Federal Budget Confirms Superannuation Earnings Tax

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As part of the 2023-24 Federal Budget announcements, the Treasurer has confirmed the Labor government's intention to implement the new superannuation earnings tax for individuals with account balances exceeding $3 million from 1 July 2025.[1]

How does it work?

Whilst draft legislation is yet to be made available, Treasury has released a Fact Sheet and a Consultation Paper[2] which provide some guidance as to how the new earnings tax is likely to operate.

Calculation of the proposed earnings tax broadly involves the following three-step process:

- first, calculating the change in an individual's total superannuation balance ("**TSB**") for the income year (adjusting upwards for withdrawals and downwards for net contributions made in the year), which change is used as a proxy for "earnings";
- second, calculating the proportion of those earnings that are attributable to a superannuation balance of more than $3 million; and
- third, applying a 15% tax rate.

These steps are illustrated by the following basic example.

Example 1 – Basic Operation
Consider an SMSF member who has a TSB of $9 million as at 30 June 2025, which increases to $10 million as at 30 June 2026. The member has also made withdrawals of $150,000 during the income year (e.g. pension payments or other drawdowns). The relevant earnings will be the difference between the previous year TSB of $9 million and the current year TSB of $10 million, adding back the $150,000 of withdrawals made during the year. Under this step, the earnings are calculated as $1,150,000.

[1] Budget Measures, Budget Paper No. 2, page 15 and Budget Overview paper, page 63.
[2] *Better Targeted Superannuation Concessions – Fact Sheet* published 28 February 2023 and *Better Targeted Superannuation Concessions – Consultation Paper* dated 31 March 2023.

The proportion of earnings attributable to a balance over $3 million is calculated by applying the following formula:

$$\frac{TSB\ (Current\ FY) - \$3\ \text{million}}{TSB\ (Current\ FY)}$$

On the above example, this results in a proportion of earnings of 0.7 (or 70%) as follows:

$$\frac{\$10\ \text{million} - \$3\ \text{million}}{\$10\ \text{million}}$$

Multiplying the earnings calculated in the first step ($1,150,000) by the proportion of earnings in step 2 (70%) and then applying a 15% tax rate, this results in an earnings tax liability for the member of **$120,750**.

The above impost is an entirely new tax imposed on changes in members' superannuation account balances and is in addition to any tax otherwise payable by the Fund (or the member) under the existing law.

A number of matters can be highlighted arising from Example 1:

- The tax is a liability of the member rather than the Fund (even though the member may elect for the Fund to pay the tax).
- The tax does not take into account the member's taxable income or other tax attributes such as personal deductions or tax losses (note that this is consistent with the existing Division 293 tax on contributions).
- The current proposal taxes unrealised gains made in the Fund, which makes it a unique proposal under Australian income tax law.
- Given that the tax includes unrealised gains, this may be problematic for Funds or members with illiquid or low yield assets as funding the tax will become a significant issue.
- The tax will impact more significantly as members' TSBs increase above the $3 million threshold. This is because the proportion of earnings attributable to the balance over $3 million will necessarily be lower for members with TSB's closer to $3 million than for those significantly higher than $3 million.
- For the same reason, members with very large existing TSBs will bear a far greater tax liability than those whose balances exceed but are closer to the $3 million threshold.

A more holistic view of the interaction between the new earnings tax and the existing tax treatment applying to superannuation funds is illustrated in Example 2:

Example 2 – Fund with Rental Income and Net Capital Gain

Consider the following factual scenario:

- On 30 June 2025, a sole member SMSF acquired real property for $9 million (using the existing cash balance of the Fund).
- The member started taking a retirement phase pension up to the $1.9 million transfer balance cap (assuming no further indexation) on 1 July 2025.
- The property generated net rent of $500,000 during the 2026 income year.
- The property is sold at the end of the income year on 30 June 2026 for $9.5 million, giving rise to a gross capital gain in the Fund of $500,000.

It is necessary to calculate two "layers" of tax in this scenario, namely the earnings tax on the increase in the member's TSB for the income year as well as the Fund's tax liability on the capital gain and net rental income.

Earnings Tax

Under step 1 of the calculation, the TSB has increased by $1,000,000 for the 2026 financial year (i.e. $500,000 in retained rental income and $500,000 in capital growth on the property).

The proportion of earnings exceeding $3 million is 0.7 (70%).

The earnings tax liability of the member is therefore **$105,000** (i.e. $1,000,000 earnings x 70% proportion of earnings x 15% tax rate).[3]

Capital Gain and Net Rental Income

A gross capital gain of $500,000 arises on the sale ($9.5 million capital proceeds less $9 million cost base).

