

DRAFT EXPLANATORY STATEMENT

Income Tax Assessment Act 1997

Income Tax Assessment Amendment Regulation 2013

Section 909-1 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 *Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Act 2013* (the Amending Act)¹ amended the *Income Tax Assessment Act 1997* (the Act) to give effect to the measure. It achieved this by introducing Division 293 of the Act which taxes certain superannuation contributions (taxable contributions) of individuals whose income broadly exceeds \$300,000 at 15 per cent (Division 293 tax) to ensure that the tax concession received by such individuals is more closely aligned with the concession received by average income earners.

Section 293-115 of the Act provides a regulation making power to specify the meaning of ***defined benefit contributions*** for a financial year in relation to a defined benefit superannuation interest and as well as specifying the method for working out an individual's defined benefit contributions for a financial year in relation to a superannuation interest. Section 293-145 of the Act provides that the regulations may specify a list of individuals who are not subject to tax under the sustaining the superannuation contribution concession in relation to certain superannuation contributions to constitutionally protected funds.

The Regulation has two purposes.

- The first purpose of the Regulation is to amend the *Income Tax Assessment Regulations 1997* (the Principal Regulations) to set out the meaning of defined benefit contributions and specify how to calculate an individual's defined benefit contributions in a financial year for the purposes of the measure.
- The second purpose of the Regulation is to amend the Principal Regulations to specify a list of individuals, who, by reason of being State higher level officer holders, will be exempt from Division 293 tax in relation to certain superannuation contributions made to constitutionally protected funds.

Defined benefit contributions

This Regulation amends the Principal Regulations to provide that the defined benefit contributions of an individual in relation to a defined benefit interest for a financial year are the sum of the actuarial value of the employer provided benefits that the

¹ The Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Bill 2013 has been introduced to Parliament. This exposure draft explanatory statement has been written on the basis that this Bill has received Royal Assent.

individual has accrued in the financial year in respect of that interest, the administrative expenses and the risk benefits attributable to the interest.

This Regulation also amends the Principal Regulations to provide that this amount is worked out using a prescribed methodology. The Regulation defines the components of the formula to be used in this methodology and the assumptions that must be applied when working out this amount.

Broadly, under this method there are four categories of benefit that are considered in working out the value of an individual's defined benefit contributions:

- Employer-provided benefits – superannuation benefits that an individual has become entitled to from a superannuation interest as a result of their employment. This category of benefit is divided between funded and unfunded benefits. The value of funded benefits is grossed up to account for the income tax borne by the superannuation provider.
- Risk benefits – insurance and other similar benefits that an employee is entitled to as a result of holding the superannuation interest.
- Administration expenses – the proportion of the superannuation provider's administration costs attributable to the individual's interest.
- Contingent benefits – benefits that an individual may become entitled to during the year because of an event, decision or election.

State higher level office holders

In *Austin v Commonwealth* (2003) 215 CLR 185 (*Austin*) and *Clarke v Commissioner of Taxation* (2009) 240 CLR 272 the High Court ruled that the Commonwealth could not impose a superannuation contributions tax (surcharge), under legislation enacted in 1997, on contributions to constitutionally protected funds for State higher level office holders. The High Court found that the application of the surcharge was unconstitutional due to the implied restriction that the Commonwealth may not act so as to threaten the capacity of the states to function.

Consistent with the approach adopted under the surcharge, Division 293 tax has not been imposed on certain superannuation contributions to constitutionally protected funds for State higher level office holders.

The concept of a State higher level office holder has not been exhaustively defined. However, in *Austin* all justices took as the starting point the statements of the majority in *Re Australian Education Union; Ex parte Victoria* (1995) 184 CLR 188 at 233, which identified officers at the higher levels of government as including 'Ministers, ministerial assistants and advisers, heads of department and senior office holders - as well as parliamentary officers and judges'. The Regulation lists these classes of officers as State higher level office holders, to provide that they are not subject to Division 293 tax in relation to certain superannuation contributions made to constitutionally protected funds. The Regulation can be amended to incorporate further changes arising from future court decisions (if any).

Conditions and commencement

The Act does not impose any conditions that need to be met before the power to make the proposed Regulation may be exercised.

