

DRAFT EXPLANATORY STATEMENT

Issued by authority of the Assistant Treasurer and Minister for Financial Services

Income Tax Assessment Act 1997

Superannuation Industry (Supervision) Act 1993

Treasury Laws Amendment (Measures for Consultation) Regulations 2023

Section 909-1 of the *Income Tax Assessment Act 1997* (the ITAA 1997) 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.

Subsection 31(1) of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) provides that regulations may prescribe standards applicable to the operation of regulated superannuation funds and to trustees of the funds.

The purpose of the *Treasury Laws Amendment (Measures for Consultation) Regulations 2023* (the Regulations) is to make consequential amendments to tax and superannuation laws to provide rules and clarify tax treatment for certain superannuation defined benefits. These changes complement Schedule 9 of Treasury Laws Amendment (2022 Measures No. 4) Bill 2022 (TLAB 22/4) introduced into Parliament on 23 November 2022.

These Regulations are subject to the Royal Assent of TLAB 22/4.

On 4 December 2020, the Full Federal Court decision in *Commissioner of Taxation v Douglas* [2020] FCAFC 220 (*Douglas*) determined that invalidity pension payments under the *Military Superannuation and Benefits Act 1991* (MSB) and invalidity pay under the *Defence Force Retirement and Death Benefits Act 1973* (DFRDB) commencing on or after 20 September 2007 were not superannuation income streams within the meaning of the ITAA 1997. The payments of these invalidity benefits were considered superannuation lump sum payments.

Schedule 9 to TLAB 22/4 confirms that invalidity payments under the MSB and DFRDB are superannuation lump sum payments while ensuring all other defined benefit pensions are to be treated as superannuation income streams for the purposes of section 307-70 of the ITAA 1997.

These Regulations make consequential amendments to the *Income Tax Assessment (1997 Act) Regulation 2021* (ITAR 2021) and the *Superannuation Industry (Supervision) Regulations 1994* (SISR) to clarify some aspects of tax law, including:

- the application of the proportioning rule to invalidity benefits under the DFRDB and MSB;
- treatment as a capped defined benefit income stream for benefits that are income streams because of Schedule 9 to TLAB 22/4; and
- conditions of release for lump sum payment relating to reversionary pension benefits under the MSB.

The Authorising Acts specify no conditions that need to be met before the power to make the Regulations may be exercised.

Details of the Regulations are set out in Attachment A.

The Regulations are a legislative instrument for the purposes of the *Legislation Act 2003*.

The Regulations commence on the later of (a) the of the day after the instrument is registered and (b) immediately after the commencement of Schedule 9 to *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*. However, the Regulations do not commence if the event mentioned in paragraph (b) does not occur.

The Office of Impact Analysis has been (OIA) has been consulted (OIA23-04687) and considered the proposal unlikely to have a more than minor regulatory impact. The preparation of an Impact Analysis (IA) is not required.

Details of the *Treasury Laws Amendment (Measures for Consultation) Regulations 2023*

Section 1 – Name of the Regulations

This section provides that the name of the Regulations is the *Treasury Laws Amendment (Measures for Consultation) Regulations 2023* (the Regulations).

Section 2 – Commencement

Schedule 1 to the Regulations commence on the later of:

- (a) the of the day after the instrument is registered on the Federal Register of Legislation; and
- (b) immediately after the commencement of Schedule 9 to the *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*.

However, Schedule 1 to the Regulations does not commence at all if the event mentioned in paragraph (b) does not occur.

Section 3 – Authority

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

Section 4 – Schedule

Each instrument that is specified in the Schedules to this instrument will be amended or repealed as set out in the applicable items in the Schedules, and any other item in the Schedules to this instrument has effect according to its terms.

Schedule 1 – Amendments

Part 1—Components of a superannuation benefit

Income Tax Assessment (1997 Act) Regulations 2021

Item 1: At the end of Subdivision 307-C

New section 307-125.03 addresses the consequences of the *Douglas* decision which determined that invalidity pay and invalidity pensions under the DFRDB and MSB are not superannuation income streams within the meaning of the ITAA 1997, as historically treated for tax purpose since 20 September 2007, but rather superannuation lump sums.

The intent of section 307-125.03 is to preserve how the tax-free and taxable components of these invalidity benefits paid under the DFRDB and MSB are proportioned. This is achieved by prescribing an alternative proportioning methodology, which treats the invalidity benefit lump sum payment as if it were a superannuation income stream.

Under the general proportioning rules set out in subsections 307-125(1) to (3) of the ITAA 1997, there are differing methods for determining the tax-free and taxable components of a benefit that is a superannuation income stream compared to a superannuation lump sum.

For superannuation income streams, the tax-free and taxable components are determined only once at the time the income stream commences. The proportioning of the components remains constant, and the same proportioning rule applies to all subsequent benefits paid from that income stream.

For a superannuation lump sum, the components are determined immediately before each time the benefit payment is made. Overtime, the general proportioning rule for lump sum benefits will result in the tax-free component of the benefit progressively decreasing and the taxable component progressively increasing.

