



8 August 2022

Director, Tax and Compliance Unit
Retirement, Advice and Investment Division
Treasury
Langton Cres
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam

Consultation: Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Taxation of military superannuation benefits

The Actuaries Institute ('Institute') welcomes the opportunity to comment on exposure draft (ED) legislation released on 25 July 2022 to ensure that the *Commissioner of Taxation v Douglas* Federal Court decision ('the Douglas decision') only affects the schemes and benefits specifically outlined in the decision and that no veteran faces worse income tax outcomes because of the decision.

The Institute is the sole professional body for actuaries in Australia. Our members have a long track record of actively contributing to the development and management of superannuation within Australia.

1 Scope

Our comments relate to the Item 1 draft amendments to various taxation laws to confirm the tax treatment of certain defined benefit pensions following the Douglas decision. We have not considered the provisions relating to the proposed non-refundable tax offset for recipients of invalidity benefits paid in accordance with the Military Superannuation Benefits and Defence Force Retirement and Death Benefits schemes.

2 Support for intent of amendments

The Institute strongly supports the intent of the proposed amendments to extend the definition of a superannuation income stream to ensure it includes all 'large' fund (more than six members) defined benefit (DB) pensions that commenced on or after 20 September 2007.

3 Potential technical issues

However, we consider modifications may be required to the draft amendments to address a number of technical issues that are set out in the Appendix to this submission. These include consideration of modifications to ensure:

- the proposed amendments are properly targeted to 'real' DB pensions that commenced on or after 20 September 2007;



- all the relevant pensions are treated as 'capped defined benefit income streams' for transfer balance cap (TBC) purposes; and
- relevant pensions in pensioner-only DB funds are covered.

The Appendix includes five recommendations relating to these technical issues.

4 Treatment of relevant DB pensions historically taxed as lump sums

We understand that there are a small number of superannuation schemes where some permanent disability DB pension payments commencing after 20 September 2007 have historically actually been taxed as lump sums because the trustee identified that the pensions do not satisfy the current SIS r1.06 requirements.

The small number of cases we are aware of relate to disability pensions which are not payable for life but only until normal retirement date, at which time the recipient becomes eligible to receive their normal retirement benefit (which may be a lump sum or a pension).

There may also be cases where DB child death benefit pension payments which commenced after 20 September 2007 are being, or were, taxed as lump sums because the trustee identified that the pensions do not satisfy the current SIS r1.06 requirements.

While we expect there would be only a small number of affected pensioners, we submit that it would be unfair to retrospectively impose different – and potentially adverse – tax and TBC treatment on these pensioners.

Recommendation L1

We recommend that the final amendments include provisions to ensure recipients of relevant pensions which have been taxed as lump sums, in accordance with the current legislation, are not disadvantaged.

We suggest that the default for such pensions be that they remain taxed as lump sums, with the pensioner able to make a once-off irrevocable election to adopt pension treatment, in which case it would be retrospective to when the pension commenced. A framework along the following lines could be considered.

- Funds would apply pension tax treatment to relevant new pensions and prospectively to any existing affected pension that the pensioner has elected be treated as a pension for tax purposes.
- There should be no obligation for affected funds to proactively initiate either:
 - A. a change to the current and future tax treatment of existing affected pensions from lump sums to pension, or
 - B. the provision of amended tax information for prior years to affected pensioners based on pension treatment being applied retrospectively back to the commencement date.



- However, affected members could request the information referred to in B above from their fund and, should they wish to do so:
 - lodge an election with their fund that their benefit be treated as a pension for tax purposes (for both past and future years), and
 - seek amended assessments for prior years from the ATO.

5 Implications for Exempt Current Pension Income (ECPI)

Our reading is that the amendments as drafted would mean that affected DB pensions (mainly invalidity pensions which commenced after 20 September 2007 which do not satisfy the current r1.06 requirements) would become 'retirement phase' superannuation income streams with effect from their commencement date.

Accordingly, where the affected pensions are provided from taxed superannuation funds, earnings on the assets backing those pensions would be eligible for inclusion in Exempt Current Pension Income (ECPI) for relevant tax years back to 2007-08.

This would be a desirable outcome and in line with the policy intent as stated in the draft Explanatory Statement. We understand that the majority of affected taxed schemes have historically claimed ECPI on affected pensions and thus the proposed amendments would avoid the potential need for them to revise past ECPI claims.

