

EXPOSURE DRAFT EXPLANATORY STATEMENT

Income Tax Assessment Act 1997

Superannuation Industry (Supervision) Act 1993

Treasury Laws Amendment (Miscellaneous Amendments) Regulations 2019

Section 909-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) and section 353 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) provide that the Governor-General may make regulations prescribing matters required or permitted by the ITAA 1997 or SIS Act to be prescribed or that are necessary or convenient to be prescribed for carrying out or giving effect to the ITAA 1997 or SIS Act.

The purpose of the *Treasury Laws Amendment (Miscellaneous Amendments) Regulations 2019* (the Regulations) is to make regulations for the purposes of the ITAA 1997 and the SIS Act. The amendments in the Regulations address minor technical issues and anomalies in the *Income Tax Assessment Regulations 1997* and the *Superannuation Industry (Supervision) Regulations 1994* that arose largely as part of the implementation of the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016*.

In particular, the amendment primarily relates to the transfer balance cap, a \$1.6 million cap on the amount of capital that can be transferred into the retirement phase of superannuation. The transfer balance cap applies from 1 July 2017 and is intended to limit the extent to which the retirement phase interests of high wealth individuals attract an earnings tax exemption. An individual's transfer balance is calculated by reference to credits reflecting the opening value of a superannuation income stream entering the retirement phase and debits reflecting the closing value of those income streams. An individual's transfer balance is then assessed against their personal transfer balance cap.

Modifications to the transfer balance cap rules apply in relation to capped defined benefit income streams. Defined benefit superannuation income streams differ from more common account-based superannuation interests that reflect member contributions. Many defined benefit superannuation income streams are subject to commutation restrictions that make the application of the general rules infeasible.

The amendments contained in the Regulations were announced by the Assistant Treasurer, the Hon. Stuart Robert MP, on 30 and 31 October 2018. The Regulations:

- amend the rules for the valuation of defined benefit pensions and annuities for the purposes of the transfer balance cap to reflect when pension payments are reduced following an initial higher payment;
- provide transfer balance credits for innovative income stream products to ensure that these products receive appropriate treatment under the transfer balance cap and ensure that existing transfer balance debits for innovative income stream products are calculated appropriately;

- maintain the capped defined benefit income stream treatment of products rolled over as a result of a successor fund transfer; and
- amend the definition of the life-expectancy period for innovative income streams to properly account for the number of days in a leap year.

Further details of the Regulations are set out in Attachment A.

The ITAA 1997 and SIS Act do not specify any conditions that need to be met before the power to make the Regulations may be exercised.

The Regulations are a legislative instrument for the purpose of the *Legislative Instruments Act 2003*.

The Regulations commence on the day after they are registered on the Federal Register of Legislation.

Details of the *Treasury Laws Amendment (Miscellaneous Amendments) Regulations 2019*

Section 1—Name of the Regulations

This section provides that the name of the Regulations is the *Treasury Laws Amendment (Miscellaneous Amendments) Regulations 2019* (the Regulations).

Section 2—Commencement

The amendments apply from the day after they are registered on the Federal Register of Legislation.

Section 3—Authority

The Regulations are made under the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Superannuation Industry (Supervision) Act 1993*.

Section 4—Schedules

Section 4 provides that each instrument in a Schedule to the regulation is amended or repealed as set out in that Schedule.

Schedule 1—Part 1—Reductions in value of lifetime pensions and annuities

Item 1 of Schedule 1 to the Regulations amends the *Income Tax Assessment Regulations 1997* (ITAR 1997) to prescribe the additional circumstances in which a transfer balance debit arises in an individual's transfer balance account and the amount of the debit.

This change addresses the fact that certain reductions in the value of defined benefit lifetime pensions and annuities are not covered by the transfer balance debit provisions in subsection 294-80(1) of the ITAA 1997 and are therefore not taken into account in working out an individual's transfer balance.

Generally, reductions in value of a superannuation income stream that are not attributable to losses or regular pension payments will be attributable to a commutation or partial commutation of the income stream. Such commutations give rise to a transfer balance debit under item 1 of the table in subsection 294-80(1) of the ITAA 1997.

