TREASURY LAWS AMENDMENT (MEASURES FOR A LATER SITTING) BILL 2022: TAXATION OF MILITARY SUPERANNUATION BENEFITS

EXPOSURE DRAFT EXPLANATORY MATERIALS

Glossary

This Explanatory Memorandum uses the following abbreviations and acronyms.

Abbreviation	***Definition***
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
Bill	Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Taxation of Military Superannuation
Commissioner	Commissioner of Taxation
Douglas	*Commissioner of Taxation v Douglas* [2020] FCAFC 220
ITAA 1997	*Income Tax Assessment Act 1997*
ITAR 2021	*Income Tax Assessment (1997 Act) Regulations 2021*
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SIS Regulations	*Superannuation Industry (Supervision) Regulations 1993*

Chapter 1: Taxation of military superannuation

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Outline of chapter

1.1 Schedule # to the Bill amends various taxation laws to confirm the tax treatment of certain defined benefit pensions following the Full Federal Court decision in *Commissioner of Taxation v Douglas* [2020] FCAFC 220 (*Douglas*).

1.2 Schedule # also provides a 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 to ensure they do not pay additional income tax or Medicare levy because of the *Douglas* decision.

Context of amendments

1.3 On 4 December 2020, the Full Federal Court found in *Douglas* that invalidity pensions paid under the Military Superannuation Benefits and Defence Force Retirement and Death Benefits schemes that commenced on or after 20 September 2007 were 'superannuation lump sum payments' rather than 'superannuation income stream benefits' within the meaning of the ITAA 1997.

1.4 This is contrary to the original policy intent. Defined benefit pensions of the type considered in the *Douglas* decision, including those with similar characteristics paid from defined benefit schemes such as Military Superannuation Benefits and Defence Force Retirement and Death Benefits schemes were taxed as ‘superannuation pensions’ under the ITAA 1936. It was not the policy intent under the 2007 Simpler Super amendments that they would be taxed under the ITAA 1997 as anything but ‘superannuation income streams’ – the new terminology for ‘superannuation pensions’ introduced as part of the 2007 Simpler Super amendments.

1.5 The *Douglas* decision identified a discrepancy in the statutory definition of a superannuation income stream that meant, contrary to the policy intent, these types of pensions do not meet the definition of a superannuation income stream, and thus defaulted to being taxed as superannuation lump sums.

1.6 With the exception of the invalidity pensions and spouse and child pensions payable on the death of a member receiving an invalidity pension paid under the two schemes considered in the *Douglas* decision, this Schedule amends the definition of a superannuation income stream applicable to defined benefits pensions that commenced on or after 20 September 2007. The amendment confirms the original policy intent to tax all other similar defined benefit pensions as superannuation income streams.

1.7 The *Douglas* decision has potentially adverse income tax outcomes for some veterans receiving an invalidity pension under the Military Superannuation Benefits and Defence Force Retirement and Death Benefits schemes. To counterbalance any adverse impact by the change in tax treatment of their superannuation benefit, this Schedule creates a non-refundable tax offset to ensure they pay no more income tax or Medicare levy on their superannuation lump sum benefits than they would pay if those benefits were still treated as superannuation income stream benefits for income tax purposes.

