EXPLANATORY STATEMENT

Issued by authority of the Minister for Revenue and Financial Services

Income Tax Assessment Act 1997
Retirement Savings Accounts Act 1997
Superannuation Industry (Supervision) Act 1993

Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017

The *Income Tax Assessment Act 1997* provides the rules that determine who must pay income tax, and the amount of income tax that must be paid.

The *Retirement Savings Accounts Act 1997* provides for retirement savings accounts to be offered by certain financial institutions, the approval of entities that can offer such accounts and the supervision of those entities.

The *Superannuation Industry (Supervision) Act 1993* provides for the prudent management of certain superannuation funds, approved deposit funds and pooled superannuation trusts and for their supervision by APRA, ASIC and the Commissioner of Taxation.

Section 909-1 of the *Income Tax Assessment Act 1997*, section 200 of the *Retirement Savings Accounts Act 1997*, and section 353 of the *Superannuation Industry (Supervision) Act 1993* (Authorising Acts) provide that the Governor-General may make regulations prescribing matters required or permitted by the Authorising Acts to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Authorising Acts.

Schedule 1 to the *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (the Regulations) amends a number of superannuation regulations to enable new innovative retirement income stream products to be offered from 1 July 2017.

The purpose of Schedule 1 to the Regulations is to introduce a new set of design rules for lifetime superannuation income stream products that will enable retirees to better manage consumption and longevity risk in retirement. The new rules are intended to cover a range of innovative income stream products including deferred products, investment-linked pensions and annuities and group self-annuitised products. The overarching goal of the rules is to provide flexibility in the design of income stream products to meet consumer preferences while ensuring income is provided throughout retirement. Superannuation funds and life insurance companies will receive a tax exemption on income from assets supporting these new income stream products provided they are currently payable, or in the case of deferred products, held for an individual that has reached retirement.

Schedule 2 to the Regulations expands 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*. Special valuation rules apply for determining the special value and debit value of capped defined benefit income streams. Schedule 2 to the Regulations will also prescribe these valuation rules for the additional income streams.

Public consultation was undertaken on both Schedule 1 and Schedule 2 to the Regulations. Consultation on a draft of Schedule 1 took place between 21 March 2017 and 12 April 2017 and consultation on a draft of Schedule 2 took place between 13 April and 4 May 2017.

The changes have effect from 1 July 2017.

Details of the Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017

Section 1 – Name of the Regulations

This section provides that the title of the Regulations is the *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (the Regulations).

Section 2 – Commencement

This section provides that each provision of the Regulations specified in column 1 of the table commences, or is taken to have commenced, in accordance with column 2 of the table, and that any other statement in column 2 has effect according to its terms.

Schedule 1 and Schedule 2 to the Regulations commence on 1 July 2017.

Section 3 – Authority

This section provides that the Regulations are made under the *Income Tax Assessment Act 1997* (ITAA 1997)*, Retirement Savings Accounts Act 1997*, and *Superannuation Industry (Supervision) Act 1993* (SISA 1993).

Section 4 – Schedule

This section provides that each instrument that is specified in a Schedule to this instrument is amended or repealed as set out in the applicable items in the Schedule concerned, and any other time in a Schedule to this instrument has effect according to its terms.

Schedule 1

The *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* amended the ITAA 1997 to enable deferred superannuation income streams to be superannuation income streams that are in the retirement phase. Those amendments provided that the term 'deferred superannuation income stream' takes on the meaning given by the *Superannuation Industry (Supervision) Regulations 1994* (SISR 1994).

Schedule 1 to the Regulations inserts a new set of income stream standards into the SISR 1994 that provide this definition of a deferred superannuation income stream. Income streams that meet these standards are pensions or annuities for the purposes of the SISA 1993.

Superannuation funds and life insurance companies that provide these new income streams are able to receive an income tax exemption (earnings tax exemption) on income from assets they hold to support these income streams where an interest in an income stream is held for an individual that is in the retirement phase. Similarly, payments from these income streams are treated as superannuation benefits under the ITAA 1997 in the hands of the recipients and consequently attract concessions in the ITAA 1997 applying to superannuation benefit payments.

