# EXPLANATORY STATEMENT

## Issued by authority of the Minister for Financial Services and Superannuation

*Income Tax Assessment Act 1997*

*Treasury Laws Amendment (XXXX) Regulations 2017*

Section 294-130(2) of the *Income Tax Assessment Act 1997* (the 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.

The purpose of the *Treasury Laws Amendment (XXXX) Regulations 2017* (the Regulations) is to expand the definition of capped defined benefit income stream to cover additional defined benefit pensions that permit commutation or are subject to other restrictions that fall outside the scope of subregulation 1.06(2) of the *Superannuation Industry Supervisory Regulations 1994* (SISR 1994). As defined benefit superannuation income streams have commutation restrictions which make commutation impractical, they are subject to modified income tax and valuation rules which ensure commensurate tax treatment with more common account-based superannuation income streams. For example, excess transfer balance tax is not imposed for breaches of the transfer balance cap attributable to defined benefit superannuation income streams. Instead, excess defined benefit income is subject to additional income tax rules. Special valuation rules apply for determining the special value and debit value of capped defined benefit income streams. The Regulations will also prescribe these valuation rules for the additional income streams.

The changes have effect from 1 July 2017.

**Exposure Draft - Attachment**

Expanding the definition of capped defined benefit income stream to cover lifetime pensions which meet the standards of subparagraph 1.06(9A)(b)(iv) of the *Superannuation Industry Supervision Regulations 1994* (SISR 1994)

The Regulations will prescribe, for the purposes of section 294-130(2) of the Act, additional income streams to receive capped defined benefit income stream treatment. Lifetime pensions provided under rules that meet the standards of subregulation 1.06(2) of theSISR 1994 are capped defined benefit income streams for the purposes of the transfer balance cap on the basis that they are generally non-commutable, and that the application of the general transfer balance cap rules would not be feasible for these pensions. While the additional income streams being prescribed may not meet the strict standards of subregulation 1.06(2) of the SISR 1994, requiring commutation of these additional superannuation income streams remains inappropriate and extending capped defined benefit income stream treatment results in a more appropriate outcome.

Under the standards in subregulation 1.06(2) of the SISR 1994 lifetime pensions are required to be paid at least annually throughout the life of the primary beneficiary (and reversionary beneficiary, if any) with the size of the pension payments in a given year generally fixed with limited scope for payment variations. The sum paid by these pensions as a benefit in each year cannot reduce except in times of deflation, when the Consumer Price Index (CPI) falls. These income streams can only be commuted to lump sum amounts in very limited circumstances including within 6 months of the pension commencing or a during a guarantee period following the death of a primary beneficiary.

Lifetime pensions that do not meet the strict standards of subregulation1.06(2) of the SISR 1994, may still be superannuation income streams that meet the more general standards for defined benefit pensions in sub regulation 1.06(9A) of the SISR 1994 . In particular, subparagraph 1.06(9A)(b)(iv) of the SISR 1994 also recognises defined benefit income streams, that would otherwise have met the standards of subregulation1.06(2), except for circumstances that allow for the pension to be commuted or for variation of cessation of payments to a child of the deceased.

New subregulation 294-130.01(2) of the Income Tax Assessment Regulations 1997 (ITAR 1997) therefore extends the definition of a capped defined benefit income stream for the purposes of subsection 294-130(2) of the ITAA 1997. This captures certain lifetime pensions that may be commuted in limited circumstances or where payments are ceased or varied for a child beneficiary. Examples of circumstances previously excluded, but now covered, are included below.

Lifetime pensions where commutation is permitted in time periods outside of six months from the commencement day of the pension were previously excluded from being a capped defined benefit income stream. Now, these pensions are treated as capped defined benefit income streams under the expanded definition. For example, lifetime pensions which permit commutation not just after commencement day of the pension, but at certain ages- such as within a period of the member exiting the fund when aged 55 or over, or within s period of the member turning a certain age, are covered. Pensions that allow commutation beyond six months after the commencement day are also covered.

In the case of payments to a child of the deceased, the payments can only be varied as specified in governing rules, to allow commutation to pay a superannuation contributions surcharge or payment split. However, the Regulations now also cover pensions which let the child beneficiary commute at any time, even if the primary pensioner had very restricted commutation rights.

