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IN THIS ISSUE

CHANGES TO TAXATION OF SUPERANNUATION – THE UNINTENDED CONSEQUENCES

In late February 2023 the Government announced a major proposed reform to the taxation of Superannuation for any members with a Total Superannuation Balance[1] (TSB) of $3 million. It is proposed to apply from 1 July 2025. The change will see the headline tax rate for accumulation balances to 30% by applying an additional 15% tax on earnings.[2]

How the tax will operate:

For members whose TSB is greater than $3 million their Fund earnings over the threshold will be taxed at 15% and the individual will receive an assessment for the Tax Amount. Members will have the choice of either paying the tax out-of-pocket or from their superannuation funds. Individuals who hold multiple superannuation funds can elect the fund from which the tax is paid. This tax will be separate to an individual's personal income tax, similar to the existing Excess Contributions tax. Negative earnings (losses) can be carried forward and offset against this tax in future years' tax liabilities.

The calculation of the Tax Amount will be done as follows:

1. Calculation of earnings:

$$Earnings = TSB\ (Current\ Financial\ Year) - TSB\ (Previous\ Financial\ Year) + Withdrawals - Net\ Contributions$$

2. Proportion of earnings corresponding to funds above $3 million:

$$Proportion\ of\ Earnings = TSB\ (Current\ Financial\ Year) - \$3\ million /\ TSB\ (Current\ Financial\ Year)$$

[1] Total Superannuation Balance comprises a members Accumulation Balance, Retirement Phase Balance, Any Rollovers in Transit and the Value of any outstanding LRBA amount for a member with a Nil cashing restriction.
[2] Earnings for the purposes of this legislation are calculated with reference to the difference in TSB at the start and end of the financial year, adjusting for withdrawals and contributions.

3. Tax Liability:

$$Tax\ Liability = 15\ per\ cent \times Earnings \times Proportion\ of\ Earnings$$

The calculation of earnings includes all notional (unrealised) gains and losses, similar to the way superannuation funds currently calculate members' interests.

As the additional tax will only apply from 1 July 2025 it will only apply to unrealised gains and losses from this date. So, if a member has a balance of $3 million at 30 June 2022 and a balance of $5 million at 30 June 2025 it is only the notional gains from this date that are subject to tax.

The Government is still looking at how these measures will affect Defined Benefit Income Streams but it is intended that this measure will also apply to them.

Examples:

The below examples illustrate how the new measures are intended to apply.[3]

Balance exceeding $3 million

- Warren is 52 with $4 million in superannuation at 30 June 2025. He makes no contributions or withdrawals. By 30 June 2026 his balance has grown to $4.5 million.

- This means Warren's calculated earnings are:

$4.5 million - $4 million = $500,000

- His proportion of earnings corresponding to funds above $3 million is:

($4.5 million - $3 million) ÷ $4.5 million = 33%

- Therefore, his tax liability for 2025-26 is:

15% × $500,000 × 33% = $24,750

Carry forward of Fund's loss

- Dave is 70 and has two APRA-regulated funds and one SMSF. At 30 June 2025, his TSB across all funds was $7 million. During 2025-26, he withdraws $400,000 from his SMSF and makes no contributions. At 30 June 2026, his TSB across all funds is $6 million.

- This means Dave's calculated Loss is:
$6 million - $7 million + $400,000 =
($600,000)

- His proportion of the Loss corresponding to funds above $3 million is:
($6 million - $3 million) ÷ $6 million = 50%
-The earnings/loss attributable to the excess balance is $300,000.

Dave can carry forward the $300,000 to offset future excess balance earnings.

[3] Examples Taken from Treasury factsheet on new measures (https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/media-releases/superannuation-tax-breaks)

At 30 June 2027, Dave's Funds make earnings on his excess superannuation balance of $650,000. He carries forward the Losses attributable to his excess balance at 30 June 2026 of $300,000 and is only liable to pay tax on $350,000 of earnings.

- This means his tax liability for 2026-27 is:

15% × $350,000 = $52,000

Consequences that require consideration:

The new rules will significantly alter the way in which clients who may be affected by these measures are advised going forward. Below are some considerations that need to be made especially where their Fund's hold property or other illiquid assets.

<u>Cashflow availability to meet liabilities</u>

These new measures will place added burdens on members who hold large assets that may be illiquid and have good capital returns but suffer from poor cashflows. For example, funds that hold large parts of their portfolio as residential property may find that the cashflows generated are not sufficient to meet member's minimum pension requirements when combined with these assessments especially where property value increase quickly but rental yields do not.

