

LI 2022/1 - Explanatory statement -



Explanatory Statement

Income Tax: Alternative method for calculating the tax free component and taxable component of a superannuation benefit paid during the 2021–22 financial year for recipients of certain pensions under the *Defence Force Retirement and Death Benefits Act 1973* and the Trust Deed referred to in section 4 of the *Military Superannuation and Benefits Act 1991*

General Outline of Instrument

1. This instrument is made under subsection 307-125(5) of the *Income Tax Assessment Act 1997* (ITAA 1997).
2. This instrument specifies an alternative method for calculating the tax free component and taxable component of a superannuation benefit paid during the 2021–22 financial year that is a superannuation lump sum under section 307-125 of the ITAA 1997 for recipients of certain pensions paid under:
 - the *Defence Force Retirement and Death Benefits Act 1973* (DFRDB Act); and
 - the Military Superannuation and Benefits Rules (MSBS Rules) set out in the Schedule to the Trust Deed as referred to in section 4 of the *Military Superannuation and Benefits Act 1991*.
3. The instrument is a legislative instrument for the purposes of the *Legislation Act 2003*.
4. Under subsection 33(3) of the *Acts Interpretation Act 1901*, where an Act confers a power to make, grant or issue any instrument of a legislative or administrative character (including rules, regulations or by-laws) the power shall be construed as including a power exercisable in the like manner and subject to the like conditions (if any) to repeal, rescind, revoke, amend, or vary any such instrument.

Date of effect

5. This instrument commences on the day after it is registered on the Federal Register of Legislation.
6. The instrument applies to payments made during the 2021–22 financial year from the pensions set out in section 4 of the instrument paid under the DFRDB Act and the MSBS Rules that, following the decision in *Commissioner of Taxation v. Douglas* [2020] FCAFC 220 (*Douglas*), are superannuation lump sum benefits.
7. While the instrument will have retrospective application to payments that were made before the instrument commences, the effect of the instrument is to establish an alternative method to calculate the tax free component and taxable component of those payments.

8. This alternative method of calculation was previously provided for affected payments made before 1 July 2021 in the legislative instrument F2021L00901 – *Income Tax: Pre-1 July 2021 alternative method for calculating the tax free component and taxable component of a superannuation benefit for recipients of certain pensions under the Defence Force Retirement and Death Benefits Act 1973 and the Trust Deed referred to in section 4 of the Military Superannuation and Benefits Act 1991* registered on 25 June 2021 (referred to as MS 2021/1). If an alternative method had not been put in place by that previous legislative instrument, the tax free component and taxable component would need to have been recalculated for each historical payment, with the tax free component being reduced after each payment, thereby potentially increasing the amount of tax payable by the recipient. The recipient of these payments will not be disadvantaged under the alternative method as it will apply an approach that is consistent with how the components were historically calculated before the *Douglas* decision. This instrument allows that approach to continue for superannuation benefits paid during the 2021–22 financial year.

9. Under subsection 12(2) of the *Legislation Act 2003* the retrospective application of this instrument does not adversely affect the rights or liabilities of any person other than the Commonwealth.

What is the effect of this instrument

10. This instrument specifies an alternative method for calculating the tax free component and taxable component of a superannuation lump sum to the method set out under paragraph 307-125(3)(b) of the ITAA 1997.

11. This instrument applies to superannuation benefits that are superannuation lump sums paid during the 2021–22 financial year from:

- invalidity pensions paid under the DFRDB Act and MSBS Rules that commenced on or after 20 September 2007;
- reversionary pensions paid after the death of an invalidity pensioner under the DFRDB Act and MSBS Rules where the original invalidity pension commenced on or after 20 September 2007;
- non-reversionary pensions paid after the death of an invalidity pensioner under the DFRDB Act that commenced on or after 20 September 2007.

12. The alternative method specified in this instrument requires each superannuation benefit paid under the pension to be taken to have the same tax free component and taxable component proportions to the superannuation interest that supports the pension. For the purposes of the alternative method, these proportions are to be determined when the pension commenced (consistent with the rules that apply to superannuation income streams). This is in contrast to the proportions being determined before each payment is made which is the normal rule for superannuation lump sum payments.