Comparison of key features of new law and current law

Table 1.1 Comparison of new law and current law

New law	***Current law***
Specifies income streams for income tax purposes	
A ‘superannuation income stream’ for the purposes of subsection 307-70(2) of the ITAA 1997 includes pensions (within the meaning of the SIS Act) that commence on or after 20 September 2007 that are: • a defined benefit pension and; • provided by a defined benefit fund, or, • provided by an exempt public sector superannuation scheme , and • is not invalidity pay within the meaning of the *Defence Force Retirement and Death Benefits Act 1973*, and • is not a invalidity pension established under the *Military Superannuation and Benefits Act 1991.* 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. Therefore, public sector superannuation schemes and exempt public sector superannuation schemes are not captured by the requirement to have more than six members. The above amendments to Subdivision 307-B of the ITAR 2021 do not apply to the pension a spouse or child receiving on the death of a recipient member where the invalidity pay within the meaning of the *Defence Force Retirement and Death Benefits Act 1973* or the member’s invalidity pension established under the *Military Superannuation and Benefits Act 1991* commenced on or after 20 September 2007.	As a result of the Douglas decision certain income streams that commenced on or after 20 September 2007 do not meet the requirements of subregulation 1.06(1) of the SIS Regulations because they can be cancelled, suspended, or reduced to nil in certain circumstances and therefore do not satisfy the definition of ‘superannuation income stream’ in regulation 307-70.01 of the ITAR 2021. A superannuation benefit that is not paid from a ‘superannuation income stream’ cannot be a ‘superannuation income stream benefit’ for the purposes of section 307-70(1) of the ITAA 1997 and is instead a ‘superannuation lump sum’ for the purposes of section 307-65(1) of the ITAA 1997.

New law	***Current law***
Non-refundable tax offset	
Provides for a new non-refundable tax offset (the veterans' superannuation (invalidity pension) tax offset) to individuals who meet certain criteria, including that they receive: • invalidity pay within the meaning of the *Defence Force Retirement and Death Benefits Act 1973;* or • an invalidity pension within the meaning of the *Military Superannuation and Benefits Act 1991;* or • a pension mentioned in a paragraph in subsection 307-70.02(1A) of the ITAR 2021. Veterans who would face a higher tax liability as a result of the *Douglas* decision will have their income tax liability reduced to the amount it would be if the benefits were treated as a superannuation income stream benefit. This tax treatment also applies available to an eligible spouse or child beneficiary receiving a pension mentioned in subsection 307-70.02(1A) of the ITAR 2021. The offset applies retrospectively to income years starting on or after 1 July 2007, to prevent adverse income tax outcomes arising as a result of the ATO's remediation process to apply the court's decision to previous years. The Commissioner retains the ability to amend assessments to give effect to the offset.	No comparison.

Detailed explanation of new law

Superannuation income stream benefits

1.8 A superannuation benefit that is not paid from a 'superannuation income stream' cannot be a 'superannuation income stream benefit' for the purposes of section 307-70(1) of the ITAA 1997 and is instead a 'superannuation lump sum' for the purposes of section 307-65(1) of the ITAA 1997.

1.9 Subdivision 307-B of the ITAR 2021 provides for the definition of superannuation income stream benefit. This schedule amends the superannuation income stream definition in regulation 307-70.02(1) to provide that defined benefit pensions (within the meaning of the SIS Regulations) that commenced on or after 20 September 2007 are a superannuation income stream if, they are:

- provided by a defined benefit fund (within the meaning of regulation 1.03 of the SIS Regulations) – this includes a public sector superannuation scheme or a regulated fund that is not a public sector superannuation scheme, or
- provided by an exempt public sector superannuation scheme (within the meaning of the SIS Act), and
- are not invalidity pensions paid from Military Superannuation Benefits scheme and Defence Force Retirement and Death Benefits scheme, and
- where the defined benefit fund (within the meaning of regulations 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 to be affected by this provision.

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.

1.11 The amendments to Subdivision 307-B of the ITAR 2021 ensures that payments of defined benefits from schemes not considered in *Douglas* continue to be taxed as superannuation income stream benefits..
[Schedule #, item 1, section 307-70.02 of the ITAR 2021]

1.12 The amendments to Subdivision 307-B of the ITAR 2021 do not apply to the pension a spouse or child receives on the death of a recipient member where the member's invalidity pay within the meaning of the *Defence Force Retirement and Death Benefits Act 1973* or invalidity pension established under the *Military Superannuation and Benefits Act 1991* commenced on or after 20 September 2007.
[Schedule #, item 2, section 307-70.02 of the ITAR 2021]

1.13 The amendments of section 307-70.02 of the ITAR 2021 apply in relation to income years starting on or after 1 July 2007.
[Schedule #, item 3, provision 1000-3.01 of the ITAR 2021]

Veterans' superannuation (invalidity pension) tax offset

1.14 Tax offsets reduce the amount of income tax a person pays in an income year. They are subtracted from a person's basic income tax liability for the income year in accordance with the method statement in section 4-10 of the ITAA 1997.