The new standards are intended to cover a range of lifetime products that do not meet the existing annuity and pension standards in subregulations 1.06(9A) and 1.05(11A) of the SISR 1994. Under the new standards the income streams are required to be payable for a beneficiary's remaining lifetime, and income stream payments could be guaranteed in whole or part by the income stream provider, or determined in whole or part through returns on a collective pool of assets or the mortality experience of the beneficiaries of the asset pool. These new income streams may also have a deferral period for annual payments and are permitted to be commuted subject to a declining capital access schedule and preservation rules.

A new condition of release is also included in the SISR 1994 and the *Retirement Savings Accounts Regulations 1997* (RSAR 1997) to enable an interest in a deferred income stream to be purchased from preserved and restricted non-preserved superannuation benefits prior to retirement.

Item 20 of the Regulations inserts a new set of income stream standards into the SISR 1994 for certain innovative superannuation income streams (new regulation 1.06A). A benefit provided by a life insurance company or a registered organisation is an annuity under subregulation 1.05(1) of the SISR for the purposes of section 10 of the SISA if it arises under a contract that meets the standards of subregulation 1.06A(2) (item 12 of Schedule 1). Similarly, a benefit is a pension under subregulation 1.06(1) of the SISR for the purposes of section 10 of the SISA 1993 if it is provided under the rules of a superannuation fund that meet the standards of subregulation 1.06A(2) of the SISR 1994 (item 16 of Schedule 1).

A contract for the provision of an annuity benefit, or the rules for the provision of a pension benefit (the governing conditions) must meet four key elements of the standards in subregulation 1.06A(2). These elements are:

- A requirement that benefit payments not commence until a primary beneficiary has died, retired, has a terminal medical condition, is permanently incapacitated or has attained the age of 65.
- A requirement that benefit payments, of at least annual frequency, be made throughout a beneficiary's lifetime following the cessation of any payment deferral period.
- A rule ensuring that after benefit payments start, there is no unreasonable deferral of payments from the income stream.
- Restrictions on amounts that can be commuted to a lump sum or for rollover purposes based on a declining capital access schedule commencing from the retirement phase.

<u>Benefit payments can only commence after a relevant condition of release is satisfied</u>

The first element of the standards ensures that income streams provided under the new standards can only start making payments once the primary beneficiary has died, retired, has a terminal medical condition, is permanently incapacitated or has attained the age of 65. This element also ensures that providers of these income streams do not receive an earnings tax exemption until the primary beneficiary has satisfied a relevant condition of release, which does not have any cashing restrictions specified in Schedule 1 to the SISR 1994.

An income stream purchased through instalments must also be fully paid prior to income stream payments commencing in order to be a pension or annuity under the SISA 1993. Under existing subparagraphs 1.05(1)(a)(ii) and 1.06(1)(a)(ii) of the SISR 1994 the governing conditions of an income stream cannot permit the capital supporting the income stream to be added to by way of contribution or rollover after the income stream has commenced. This requirement continues to apply to superannuation income streams covered by new regulation 1.06A.

<u>Recognition of deferred income streams and an annual payment requirement</u>

The second element of the standards requires payment of the income stream benefit to be made at least annually unless the income stream is a deferred superannuation income stream and payment of the benefits have not yet started. After benefit payments start for any income stream provided under the new standards they must continue throughout the life of a beneficiary.

Further amendments to the regulations enable a deferred superannuation income stream to be provided as a superannuation income stream. These amendments are necessary as the current definition of a superannuation income stream in the *Income Tax Assessment Regulations 1997* (ITAR 1997), only covers 'income streams' that, according to their ordinary meaning, are currently payable.

