THE TAX INSTITUTE

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Dear Sir/Madam

Reversionary Transition to Retirement Income Streams

The Tax Institute (**TTI**) refers to the consultation on the exposure draft legislation referred to as *Treasury Laws Amendment (Measures for a Later Sitting) Bill 2018 – Miscellaneous Amendments – Transition to Retirement Income Streams.*

TTI welcomes the proposal to clarify the operation of reversionary transition to retirement income streams (**TRIS**).

It is noted that TTI has taken the view (as expressed in its submission of 17 October 2017) that a TRIS (on properly drafted terms) was always eligible for automatic reversion to eligible dependants upon the death of the primary pensioner and that legislative reform was therefore unnecessary. As such, in the view of TTI, the issue could have been more immediately addressed via administrative guidance (potentially offering better flexibility to the superannuation industry for the various approaches taken by both self-managed superannuation funds (**SMSFs**) and large Australian Prudential Regulation Authority (**APRA**) regulated funds (including public sector, industry and retail funds). For this reason, we ask that the alternative of the provision of administrative guidance rather than the introduction of more legislation is further considered.

In the meantime, TTI makes the following points with respect to the exposure draft legislation:

1. **Commencement date**

   It is unclear to TTI whether the legislature intends the amendments to apply retrospectively from 1 July 2017.

   A statement in the explanatory materials suggests that the amendments will apply retrospectively as it is stated that: '*in practice, the amendment largely applies from 1 July 2017*' (see paragraph 1.15 of the exposure draft explanatory memorandum (**EM**)).

However, the draft bill does not in fact provide for commencement of the amendments until the first day of the relevant quarter first occurring after the legislation receives Royal Assent (see item 2 of the table appearing with 'Commencement information' at the start of the draft bill).

Accordingly, it is not clear to the TTI why the EM assumes practical commencement retrospectively occurs on 1 July 2017. Therefore it is submitted that further clarification is required on this timing issue. There are also practical ramifications for any retrospective application set out below.

2. **Retrospective application**

If the proposed amendments are to apply retrospectively from 1 July 2017 there are various problems that can be envisaged around how death benefits might have already been paid since 30 June 2017. For example, a trustee may have determined not to automatically pay a reversionary TRIS to a reversionary beneficiary (due to the stated position of the Australian Taxation Office (**ATO**)) and the death benefit may have then had to have been paid and distributed amongst dependants and the legal personal representatives at the discretion of the trustee or in accordance with a binding nomination that applied if there was no reversionary beneficiary in play.

Similarly, there may have been confusion since 1 July 2017 about the ongoing payment of a reversionary TRIS in respect of a primary pensioner who died many years prior to 1 July 2017. It is possible that any such reversionary pensions were commuted and re-commenced and/or cashed out (with possible adverse ramifications for the recipient) by 1 July 2017.

Accordingly, as is often the difficulty with retrospective legislation treatment, now seeking to apply these amendments from 1 July 2017 (if that is in fact what is intended) has the potential to interfere with the process for payment of death benefits that have actually been paid out since 30 June 2017.

TTI submits that this particular issue could not be addressed by administrative action by the ATO (or the Australian Prudential Regulation Authority (**APRA**)) because the death benefit may have already been paid on the basis that the reversionary beneficiary was *not* automatically entitled. This is not simply a matter impacting the taxation treatment of reversionary TRISs, but it extends to a trustee determining whether a dependant has a binding entitlement to a death benefit pension.

TTI considers that a preferred approach is for the amendments to apply prospectively only and that the explanatory materials contain an acknowledgment that differing treatment of reversionary TRISs has been open to funds depending upon the terms governing the pension benefits offered and it is a decision for each fund to determine how their own rules have been applied.

3. **Automatic reversion on death**

The proposed insertion of a new paragraph (aa) after paragraph 307-80(3)(a) in the manner set out in the draft bill has the potential to be administratively problematic for large APRA funds with unitised investments where they may not be in a position to immediately transfer (or back-date) a TRIS from the taxed pool of assets to the untaxed pool of assets that is subject to the exempt current pension income (**ECPI**) exemption on the death of a pensioner with a reversionary TRIS. Further, even where the death is reported promptly to the trustee there may be administrative difficulties in then promptly transferring the pension to the ECPI pool of investments.