13. In effect, the alternative method will result in a tax free component proportion for a superannuation benefit (that is a superannuation lump sum payment following the *Douglas* decision) that is the same as it would have been if it was a superannuation income stream benefit payment (as it was treated prior to the *Douglas* decision).

Example

14. Dylan is a member of the *Defence Force Retirement and Death Benefits Scheme*. He leaves the armed forces on 1 January 2022 and commences to receive an invalidity pension from the DFRDB on 1 March 2022.

15. At the time the pension commenced the amount of the tax free component was \$10,000, and the superannuation interest that supported the pension was valued at \$100,000.

16. Dylan received his first superannuation benefit from the pension on 15 March 2022 of \$100. This payment was originally treated as being a superannuation income stream benefit but following the *Douglas* decision is now to be taxed as a superannuation lump sum. Using the alternative method specified in this instrument, the tax free component of the benefit is determined by multiplying the amount of the benefit by the proportion of the tax free component of the interest determined at the time the pension commenced.

17. At the time the pension commenced the amount of the tax free component of the interest was 10% of the value of the interest (\$10,000 of the \$100,000). This means each benefit paid between the time the pension commenced and 1 July 2022 will comprise a tax free component equal to 10% of the benefit. The taxable component of each benefit will be equal to the amount of the benefit less the tax free component.

18. As the superannuation benefit paid on 15 March 2022 was \$100, the tax free component of the is \$10. The taxable component of the superannuation benefit is the remainder of the benefit, in this case \$90.

19. In contrast, if the method in the instrument was not adopted the tax free component would gradually decrease over time and the taxable component would increase. For instance, in this example if this method was not used the second superannuation benefit would have a tax free component of \$9.99 and the taxable component would be \$90.01, assuming the benefit was \$100. This effect would compound for each subsequent benefit paid from the pension.

Compliance cost assessment

20. Compliance cost impact: Low – The regulatory impacts are minor. The Legislative Instrument is considered minor or machinery in nature.

Background

Commissioner of Taxation v Douglas

21. In the *Douglas* decision, the Full Federal Court found that invalidity pensions which commenced to be paid from the Defence Force Retirement and Death Benefits Scheme and the Military Superannuation and Benefits Scheme on or after 20 September 2007 are not superannuation income streams. Consequently, all payments made from those pensions are superannuation lump sums as defined in subsection 307-65(1) of the ITAA 1997.

22. The Commissioner considers that, following the reasoning of the *Douglas* decision, the same tax treatment applies to:

- reversionary pensions paid after the death of an invalidity pensioner under the DFRDB Act and MSBS Rules where the original invalidity pension commenced on or after 20 September 2007;
- non-reversionary pensions paid after the death of an invalidity pensioner under the DFRDB Act that commenced on or after 20 September 2007.

23. The *Douglas* decision gives rise to some unique and exceptional circumstances. Prior to the decision, the relevant pensions were considered to be superannuation income streams and the tax free component and taxable component of all payments from the pensions were determined under paragraph 307-125(3)(a) of the ITAA 1997 when the pension commenced. However, following the *Douglas* decision, the tax free component and taxable component should have been determined for each superannuation lump sum payment just before the benefit was paid in accordance with paragraph 307-125(3)(b) of the ITAA 1997.

24. As a result, in the absence of an alternative method, the tax free component and taxable component of all payments made from the affected pensions on or after 20 September 2007 would be required to be recalculated on the basis the payments are now to be treated as superannuation lump sums. For each historical payment, the value of the superannuation interest from which the lump sum was paid would be determined under section 307-205 of the ITAA 1997 and the tax free component of the interest would be determined in accordance with sections 307-210, 307-220 and 307-225 of the ITAA 1997 as at just before the payment was made. The combined effect of these provisions is that the amount of the tax free component would be reduced after each successive payment and this would result in a corresponding increase in the proportion of the taxable component.

25. On 25 June 2021 Legislative Instrument MS 2021/1 issued and provided an alternative method for determining the tax free component for affected payments made before 1 July 2021. Under the alternative method, because the proportion of the tax free component is only calculated at the time the pension commences (in contrast to every time the benefit is paid), the proportion of the tax free component (and hence the taxable component) of the benefit paid remains constant – consistent with how the components' proportions were historically calculated before the *Douglas* decision.