The Regulation is a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The Regulation is taken to have commenced on 1 July 2012.

- For the provisions relating to defined benefit calculations, the retrospective application date ensures that there is a method provided for calculating defined benefit contributions for the 2012-13 financial year. Allowing the Regulation to apply retrospectively from the day from which the amendments to the Act apply ensures that individuals with defined benefit interests are treated consistently with those with other interests (commonly referred to as accumulation interests).
- For the provisions relating to State higher level office holders, this retrospective application date is beneficial to individuals declared in the Regulation as it ensures that they are not subject to Division 293 tax in relation to certain superannuation contributions to a constitutionally protected fund.

Details of the Income Tax Assessment Amendment Regulation 2013

Section 1 – Name of Regulation

This section provides that the title of the Regulation is the *Income Tax Assessment Amendment Regulation 2013* (the Regulation).

Section 2 – Commencement

This section provides that the Regulation is taken to commence on 1 July 2012.

Subsection 293-115(6) of the *Income Tax Assessment Act 1997* (the Act) provides that, despite subsection 12(2) of the *Legislative Instruments Act 2003* (which provides that regulations have no effect to the extent that, *inter alia*, they would impose a retrospective liability) the Regulation made under section 293-115 may apply on or after 1 July 2012.

Without a retrospective Regulation, there would be no method provided for calculating defined benefit contributions for the 2012-13 financial year and the tax imposed by Division 293 of the Act could not operate in respect of defined benefit interests for the 2012-13 financial year. Allowing the Regulation to apply retrospectively from the day from which the amendments to the Act have application ensures that individuals with defined benefit interests are treated consistently with individuals with accumulation interests.

Section 3 – Authority

This section provides that the Regulation is made under the Act.

Section 4 – Schedule

This section provides that the amendments in Schedule 1 amend the specified instruments, in this case the *Income Tax Assessment Regulations 1997* (the Principal Regulation).

Schedule 1 – Amendments to the Principal Regulations

Item 1

Defined benefit contributions

This Regulation sets out the meaning of defined benefit contributions and prescribes the method that must be employed to determine an individual's defined benefit contributions for a financial year in respect of a defined benefit interest.

Definition of defined benefit contribution

Regulation 293-115.01 provides that a defined benefit contribution is, for a financial year in respect of a defined benefit interest, the sum of:

- the actuarial value of the employer provided benefits that have accrued to the individual in the financial year in respect of the interest;

- the administrative expenses attributable to the interest; and
- risk benefits (such as insurance) attributable to the interest.

The definition is largely the same as ‘surchargeable contributions’ for members of defined benefit superannuation schemes under subsections 8(3), (4) and (5) of the *Superannuation Contributions Tax (Assessment and Collection) Act 1997*.

The definition applies broadly. Given the complex arrangements underlying many defined benefit interests it applies to the value of the benefit provided rather than seeking to identify exactly how the benefits are funded by the employer.

The definition also includes in defined benefit contributions, risk benefits, such as insurance, that the individual is entitled to receive as a result of holding the interest and the superannuation provider’s relevant administrative expenses. These amounts do not form part of the value of the benefits the employee may receive when superannuation benefits are paid. However, both the provision of insurance and the administration of the individual’s superannuation interest by the superannuation provider have a value and this value needs to be taken into account to determine the value of the benefits the individual is entitled to as a result of holding the superannuation interest.

However, there are a number of exclusions.

This definition restricts the value of ‘defined benefit contributions’ to the value of those benefits that are funded by the individual’s employer. Consistent with the treatment of individuals with interests that are accumulation interests, other contributions such as those made by an individual and Government co-contributions are not included in the value of defined benefit contributions. However, to the extent that individuals enter into arrangements to increase their benefits in exchange for a reduced salary, the increased benefits are reflected in the value of the defined benefit contributions.

The definition also only applies to defined benefit interests. This principally ensures that it does not overlap with amounts in relation to accumulation interests that are subject to tax under the other provisions of Division 293 of the Act and thus there is no double taxation.