Item 11 of Schedule 1 inserts a definition of a deferred superannuation income stream into the SISR 1994 which is adopted by subsection 995-1(1) of the ITAA 1997. A deferred superannuation income stream is a benefit supported by a superannuation interest if the contract or rules for the provision of the benefit provides for payments of the benefit to start more than 12 months after the superannuation interest supporting the benefit is acquired, and to then be made at least annually afterwards. Items 7 and 8 of Schedule 1 amend the definition of a superannuation annuity in the ITAA 1997, so that interests in superannuation annuities that are deferred superannuation income streams are superannuation interests within the meaning of the ITAA 1997. Item 9 of Schedule 1 adds new paragraph (c) to the definition of a superannuation income stream in the subregulation 995-1.01(1) of the ITAR 1997 to include a deferred superannuation income stream that is taken to be an annuity or pension for the purposes of the SISA 1993 because the governing conditions for that pension or annuity meet the standards in subregulation 1.06A(2) of the SISR 1994. Item 1 then ensures an interest in a deferred superannuation income stream, covered by paragraph (c) of the definition of superannuation income stream in the ITAR 1997, is always treated as a separate superannuation interest. Items 17, 18, 21 and 22 make minor drafting corrections to the definitions of a pension and a transition to retirement income stream in the SISR 1994.

Following amendments made to the ITAA 1997 by Schedule 8 to the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* an earnings tax exemption in relation to superannuation income streams can only apply to complying superannuation funds, RSA providers and life insurance providers if the superannuation income stream is in the retirement phase. A superannuation income stream is in the retirement phase at a time if a superannuation benefit is payable from it at that time. A superannuation income stream is also in the retirement phase at a time if it is a deferred superannuation income stream and a superannuation income stream benefit will be payable to a person after that time, and that person has retired, has a terminal medical condition, is permanently incapacitated or has attained the age of 65.

<u>No unreasonable deferral of income stream payments</u>

The third element of the standards introduces a rule so the amount of benefit payments is determined using a method that ensures there is no unreasonable deferral of benefit payments after the start of payments from the income stream. This rule ensures that a genuine retirement income stream is provided to a beneficiary, with benefit payments being set in a manner that does not circumvent the commutation rules or provide estate planning benefits.

Specifically, new paragraph 1.06A(3)(c) of the Regulations applies the following factors to determine whether there is any unreasonable deferral of benefit payments:

- To the extent payments depend on the returns on an investment of the assets supporting the benefit – when the payments are made and when returns are derived.
- To the extent that payments depend on the ages, life expectancies, or other factors relevant to mortality, of other individuals – the age, life expectancy, or other factors relevant to mortality, of those individuals.
-

- To the extent that payments do not depend on returns, age or life expectancies – the relative sizes of annual total payments from year to year.
- Any other relevant factors.

Factors that are relevant to mortality could include an individual's gender, occupation or risk factors relating to their health.

These factors provide some flexibility to enable benefit payments to be varied between years having regard to an indexation method, or investment returns and/or the mortality experience of beneficiaries, of a collective pool or of the fund. They also enable benefit payments to be set within a targeted but not guaranteed range, with scope for reserving to be applied to meet future payment targets. The overarching requirement for the method to ensure that payments are not unreasonably deferred requires a method for determining the amount of benefit payments to have an objective basis, and for relevant factors applying to the method to be set out in the governing conditions for the income stream.

By way of example, a reversionary annuity purchased for $250,000 at age 60 with payments starting at age 80 would likely be considered unreasonable if the payments for the first twenty years were $1000 per annum, but then were very large, such as $50,000 per annum for any following payment year. A further example of an unreasonable deferral might be a pooled product where the payments, although not necessarily wholly deferred for any period, are very heavily weighted to higher payments in later years and do not represent any alignment with investment returns or mortality experiences.

While it is unlikely that there is an incentive for providers to offer such products, if they did the product would be considered unreasonable as it would not provide a genuine retirement income stream and would likely be an attempt to circumvent the capital access schedule rules and normal taxation arrangements.