It appears to TTI that the effect of the amendment is that as soon as the primary pensioner under a reversionary TRIS dies the assets supporting the TRIS are then in retirement phase and eligible for the ECPI pool. However, it may be a number of weeks or months (or into the next financial year) before the trustee is informed about the death of the primary pensioner and it would only be after that notice that the trustee can act to move the pension into the ECPI pool of assets.

This might be contrasted with the position where a TRIS has already been moved to 'retirement phase' as a consequence of a pensioner reaching age 65 years or satisfying one of the other relevant conditions of release with a nil cashing restriction and notifying the trustee.1 In these cases, following the death of the primary pensioner the TRIS would continue in the ECPI pool and there would be no change of taxation treatment necessary.

As such, the automatic transfer to retirement phase makes sense where the TRIS has already entered 'retirement phase' prior to the death of the primary pensioner and therefore differs to the scenario above, where the TRIS has never been in retirement phase.
Accordingly, the TTI submits that there is scope for the legislation to distinguish between reversionary TRISs where the primary pensioner has entered retirement phase and those where the primary pensioner is yet to enter retirement phase.

4. **Reversionary beneficiary definition**

TTI is concerned that the intended operation of s 307-80(3)(aa) may be undermined by the absence of a clear and practical definition for 'reversionary beneficiary' (**RB**). Accordingly, the TTI recommends that an appropriate definition be included in the draft bill to define RB for the purposes of the *Income Tax Assessment Act 1997* (**ITAA 97**) provisions.

It is submitted that such a legislative definition is necessary to provide greater certainty about the operation of s 307-80(3)(aa) as well as other relevant provisions (e.g., the 12-month deferral in the timing of transfer balance account credits under s 294-25(1) of ITAA 97). It would also be desirable to define 'reversionary pension' with reference to the meaning of RB.

TTI respectfully submits that RB has no fixed normative meaning at common law and that the appeal to a plain language 'ordinary meaning' of RB in paragraph 1.12 of the exposure draft EM is unhelpful. Anecdotal experience suggests there is widespread confusion about the precise meaning of RB. This is perhaps unsurprising given there is no full legislative definition and the main ATO guidance dealing with this issue takes the following form in three different sections of TR 2013/5 as follows:

[1] In these circumstances TTI would argue that the terms and conditions of some pensions would mean that it is no longer a TRIS at this point (with a condition of release with a 'nil' cashing restriction having been satisfied by the primary pensioner).

> 14. A superannuation income stream ceases when there is no longer a member who is entitled, or a dependant beneficiary of a member who is automatically entitled, to be paid a superannuation income stream benefit from a superannuation interest that supports a superannuation income stream
> …
> 29. A superannuation income stream ceases as soon as a member in receipt of the superannuation income stream dies, unless a dependant beneficiary of the deceased member is automatically entitled, under the governing rules of the superannuation fund or the rules of the superannuation income stream, to receive an income stream on the death of the member. If a dependant beneficiary of the deceased member is automatically entitled to receive the income stream upon the member's death, the superannuation income stream continues.
> …
> 125. If the entitlement to a superannuation income stream automatically transfers to a dependant beneficiary on the death of a member, the superannuation income stream does not cease. There is a continuing liability to make the payments under that superannuation income stream albeit the recipient of those payments has changed.
>
> 126. A superannuation income stream automatically transfers to a dependant beneficiary on the death of a member if the governing rules of the superannuation fund, or other rules governing the superannuation income stream, specify that this will occur. The rules must specify both the person to whom the benefit will become payable and that it will be paid in the form of a superannuation income stream. The rules may also specify a class of person (for example, spouse) to whom the benefit will become payable. It is not sufficient that a superannuation income stream becomes payable to a beneficiary of a deceased member only because of a discretion (or power) granted to the trustee by the governing rules of the superannuation fund. The discretion (or power) may relate to determining either who will receive the deceased member's benefits, or the form in which the benefits will be payable.