However, the value of certain defined benefit superannuation income streams can be reduced in circumstances that are not captured by the debits currently provided for in subsection 294-80(1). This can arise under the rules of the fund or scheme where the calculation of the superannuation income stream benefit is varied due to a change in the circumstances of the individual recipient, rather than from a commutation of the defined benefit income stream. These reductions occur mainly in respect of public sector superannuation schemes.

Examples of where these reductions can occur include:

- a reversionary defined benefit pension paid to a surviving spouse or a beneficiary. In some cases, the first payment is the full amount of the payment that was made to the deceased, whereas the second and all subsequent payments are a proportion of the full entitlement. As a result, the annualised payment is based on an inflated figure;
- a reversionary defined benefit pension paid to a surviving spouse that is calculated by reference to the deceased's dependent children. In such cases the surviving spouse's entitlement can be reduced as the children cease being dependent (generally at 18 or 25 years depending on their circumstances).

For each of these examples, the fund or scheme rules will determine whether the re-classification simply involves:

- a recalculation of payments (which would not provide a transfer balance debit);
- a partial commutation of the superannuation interest (which would provide a transfer balance debit); or
- the cessation of the original superannuation interest (which would provide a transfer balance debit) and the commencement of a new superannuation income stream (which would give rise to a credit that will be lower than the debit).

Item 1 amends the ITAR 1997 to insert regulation 294-80.01 to ensure a consistent treatment between reductions in the value of lifetime defined benefit income streams. The amendment achieves this by providing individuals with a transfer balance debit where:

- the individual has a superannuation income stream for which they are a retirement phase recipient;
- the superannuation income stream is a lifetime pension or annuity, or a similar superannuation income stream prescribed under regulation 204-130.01 of the ITAR 1997; and
- the individual was entitled to receive a superannuation income stream benefit that is subsequently reduced where the reduction is not attributable to either:
 - circumstances that give rise to another transfer balance debit (either under items 1 to 7 of the table in subsection 294-80(1) of the ITAA 1997 or another regulation made under item 8 in that table); or
 - a CPI adjustment.

As a result of this amendment, the individual's transfer balance account will reflect the decrease in the value of the individual's annual entitlement to superannuation income stream benefits. The amount of the debit arising in the individual's transfer balance account will be the special value of the superannuation interest supporting the superannuation income stream just before the earlier time, less the special value of the superannuation interest supporting the superannuation income stream just before the later time. The special value of a lifetime pension or annuity at a particular time is the member's annual entitlement to superannuation income stream benefits multiplied by 16 (subsection 294-135(2) of the ITAA 1997).

Example 1.1: Debit for a reduction in payments from a reversionary defined benefit pension

On 1 July 2017, Anna was receiving fortnightly pension payments equivalent to an annual entitlement of \$100,000. In August 2019, Anna passes away and her husband, Jorge, begins receiving a reversionary defined benefit pension. The rules of the fund provide for the first payment to the reversionary beneficiary (Jorge) to equal the previous entitlement from the original recipient, however all subsequent payments are reduced to $\frac{3}{4}$ of that previous entitlement.

The rules of the fund make it clear that it is the same pension payable to the reversionary beneficiary and that it is merely the amount of the periodic payments that have changed.

A credit arises in Jorge's transfer balance account of \$1.6 million (being the special value of the defined benefit pension when he receives it). This is based on the amount of the first superannuation income stream benefit that Jorge is entitled to receive.

The next fortnightly payment that Jorge is paid is reduced, and is equivalent to an annual entitlement of \$75,000. This annual entitlement equates to a special value of \$1.2 million.

A debit arises in Jorge's transfer balance account and is calculated as the difference between the special value based on the earlier annual entitlement and the special value based on the later annual entitlement (i.e. \$1.6 million less \$1.2 million = \$400,000).

Schedule 1—Items 1 and 2—Innovative income streams

The product standards for deferred superannuation income streams were enacted by Schedule 1 to the *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017*. Income streams that do not immediately pay a superannuation income stream benefit can still be a superannuation income stream that is in the retirement phase if an individual to whom superannuation income stream benefits will be payable has met a specified condition of release (see subsection 307-80(2)). This means that a provider of such a product is able to claim an earnings tax exemption prior to the time that amounts are paid to the member.

However, there are currently two issues that arise in respect of the way that deferred superannuation income streams are accounted for under the transfer balance cap.

