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Commonwealth Department of Treasury

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Dear Jordan

Capped defined benefit income streams and SFTs
Exposure draft *Treasury Laws Amendment (Measures for Consultation) Regulations 2021: Miscellaneous and Technical Amendments Autumn 2022*

We are writing to seek your Department's assistance with the 'transfer balance account' rules in Division 294 of the *Income Tax Assessment Act 1997* and the corresponding income tax regulations.

As you know Sunsuper is in the process of merging with QSuper to form the Australian Retirement Trust, a circa $230 billion fund, and a transfer balance account problem has arisen in relation to our lifetime pension recipients.

Special transfer balance account rules apply to lifetime and term pensions and annuities defined by section 294-130 of the *Income Tax Assessment Act 1997* as 'capped defined benefit income streams'. These income streams cannot of themselves cause recipients to breach transfer balance caps such as would require commutations. Instead, recipients are required to pay additional income tax on cap excesses.

The value of lifetime pensions and annuities is, broadly, the annual income x 16. The value of term pensions and annuities for transfer balance account purposes is, broadly, the annual income x the remaining term. In the case of capped defined benefit income streams that value is struck at 1 July 2017, or at commencement if later in the case of lifetime pensions.

Although the income payable on these products can increase over time with indexation, this does not affect their transfer balance account value, which as mentioned is struck at 1 July 2017 or commencement. This is a design feature of the transfer balance account rules and is consistent with earnings supporting account based pensions also being excluded from the transfer balance account value of those income streams – as the name connotes, the transfer balance account sets a 'transfer' cap for amounts transferred to pension phase.

Naturally, a pension or annuity recipient's transfer balance account is reduced, by debit, when pensions and annuities are commuted or otherwise terminated i.e., assuming they can be, which will not normally be the case with capped defined benefit income streams. The debit allows a pension or annuity to be recommenced later, within the available transfer balance cap. This ensures retirees have equal ongoing access to concessionally taxed pension incomes.

A pension or annuity recommenced in this manner is valued for transfer balance purposes at its (refreshed) commencement value, which may be higher than the debit value of the discontinued pension or annuity. In other words, the credit to the transfer balance account for the new pension or annuity may exceed the debit for cessation of the old pension or annuity. This is appropriate because the recommenced and replaced pensions or annuities may not be the same, and also because the transfer balance cap itself, and therefore also a retiree's available cap space, also increase with indexation to CPI. There is both a new income stream and a new yardstick for concessional taxation. Equivalence is maintained for all retirees.

However, under current law this otherwise equitable system breaks down for retirees involved in a successor fund transfer (SFT). An SFT ceases and recommences any capped defined benefit income streams payable from the closing fund. The new pensions or annuities payable from the continuing fund are directly equivalent (normally identical) to those replaced, and yet the SFT can cause further utilisation of or further excesses over the affected retiree's transfer balance caps. The affected retirees are disadvantaged, by the SFT, compared to retirees not involved in an SFT – noting also that an SFT is involuntary so far as the retirees are concerned.

This is a flaw in the legislative scheme (i.e., it is an inequity) and it arises because cessations and recommencements of capped defined benefit income streams pursuant to (involuntary) SFTs are subject to the same general transfer balance account rules as other voluntary cessations and recommencements of pensions and annuities. While the debit value of the ceased capped defined benefit income stream is appropriately the transfer balance account value of that income stream at the time, the credit value of the new income stream will reflect any indexation of [(or other increase in)] it's payments to the date of the SFT. This is inappropriate. It is equivalent to adding the earnings supporting account-based pensions to the transfer balance account value of those pensions.

A separate rule is therefore needed to value, for transfer balance account purposes, capped defined benefit income streams commenced as a result of an SFT. This would be a very simple measure. It could be done by income tax regulation. Suitable drafting is set out in Appendix 1 to this letter. Very simply, the transfer balance account credit for a capped defined benefit income stream commencing with an SFT needs to be equal to the debit for the corresponding income stream ceased by the SFT.

We note that your Department has released for comment exposure draft *Treasury Laws Amendment (Measures for Consultation) Regulations 2021: Miscellaneous and Technical Amendments Autumn 2022* which also deals with some other deficiencies in the application of the transfer balance account rules to capped defined benefit income streams. It would seem simple and convenient to also address the problem outlined here with that measure.

Finally, note that this issue does not concern account-based pensions and annuities. The general transfer balance account rules already provide that SFT debits and credits are the same for those income streams. The measure additional recommended here would simply put capped defined benefit income streams in the same SFT position as account-based income streams.

Thank you for your interest in resolving this problem. Please do not hesitate to call me if you have any questions or if we can be of further assistance.

Yours sincerely

Ian Roberts
Head of Tax – Sunsuper

Item 1: Amendment of the *Income Tax Assessment (1997 Act) Regulations 2021* to insert a new regulation 294-135.02.

Regulation 294-135.02

Transfer balance credits – credit value of capped defined benefit income stream commencing with an SFT

For the purposes of subsection 294-135(4) of the Act, the credit value of a capped defined benefit income stream that commences to be payable from a continuing fund upon a successor fund transfer is equal to the transfer balance debit that arose in your transfer balance account in respect of the corresponding income stream that ceased to be payable from the closing fund at that time.

Item 2: Amendment of the *Income Tax Assessment (1997 Act) Regulations 2021,* regulation 294-135.01, to insert a new sub-section (6) as follows.

(6) This section does not apply to capped defined benefit income streams in circumstances (successor fund transfers) where section 294-135.02 of this instrument applies.

Item 3: Amendment of the *Income Tax Assessment (1997 Act) Regulations 2021,* regulation 294-130.01, to insert a new sub-section (7) as follows.

(7) For the purposes of subsection 294-130(2) of the Act, a superannuation income stream is prescribed if it is a capped defined benefit income stream that commences to be payable from a continuing fund upon a successor fund transfer.

Alternative approach: We have also included an alternative approach for your consideration.
Amendment of the *Income Tax Assessment (1997 Act) Regulations 2021* to insert a new regulation 294-25.02.

Regulation 294-25.02

Credit in transfer balance account – credit for capped defined benefit income stream commencing with an SFT

(1) For the purposes of item 5 of the table in subsection 294-25(1) of the Act, a transfer balance credit arises under this section (instead of item 2 of the table in subsection 294-25(1) of the Act) in your transfer balance account if:

(a) you are the retirement phase recipient of a superannuation income stream; and

(b) the superannuation income stream is a capped defined benefit income stream; and

(c) the capped defined benefit income stream commences to be payable from a continuing fund upon the happening of a successor fund transfer.

(2) The amount of the credit is equal to the transfer balance debit that arose in your transfer balance account in respect of the corresponding income stream in the closing fund ceasing to be payable at that time.

(3) The credit arises at the time of the SFT.