It is also useful to note that the phrase ‘superannuation income stream did not automatically revert to another person’ is used in regs 307-125.02 and 995-1.01 of *Income Tax Assessment Regulations 1997*.

TTI considers that enacting a legislative definition is the preferable approach given that a statutory standard that can only be precisely construed by reference to extrinsic materials is not ideal, particularly given the importance of the RB standard in affecting the fundamental rights and entitlements of superannuants (including from a tax, superannuation and trust law perspective). For example, it should be borne in mind that the standard is likely to impact many issues of importance, including allocation of life insurance proceeds and asset testing eligibility for Centrelink/DHS concessions.

TTI expects that certain ATO materials (refer to TR 2013/5 and LCG 2017/3) would inform Treasury’s consideration of potential standards for a definition of RB. However, we note that TR 2013/5 provides a very strict standard that we believe many industry documents fall short of (eg, the ATO does not allow any discretionary element but many superannuation fund documents do not satisfy this test and in practice many simply consider a reversionary nomination to be sufficient evidence). Accordingly, TTI recommends that in considering a definition for RB, Treasury should have regard to the desirability of implementing a workable standard that provides for a nomination and that provided some documentary evidence exists that the intent was to revert the pension, that would suffice.

Broadly, a substantial compliance test could be provided where a written nomination that the member and trustee intend the pension to be automatically reversionary will suffice despite the deed or pension documents not having the power to 'fetter' the trustee's discretion as effectively promulgated as 'law' by the ATO in TR 2013/5. This substantial compliance test should apply across the industry, both for public offer funds where the wording in documents vary widely (and probably not satisfying the ATO's criteria) and in the SMSF sector where most documents are supplied by non-qualified suppliers (who are not only not legally trained but would not know what an automatically reversionary pension is).

Accordingly, TTI recommends that paragraph 1.12 of the exposure draft EM should be replaced with new explanatory material to provide further context for the proposed RB definition with examples to illustrate the operation of the RB standard. Alternatively, if Treasury decides not to define RB, the paragraph should be recast so that the explanatory memorandum provides express guidance on the meaning of RB.

5. **Automatic conversion of primary TRIS**

Following from the point immediately above, TTI submits that there are clearly now strong grounds for the legislation to provide for the 'TRIS' nomenclature to cease to apply upon a primary pensioner with a TRIS entering retirement phase pursuant to the current provisions under section 307-80(3).

From a practical and administrative point of view it is usual for most funds to treat a TRIS as having ceased to be treated as a TRIS upon a primary pensioner having satisfied a condition of release with a 'nil' cashing restriction. Following from the terms of the proposed amendment, any requirement on funds to continue to 'earmark' these pensions as TRIS' no longer has any relevance or practical application.

Further, such an approach would not prevent funds from still choosing to require that TRIS' be formally commuted and re-commenced as an account-based pension (**ABP**) on reaching one of the relevant conditions of release.

TTI has previously made the point that if a member commences a TRIS before age 65 years and is permitted by the fund to continue that pension for life it is unlikely that the fund would continue to recognise the pension as a TRIS – instead the TRIS conditions would have fallen away by no later than the pensioner reaching age 65 years and, unless required by the terms of the pension, the pension would continue to be paid beyond age 65 years as an ordinary ABP.

TTI submits that this matter be addressed in the amendments.

6. Background and legal analysis – conversion of TRIS to ABP

A TRIS is a type of ABP that is overlaid with certain extra terms which limit the size of pension payments and prevent lump sum withdrawals unless the pensioner has satisfied a condition of release with a 'Nil' cashing restriction, e.g. retirement, death, terminal illness, permanent incapacity, or attaining age 65 years (see the definition of TRIS under r 6.01(2) of *Superannuation Industry (Supervision) Regulations 1994* (**SISR**)). The standards that allow for a TRIS were originally introduced to permit members who had attained preservation age but not otherwise satisfied a condition of release to 'transition to retirement' by commencing a pension subject to limited draw-downs.