The first issue arises because transfer balance credits are generally based on the value of a superannuation income stream at the time that it enters the retirement phase (see the table in subsection 294-25(1) of the ITAA 1997).

This means that any subsequent instalment payments that are made for a deferred income stream will not give rise to a transfer balance credit. As these instalments represent a transfer that increases the value of an individual's retirement phase interest, a failure to receive a credit for the transfer means that their transfer balance account is understated. This issue does not arise for other superannuation income stream products as the ability to make instalment payments after a superannuation income stream has commenced is unique to deferred superannuation income streams.

Item 1 of Schedule 1 to the Regulations amends the ITAR 1997 to correct this anomalous outcome. It achieves this through new regulation 294-25.01, which causes a transfer balance credit to arise in an individual's transfer balance account where an amount of consideration is paid for the interest for a 'deferred superannuation income stream' after the time that the income stream enters the retirement phase. The amount of the credit is the amount of the consideration and the credit arises at the time the consideration is paid.

The focus on amounts of consideration paid for the interest is broadly consistent with the way the special valuation rule for deferred superannuation income streams takes into account instalment payments under subsection 307-205.02C(1) of the ITAR 1997.

The second issue that arises is that the special valuation rule for deferred income streams overvalues those income streams when calculating a transfer balance debit under items 5 and 6 of the table in subsection 294-80(1) of the ITAA 1997.

Items 5 and 6 of the table in subsection 294-80(1) of the ITAA 1997 provide an individual with a debit for the value of the superannuation interest that supports an income stream that stops being in the retirement phase. This can occur where the provider of the income stream fails to comply with a commutation authority, or where the income stream does not conform with the pension or annuity standards that are applicable to it.

The valuation rule in regulation 307-205.02C of the ITAR 1997 takes the greater of the sum of indexed consideration paid for the superannuation interest and the amount that would become payable if the individual voluntarily ceased to hold the superannuation interest. Because of this, the transfer balance debit that would arise under items 5 or 6 of the table in subsection 294-80(1) for a deferred superannuation income stream would always be at least equal to the amount of the indexed consideration paid for the interest for the income stream.

This outcome is inappropriate because the transfer balance debit would not reflect the value of the superannuation interest supporting the income stream at the time when superannuation income stream benefits have commenced to be paid (thereby reducing the value of the superannuation interest). Further, it would not reflect the limitations on amounts that could be commuted applying the capital access schedule.

In such circumstances, applying the higher value of the indexed consideration paid would neutralise the transfer balance credit that originally arose for the deferred superannuation income stream, without recognising that the individual is not entitled to be paid that full amount.

Similar issues do not arise for the other items of the table in subsection 294-80(1) of the ITAA 1997. This is because item 1 of the table will apply appropriately as the amount of the transfer balance debit will be equal to the amount of the lump sum paid from the commutation of a deferred superannuation income stream. The other items of the table in subsection 294-80(1) of the ITAA 1997 similarly do not calculate the transfer balance debit by reference to the value of a superannuation interest and as such do not need to be modified.

Item 2 of Schedule 1 to the Regulations amends the ITAR 1997 to correct this anomalous outcome by modifying the way the valuation rule in regulation 307-205.02C applies for the purposes of items 5 and 6 of the table in subsection 294-80(1) of the ITAA 1997.

As a result of this modified application, the value of a deferred superannuation income stream for the purposes of items 5 and 6 of the table in subsection 294-80(1) of the ITAA 1997 is simply the amount that the individual would be entitled to if they voluntarily ceased to hold the interest. This means that the indexed consideration paid for the interest is no longer relevant for items 5 and 6.

Schedule 1—Part 3—Successor fund transfers

A successor fund transfer occurs where a fund (the original fund), as part of a superannuation fund merger or acquisition, transfers its members' interests to a successor fund. A critical feature of a successor fund transfer is that, unlike an ordinary rollover or transfer, it is normally undertaken without the consent of the member.

In a circumstance where an original fund is paying a capped defined benefit income stream as set out in the table in subsection 294-130(1) of ITAA 1997 to an individual, the successor fund transfer will result in the original fund ceasing the superannuation income stream and the successor fund commencing to pay an equivalent superannuation income stream to the individual.