The commutation made to the benefit of a reversionary beneficiary upon death was also previously limited to 20 years. However, the Regulations expand the definition to capture a range of lifetime pensions where the reversionary beneficiary may commute, even if the primary beneficiary has been receiving the pension for more than 20 years.

Many of the circumstances above may not have met the requirements of subregulation 1.06(2), but did meet those of subparagraph 1.06(9A)(b)(iv) of the SISR 1994. The changes enable lifetime pensions with these characteristics to be brought within the scope of the capped defined benefit definition.

Expanding the definition of capped defined benefit income stream to include pensions paid on the grounds of invalidity

In addition, new subregulation 294-130.01(3) of the ITAR 1997 expands the definition of capped defined benefit income stream to cover public sector superannuation scheme funded invalidity pensions that can be varied, suspended or ceased in certain circumstances. These previously fell outside the scope of the definition, as the amount of the invalidity pension paid is not always increased in line with increases in CPI, but can increase or reduce, mainly due to re-assessments of the individual’s level of incapacity. New subregulation 294-130.01(3) applies to pensions payable on the grounds of invalidity under a government superannuation scheme of the Commonwealth, State or Territory. It allows these pensions to be treated as capped defined benefit income streams despite the restriction in paragraph 1.06(2)(c) of the SISR 1994. This takes into account circumstances where pension payments are varied (because of the primary beneficiary’s level of incapacity being reclassified, or the primary beneficiary’s personal earnings changing), suspended (for example, where the primary beneficiary fails to provide information as required by the rules) or ceased (where the primary beneficiary is employed by a participating employer of the relevant superannuation scheme).

For example, military schemes provide invalidity benefits intended to cover resettlement into the civilian workforce. The amount of invalidity benefit depends on the percentage of the individual’s incapacity to undertake civilian employment, taking into consideration skills, qualifications and experience. Incapacity is assessed on a sliding scale, and subject to periodic review. If the individual’s level of incapacity or skills, qualifications or work experience has changed, the individual may be reclassified, resulting in their pension being increased, reduced or ceased.

Similarly, Public Service Schemes may provide partial invalidity pensions where salary is permanently reduced because of a medical condition. Invalidity pensioners may be subject to earnings reviews until age 65, to assess whether they become well enough to return to work. The pension amount may not only be adjusted in accordance with CPI, but may reduce, increase or cease if the individual earns income above a certain level.

Invalidity pensions generally cease if the individual is re-employed, for example in Government, the Australian Defence Force, or if taking up a statutory office.

These pensions cannot vary for any other reasons and forced commutation under the transfer balance cap would impact the scheme.

Valuation rules to apply to additional capped defined benefit income streams prescribed under regulations

New subregulations 294-135.01 and 294-145.01 of the ITAR 1997 ensure the modified valuation rules and debit value rules which apply in relation to capped defined benefit income streams in subsection 294-130(1) of the ITAA 1997 also apply in relation to the additional capped defined benefit income streams newly prescribed under subsection 294-130(2) of the ITAA 1997. The regulation making power in subsections 294-135(4) and 294-145(7) of the ITAA 1997 are also used to make regulations. The new subregulations specify that the special (modified) value of a capped defined benefit income stream is calculated by multiplying the annual entitlement by a factor of 16. Similarly, the debit value generally mirrors the treatment given to lifetime pensions. That is, the amount of the transfer balance credit arising in the member’s account less the amount of any transfer balance debits.

The Regulations commence on 1 July 2017.

### Statement of Compatibility with Human Rights

*Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011*

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

### Overview of the Legislative Instrument

This Legislative Instrument intends to expand the definition of capped defined benefits to include those defined benefit pensions (including defined benefit invalidity pensions) that do not fit within the rules of subregulation1.06(2) of the SISR 1994 as required by item 1 of the table. These pensions may allow for variation, suspension or cessation of invalidity pension payments, or be subject to commutable only in limited circumstances. This is being done so that those pensions subject to commutation restrictions which make requiring commutation infeasible, or defined benefit invalidity pensions where amounts payable may be re-assessed on the basis of changing levels of incapacity, are afforded commensurate tax treatment by being treated as capped defined benefits.

### Human rights implications

This Legislative Instrument does not engage any of the applicable rights or freedoms.

### Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.