A significant feature of the 2016 Budget reform measures was to rationalise the tax incentives associated with TRIS by coupling the fund-level ECPI exemption with a new 'retirement phase' standard (refer to ss 295-385 and 295-390 of ITAA 97). As such, the first major tranche of super reform legislation excluded TRIS from being in 'retirement phase' so as to remove ECPI in respect of the earnings on assets supporting a TRIS. However, at first instance, industry's concerns about the widespread loss of ECPI due to the TRIS changes was tempered by the understanding that many members who had originally commenced TRIS had, over time, converted their TRIS to ABPs when a condition of release with a 'Nil' cashing restriction was met without necessarily ceasing the TRIS.

Industry's broadly accepted understanding of such a conversion process is that, subject to the governing rules and pension documentation of the fund, a pension being paid to a member can meet the standards of a TRIS at a point in time and then subsequently meet the standards of an ABP, when a relevant condition of release is met. TTI is aware that industry practice has varied in respect of TRIS-to-ABP conversion, and there are cases where conversion was implemented via adaptable documents that permitted auto-conversion, as well as cases where specific conversion documents were used. Moreover, it is readily acknowledged that the governing rules and pension documents used by many funds do not facilitate conversion due to hard-wired restrictions.

However, it was not until June 2017 (i.e., the time that *Treasury Laws Amendment (2017 Measures No. 2) Act 2017* was enacted as law) that TRIS-to-ABP conversion emerged as a major source of contention between industry and Treasury (and the ATO). The gulf of understanding between industry and Treasury on this issue was first made apparent to TTI at this time due to paragraphs 1.131–1.132 of the explanatory memorandum to the Treasury Laws Amendment (2017 Measures No. 2) Bill 2017 which asserted that '…a superannuation income stream that is established as a TRIS will always retain its character…' which strongly implies TRIS-to-ABP conversion is impossible. Over time, this implication has only been reinforced, particularly in light of ATO commentary in the media, and TTI notes that paragraph 1.5 of the EM essentially repeats the same assertion of the earlier explanatory memorandum. The implication of this assertion is that the definition of a TRIS is to be construed as a 'legal straitjacket' whereby the applicable standards of the income stream are irrevocably determined at its commencement. With respect, TTI does not accept that this assertion has a sound basis in law.

If the exposure draft bill is enacted as law, the issue of TRIS-to-ABP conversion may be something of a moot point insofar as there appears to be no revenue impact or anything of legal significance that turns on the issue. However, as it is a matter of proper legal construction which could impact future income stream products, TTI considers that it is important to deal with this issue in this submission.

It is submitted that the term pension as used in SISR is an adaptive term as prescribed by the governing rules of the particular fund from time to time rather than being a fixed term as Treasury asserts (presumably by relying on reg 6.01 of the SISR). As noted above, a TRIS is by definition an ABP with additional restrictions and TTI submits that a TRIS becomes an ABP when the two restrictions discussed above are satisfied, subject to the documentation and applicable standards. More specifically, if the governing rules of the fund and related pension documents provide for the rules of an ABP once a relevant condition of release with a 'Nil' cashing restriction is met, the income stream meets the definition of an ABP regardless of whether it commenced as a TRIS originally. We refer to the following extracts:

The definition of TRIS in reg 6.01 of SISR states that a 'transition to retirement income stream' means:

> (*b*) *a pension provided from a superannuation fund, the rules of which:*
>
> *The definition of pension in reg 1.06(1):*
>
> *A benefit is taken to be a pension for the purposes of the Act if:*
>
> *(a) it is provided under rules of a superannuation fund that:*
>
> *(i) meet the standards of subregulation (9A) or 1.06A(2); and*
>
> *(ii) do not permit the capital supporting the pension to be added to by way of contribution or rollover after the pension has commenced; and …*

This TRIS definition relies on the definition of pension which is defined in s 10 of the *Superannuation Industry (Supervision) Act 1993* (**SISA**) to mean:

> *"pension, except in the expression old-age pension", includes a benefit provided by a fund, if the benefit is taken, under the regulations, to be a pension for the purposes of this Act.*

For completeness since the term pension refers to old-age pension we have extracted that definition from s 10 of the SISA below:

> *"old-age pensions" has the same meaning as in paragraph 51(xxiii) of the Constitution.*

It is therefore submitted that the term 'pension' for SISA and SISR purposes is an adaptive term that depends on what is reflected in the deed and terms that govern the pension being provided by the particular fund from time to time. The term 'pension' is not a fixed term as implied by paragraph 1.5 of the EM.