<u>Restrictions on accessing capital supporting the income stream</u>

The fourth element of the standards restricts the amount of capital from the income stream that can be accessed through a lump sum commutation or a commutation of an amount that is then rolled over within the superannuation system. These restrictions apply from the day that the primary beneficiary of the income stream enters the retirement phase.

Item 11 of Schedule 1 inserts a definition of retirement phase start day for a benefit supported by a superannuation interest (within the meaning of the ITAA 1997). For a deferred income stream this is the later of the day that the primary beneficiary has satisfied a relevant condition of release that has a nil cashing restriction, and the day the superannuation interest is acquired. Otherwise, it is the day that payments of the benefit supported by a superannuation interest start to be payable. This day aligns with the point in time that a credit for a superannuation income stream is applied to the transfer balance account in Subdivision 294-B of the ITAA 1997.

Item 20 of Schedule 1 inserts a formula that restricts the maximum commutation amount that can be accessed after 14 days from the retirement phase start day, on a declining straight line basis over the primary beneficiary's life expectancy, or where a primary beneficiary is not alive on their retirement phase start day an eligible reversionary beneficiary's life expectancy, on the retirement phase start day

The maximum commutation amount is worked out by dividing the 'access amount' by the beneficiary's life expectancy period on the retirement phase start day and then multiplying this by the remaining life expectancy at the time of commutation. If the primary beneficiary of a deferred superannuation income stream dies, prior to otherwise reaching their retirement phase start day, and the income stream reverts to an eligible beneficiary, the reversionary beneficiary's life expectancy period is then used. To be an eligible beneficiary under paragraph 6.21(2)(b) of the SISR 1994 the reversionary beneficiary must have reached their own retirement phase start day, on the death of the primary beneficiary, to then be an eligible reversionary beneficiary of a deferred superannuation income stream that has yet not started payments.

If the reversionary beneficiary is a dependent beneficiary who does not satisfy this requirement, regulation 6.21 of the SISR 1994 requires that the trustee cash out the benefit as soon as practicable. This can be done by commuting the deferred superannuation income stream and either paying the deceased's superannuation interests out as a lump sum to the beneficiary or paying it through one or more new pensions or annuities.

The payment of the deceased's interests by way of a pension or annuity will satisfy the cashing requirements in regulation 6.21 if the new pension or annuity is in the retirement phase. For most superannuation income streams, this is when superannuation income stream benefits are payable (see subsection 307-80(1) of the ITAA 1997). However, transition to retirement income streams and deferred superannuation income streams can only be in the retirement phase when the person to whom benefits are (or will be) payable has satisfied a relevant condition of release.

The life expectancy period for an income stream is rounded down to a whole number of years then multiplied by 365 days. The remaining life expectancy is the life expectancy period less the number of actual days since the retirement phase start day. The reference to 'actual days' takes account of all of the days in a leap year which is intentionally different to the approach in working out the life expectancy period (which uses a general 365 day multiplier). The maximum commutation amount is also reduced by the sum of all amounts previously commuted from the income stream prior to the time of the commutation.

Item 11 of Schedule 1 inserts a definition to determine the value of the 'access amount' on the retirement phase start day for the income stream or at a point in time after the retirement phase start day. The access amount is the maximum amount payable on commutation of an interest on the retirement phase start day as determined by an annuity contract or pension rules. Any instalment amounts paid for an interest in a deferred superannuation income stream after the retirement phase start day are then added to the access amount at the point in time that an instalment is paid.

Item 11 of Schedule 1 also inserts a definition of life expectancy period, and a definition of prescribed life tables, for the purposes of the formula inserted in item 20 of Schedule 1.

An income stream provider can set, or provide a method for calculating, the access amount on the retirement phase start day in the rules or contract for the income stream. Any such amount is the maximum amount that may be paid on commutation of the superannuation interest on the retirement phase start day or within 14 days starting on the retirement phase start day.

The full access amount may be paid as a commutation amount if the income stream is commuted on the death of a beneficiary within the first half of the life expectancy period of the primary beneficiary.