By application of the one third discount,[4] the gross capital gain is reduced to a net capital gain of $333,333.33.

The assessable income of the Fund for the 2026 income year before calculating exempt current pension income ("**ECPI**") is therefore $833,333.33 (i.e. net capital gain of $333,333.33 plus net rental income of $500,000).

[3] Note that there would have been pension drawdowns made during the year, which are ignored here as they would be added back into earnings in any event.
[4] Section 115-100(b) of ITAA97.

The ECPI percentage here might be expected to be in the order of 19%.[5]

Applying the ECPI percentage of 19% reduces the Fund's assessable income to $675,000.

The Fund's ordinary income tax liability is therefore calculated as **$101,250** (applying the 15% tax rate ordinarily payable by Funds on assessable income after application of the one third discount for capital gains and the ECPI percentage).

A summary of the total tax liability referrable to the Fund's activities in the 2026 income year under Example 2 is summarised in the following table:

Summary of Tax Position – 30 June 2026		
Tax	**Amount of Tax**	**Tax Rate**
New Earnings Tax	$105,000	15%
Tax on Net Rental Income	$60,750	15% on net rent less ECPI
CGT	$40,500	15% on gross capital gain less 1/3rd discount less ECPI
Total	**$206,250**	**20.63%**

A number of observations can be drawn from Example 2:

- The earnings tax liability of the member combined with the Fund's liability on its income and capital gains (whether realised or unrealised) will mean that the same gain/profit is effectively subject to tax twice (i.e. once under the earnings tax regime and again under either the CGT regime when the asset is realised or under ordinary principles of fund taxation).
- Under the current Treasury proposal, there is no ability to apply an equivalent one third discount to earnings growth referrable to unrealised capital gains, meaning that inflationary unrealised gains will also effectively become subject to tax.

[5] Average pension balance of $1.9 million divided by average total fund balance of $10 million. In reality, this percentage may be slightly higher as the average pension balance would have grown over the income year. For simplicity, however, this change in the pension balance is ignored for the purposes of this calculation.

- The total tax in the SMSF environment must still nevertheless be equal to or less than 30% (calculated at an effective tax rate of approximately 20.63% on this particular example). Often, the effective tax rate in superannuation will still be materially less than 30% on account of the one-third CGT discount (where available) and the impact of the ECPI concession for Funds paying retirement phase income streams.

- For members whose TSBs significantly exceed $3 million, however, the impact of the ECPI concession for SMSFs in pension phase will be relatively marginal given the limitations imposed under the existing transfer balance cap regime.

- There is a question as to whether tax liabilities the Fund has provisioned for can be taken into account in determining the member's closing TSB. For example, it may be possible for the Fund to recognise a liability on account of the tax payable by it on the net rental income and net capital gain in the above example. This might operate to reduce the member's closing TSB and hence the amount of earnings subject to the new earnings tax.

Negative Earnings

A design feature of the earnings tax is that where the earnings calculation results in a negative balance, the negative earnings amount can be carried forward and offset against future earnings. The following example illustrates how this might work.

Example 3 – Negative Earnings
Continuing from Example 1 above, say the member's TSB falls from $10 million on 30 June 2026 to $9.5 million on 30 June 2027, giving rise to negative earnings of $500,000 for the 2027 income year. As negative earnings have been generated, no earnings tax is imposed. Instead, the negative earnings can be carried forward by the member and offset against positive earnings generated in future income years. Note here that the negative earnings are non-refundable and can only be applied against positive earnings and not against the tax liability generated. Assume now that by 30 June 2028, the member's TSB has increased from $9.5 million at 30 June 2027 to $10.5 million on 30 June 2028. The member's earnings for the 2028 income year are therefore calculated as $500,000 (current TSB of $10.5 million less previous TSB of $9.5 million, less the $500,000 of negative earnings generated in the previous income year). Working through steps 2 and 3 of the calculation method set out above results in an earnings tax liability in this scenario of $53,571.

A number of observations can be made in relation to negative earnings:

- Under the present proposal, it is unclear what (if anything) is to happen if a member with negative earnings dies. At this stage, it would appear that any carry forward negative earnings on a member's death are simply lost without the member having been able to realise any benefit associated with those unapplied earnings. Further, it appears that those negative earnings are not able to be applied by non-death benefits dependants subject to the death benefits tax or recipients of death benefit pensions.