Members would need to carefully consider strategies to get cash flowing into funds if affected by this. Strategies could include selling down some properties or bringing younger members into the fund to allow for their contributions to aid in the cashflow requirements of the fund.

<u>Funding of Tax Liability</u>

As the tax liability will arise from earnings is one year but will be payable in the next financial year, there is a risk that notional earnings will be taxed in year one yet the assets fall in value by the time an assessment has been made on these earnings, leaving members in a position where they need to sell assets to fund the tax liability at a time that asset prices are depressed.

An example where this may have occurred is between the 2021 financial year and 2022 financial year. If a member had a large portion of their $3m fund into Zip Pay at 1 July 2020 by 30 June 2021 it would have been worth $4,530,275. This would have resulted in an assessment to the member of $75,749. At 30 June 2022 this same portfolio would have been worth $262,220 and the tax would now be a large portion of the member's balance.

This is a real issue when markets are volatile. Members would need to consider a strategy of ensuring that they have sufficient liquidity to meet any tax liabilities.

If you have any queries about Superannuation and the changes above, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

financial situation or needs, you should consider seeking financial advice from an Australian Financial Services licensee before making a financial decision.

ATO Stymies Greatest GST Fraud in Australian History – Where to from here?

On 17 February 2023, the ATO announced a significant milestone in GST history. They quashed the biggest GST fraud in Australian history. The ATO together with the Australia Federal Police (AFP) arrested several individuals related to a scheme where more than 53,000 clients tried to claim over $1 billion in fraudulent GST refunds.

Promoters of the fraud used social media and other channels to recruit participants with more than 20,000 individual offenders inventing fake businesses and Australian business number (ABN) applications, then submitting fictitious Business Activity Statements in an attempt to gain a false GST refund.

"Make no mistake, we are watching*, and we have the ability to identify the people behind these posts. What they are doing is criminal and they will be dealt the full force of the law….Simply speaking, if you don't operate a business, you don't need an ABN, and you shouldn't lodge a BAS. This is fraud,"* ATO Deputy Commissioner and Chief of the Serious Financial Crime Taskforce (SFCT) John Ford said.

More telling is Mr Ford's warning that;

"The ATO has sophisticated risk models and works with banks, law enforcement agencies and other organisations to share information and detect fraud. It also has access to intelligence through community tip offs, social media platforms and other information sources."

What could this mean for the future of the GST system in Australia? We are already seeing this in the tighter scrutiny of new ABN applications and the GST registration process. Accountants are often the gatekeeper for the ATO and it is a timely reminder to consider that the main criteria to be entitled to an ABN is that an "enterprise" exists for GST purposes.

This is also a relevant consideration for those entities considering whether they are <u>required</u> to be register, particularly in respect of property transactions.

The term 'enterprise' is a defined term in section 9-20 of *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act). An enterprise is defined in terms of an activity or series of activities done in a certain manner or by certain entities. The activities covered include those done in the form of a business or an adventure or concern in the nature of trade, leasing on a regular or continuous basis, activities done by charitable or religious institutions, and activities done by the Commonwealth, a State, a Territory, or local government.

Also, there are certain activities that are excluded from the definition. The exclusions include activities done as an employee, as a private recreational pursuit or hobby, or by individuals without a reasonable expectation of profit or gain.

In the context of property transactions, examples of activities that may be regarded as an enterprise include when an entity:

- buys property with the intention of immediate resale at a profit;
- develops property to sell;
- leasing out premises on a continuous and regular basis[4]; and
- a once-off property transaction that meets the criteria to be an enterprise.

Importantly, the nature of a property can change from being a private or capital asset to that of trade and vice versa. In cases where an entity acquired the land with the intention to build a property for renting purposes and then that intention changed, it is necessary to have evidence of when that intention changed and the facts and circumstances surrounding this change. This may often be relevant for determining when the enterprise commenced when applying for an ABN.

Accordingly, although news of the GST fraud being stymied may seem irrelevant for law abiding entities, the ripples of these attempted frauds are likely to be felt by all in the tax community either directly or indirectly through potentially increased stringent checks and substantiation requirements.

If you would like to discuss these matters, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

Division 7A on Loans from Trusts – Is this still relevant?

The treatment of Unpaid Present Entitlements (**UPEs**) between a trust and a private company for Division 7A purposes has evolved over time. Division 7A can apply to counter arrangements where a trust would make a loan to an associate or shareholder of a company that was owed a UPE by that trust.

Prior to 16 December 2009, the ATO did not seek to apply Division 7A to UPEs owing to companies. Whilst the UPE owing to the company could essentially remain unpaid without any consequences under Division 7A, the subsequent borrowing or causing of beneficiary accounts to be 'overdrawn' would trigger Division 7A on such transactions.

