25,500

= $4.2m + $200,000 - $25,500

= $4,374,500



Current Adjusted TSB

= TSB at end of year

+ total withdrawals for year

- net contributions for year

Basic Earnings

= $4,374,500 - $4,500,000

= ($125,500)

Transferrable negative superannuation earnings

30 June 2026

Jan has TSB = $4.5m

30 June 2027

Jan has TSB = $4.2m

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Div. 296 tax analysis

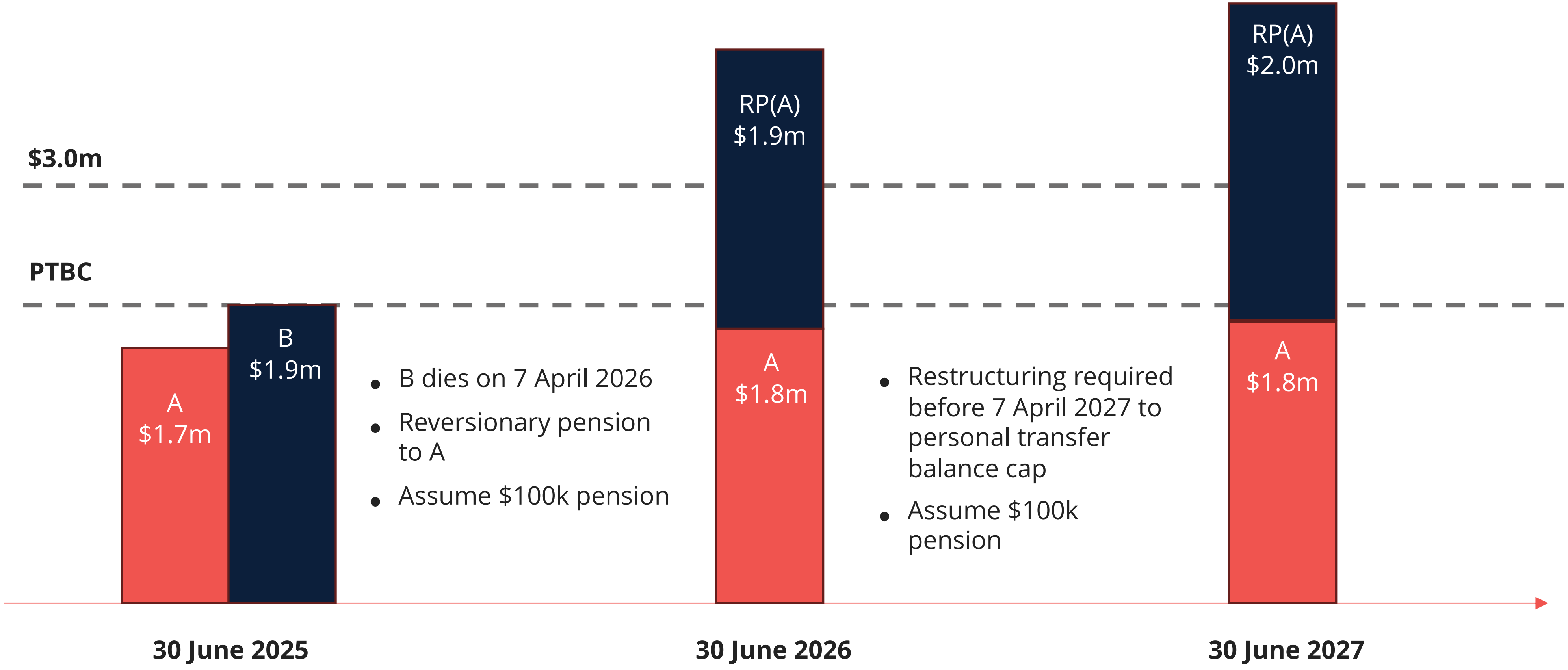
Case study

- At the end of the year:
  - Jan's TSB is > than LSB threshold ($3.0m) **BUT**
  - Her basic super earnings for 2025-26 are < nil
- **Jan has transferrable negative taxable super earnings for Div. 296 tax purposes under s.296-40 and subdivision 296C of the ITAA 1997**

Jan has $125,500 of unapplied transferrable negative superannuation earnings available to apply in future income years.