1.15 This schedule provides the eligibility criteria and framework for the veterans' superannuation (invalidity pension) tax offset. ***[Schedule #, item 7, Subdivision 301-F of the ITAA 1997]***An individual may only be entitled to the veterans' superannuation (invalidity pension) tax offset for an income year if they received invalidity pay within the meaning of the *Defence Force Retirement and Death Benefits Act 1973* or an invalidity pension within the meaning of the *Military Superannuation and Benefits Act 1991* that commenced on or after 20 September 2007. ***[Schedule #, item 7, subsection 301-275(1) of ITAA 1997]***

1.16 Spouse or child pension recipients where entitlement arises because of the death of a member in receipt of an invalidity pension under the *Military Superannuation and Benefits Act 1991* or invalidity pay under the *Defence Force Retirement and Death Benefits Act 1973* scheme are eligible for the new non-refundable tax-offset. ***[Schedule #, item 7, subsection 301-275(1) of ITAA 1997]***

1.17 Invalidity pay is an invalidity benefit where the contributing member is retired on the grounds of invalidity or of physical or mental incapacity to perform their duties (see sections 3 and 26 of the *Defence Force Retirement and Death Benefits Act 1973*). An invalidity pension means a pension benefit payable in accordance with rule 27(1) or rule 28(1) of the Military Superannuation and Benefits Rules set out in the Schedule to the Trust Deed as referred to in section 4 of the *Military Superannuation and Benefits Act 1991*.

1.18 In circumstances where an individual is eligible for one or more tax offsets, the items tabled in subsection 63-10(1) of the ITAA 1997 prioritise the order an offset is applied, to the extent that a tax liability remains. The table also explains what happens to any excess offset amount.

1.19 This schedule amends the table in subsection 63-10(1) to insert item 21 to add the new veterans' superannuation (invalidity pension) tax offset. To the extent that any offset remains after applying it to the person's income tax liability, any excess is first applied against the liability to pay Medicare levy, then to any liability to pay Medicare levy (fringe benefits) surcharge. In circumstances where any further excess remains, the excess is not available to be refunded or to be transferred or carried forward to later income years. ***[Schedule #, item 6, subsection 63-10(1) of ITAA 1997]***

Calculating the amount of the tax offset

1.20 To calculate the amount of the veterans' superannuation (invalidity pension) tax offset, the first step is to work out the individual's basic income liability and the amount by which it exceeds the total amount of the individual's tax offsets (if any) for the income year as provided for under Division 301 (other than subdivision 301-F) and subdivision AB of Division 17 of Part III of the *Income Tax Assessment Act 1936* with the invalidity pension treated as a

superannuation lump sum.
[Schedule #, item 7, paragraph 301-275(2)(a) of ITAA 1997]

1.21 For the purposes of working out an individual's basic income liability, taxable income includes all non-superannuation income sources (including passive income).

1.22 The second step is to work out the total of the amounts worked out in the first step and the amounts of the individual's liability to pay the Medicare levy and Medicare levy (fringe benefit) surcharge (if any) for the income year with the invalidity pension treated as a superannuation lump sum.
[Schedule #, item 7, paragraph 301-275(2)(b) of the ITAA 1997]

1.23 The third step is to work out the total of the amount worked out under the first step and the amounts (if any) of Medicare levy and Medicare levy (fringe benefits) surcharge the individual is liable to pay for the income year on the assumption the invalidity pension was instead treated as a superannuation income stream benefit.
[Schedule #, item 7, paragraph 301-275(2)(c) of ITAA 1997]

1.24 In calculating the taxation outcome if the invalidity pension was treated as a superannuation income stream benefit, it is assessed according to the rules applicable to superannuation income stream benefits subject to the assumptions contained in subsection 301-275(3) that are outlined in paragraph [1.28].