The general proportioning rules outlined above will not apply if the regulations specify an alternative method for determining the components of the benefit. For the purposes of paragraph 307-125(4)(a) of the ITAA 1997, section 307-125.03 provides an alternative method in determining the components of the invalidity pay or invalidity pension paid as a superannuation lump sum under the DFRDB and MSB, as mentioned in subparagraph 301-275(1)(b)(i) or (ii) in the ITAA 1997.

The alternative method provides that when determining the components in accordance with subsection 307-125(1), (2) and (3) of the ITAA 1997, to assume the invalidity benefit:

- is a superannuation income stream benefit; and
- the superannuation income stream commenced when the invalidity pay or invalidity pension commenced.

This approach means the components of the invalidity benefit are to be proportioned only once at the time the benefit commenced. This alternative approach preserves the benefits pre-*Douglas* proportioning rule methodology and ensures the tax-free and taxable components of the invalidity benefit are not adversely impacted by the *Douglas* decision.

The approach further aligns with the Australian Tax office's interim legislative instruments specifying an alternative proportioning rule for the 2007-08 to 2022-23 income years.¹ The ATO's instruments treated the invalidity benefits paid under the DFRDB and MSB as a superannuation income stream for the proportioning rule. This approach will be continued by these regulations.

Part 2—Capped defined benefit income streams and the transfer balance cap

Item 2: Subsection 294-130.01(1)

The amendments in Part 2 to these Regulations are made for the purposes of subsection 294-130(2) of the ITAA 1997, which provides that a superannuation income stream is also a capped defined benefit income stream (CDBIS) if the income stream is prescribed by the regulations.

A CDBIS allows for a special value to be calculated that counts towards the pension's transfer balance cap, and any excess transfer balance does not need to be commuted

¹ see F2021L00901 (pre-I July 2021 income years); F2022L00004 (2021/22 income year) and F2022L01347 (2022/23 income year).

from the income stream. Instead, CDBIS pensions are taxed under the defined benefit income tax regime.

Subsection 294-130.01(1) of the ITAR 2021 is prescribed for that purpose and provides that a superannuation income stream is a CDBIS if a prescribed subsection applies to the income stream.

This item amends subsection (1) for the purposes of adding new subsection (7) which is further detailed in item 3 below, to be a superannuation income stream that is a prescribed CDBIS.

Item 3: At the end of subsection 294-130.01

This item has the effect of prescribing a superannuation income stream to also be a CDBIS because of the amendments made by paragraph 307-70.02(1)(ba) of Schedule 9 to TLAB 22/4.

This item is intended to address the legal effect the *Douglas* decision has on permanent incapacity defined benefit pensions from funds or schemes (other than invalidity benefits paid from the DFRDB and MSB) that may have lost their CDBIS status.

Before the *Douglas* decision these funds or schemes may have self-assessed and reported many of these pensions as a CDBIS, most likely as lifetime pensions covered in item 1 in the table of subsection 294-130(1) of the ITAA 1997.

Applying the common law principles of the *Douglas* decision, many of the permanent incapacity defined benefit pensions are to be considered superannuation lump sum benefits. Consequently, those affected pensions would not have been superannuation income streams that could satisfy requirements as a CDBIS, potentially since 1 July 2017 when managing funds could first assess the pension as a CDBIS following the introduction of the framework in Division 294 of the ITAA 1997.

Amendments in Schedule 9 to TLAB 22/4 mean that that all pensions paid from defined benefit funds (other than invalidity benefits paid from the DFRDB and MSB schemes) will be superannuation income streams, with retrospective effect from 1 July 2007. However, affected superannuation lump sum pensions that lost their CDBIS status because of the *Douglas* decision will not automatically satisfy CDBIS requirements upon enactment of Schedule 9 to the Bill.

This item will cause those affected permanent defined benefit pensions to automatically satisfy CDBIS requirements when their superannuation lump sum payments revert to a superannuation income stream upon enactment of Schedule 9 to the Bill.

The effect of Part 4 of these Regulations will retrospectively deem the affected pensions to satisfy CDBIS requirements immediately before and after 1 April 2021 (see subsection 1000-4.02(2)).

This means those affected pensions can be valued by valuation rules specific to CDBIS rather than valued using transfer balance cap rules in section 307-205.02 of the ITAR 2021 which would result in a different value.

Furthermore, the managing funds of the affected pensions will not be required to administratively recalculate and re-report the pensions for transfer balance cap purposes going back to 1 July 2017.

Part 3—Cashing requirements

Superannuation Industry (Supervision) Regulations 1994

Item 4: After paragraph 6.21(2)(a)

Section 6.21 of the SISR sets out how a member benefit in a regulated superannuation fund must be paid out after the member dies.

This item is intended to prevent any unintended negative taxation outcomes for MSB reversionary pensions resulting from the *Douglas* decision.

Before the *Douglas* decision, MSB reversionary pensions satisfied payment standards in subsection 6.21(2) of the SISR because they were treated as a superannuation income stream from a pension in retirement phase (see paragraph 6.21(2)(b)). The *Douglas* decision resulted in the payments from MSB reversionary pensions to be retrospectively considered superannuation lump sum payments which causes the pension to not satisfy the payment standards in paragraph 6.21(2)(b) of SISR, potentially from 1 July 2017 when that standard was first introduced.