Death of a member

Reversionary vs. non-reversionary pensions - Impact of the Div. 296 rules



- B dies on 7 April 2026
- Reversionary pension to A
- Assume $100k pension

- Restructuring required before 7 April 2027 to personal transfer balance cap
- Assume $100k pension

Death & Div. 296 tax

Reversionary vs. non-reversionary pensions - Impact of the Div. 296 rules

- Div. 296 tax not relevant on death of Member A
  - NB. even where TSB > $3.0m
- **Member B:** auto-reversionary – balance of death benefit immediately applies for TSB purposes

2025-26

= Adjusted TSB + withdrawals – contributions

= $3,700,000 + $100,000 - $1,900,000

= $1,900,000

No Div. 296 tax applies to Member B for income year

2026-27

= Adjusted TSB + withdrawals – contributions

= $3,800,000 + $100,000 - $0

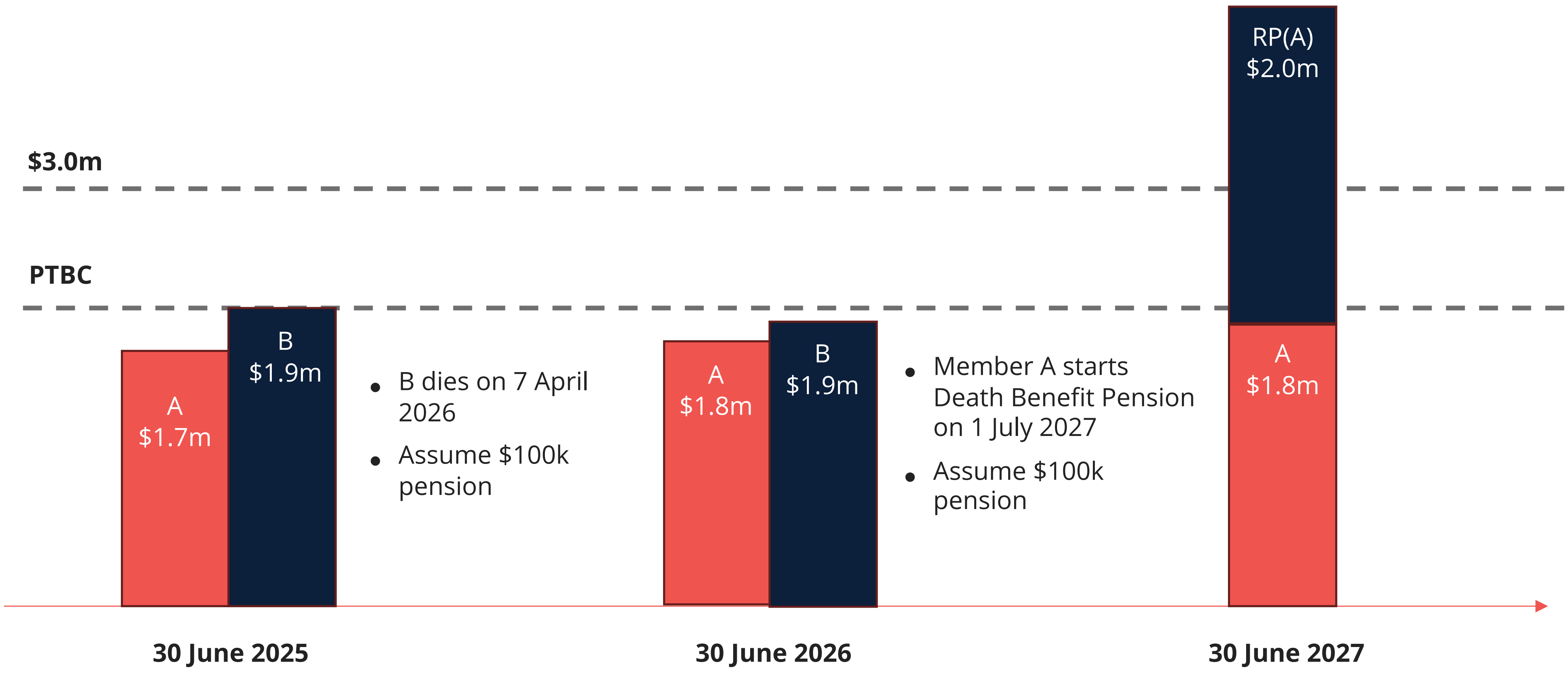
= $3,900,000

Div. 296 tax applies where Member B has super earnings > nil for income year

Div. 296 tax = 21.05% proportion x super earnings x 15%

Death of a member

Reversionary vs. non-reversionary pensions - Impact of the Div. 296 rules



- B dies on 7 April 2026
- Assume $100k pension

- Member A starts Death Benefit Pension on 1 July 2027
- Assume $100k pension

Death & Div. 296 tax

Reversionary vs. non-reversionary pensions - Impact of the Div. 296 rules

- Div. 296 tax not relevant on death of Member A
  - Benefit cashed *'as soon as practicable'*
- **Member B:** Death Benefit Pension started in following income year