1.25 The final step involves working out the amount (if any) the amounts in step 2 exceeds the amount in step 3 which is the amount of the veterans' superannuation (invalidity pension) tax offset.
[Schedule #, item 7, paragraph 301-275(2)(d) of the ITAA 1997]

1.26 In effect, the process involves subtracting the liability worked out in step 3 where the invalidity pension is assessed as a superannuation income stream benefit, from the total liability worked out in step 2 where the invalidity pension is assessed as a superannuation lump sum.

1.27 Where the liability worked out in step 2 is less than the liability worked out in step 3 (that is, where the tax payable if the invalidity pension is treated as superannuation lump sum is less than the tax payable if the invalidity pension is treated as a superannuation income stream benefit), the tax offset is zero.

1.28 For the purposes of calculating the tax offset, the assumptions in paragraph 301-275(2)(c) are:

- that each superannuation lump sum benefit are instead a superannuation income stream; and
- for the purposes of applying the proportioning rule in 307-125 of the ITAA 1997, the invalidity pay or invalidity pension is a superannuation income stream.

[Schedule #, item 7, subsection 301-275(3) of the ITAA 1997]

Consequential amendments

1.29 The new veterans' superannuation (invalidity pension) tax offset set out in Subdivision 301-F is added to the list of tax offsets in section 13-1 of the ITAA 1997.
[Schedule #, item 5, section 13-1 of ITAA 1997]

Commencement, application and transitional provisions

1.30 The amendments to the ITAA 1997 apply in relation to income years commencing on or after 1 July 2007. Accordingly, the amendments in this Schedule have retrospective application.
[Schedule #, item 8, section 301-90 of the Income Tax (Transitional Provisions) Act 1997]

1.31 The purpose of this Schedule is to ensure that no eligible veteran that was paid an invalidity pension that commenced on or after 20 September 2007 is worse off because of the Full Federal Court's decision in *Douglas*.

1.32 The Schedule also applies retrospectively to spouse and child beneficiaries receiving eligible pensions mentioned in a paragraph in 307-70.02(1A) of the ITAR 2021 to ensure that no one is adversely impacted or disadvantaged.

1.33 No veteran (or their spouse or child) is adversely affected by the retrospectivity of these amendments.

1.34 The amendments to the ITAR 2021 apply in relation to income years starting on or after 1 July 2007. The amendments have retrospective application to restore the understanding of the law as it was intended to operate before the decision in *Douglas* and applies to income tax assessments of these defined benefit pensions for income years from 1 July 2007. The amendments ensure a consistent tax outcome with similar types of superannuation income stream benefits.
[Schedule #, item 3, Part 1000-3 of the ITAR 2021]

1.35 Part 1000-3 of the *Income Tax Assessment (1997 Act) Regulations 2021*, as inserted by this Schedule, has effect despite subsection 12(2) of the *Legislation Act 2003*.
[Schedule #, item 3, Part 1000-3 of the ITAR 2021]

1.36 The amendments made to the ITAA 1997 and ITAR 21 do not prevent under section 170 of the *Income Tax Assessment Act 1936* the Commissioner of Taxation from amending an assessment for an income year that commenced on or before 1 July 2020 to give effect to the amendments made by this Schedule.

1.37 Section 170 of the *Income Tax Assessment Act 1936* sets out the period within which assessments may be amended and the discretionary powers available to the Commissioner of taxation (the Commissioner) for purpose of amending

assessments. Item 7 clarifies that the discretionary powers to amend an income tax assessment for an income year are not prevented by this Schedule's amendments. This amendment applies to income years on or before 1 July 2020.
[Schedule #, item 8, section 301-95 of the Income Tax (Transitional Provisions) Act 1997