As you would be aware, the governing rules of a pension can include the superannuation fund deed, pension documents and any unwritten rule. In particular, the term governing rules is defined in s10 of the SISA to mean:

> ***"governing rules"***, in relation to a fund, scheme or trust, means:
>
> (a) any rules contained in a trust instrument, other document or legislation, or combination of them; or
>
> (b) any unwritten rules;
>
> governing the establishment or operation of the fund, scheme or trust.

Furthermore, there is no express provision in the legislation that precludes the conversion of a TRIS to an ABP. One would have expected express wording in the recent legislative changes including some clarification in s 307-80(3) of the ITAA 1997 if there was an intent to change long established industry practice that was initiated by the explanatory statement to the *Superannuation Industry (Supervision) Amendment Regulations 2007 (No. 1)*. There have been no relevant changes to the definition of a TRIS or an ABP in the SISR that would support the conclusion that a TRIS cannot be converted to an ABP. In particular, TTI understands from numerous members that TRISs have since 1 July 2007 been able to convert to an ABP and we understand that this has been undertaken on a fairly widespread basis in the superannuation industry. This practice may not have been as popular in some large APRA funds since many of these are systemised to treat a TRIS as a separate 'financial product' type offering and therefore an auto conversion is not always possible under their systems.

TTI understands that this conversion practice became quite popular following the super reforms that occurred in mid-2007 aimed at 'crystallising' a tax free component in respect of a pension (broadly, the then pre-1983 component); which was typically then an allocated pension, which soon followed in respect of transition to retirement allocated pensions ('TRAP') (a TRAP was the predecessor to a TRIS) converting to an allocated pension or an ABP. Following the mid-2007 reforms a member was permitted to convert their allocated pension (which were phased out with no new allocated pensions being allowed to commence after 19 September 2007) to an ABP without the need to first commute their original allocated pension back to accumulation to commence a new ABP (and therefore be subject to the proportioning rule on the commencement of the new ABP). Instead, the member could convert straight across from their allocated pension to a new ABP. Similarly, the practice developed of converting a TRAP to an allocated pension or an ABP. In this regard, the Explanatory Statement to the *Superannuation Industry (Supervision) Amendment Regulations 2007 (No. 1) (Cth)* made the following comment:

> *The new minimum standards [being the payment rules for an ABP] will not be restricted to income streams which commence on or after 20 September 2007. This means that existing allocated pensions will be able to operate under the new minimum payment rules from 1 July 2007* ***without the need to commute and restart the pension****.*
>
> *[Emphasis added]*

For the purposes of s 307-80(3) of ITAA 97 (and despite the operation of Part 6 of SISR) TTI accepts that a pension that does not have flexible governing rules that enables an auto conversion to an ABP and therefore does remain a TRIS under the particular governing rules that such a pension is deemed to remain a TRIS and the ECPI consequences of such a TRIS will be fully determined by the retirement phase rules in s 307-80(3).

TTI also considers that in the absence of express provisions to preclude the conversion of a TRIS to an ABP, if the pension standards and governing rules provide for a conversion mechanism after a relevant condition of release is met, the resulting income stream is not 'locked in' as a TRIS. One would have expected express wording in the legislation if there was an intent to change long established industry practice discussed above regarding conversion of allocated pensions to

ABPs, TRAPs to allocated pensions and TRISs to ABPs that was initiated and encouraged by the explanatory statement to the *Superannuation Industry (Supervision) Amendment Regulations 2007 (No. 1)*. There have been no such relevant changes to change long established practice.

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If you would like to discuss any aspects of this submission, please contact either me or Senior Adviser, Bruce Quigley, on 02 8223 0011.

Yours sincerely

Tracey Rens
President