2025-26

TSB = $1,900,000

No Div. 296 tax applies to Member B for income year

2026-27

= Adjusted TSB + withdrawals – contributions

= $3,800,000 + $100,000 - $1,900,000

= $2,000,000

No Div. 296 tax applies to Member B for income year

2027-28

Div. 296 tax to apply.

Subject to:

- Adjusted TSB & super earnings calculation, **then**
- Proportion x super earnings x 15% tax rate

Consider restructuring of reversionary pensions prior to 30 June 2025

Practical issues

Total Super Balance changes

- The way TSB is calculated will change for members with DB interests
- May impact:
    - Carry forward unused CCs
    - NCCs
    - Whether SMSFs had disregarded small fund assets (DSFAs)

Tax-effecting accounting and exit costs (e.g. property assets) will become an important part of TSB reporting.

New reporting requirements

- Value of DB interest each year
- Contribution / withdrawal amounts not reported separately in SMSF annual return
    - Life / TPD insurance proceeds
- Options:
    - Change annual return?
    - Request further information from funds with potentially impacted members?
        - Insurance proceeds
        - Contribution splitting / family law splits

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NALE / NALI provisions

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NALE / NALI

- Bill currently before Parliament to finalise amendments to s.295-550 of ITAA 1997 relating to general fund expenses
- Amendments only apply to SMSFs & SAFs
  - APRA funds excluded from NALE rules
- **Why?** ATO's views in LCR 2021/2 created a severely disproportionate outcome for breaches relating to general expenses of the fund
- ATO relief via PCG 2020/5 to 30 June 2023 – no further extension.

Services provides on a non-arm's length basis

Expense relating to a specific fund asset

General fund expenses

PCG 2020/5 updated
ATO will **not** allocate compliance resources for 2018-19 to 2022-23

Income derived from the asset, including capital gains, taxed as NALI (45%)

ALL fund income taxed as NALI

NALE / NALI

- NALI amount is the **lessor** of:
  - 2 times the level of the general expenditure breach (90%, or 2 x 45%)
  - Total taxable income less assessable contributions ^
- Calculated as the difference between:
  - The amount that would have been charged as an arm's length expense; and
  - The amount that was charged to the fund.

^ Reduced by deductions relating to assessable contributions

SMSF using an accounting service

Example

- John has his own SMSF and is the sole member.
- Through his own accountancy business, he provides SMSF compliance services to his own fund (s.17B – individual capacity)
- The cost of similar services offered to his clients is approximately $3,000, which his fund acquires these services for free (i.e. acquisition of accounting services under a scheme, or non-arm's length arrangement).
- The SMSF's income (after relevant expenses) in the 2023-24 financial year is $20,000 in rent, with $5,000 in deductions = taxable income of $15,000. No assessable contributions were made for the income year.

SMSF using an accounting service

Example

- As no expense was incurred, NALI is 2x amount on the difference between the:
    - market value of accounting service **($3,000)**; and
    - Actual fee charged **($0)**.
- $3,000 x 2 = $6,000
- Applying the NALC, the cap amount is the total income ($20k rent), less deductions ($5k) = $15,000
- As the cap ($15k) is higher than the NALC ($6k), the $6,000 amount is to be taxed at 45%, with the low-tax component (LTC)^ of $9,000 taxed at the 15% concessional tax rate.
- **Total tax payable = NALC of $2,700 + LTC of $1,350 = $4,050**

^ Low Tax Component (LTC) is any remaining taxable income after calculating the NALC

SMSF using a legal service

Example

- Tanya is a trustee of her SMSF and is a lawyer at her legal practice.
- She provides $17,000 of legal services to her fund, which the fund acquires for $12,000 – these were done in her individual capacity (s.17B)
- The legal services were general in nature and did not relate to any particular asset
- Fund has taxable income of $16,000, made up of:
  - $34,000 in rent + $10,000 in assessable contributions
  - less $15,000 property maintenance deductions + $12,000 legal services + $1,000 other deductions (relating to contributions)