The definitions of defined benefit interest in section 292-175 of the Act excludes an interest from being a defined benefit interest if it only provides an entitlement to death benefits, disability benefits or temporary disability payments. As a result, superannuation interests that only provide disability or death benefits are not defined benefit interests and individuals will not have defined benefit contributions in respect of these interest. However, consistent with other accumulation interests, employer-provided contributions to these interests will be subject to Division 293 tax where the other provisions of the Act apply.

Method for calculating defined benefit contributions for a financial year

Regulation 293-115.02 provides that an individual's defined benefit contributions for a financial year in respect of a defined benefit interest are to be worked out using the following formula:

$$\left(\frac{A(f) + B(f) + C(f)}{0.85} \right) + A(u) + B(u) + C(u) + E + F + G$$

Broadly, under this method there are four general categories of benefit that are considered in working out the value of an individual's defined benefit contributions:

- Accrued employer-provided benefits (A(f), A(u), B(f), B(u), C(f) and C(u)) – superannuation benefits that an individual has become entitled to as a result of holding the superannuation interest. This category of benefits is divided between funded (f) and unfunded (u) benefits. The value of funded benefits is grossed up to account for the income tax that the superannuation provider has borne in providing the benefit.
 - All benefits from untaxed funds and benefits directly attributable to amounts on which a superannuation scheme has not paid tax as a result of a choice by the trustee of the fund under section 295-180 of the Act are treated as unfunded contributions.
- Risk benefits (E) – the costs of death and disability insurance and other similar risk benefits that a member is entitled to as a result of holding the superannuation interest.
- Administration expenses (F) – the proportion of the superannuation provider's administration costs attributable to the interest.
- Contingent benefits (G) – benefits that an individual may become entitled to during the year because an event occurs during the year (for example as a result of a change in the scheme rules).

Within the categories of funded and unfunded employer benefits, a distinction is drawn between benefits that automatically accrue to members (A(f) and A(u)), benefits that accrue from an election by the member (B(f) and B(u)) and benefits that accrue from the exercise of a discretion by the superannuation provider (C(u) and C(f)).

This method is similar to the method for determining an individual's 'surchargeable contributions' as set out in the Schedule 2 to the *Superannuation Contributions Tax (Assessment and Collection) Regulations 1997*. Consistent with the method that applied for 'surchargeable contributions', while the formula is expressed to provide an amount, if the superannuation provider prefers to determine this amount as a factor to be applied to salary, then this satisfies the requirements of the Regulation.

Broadly, the value of the benefits under each category is the actuarial value as determined by an actuary (defined in section 995-1 of the Act as a Fellow or Accredited member of the Institute of Actuaries of Australia). However, the

Regulation prescribes certain rules and parameters that must be used by an actuary in determining this value.

Employer- provided benefits accruing to members (A)

The only requirements for an actuary in determining the value of employer provided benefits that individuals are entitled to (A) relate to the valuation of accrued employer provided risk benefits (which are covered under A to the extent they are not covered under E).

Regulation 293-115.04 confirms that an employer-provided benefit does not include any part of a benefit relating to member contributions or earnings on such contributions.

Employer- provided benefits accruing as a result of a member's choice (B)

Stricter rules apply to valuing employer provided benefits that accrue from an election by the member (B). The actuary must use a particular valuation method (as set out in the table in subregulation 293-115.02(3)) based on when the choice or option became available to the member before or from 1 July 2012 and how the actuary has taken the option into account.

Employer provided benefits accruing by exercise of a discretion (C)

For employer provided benefits accruing by exercise of a discretion (C), the special rules distinguish between cases where a benefit is provided to all fund members or a class of members and cases where the benefit is provided specifically to the member.

If the benefit is provided to all holders of an interest with the superannuation provider or a defined class of interests, the value of C must be the actuarial value of the benefit.

In all other cases, the value of the benefit is the difference between the actuarial value of the benefit received and the greater of the actuarial value of any benefit that the actuary had assumed would be provided and the actuarial value of the benefit that had accrued to the member when the discretion was exercised.

Employer provided risk benefits (E)

For employer provided risk benefits (E), the Regulation provides that the cost of death and disability insurance and similar risk benefits is to be worked out based on the cost of insurance for one year for the non-accrued component of those benefits.