However, there may be some taxed funds which have excluded affected DB pensions from past ECPI calculations and could seek to amend past tax returns to claim higher ECPI amounts should the proposed amendments proceed. Again, as noted in the draft Explanatory Statement, the exclusion of these DB pensions was unintended so this would seem an unobjectionable outcome.

6 Further information

We would be pleased to discuss this submission or to provide further information. Please contact our CEO, Elayne Grace elayne.grace@actuaries.asn.au if you wish to clarify any aspects of this submission.

Yours sincerely

Tim Jenkins
Chair, Superannuation and Investments Practice Committee



Appendix – Potential technical issues

1. Meaning of defined benefit pension for this purpose

Draft regulation 307-70.02(1)(ba)(i) requires that the income stream is a defined benefit pension within the meaning of regulation 1.03 of the SIS Regulations.

Paragraph 1.10 of the draft Explanatory Statement (copied below) explains that the definition of 'pension' in the SIS Act is 'inclusive' rather than limited to pensions that meet the definitions in the SIS Regulations.

1.10 The superannuation income stream definition in regulation 307-70.02(1) of the ITAR 2021 includes an income stream that is a pension for the purposes of the SIS Act. Section 10 of the SIS Act provides an inclusive definition for 'pension'. It is inclusive of pensions that meet the definitions in the SIS Regulations, but not limited to those pensions, and is inclusive of common law pensions. This was confirmed in *Douglas* where the Full Federal Court also determined that the Military Superannuation Benefits and Defence Force Retirement and Death Benefits schemes invalidity benefits were pensions in accordance with the ordinary meaning of the word, and so meet the section 10 definition of a pension in the SIS Act.

We query whether the 'inclusiveness' of the SIS Act pension definition was recognised in the drafting of the (current) SIS r 1.03 definition of 'defined benefit pension', which is:

"defined benefit pension " means a pension mentioned in section 10 of the Act, other than:

- (a) a pension wholly determined by reference to policies of life assurance purchased or obtained by the trustee of a regulated superannuation fund, solely for the purposes of providing benefits to members of that fund; or
- (b) an allocated pension; or
- (c) a market linked pension; or
- (d) an account-based pension.

As this definition works by excluding specified pensions, this would appear to mean that effectively any 'common law pensions' not covered by (a) to (d) are technically 'defined benefit pensions' under SIS r1.03.

As far as we are aware, this apparent broad scope has not presented a significant problem under current legislation, as r.307-70.02 currently restricts pension tax treatment to pensions which meet the SIS r1.06 standards (unless the pension commenced prior to 20 September 2007).

However, if the Exposure Draft amendments were to proceed, the broad scope of the SIS r1.03 definition of 'defined benefit pension' may potentially have the effect that any common law pensions paid from a defined benefit fund would technically be eligible for the same tax treatment as pensions that meet the r1.06 standards.



Arguably this could include, for example, a superannuation account that provides a regular income stream that does not meet the SIS r1.06 minimum drawdown rules, or virtually any newly designed product that provides a regular income stream.

In practice, however, it is difficult to envisage the trustee of a large defined benefit fund seeking to take advantage of the broad scope to launch such 'defined benefit pensions', given matters such as their design and distribution obligations, duty to act in members' best financial interests and the likelihood that any such products would quickly be closed down via regulatory action.

Recommendation A1:

We recommend consideration be given to whether the scope of DB pensions covered by draft sub-regulation 307-70.02(1)(ba)(i) is likely to have unintended consequences and whether or not changes should be made to better target the desired outcome of only covering 'real' DB pensions that do not meet the current r1.06 standards as identified in the Douglas decision.

Options that could be considered include:

- a) Restricting the provisions to DB pensions provided under fund rules that were in place at 20 September 2007 (or similar), or
- b) Amending SIS r1.06(9A)(b)(iv) to specifically include permanent disability DB pensions whose amount may vary and/or may not be payable for the pensioner's lifetime, plus DB child death benefit pensions – though an exclusion would then be required for the two defence forces schemes.

Option (a) could be considered on the basis that it is unlikely there would be any pension products other than 'real' DB pensions and SIS r1.06 pensions that would have been provided for under fund rules that were in place at 20 September 2007. Indeed, the current r.307-70.02(1)(b) appears to support this rationale as it provides pension tax treatment to any pensions (within the meaning of the SIS Act) which commenced prior to 20 September 2007.