For UPEs to private companies arising from 16 December 2009, the ATO provided for two broad options to deal with UPEs to corporate beneficiaries, namely converting the UPE to a loan or placing the UPE on a 'sub-trust'. If the UPE was converted to a loan, Division 7A would not have any application to funds lent out of the trust as there would not be a UPE in existence. However, for UPEs placed on sub-trust arrangements, Division 7A would apply to further amounts lent out of the trust as the UPE (albeit on a sub-trust arrangement) was still in existence.

From 16 December 2009, the application of Division 7A to Trust loans was therefore limited to quarantined pre-2009 UPEs and post-2009 UPEs that had been placed on sub-trusts.

4 GSTD 2000/9 Goods and services tax: if you let out residential premises do you need to get an ABN for PAYG purposes or register for GST?

On 13 July 2022, the ATO released TD 2022/11 which outlines the Commissioner's most recent view on the application of Division 7A for UPEs to private companies, removing the sub-trust option from the 2023 tax year. This has further limited the scope of Division 7A to Trusts as it would only be applicable to pre-2009 UPEs and older sub-trust arrangements that are gradually expiring.

There are some interesting observations that can be made from the above. It may be accepted that Division 7A will have limited utility in future years in respect to loans from Trusts as a result of the ATO's view outlined in Tax Determination 2022/11. However, TD 2022/11 is simply the Commissioner's view and not the law itself. The law as it currently stands is contained in Division 7A and it contains a measure to capture funds lent out by a trust with a subsisting UPE to a company.

When this subdivision was introduced, it was envisaged by the Parliament that it was a necessary set of provisions, which the ATO has now somewhat undermined by requiring UPEs to be converted to loans. That is, there is now a conflict between what the Parliament intended with Division 7A and the ATO's approach with UPEs to private companies which has made the subdivision irrelevant to a large extent.

If you need assistance with any Division 7A matters for your clients, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

Managing Risks in the Allocation of Professional Services Firm Profits – Part 1

The ATO are again taking aim at how Professional Services Firms allocate their profits to the owners with the announcement late last year that they will start contacting Professional Service Firms to "assist" them in managing those risks.

You might recall that in December 2021 the ATO outlined their compliance approach in regards to how profits are allocated within Professional Service Firms. The Guidelines were to apply from 1 July 2022, so the 2023 tax year will be the first year the ATO expects to formally apply its Guidelines.

The Guidelines only apply to Professional Service Firms, which they define to mean "knowledge based services" including accounting, architecture, engineering, financial services, law, medicine and management consulting.

The object of the Guidelines is to determine the Firm's risk level and as such, the level of engagement the Firm can expect from the ATO.

The ATO expects that the Principals/owners of Professional Service Firms will annually assess their eligibility to apply the PCG to determine their risk level.

The eligibility question is dealt with by two Gateways that the ATO expects Firms to satisfy in order to be able to use the ATO's risk matrix.

The first Gateway requires that there is a genuine commercial rationale for the legal structure of the Firm and the way in which it is operated. Factors such as complexity, non-commercial terms or arrangements (including the amount of the salaries paid to Principals) and unusual risk mitigation strategies are taken into account in determining whether a Professional Firm can meet this gateway.

The second Gateway looks at whether the Firm and/or its principals exhibit any high-risk features. These are listed by the ATO to be:

- Non-arm's length financing arrangements;
- An exploitation of accounting treatment versus tax treatment;
- Assignments of Partnership interests (so-called Everett Assignments); and
- Multiple classes of shares held by non-equity holders.

It is unlikely that these Gateways would preclude most Professional Service Firms from applying the Guidelines, however it is important that Firms consider these Gateways in the first instance. For Firms and Principals that cannot pass both Gateways, the ATO's Guidelines do not apply and they are not able to self-assess their risk factor, instead the ATO expects them to engage directly with the ATO to justify the position they have taken.

Where a Professional Services Firm has determined that it has satisfied the two Gateways, it can then undertake its 2023 Risk Assessment, using either the first two, or all three of the Risk Assessment Factors.

In our next article we will drill down into each of the three Risk Assessment Factors and outline how you need to calculate the outcome under each factor.

The first factor deals with the Principal's share of their profit entitlement from the Firm and how that is taxed. The second factor deals with the total effective tax rate for all income the Principal is entitled to receive for that year, whereas the third factor, which is optional, looks at the remuneration returned by the Principal as a percentage of the commercial benchmark for the Principal's services.

If you own or have an interest in a Professional Services Firm and have any queries on how the Gateways apply to your business, please call Andrew Lowry or Leonard Tebbutt on 08 9444 9711.