SMSF using a legal service

Example

- For NALE general expense, need to apply 2 x difference between $12k (actual) and $17k (arm's length) value of legal services = $10,000
- The cap on the non-arm's length component (NALC) is calculated as:
  - Taxable income = $16,000 less $10,000 (assessable contributions) plus $1,000 deduction (relates to contributions) = $7,000
- As this amount is lower than the $10,000 previously calculated, the cap applies to limit the NALC to $7,000.
- Leaves the low tax component (LTC) at $9,000 ($16k - $7k).
- Result ensures that the assessable contributions are excluded from NALC calculation, including any deductions attributable to them.
- **Total tax payable = NALC of $7,000 + LTC of $9,000 = $4,050**

What might general expenses include?

- Accounting fees
- actuarial costs
- fees to an auditor
- general legal fees^
- admin costs in managing the fund
- general investment adviser fees^
- trustee fees (APRA)
- compliance costs within regulatory obligations of the fund

^ fees must relate generally to the operation of the fund, and not to a specific asset or particular pool of assets.

What else needs to be considered?

- Amendments (once passed) to commence of start of first quarter after Royal Assent is received (e.g. 1 January 2024).
- To apply from 2018-19 income year
  - NB. PCG 2020/5
- What about LCR 2021/2?
  - To be updated
  - Use of (discount) policies?

What hat are you wearing?

- Section 17A – in capacity as trustee?
- Section 17B – individual capacity

NALE / NALI

Specific expenses

- No changes – effective since 1 July 2018
- Part-purchase / in-specie contribution
    - Documentation critical
- Beware undertaking improvements
    - LCR 2021/2 – Trang example
    - Taint asset – ordinary & statutory income

Issues

- **Specific expenses** – expense related to earning income from a particular asset
    - Asset repair / maintenance
    - Investment advice for a particular pool of assets / LRBA
    - Expenses related to holding or acquiring units in a unit trust
- **General expense** – expense not related to gaining or producing income from any particular asset or assets.

This can create problems in certain scenarios…

NALE dilemma

- Must charge for services provided other than as trustee (i.e. individual capacity)
  - Material use of business tools / equipment
  - Must hold license or qualification to perform the service
  - Work covered by insurance
- Can only charge in accordance with s.17B, SIS Act requirements
  - Runs a business of providing those services to the public.

Example

- Sam is director/member of his SMSF
- Employed as qualified electrician
- Re-wires property held within SMSF; no fee charged
- **s.17A** – cannot charge in capacity as trustee; service must be performed by licensed electrician (for a fee)
- **s.17B** – Sam can't charge his fund as not running a business of providing electrical services to the public
- ***NALE or breach of s.17B?***

Solution? TR 2010/1DC: Paragraph 171A1

Where… the super fund would record the market value of the increase in capital as a contribution… the 'non-arm's length income' provisions in s.295-550 would not apply **[STILL DRAFT]**

Fixing a problem that doesn't exist?

- Joint submissions (Accounting bodies & SMSFA) made to Treasury to recommend removal of amendments (Schedule 7) from current Bill before the Senate

Zero interest related party LRBAs → Resolved by PCG 2016/5 (safe harbour)

- New measures create a dual tax system between SMSFs/SAFs and large APRA funds
- Repeal previous 2019 amendments to s.295-550
  - Contributions framework deals with issues (TR 2010/1)
  - SMSF specific solution – s.109 arm's length dealing (as integrity measure)
- Current Bill continues to have concerns raised previously without resolution

In summary - spot fires or wildfires?

- Both Division 296 tax and NALE/NALI issues are burning topics for the SMSF industry right now…
- Will the current lobbying help us to control these current burning issues? **<u>or</u>**
- Will the Government's lack of consultation ultimately create wildfires for the SMSF industry to deal with?

Disclaimer

Changes in circumstances may occur at any time and may impact on the accuracy, reliability or completeness of the information and we exclude liability for any decision taken based on the information shown in or omitted from this presentation. We have taken reasonable care in producing the information found in this presentation at the time of writing.

Prepared as of 7 November 2023

Q&A

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Thank you for attending this session

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