26. The *Douglas* decision impacts approximately 12,000 pension recipients who, in the absence of an alternative method, would require the tax free component and taxable component calculations of all their past pension payments to be recalculated. Identifying accurate data over historical periods to undertake these recalculations creates significant administrative challenges for the administrator of the Defence Force Retirement and Death Benefits Scheme and the Military Superannuation and Benefits Scheme.

27. There is a risk that any attempt to recalculate the tax free components and taxable components based on historical information that may not be accurate could result in a detrimental tax outcome for some affected pension recipients through a reduction in their tax free component. Further, recalculating the tax free component and taxable component for historical payments would significantly delay the re-assessment of the tax outcome for individuals under the ATO remediation program following the *Douglas* decision.

28. Given the risks identified above concerning historical information not being accurate which may result in detrimental tax outcomes, the Commissioner considered it appropriate to set out an alternative method in MS 2021/1. This ensured no affected pension recipient was disadvantaged by the recalculation of the tax free and taxable components of their past pension payments.

29. The 2021-2022 year being part way through, this instrument extends the approach taken in MS 2021/1 to apply to affected superannuation benefits paid during the 2021–22 financial year.

30. The method outlined above operates to determine the tax free component and taxable component of the benefit required by section 307-125. Any modifications to these components will continue to be applied after they are determined under section 307-125. This may occur, for instance, where sections 307-145 (concerning disability superannuation benefits) or 307-150 (concerning superannuation lump sums with untaxed elements) are required to be applied to the superannuation lump sum.

Consultation

31. Subsection 17(1) of the *Legislation Act 2003* requires, before the making of a determination, that the Commissioner is satisfied that appropriate and reasonably practicable consultation has been undertaken.

32. The Commissioner routinely publishes draft legislative instruments seeking public feedback for a minimum of four weeks. To avoid any detrimental effects for the affected pension recipients the Commissioner reduced this consultation period to two weeks, from 19 November to 3 December 2021 inclusive. The draft instrument and draft explanatory statement were published to the ATO

Legal database. Publication was advertised via the 'What's new' page on that website, and via the 'Open Consultation' page on ato.gov.au. Major tax and superannuation publishers and associations monitor these pages and include the details in the daily and weekly alerts and newsletters to their subscribers and members. This ensures advice of the draft is disseminated widely across the tax professional community, and that they are in an informed position to provide comments and feedback.

33. The administrator of the affected schemes was also separately consulted about the legislative instruments.

34. In consultation, six comments were received, which were seeking confirmation of how the instruments would apply in practice.

Exemption from disallowance and sunseting regime

35. Section 42 of the *Legislation Act 2003* provides for the disallowance of legislative instruments. However, paragraph 44(2)(b) of the *Legislation Act 2003* provides that section 42 does not apply to legislative instruments prescribed by regulation. Section 9 of the *Legislation (Exemptions and Other Matters) Regulation 2015* (EOMR) provides a list of instruments that are not subject to disallowance. Item 3 of the table in section 9 of the EOMR lists instruments (other than regulations) relating to superannuation. As a result, this instrument is not a disallowable legislative instrument under section 42 of the *Legislation Act 2003*.

36. Part 4 of the *Legislation Act 2003* provides for the sunseting of legislative instruments. However, paragraph 54(2)(b) of the *Legislation Act 2003* provides that Part 4 of the LA does not apply if the legislative instrument is prescribed by regulation. Section 11 of the EOMR provides a list of instruments that are not subject to sunseting. Item 6 of the table in section 11 of the EOMR lists instruments (other than regulations) relating to superannuation. As a result, Part 4 of the *Legislation Act 2003* does not apply to this instrument.

Legislative references

Acts Interpretation Act 1901

Defence Force Retirement and Death Benefits Act 1973

Human Rights (Parliamentary Scrutiny) Act 2011

Income Tax Assessment Act 1997

Legislation Act 2003

Legislation (Exemptions and Other Matters) Regulation 2015

Military Superannuation and Benefits Act 1991

Statement of compatibility with Human Rights

As section 42 of the *Legislation Act 2003* does not apply to this instrument, a Statement of compatibility with Human Rights in respect of this instrument is not required under section 9 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.