

EXPLANATORY STATEMENT

Issued by authority of the Acting Assistant Treasurer

Income Tax Assessment Act 1997

Tax and Superannuation Laws Amendment (2014 Measures No. 2) Regulation 2014

Subsection 909-1(1) of the *Income Tax Assessment Act 1997* (Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

Division 293 tax applies to high income earners, broadly those whose income and concessional tax superannuation contributions exceed \$300,000 in an income year. Individuals are liable to pay the tax imposed at 15% on certain superannuation contributions that exceed the \$300,000 threshold. The tax is designed to ensure that the tax concession received by these individuals on superannuation contributions is more closely aligned with the concession received by average income earners.

Division 293 tax was introduced by the *Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Act 2013*, which received Royal Assent on 28 June 2013.

Subdivision 293-D of the Act provides that an individual's concessional tax superannuation contributions—or their low tax contributions—includes notional contributions in respect of defined benefit interests (defined benefit contributions). The inclusion of defined benefit contributions ensures that individuals with defined benefit interests are treated in a similar way to individuals with interests other than defined benefit interests (accumulation interests). However, as the *actual* value of benefits received by an individual from a defined benefit interest can only be known when the benefit is paid, it is necessary to *estimate* the value of the employer financed benefits that accrue in a financial year for the interest (notional employer contributions) in order to assess liability to Division 293 tax each year.

Section 293-115 of the Act provides that an individual's defined benefit contributions for a financial year in respect of a defined benefit interest has the meaning given by regulation.

The Regulation provides that an individual's defined benefit contributions is an estimate of the amount of employer contributions that would be made if contributions to fund all the employer provided benefits expected to be paid were made annually. Generally, this is the sum of: the actuarial value of the employer provided benefits attributed to the individual for a financial year; the administrative expenses; and the risk benefits attributable to the interest.

The method for determining defined benefit contributions averages the cost of employer provided benefits across all defined benefit members and all years of service. There are special rules for accruing members with interests other than funded benefit interests. Generally, these interests are in superannuation funds for Commonwealth, state and territory employees including constitutionally protected funds and certain public sector superannuation schemes.

Division 293 tax applies to taxable contributions made since 1 July 2012. In respect of the 2012-13 financial year, an interim regulation for determining defined benefit contributions was made on 17 February 2014.

The Regulation amends the *Income Tax Assessment Regulations 1997* to provide the meaning of defined benefit contributions and to specify a method of determining an individual's defined benefit contributions for the 2013-14 financial year and subsequent years.

Details of the Regulation are set out in the **Attachment**.

Consultation

Public consultation on a previous draft Regulation, specifying a method to determine the amount of an individual's defined benefit contributions was undertaken between 31 May 2013 and 6 June 2013. The approach adopted in the previous exposure draft Regulation was based on a method used for determining employer financed contributions for defined benefit interests for the previous superannuation surcharge on contributions. That method required an actuarial calculation of employer provided benefits accruing in a particular year based on each individual's specific circumstances. As such, it differed from the approach taken for determining the employer financed contributions for defined benefit interests for Excess Contributions Tax (ECT) purposes where the cost of employer provided benefits is averaged across all defined benefit members and all years of service.

Eleven submissions were received on the previous draft Regulation. A number of these submissions, prepared from the perspective of defined benefit funds, raised concerns about the excessive compliance costs that would be imposed by prescribing a different approach from that used for ECT purposes, effectively requiring two actuarial calculations each year. In particular, it was suggested that the costs of determining the defined benefit contributions under the approach originally proposed would exceed the expected tax to be collected from affected individuals with defined benefit interests.

As a result of the concerns raised in this previous consultation, the on-going method for determining defined benefit contributions has been changed to avoid the need for dual reporting for most defined benefit funds. The changes are reflected in this draft regulation.

Conditions and commencement

The Act does not specify any conditions that need to be met before the power to make the Regulation can be exercised.

The Regulation will be a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The amendments to the *Income Tax Assessment Regulations 1997* will apply on and after 1 July 2013. This retrospective date of effect is specifically permitted by subsection 293-115(6) of the Act. The retrospective date of effect ensures that there is a method provided for determining defined benefit contributions for the 2013-14 financial year.

ATTACHMENT

In defined benefit funds, employer contributions are typically not allocated to individual members defined benefit interests. Employer contributions are made in aggregate to the fund, based on actuarial advice, to ensure that there is enough money in the fund to pay benefits to members from defined benefit interests as they leave and benefit payments become due.

This requires that there be a method to determine employer contributions made in respect of individual members in respect of their defined benefit interest. Subsection 293-115(1) of the *Income Tax Assessment Act 1997* (Act) provides that defined benefit contributions for an individual for a financial year in respect of a defined benefit interest has the meaning given by regulation. Subdivision 293-DA of the *Income Tax Assessment Regulations 1997* (Regulations) provides the method for determining the amount of defined benefit contributions for an individual who is an accruing member with a defined benefit interest in a superannuation fund. The terms accruing member and non-accruing member are defined in subregulation 293-115.05(2).