The cost must also take into account the assumptions about the likelihood of death, disability and other adverse events assumed in the actuarial valuation of the scheme.

Where no such rates exist, an actuary must use the expected rates for the next valuation of the scheme or default rates set out in the Regulation (as set out in the table in subregulation 293-115.02(8)).

Administration expenses (F)

For administration expenses (F), the Regulation specifies that an actuary must, in determining administration expenses, use the rate of expenses assumed in the most recent valuation of the scheme or another appropriate rate if there is no prior valuation or the actuary considers the rate assumed in the prior valuation is no longer appropriate.

Increases in employer provided benefits due to an event (G)

For increases in employer provided benefits due to an event (G), the Regulation provides special valuation rules for particular events that may result in an individual's entitlements changing, including:

- changes to fund rules or member classes;
- transfers by members between different schemes;
- an interest switching from defined benefit to accumulation; and
- pension increases outside of those provided for at the later of the time the pension became payable or 1 July 2012.

These rules are set out in the table in subregulation 293-115.02(11).

The Regulation includes a default provision to include the value of an increase in benefits due to any other event that results in an increase in the actuarial value of the employer-provided benefits that an individual accrued.

However, the Regulation specifies that an event does not occur for G if the valuation parameters specified by the Regulation, differs from the actual experience of the superannuation scheme in the year.

Valuation parameters

Regulation 293-115.03 also specifies certain valuation parameters that an actuary must apply when determining the value of defined benefit contributions.

These parameters include the discount rate of 8 per cent per annum, rates of salary and wages growth of 4.5 per cent per annum, increases in price indexes of 2.5 per cent per annum and what rates of decrement and other parameters are to be used.

Non-accruing members

In certain cases an individual may have defined benefit contributions but it will be clear that the individual will not accrue any further employer-provided benefits in a financial year. For example, if an individual has retired and only receives pension payments at the same fixed rate, they cannot have accrued any benefit in the financial year.

In this case the individual would not be subject to any tax under Division 293 in respect of that interest. However, without special rules there would still be a need to determine that the amount of the individual's defined benefit contributions is nil.

To address this, Regulation 293-115.05 establishes that an individual who holds a defined benefit interest and satisfies certain requirements is considered to be a non-accruing member in respect of that interest.

The amount of an individual's defined benefit contributions in a financial year in respect of an interest for which they are a non-accruing member is nil.

The Regulation provides that employer contributions to a superannuation scheme to meet partially or wholly unfunded benefit liabilities are to be disregarded when applying this test. This ensures that contributions from an employer to meet the fund's existing liabilities without changing an individual's entitlements do not adversely impact upon the individual.

State higher level office holders

Regulation 293-145.01 specifies that the following individuals are not subject to Division 293 tax in relation to certain contributions to a constitutionally protected fund, due to their status as a State higher level office holder:

- State Ministers and their staff;
- Governors of States and their staff;
- members of State Parliaments;
- Clerks of Houses of State Parliament;
- heads of State public service departments and statutory office holders of equivalent seniority, including a statutory office holder who is the head of an instrumentality or agency of a State; and
- judges, justices and magistrates of the courts of a State.

As the case law identified officers at the higher levels of government as including ministerial assistants and advisers, the Regulation includes staff of Ministers as State higher level office holders. While it is not clear that all of the staff of a Minister would necessarily qualify as being at the higher levels of government, this approach still achieves the intended outcome as it is unlikely that staff employed in junior positions would exceed the income and concessional tax superannuation contributions threshold at which Division 293 tax would apply (\$300,000 per annum).

The Regulation includes both State Ministers and members of State Parliaments to ensure that a State Minister, who is not also a member of the State Parliament, is treated as a State higher level office holder. This is possible under some State constitutions which enable an individual who is not a member of Parliament to be a State Minister for a limited period (usually for a maximum period of three months).

The Regulation also refers to heads of departments and similar agencies. Heads of similar instrumentalities include the heads of significant public bodies that may not be called departments. This item also includes the holders of key governmental offices

established under statute such as Directors of Public Prosecutions, Chief Commissioners of Police, Solicitors-General, Auditors-General, Ombudsmen and Electoral Commissioners. It does not cover the heads of government-owned business enterprises or more junior officials.