Example 1.1: Maximum commutation amount - income stream purchased by a single payment

Hector purchases an immediate annuity for $20,000 on his 65th birthday on 21 August 2017. The annuity is immediately payable.

The contract only enables the income stream to be commuted within the 14 days of the purchase day, or on Hector’s death up until his 80th birthday. The full amount of the purchase consideration is payable if the annuity is commuted within 14 days of the retirement phase start day.

Hector passes away on 30 December 2028 age 76 years.

The following inputs are required for the purposes of working out the maximum commutation amount of the death benefit:

> Access amount on retirement phase start day - $20,000
>
> Access amount at the time of commutation - $20,000
>
> Prescribed Life Tables - 2010-2012 Australian Life Tables - Male
>
> Life expectancy period for the income stream = 19 × 365 = 6,935 days
>
> First half of the life expectancy period – 3,467 days
>
> Remaining life expectancy is 6,935 – 4,149= 2,786 days

Applying the formula in new subregulation 1.06B(2) of the SISR 1994 the maximum amount that could be payable on commutation of the income stream on Hector’s death is:

$$= \left[\frac{\text{Access amount for the income stream at the time of the commutation}}{\text{Life expectancy period for the income stream}} \times \text{Remaining life expectancy} \right] - \text{Previously commuted amount}$$

= ($20,000 ÷ 6,935 x 2,786) - 0

= $8,034.61

If Hector had passed away before 17 February 2027, being within 3,467 days of the retirement phase start day, the maximum commutation amount for the income stream would have been $20,000 (being the access amount at that point in time).

Example 1.2: Maximum commutation amount – income stream purchased by instalments

Suzie acquires an interest in a deferred annuity by making the first of 20 annual instalment payments of $1,000 on 22 August 2017. Suzie retires on her 60th birthday on 21 August 2022. The deferred annuity is only payable from age 80.

The contract permits an amount equal to the amount of consideration paid for the income stream to be accessed on Suzie’s death on or before the retirement phase start day. The annuity can also be commuted on either the retirement phase day or Suzie’s death, up until her 80th birthday.

Suzie passes away on 20 December 2041 age 79.

The following inputs are required for the purposes of working out the maximum commutation amount on Suzie’s death on 20 December 2041.

Access amount on retirement phase start day - \$5,000

Access amount at the time of commutation - \$20,000

Prescribed Life Tables* - 2010-2012 Australian Life Tables – Female

Life expectancy period for the income stream – 26 x 365= 9,490 days

Remaining life expectancy is 9,490 – 7,061 = 2,429 days

*for illustrative purposes only-as these tables will not be prescribed until 2022

Applying the formula in new subregulation 1.06B(2) of the SISR 1994 the maximum amount payable on commutation of the deferred annuity on Suzie's death is:

$$= \left[\frac{\text{Access amount for the income stream at the time of the commutation}}{\text{Life expectancy period for the income stream}} \times \text{Remaining life expectancy} \right] - \text{Previously commuted amount}$$

= (\$20,000 ÷ 9,490×2,429) - 0

= \$5,119.07

<u>Other income stream standards</u>

Prior to the retirement phase start day, commutation amounts are not restricted. However the circumstances under which a commutation can be made remain subject to the preservation rules in the SISR 1994. To ensure that income stream contracts cannot be used for early release purposes, the governing conditions for the new income streams must include relevant SISR 1994 preservation rules.

In addition, new regulation 1.06A of the SISR 1994 also requires the governing conditions to ensure that a death benefit can only be transferred or paid to another person who is eligible to be paid or transferred a death benefit in a given form under the SISR 1994 cashing rules. Items 15 and 19 will make consequential amendments to existing subregulations 1.05(11B) and 1.06(9B) of the SISR 1994 to ensure recent amendments to the SISR cashing rules also apply to benefits arising under contracts entered into on or after 1 July 2017.