However, option (a) would be problematic if it worked to exclude relevant pensions that have been subject to minor amendments since 2007. For example, we are aware of relevant pensions where amendments have been made since 2007 to provide consistency with the SIS definition of dependant and associated limitations on pension payment periods.

Option (b) is also not ideal as, by being so specific, it risks excluding some legitimate DB pensions.

Given that narrowing of the scope in a suitable manner is not straightforward and, as noted above, there seems little risk of the trustee of a large defined benefit fund seeking to take advantage of the broad scope of the 'defined benefit pension definition', maintaining the approach to draft sub-regulation 307-70.02(1)(ba)(i) that is set out in the Exposure Draft may be the best course of action.



2. Meaning of capped defined benefit income stream

While on our reading ITAR regulation 294-130.01(6) caters for public sector scheme invalidity pensions similar to those considered in the Douglas decision, we suggest that consequential amendments will be required to ITAR regulation 294-130.01 so that other relevant DB pensions (such as similar invalidity pensions paid from corporate schemes) are retrospectively classified as a 'capped defined benefit income stream' for transfer balance cap purposes.

Excluding the small number of pension referred to in section 4 of the body of this letter, we expect this will retrospectively validate the transfer balance cap treatment that has actually been applied since 1 July 2017.

Recommendation A2:

We recommend consequential amendments to ITAR regulation 294-130.01 be considered.

3. Meaning of defined benefit fund for this purpose

Draft regulation 307-70.02(1)(ba)(iii) requires that the income stream is provided by a defined benefit fund (within the meaning of SIS r 1.03), or an exempt public sector superannuation scheme (within the meaning of the SIS Act).

We query whether this may inappropriately exclude DB pensions paid from an APRA-regulated fund which has DB pensioners but no (non-pensioner) DB members. This is because (as we understand it), such a fund is only a DB fund for the purpose of the provisions specified in SIS r1.03AAA, as follows:

SUPERANNUATION INDUSTRY (SUPERVISION) REGULATIONS 1994 - REG 1.03AAA

Defined benefit fund

For the following provisions, a fund is taken to be a defined benefit fund if at least one member of the fund receives a defined benefit pension:

- (a) paragraph (c) of the definition of **investment return** in subregulation 5.01(1);
- (b) subregulation 5.04(3);
- (c) regulation 7.05;
- (d) Divisions 9.3 to 9.5.

Recommendation A3:

We recommend draft sub-regulation 307-70.02(1)(ba)(iii) be amended to make it clear that, for this purpose, an APRA-regulated fund which only has DB pensioners meets the specified condition e.g. '*...the income stream is provided by a defined benefit fund (within the meaning of regulation 1.03 of the SIS Regulations as applicable under Divisions 9.3 to 9.5 of the SIS Regulations)*...'

4. More than six members condition

Where the defined benefit fund (within the meaning of regulation 1.03 of the SIS Regulations) is a regulated fund but not a public sector superannuation scheme, that fund or scheme must have more than six members in order for a DB pension that commenced on or after



20 September 2007 to be classified as a superannuation income stream under draft regulation 307-70.02(1)(ba).

Although it seems unlikely to occur in practice, in our view it would not be a satisfactory outcome from an affected pensioner's standpoint if the tax treatment of their DB pension were to change simply because the number of fund members fell below six, a matter clearly beyond their control. As well as the income tax impact on the pension payments, we note a reclassification of the pension would also have significant implications for matters such as the transfer balance cap e.g. would the change be treated as a commutation, resulting in a transfer balance account debit?

Recommendation A4:

To avoid the potential for this to occur, we recommend the final regulations include grandfathering of tax treatment for affected benefits in these circumstances e.g. the 'more than six members' test could be based on the number of fund members at the date the pension commenced.

5. DB temporary disability pensions

We query whether the amendment may give rise to ambiguity about the benefit tax treatment of payments from DB pensions commencing after 20 September 2007 that are paid due to temporary disability (strictly 'temporary inability to engage in gainful employment'), given s307-10(a) of the Act specifies that these are not superannuation benefits, whereas under the amended regulations the pensions would be superannuation income streams.

Perhaps s307.70(1) of the Act overcomes this by restricting 'superannuation income stream benefits' to 'superannuation benefits', however it is counter-intuitive that a payment from a 'superannuation income stream' may not be a 'superannuation income stream benefit'.

Recommendation A5:

To provide clarity, we recommend consideration be given to adding an explicit exclusion in new sub-regulation 307-70.02(1)(ba) for DB pensions that are paid due to temporary disability.