- Further, it would appear that negative earnings can only be carried forward to reduce future year earnings and not "carried back" to apply against amounts of earnings tax actually paid by the member in prior years.

- As the earnings tax is based on members' total TSBs rather than on a fund by fund basis, if a member has more than one fund, it appears that it will be permissible for any negative earnings generated in relation to a member's balance in one fund to be applied against positive earnings generated by the member's balance in another fund.

Alternative Investment Structures

In light of the proposed earnings tax, a significant issue that taxpayers and their advisers will need to consider is whether it might be preferable to structure investments through private trusts or companies rather than through SMSFs.

A comparison of some of the key tax attributes of these alternative investment vehicles (including SMSFs assuming members are subject to the new earnings tax) is set out in the following table:

	Self-Managed Superannuation Fund	Private Company	Discretionary Trust
Income Tax Rates	Between 0% and 30% (taking account of Fund and member earnings tax)	30%	Dependent on tax rates of presently entitled beneficiaries

Discount Capital Gains	1/3rd discount available *and* gain can be reduced by ECPI concession when in pension phase	N/A	50% discount available provided gain distributed to qualifying beneficiaries
Taxing of Unrealised Gains	✓	×	×
Potential to Tax Same Earnings / Gains Twice	✓	×	×
Multiple Levels of Taxpayer	Fund and member	Company and shareholders	Either beneficiaries or trustee (but not both on same income or net capital gain)
Death Benefits Tax (on non-death benefits dependants)	✓	×	×

A number of observations can be made in making this comparison between investment structures:

- For fund members with significant account balances, and therefore a limited ability to access the ECPI concession, the benefits of an SMSF investment structure may be significantly diminished compared against using a private company or discretionary trust.

- For instance, even where a discount capital gain is assessed to an individual on the highest marginal tax rate (45% plus 2% Medicare levy), the effective rate of tax is likely to be in the order of 23.5% (i.e. 47% x 50% discount) as opposed to 25% in the superannuation environment (i.e. 10% on the capital gain after the one third discount plus 15% due to earnings tax on the accretion in the asset's capital value). Moreover, a discretionary trust will not be subject to tax on unrealised gains as the asset's capital value increases over time.

- In terms of high yield but low capital growth assets, we have seen an increasing trend amongst our high net worth client base of housing these assets in private company structures to cap the tax rate at 30% and allow for value to be "drip fed" out of the company over time on a tax-effective basis with franking credits as circumstances allow.

- The above distinction between SMSF and private company/trust structures is particularly relevant for members who plan for the succession of their wealth to non-death benefits dependants (e.g. adult children), in which case the taxable component of any death benefits paid from the member's superannuation account will be subject to a further amount of tax of 15% (plus Medicare Levy where applicable).

- Having said this, superannuation funds may still be seen as a highly tax effective investment vehicle in circumstances where the members will qualify for a material ECPI concession and there is sufficient liquidity to pay the earnings tax on unrealised gains over time.

Other Observations and Planning Issues

A number of other observations should be made in relation to the proposed superannuation earnings tax, namely:

- At this stage, the Labor government has made it clear that the $3 million threshold is not to be indexed, meaning that far more individuals are likely to be subject to the proposed earnings tax over time especially in a high-inflationary environment.

- Valuations are likely to have a key role in determining TSBs, especially in relation to the capital values of relatively illiquid assets such as real property.

- Following on from the above point, high growth but low yielding real property such as primary production land will need to be carefully managed in terms of fund liquidity issues.

- A question arises as to whether current or deferred tax liabilities can be taken into account in determining a member's TSB.

- Many definitional and conceptual issues remain unanswered. For example:

    - Does the definition of contributions in the earnings tax formula include CGT cap contributions?

    - Will amounts applied for a member to commence a reversionary pension following another member's death accrue to the TSB of the reversionary beneficiary and therefore effectively give rise to earnings tax on the capital so applied?

- Precisely how will the formula apply to LRBAs given that LRBAs are currently included in the existing definition of TSBs?
- Do withdrawals from the Fund to pay the earnings tax or Division 293 tax count as withdrawals for the earnings tax calculations and hence need to be added back into earnings for the purposes of the new tax?

On the basis that the Labor government wins a second term, it will be critical for members of SMSFs and their advisers to carefully monitor the developments in this area and consider the need to properly structure investments to optimise outcomes.

Cowell Clarke's specialist Tax & Revenue and Superannuation practice groups are well placed to assist you and your clients in navigating the implications and planning issues associated with the new superannuation earnings tax.

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