Statement of Compatibility with Human Rights

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

Income Tax Assessment Amendment Regulation 2013

This Regulation 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

The *Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Act 2013* (the Amending Act) amended the Income Tax Assessment Act (1997) to give effect to sustaining the superannuation concession contribution. It achieved this by introducing Division 293 which effectively taxes concessional-taxed superannuation contributions (taxable contributions) of individuals whose income and concessional contributions exceed \$300,000 at 15 per cent (Division 293 tax) to ensure that the tax concession received by such individuals is more closely aligned with the concession received by average income earners.

The Regulation amends the *Income Tax Assessment Act Regulation 1997* (Principal Regulations) to specify a list of individuals who, because of their status as State higher level officer holders, are not affected by the sustaining the superannuation contribution concession in relation to certain superannuation contributions made to constitutionally protected funds.

The Regulation amends the *Income Tax Assessment Act Regulation 1997* (Principal Regulations) to specify a list of individuals who, because of their status as State higher level officer holders, are not affected by the sustaining the superannuation contribution concession measure in relation to certain superannuation contributions made to constitutionally protected funds.

The measure improves the fiscal sustainability of the existing superannuation tax concessions by imposing a 15 per cent tax (Division 293 tax) on concessional taxed superannuation contributions of very high income earners. The measure affects individuals with combined income and concessional taxed superannuation contributions of more than \$300,000 per year, and ensures that the tax concession for these individuals is more closely aligned with the concession received by average income earners.

The High Court has ruled in relation to a similar tax on superannuation contributions (surcharge) that the Commonwealth could not impose a superannuation contributions tax (surcharge), under legislation enacted in 1997 on contributions to constitutionally protected funds for State higher level office holders. The High Court found that the application of the surcharge was unconstitutional due to the implied restriction that the Commonwealth may not act so as to call into question the continued capacity of the states to function as governments. Therefore, this Regulation ensures that Division 293 tax is not imposed on individuals who are State higher level office holders in relation to certain superannuation contributions to constitutionally protected funds.

The Regulation specifies officers identified in High Court decisions as State higher level office holders and officers in equivalent positions as not being subject to Division 293 tax in relation to certain superannuation contributions, and can be amended to incorporate further changes arising from future court decisions.

The Regulation also amends the Principal Regulations to set out the meaning of ‘defined benefit contribution’ and specifies how to calculate an individual’s defined benefit contributions in an income year to determine an individual’s liability for tax on their superannuation contributions under Division 293 of the *Income Tax Assessment Act 1997*. This effectively provides a mechanism to apply Division 293 tax under the sustaining the superannuation contribution concession measure to individuals with defined benefit interests in a similar way to individuals with other interests.

Human rights implications

This Regulation engages the following human rights:

Right to equality and non-discrimination

The provision of preferential tax treatment to certain individuals based on their status as a State higher level office holder engages Article 26 of the International Covenant on Civil and Political Rights. Article 26 guarantees equality before the law and equal protection of the law without any discrimination on a range of grounds. Status as a State higher level office holder is not mentioned explicitly as a grounds of discrimination, but falls within the ‘other status’ category mentioned in the Article.

The Regulation limits the right to equality and non-discrimination by providing preferential tax treatment on the grounds of whether an individual is a State higher level office holder.

This objective of this limitation is to ensure that the Commonwealth can legislate to improve the fiscal sustainability of the superannuation tax concessions it provides, in a way that is consistent with the implied constitutional restriction that the Commonwealth may not act so as to call into question the continued capacity of the states to function as governments.

The limitation is reasonable, proportionate and necessary because the preferential treatment given is the minimum necessary to ensure that the Commonwealth does not exceed its constitutional powers. It is only available for certain superannuation contributions for individuals that have been identified as State higher level office holders in the case law, and equivalent positions.

The provisions relating to the calculation of defined benefit contributions do not engage with any human rights – the function of these provisions is simply to prescribe a concept and calculation methodology to give effect to policy arrangements established under the principal legislation.

Conclusion

This Regulation is compatible with human rights as the limitation to the right to non-discrimination is reasonable, necessary and proportionate, and is aimed at achieving a legitimate objective.