Furthermore, because the usual payment cycle for MSB reversionary pensions is fortnightly over the lifetime of the pension, the pension did not meet the payment standard for lump sums prescribed in paragraph 6.21(2)(a) of the SISR, which only provides for a maximum of two lump sum payments.

This item ensures a MSB reversionary pension will satisfy the payment standards set out in subsection 6.21(2) of the SISR and enables the pension to be paid as series of lump sum payments.

This item refers to superannuation lump sum from pensions mentioned in paragraph 301-275(1)(b) of Schedule 9 to the Bill, which includes invalidity pay and invalidity pensions under the DFRDB and MSB schemes. However, this item only covers MSB reversionary pensions because the payment standard in section 6.21 of the SISR can only apply to regulated funds. The relevant DFRDB pensions under the DFRDB scheme are part of an unregulated ‘exempt public sector scheme’ to which section 6.21 does not apply.

Part 4—Application

Item 5: Part 1000-4—Transitional matters relating to the *Treasury Laws Amendment (Measures for Consultation) Regulations 2023*

Item 5 inserts new Part 1000-4 into the ITAR 2021 to provide how the amendments made in Parts 1 and 2 of the Regulations are to be applied.

Part 1000-4.01 defines a few terms for this purpose. The term *old regulations* means the *Income Tax Assessment Regulations 1997*. The term *2021 commencement time* is a reference to when the new ITAR 2021 commenced on 1 April 2021.

Subsection 1000-4.02(1) relates to the components of certain military superannuation benefits in Part 1 of the Regulations and will apply in relation to income years starting on or after 1 July 2023.

Subsections 1000-4.02(2) and (3) relate to the CDBIS and transfer balance cap in Part 2 of the Regulations.

Subsection 1000-4.02(2) means the amendments apply in relation to a superannuation income stream that commenced on or after 1 April 2021 when the ITAR 2021

commenced. The superannuation income stream relates to the defined benefit pension payments mentioned in paragraph 301-70.02(1)(ba) of Schedule 9 to TLAB 22/4. Therefore, the amendments made in Part 2 are retrospective in relation to those defined benefit pensions on and after 1 April 2021.

Subsection 1000-4.02(3) provides for the retrospective application of the superannuation income stream before 1 April 2021. In effect, the provision ensures those defined benefit pensions satisfy CDBIS requirements on and after 1 July 2017 when Division 294 and the CDBIS framework commenced.

Item 6: Part 1000-4—Transitional arrangements arising out of the *Treasury Laws Amendment (Measures for Consultation) Regulations 2023*

Item 6 inserts new Division 14.33 into the SISR 1994 to provide transitional arrangements for matters in Part 3 of the Regulations and ensures MSB reversionary pension payments satisfy cashing requirements. In effect, the amendments in Part 3 will retrospectively apply to the prescribed superannuation lump sums paid on and after 1 July 2017.

Retrospective application in items 5 and 6

The transitional application arrangements prescribed for the Part 2 and Part 3 amendments purposely deal with historical and complex matters flowing from the *Douglas* decision, and the retrospective application of Schedule 9 to TLAB 22/4 that made defined benefit pensions (except pensions under the DFRDB and MSB schemes) superannuation income streams for income years starting on or after 2007 (see paragraph 301-70.02(1)(ba) of Schedule 9 to TLAB 22/4).

The retrospective application prescribed in Part 4 are appropriate and necessary to mitigate adverse superannuation outcomes.

The retrospective application to the defined benefit pensions mentioned in paragraph 301-7.02(1)(ba) has direct bearing on the superannuation income stream status of those pensions for the purposes of CDBIS requirements in Division 294 of the ITAA 1997, which commenced 1 July 2017.

Part 2 is intended to mitigate potential adverse consequences arising from the *Douglas* decision resulting in some defined benefit pensions being considered lump sum payments and losing their CDBIS status, including their historical CDBIS treatment for past income years. The amendments in Part 2 ensure affected defined benefit pension payments for permanent incapacity will retrospectively satisfy CDBIS requirements and treated for tax purposes in a like manner before the *Douglas* decision.

In relation to the Part 3 amendments, the *Douglas* decision resulted in the payments from MSB reversionary pensions to be retrospectively considered superannuation lump sum payments. Consequently, the MSB reversionary pensions did not satisfy the payment standards in paragraph 6.21(2)(b) of SISR, potentially from 1 July 2017 when the applicable payment standard for superannuation income streams was first introduced.

Furthermore, as discussed above, because the usual payment cycle for MSB reversionary pensions is fortnightly over the lifetime of the pension, the payment cycle as a superannuation lump sum did not meet the payment standard for lump sums

prescribed in paragraph 6.21(2)(a) of the SISR, which only provides for a maximum of two lump sum payments.

The transitional arrangement provided in item 6 ensures a MSB reversionary pension retrospectively satisfied the payment standards set out in subsection 6.21(2) of the SISR as a series of lump sum payments.