Non-accruing Members

The amount of defined benefit contributions for an individual who is a non-accruing member for the whole of a financial year in respect of a defined benefit interest is nil.

Individuals in the pension phase and members who have ceased employment whose benefits are deferred in the fund for the whole of the financial year are likely to constitute the majority of non-accruing members, but employed members who have reached their maximum benefit accrual can also be non-accruing members.

Accruing Members with Funded Benefit Interests

The method for determining the amount of defined benefit contributions for accruing members with funded benefit interests is set out in subregulation 293-115.15(3). A funded benefit interest is a defined benefit interest that is not an interest in a constitutionally protected fund. If the fund is a public sector superannuation scheme, the fund trustee must also certify that it considers benefits will be sourced only from contributions made into a fund, or earnings from such contributions (which is typically the case for members of fully funded schemes), and has not chosen to have contributions made by or on behalf of members excluded from its assessable income under section 295-180 of the Act for the interest to be a funded benefit interest. Section 295-180 of the Act allows the fund to exclude certain contributions from its assessable income, making the related superannuation benefit paid from the interest contain an untaxed element of the taxable component, and potentially subject to tax in the hands of the member.

Superannuation funds that are not public sector superannuation schemes do not need to provide this certification since benefits from such schemes are sourced only from contributions made into a fund, or earnings from such contributions.

The amount of defined benefit contributions for an individual who is an accruing member with a funded benefit interest is the individual's notional taxed contributions for the financial year but without the limiting the amount to the individual's concessional contribution cap under grandfathered arrangements. An individual's notional taxed contributions in respect of a defined benefit interest are the amount

determined under Subdivision 292-D and Schedule 1A of the Regulations for the purposes of determining excess concessional contributions. This approach ensures that the value of superannuation benefits accruing to a defined benefit member during the financial year are included for the purposes of Division 293 tax without imposing excessive compliance costs on superannuation funds with fully funded defined benefit interests.

The amount of notional taxed contributions is an estimate, using prescribed assumptions, of the cost of providing the benefits financed by employer contributions to the fund, payable to the member on voluntary exit.

Circumstances where notional taxed contributions are taken to be equal to the individual's concessional contributions cap (grandfathered arrangements) for excess contributions tax purposes do not apply in determining notional taxed contributions for the purposes of subregulation 293-115.15(3). That is, the full (unlimited) value of notional taxed contributions for a funded benefit interest will be counted as defined benefit contributions for that interest for the purposes of Division 293 tax.

Where a member is an accruing member for part of a year their defined benefit contributions will only reflect that part of the year in which they were an accruing member.

Accruing Members with Interests other than Funded Benefit Interests

Subregulation 293-115.20(2) provides that defined benefit contributions for accruing members with defined benefit interests other than funded benefit interests are determined using the method set out in Schedule 1AA. The method in Schedule 1AA is modelled on the method in Schedule 1A used for determining notional taxed contributions for the purposes of calculating excess concessional contributions.

A new method is required as the full value of benefits accruing to individual members during the financial year is not currently included when determining notional taxed contributions where at least part of such benefits are financed from unfunded or untaxed sources.

This covers all defined benefit interests in constitutionally protected funds and all defined benefit interests that are sourced, at least in part, from amounts other than contributions to a fund or earnings from those contributions. It is also possible that a public sector superannuation scheme may choose to not certify under subregulation 293-115.15(2)(b) and, as a result, need to determine defined benefit contributions using Schedule 1AA. However, defined benefit interests in constitutionally protected funds and defined benefit interests in fully or partially unfunded schemes would be expected to account for the vast majority of the interests using Schedule 1AA. These funds will generally have to report to the Australian Taxation Office both an amount of notional taxed contributions and an amount of defined benefit contributions for each defined benefit member that will differ.

In determining the defined benefit contributions for these interests, the component representing benefits sourced from concessional contributions to a fund, is the notional taxed contributions for the individual, calculated under Schedule 1A of the Regulations. As with funded benefit interests, the grandfathered arrangements do not apply in determining notional taxed contributions.

The employer financed component of the benefits included in determining defined benefit contributions that are not sourced from concessional contributions is the

difference between an amount of 'notional employer contributions' and notional taxed contributions (calculated under Schedule 1A), multiplied by 0.85 as the formula at clause 4(1) includes a term $(BC - NTC) \times 0.85$. The 0.85 factor takes account of the fact that the formulae used to calculate both notional employer contributions and notional taxed contributions include a factor of 1.2 to reflect the additional contributions that would be required to fund the benefits after allowance is made for deductions due to contributions tax and expenses. Effectively, the factor of 0.85 removes the grossing up for contributions tax, recognising that income tax will not be payable by the superannuation fund on amounts used to provide these benefits.

The amount of notional employer contributions is an estimate, using prescribed assumptions, of the cost of providing the benefits payable to the member on voluntary exit that are not sourced from contributions made by the member themselves or earnings on amounts in the fund. It includes the value of benefits funded by employer contributions to the fund, as well as the value of benefits that are sourced from outside the fund.

Where a member is an accruing member for part of a year their defined benefit contributions will only reflect that part of the year in which they were an accruing member.