Under paragraph 294-130(1)(b) of the ITAA 1997, a superannuation income stream covered by items 2 to 7 of the table is not a capped defined benefit income stream where the income stream commences to be in retirement phase on or after 1 July 2017. Accordingly, where the successor fund transfer occurs on or after 1 July 2017, the superannuation income stream paid to the member by the successor fund will not be a capped defined benefit income stream for the purposes of the transfer balance cap. This in turn has the potential to give rise to adverse consequences under the transfer balance cap.

If the capped defined benefit income stream is the only superannuation income stream the member has that is in the retirement phase, and its special value exceeded their transfer balance cap just before the successor fund transfer, the member will not have an excess transfer balance before the transfer (see section 294-140 of the ITAA 1997). However, as the new superannuation income stream paid by the successor fund is not a capped defined benefit income stream, the member may (depending on the value of the superannuation interest supporting the income stream) have an excess transfer balance immediately after the transfer.

Due to commutation restrictions on such superannuation income streams if the member finds themselves in excess of their transfer balance cap, they will not be able to reduce their transfer balance under their transfer balance cap by commuting part of their new income stream.

These outcomes are inconsistent with the policy intent.

In this scenario, the transfer of a member's benefit between funds as part of a successor fund transfer is not done at the member's direction or with the member's consent and no adverse taxation consequences should apply to the member.

Items 3 and 4 of Schedule 1 to the Regulations amends regulation 294-130.01 of the ITAR 1997 to prescribe a superannuation income stream to be a capped defined benefit income stream under subsection 294-130(2) of the ITAA 1997 where:

- it would be a capped defined benefit income stream if it had started on or before 1 July 2017; and
- it arises as a direct result of the payment of an involuntary roll-over superannuation fund to a successor fund.

The special value of a lifetime annuity started under a successor fund transfer is the individual's annual entitlement to superannuation income stream benefits multiplied by 16. This is achieved under current regulation 294-135.01 of the ITAR 1997.

Items 5 and 6 of Schedule 1 to the Regulations amend regulation 294-135.01 of the ITAR 1997 to prescribe special values for other superannuation income streams—life expectancy or market linked pensions or annuities—created under a successor fund transfer. The special value is the individual's annual entitlement to superannuation income stream benefits multiplied by the remaining term of the income stream.

Schedule 1—Part 4—Life expectancy periods in a leap year

Regulation 1.06A of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) sets out the standards for innovative superannuation income streams. These income streams are required to meet certain standards including a cap on the maximum commutation amount of a benefit.

The maximum commutation amount for the income stream is worked out with reference to the beneficiary's life expectancy calculated as the remaining years of the beneficiary's life expectancy multiplied by 365 days.

However, converting the remaining years of the beneficiary's life expectancy to days by multiplying by 365 does not deliver the intended outcome for innovative superannuation income stream products that rely on an anniversary date, such as life annuities.

For example, if an investment was made in a life annuity on 15 January 2018, the life annuity's anniversary date (which is also the annuity's payment date) will always be 15 January, regardless of leap years. As such, the life annuity's anniversary date is not specifically a multiple of 365 days after the investment date, but the calendar anniversary of the investment date.

If a beneficiary has a life expectancy period that includes a leap year, the beneficiary's annuity anniversary date and the end life expectancy period date will be different. The annuity anniversary date will always be a later date than the life expectancy period date. There is a mismatch of the actual number of days of the life expectancy period and the annuity anniversary date.

Item 7 of Schedule 1 to the Regulations amends the definition of life expectancy in subregulation 1.03(1) of the SIS Regulations to correct this mismatch. The amended definition ensures that the life expectancy period accounts for leap years by converting the years to the actual number of days remaining to the end of the life expectancy period.

Schedule 1—Part 5—Application provisions

Item 8 of Schedule 1 provides that the the amendments in relation to:

- reductions in the value of defined benefit pensions and annuities; and
- successor fund transfers,

apply to reductions in value and successor fund transfers that occur on or after 1 July 2017.

Item 8 also provides that the amendments in relation to innovative income streams apply to credits and debits arising on or after the day the amendments commence (the day after they are registered).

Item 9 of Schedule 1 provides that the amendments in relation to life expectancy period and leap years apply to working out an individual's maximum commutation amount on or after 1 July 2017.