Last Minute Contributions

Some public sector superannuation schemes finance benefits for defined benefit interests through contributions made just before benefits are payable, and choose under section 295-180 of the Act to exclude those contributions from the assessable income of the fund. These contributions are known as 'last minute contributions'. Superannuation benefits paid from members' interests in such schemes include an untaxed element of the taxable component.

In these circumstances the interest is an interest other than a funded benefit interest to which subregulation 293-115.20 applies, and the amount of defined benefit contributions for the individual will be worked out under Schedule 1AA. In this case, if the interest is fully funded, under clause 4 of Schedule 1AA the calculation of notional employer contributions will be equal to notional taxed contributions (ignoring grandfathered arrangements), and defined benefit contributions will therefore be equal to notional taxed contributions (ignoring grandfathered arrangements).

Where the trustee chooses to certify that benefits will only ever pay superannuation benefits from contributions made to the scheme or earnings on those contributions and the trustee has not chosen, under section 295-180 of the Act, to have the last minute contributions excluded from the assessable income of the scheme, the interest is a funded benefit interest to which subregulation 293-115.15 applies and the amount of defined benefit contributions for an individual will be worked out under Schedule 1A. This means again that the individuals defined benefit contributions will be equal to their notional taxed contributions (ignoring grandfathered arrangements).

Constitutionally Protected Funds

Constitutionally protected funds are operated by some state governments for their employees. These funds do not pay income tax on any contributions they receive or any earnings thereon.

The amount of defined benefit contributions for an individual with a defined benefit interest in a constitutionally protected fund is worked out using the method in Schedule 1AA. This is because a defined benefit interest in a constitutionally protected fund is an interest other than a funded benefit interest.

Under Schedule 1AA, defined benefit contributions are worked out under subclause 4(1), and will equal notional employer contributions multiplied by 0.85. This is because notional taxed contributions are not calculated for members of constitutionally protected funds due to the operation of sub-paragraph 291-25(2)(iii) of the Act. In these circumstances, notional taxed contributions are nil.

For the purposes of calculating taxable contributions for Division 293 tax under section 293-20 of the Act, low tax contributions will need to be determined for all members of constitutionally protected funds, including State higher level office holders. The amount of defined benefit contributions is included in the individual's low tax contributions under section 293-105 of the Act.

However, low tax contributions for interests held by State higher level office holders in a constitutionally protected fund are modified by Subdivision 293-E of the Act.

Regulation 293-145.01 lists the classes of officers that are State higher level office holders. For constitutional reasons, these listed officers are not subject to Division 293 tax in relation to certain superannuation contributions made to constitutionally protected funds.

Subsections 293-150(2) and 293-150(3) of the Act provide that a State higher level office holder's low tax contributions for a financial year in respect of an interest in a constitutionally protected fund are nil, except in certain circumstances (salary packaging).

Salary packaged contributions

Salary packaged contributions made to a defined benefit interest are a funded employer financed component of that interest. The contributions are employer contributions and are treated in the calculations as such.

If superannuation benefits from the interest are sourced wholly from contributions, or earnings from contributions, including the salary packaged contributions, and the trustee has not chosen under section 295-180 of the Act to have any contributions made by or on behalf of a member excluded from the assessable income of the scheme, the interest is a funded benefit interest. As such, subregulation 293-115.15 applies and the amount of defined benefit contributions is the individual's notional taxed contributions. In this case, the salary packaged contributions will form part of the total contributions that are reflected in the new entrant rate calculated for the purposes of working out the amount of notional taxed contributions under clause 1.7 of schedule 1A of the regulations.

However, if superannuation benefits from the interest are sourced partially from amounts other than contributions to a fund or earnings from those contributions-including the salary packaged contributions, or contributions by or on behalf of a member to the interest are excluded from the assessable income of the scheme under section 295-180 of the Act (or both), the interest is an interest other than a funded benefit interest. As such, subregulation 293-115.20 applies and the amount of defined benefit contributions is worked out using the method in Schedule 1AA.

In this case, under Schedule 1AA the salary packaged contributions, including any subject to a choice under section 295-180 of the Act, are included in notional employer contributions in clause 4 by way of the new entrant rate.

The amount of notional taxed contributions under subclause 4(1) is worked out under Schedule 1A. If the funded component of the interest comprises only amounts contributed in respect of a member, then the notional taxed contributions would be calculated under clause 1.6 of Schedule 1A as the amount of the contributions, including any salary packaged contributions that have been included as assessable income of the fund. If the funded component includes amounts which are not contributed in respect of individual members, the notional taxed contributions would be calculated under item 1.7, with the new entrant rate including the component of benefits funded through salary packaged contributions that have been included as assessable income of the fund. Salary packaged contributions in respect of the interest that are not included in the assessable income of the fund because of section 295-180 of the Act are, as noted above, also included in the notional taxed contributions by way of the new entrant rate.

Salary packaged contributions for the individual made to an interest not in respect of a defined benefit interest are covered by section 293-30 of the Act and are included in the individual's low tax contributions under section 293-105.