These amendments ensure that the death benefit cashing rules that apply to superannuation funds in regulation 6.21 of the SISR 1994 also apply to all superannuation income stream contracts. Amendments made to the cashing rules in the *Treasury Laws Amendment (Fair and Sustainable Superannuation Regulations) 1997* only permit a death benefit to be cashed in the form of a deferred income stream superannuation income stream, which is immediately payable to a dependant, or cashed in favour of a dependant in the retirement phase.

By way of example, new subregulation 1.06A(4) of the SISR 1994 permits an interest in a deferred superannuation income stream, which had not started payments prior to the death of a primary beneficiary, to revert (transfer) to a surviving spouse provided the surviving spouse in the retirement phase. However, if the surviving spouse was not in the retirement phase a reversion of the interest would only be permitted if the deferred superannuation income stream had commenced payments prior to the death of the primary beneficiary. In circumstances where a deferred superannuation income stream could not revert to a surviving spouse, an annuity provider could still rollover any death benefit amount arising from the commutation of the income stream, to then commence a new income stream, which was immediately payable, to the surviving spouse.

The capital value of the benefit could not be used as security for a borrowing.

Ensuring innovative income stream do not overlap with existing standards

The standards in new regulation 1.06A of the SISR 1994 only apply to annuities or pensions that are not superannuation income streams that meet the existing standards in subregulations 1.06(9A) or 1.05(11A) of the SISR 1994. An income stream intended to be offered under 1.06A, may also inadvertently meet the standards for a non-account based income stream in 1.06(9A) or 1.05(11A) of the SISR 1994, and therefore not be governed under the 1.06A standards. To remove this uncertainty, new subregulation 1.06A(5) of the SISR permits the governing conditions for an income stream provided under the new standards to state that they do not meet the standards in subparagraphs 1.05(11A)(b)(i) or (ii) or 1.06(9A)(b)(i) or (ii) of the SISR 1994 for the purposes of the annuity and pension standards in the SISR 1994. Such statements continue to have effect whether or not the statement is later changed or removed.

Provision of new income streams by small funds

Small superannuation funds cannot provide pensions to their members that meet the new standards in regulation 1.06A of the SISR 1994 unless the pension is wholly determined by reference to policies of life assurance purchased by the trustee of the superannuation fund. For example, a small superannuation fund is permitted to purchase an interest in a deferred annuity, which was then on paid by the superannuation fund as a pension, where the rules for the provision of the pension mirrored those under the deferred annuity contract.

This outcome is a result of the current operation of Division 9.2B of the SISR that prohibits superannuation funds with fewer than 50 members providing a defined benefit pension within the meaning of regulation 9.04E of the SISR. However, Division 9.2B of the SISR 1994 does not preclude a small superannuation fund directly investing in an income stream that meets the standards of 1.06A of the SISR 1994 as an investment option for a member’s account based pension.

Valuation of new income streams for ITAA 1997 purposes

Items 2 to 5 insert new regulations to value an individual’s interest in a deferred superannuation income stream and an individual’s interest in a pooled investment pension or pooled investment annuity for ITAA 1997 purposes.

New subregulation 307-205.02C(1) of the ITAR 1997 sets out a method for determining the value of an individual’s superannuation interest that supports a deferred superannuation income stream, referred to in new subregulation 307-205.02C(3), at a particular point in time, for the purposes of paragraph 307-205(1)(a) of the ITAA 1997. This is the value credited to the individual’s transfer balance account in subdivision 294-B of the ITAA 1997, when the interest holder enters the retirement phase, and also the value for the purposes of applying the proportioning rule in section 307-125 of the ITAA 1997.

New subregulation 307-205.02C(3) applies to a deferred superannuation income stream, covered by paragraph (c) of the definition of superannuation income stream in the ITAR 1997. To ensure that there is no overlap with the other valuation rules introduced by Schedule 1, the deferred superannuation income stream must be neither a pooled investment pension nor a pooled investment annuity.

New subregulation 307-205.02C(1) of the ITAR provides that the value of such an interest at a particular time is the greater of:

- the sum of each amount of consideration paid for the income stream, and a notional earnings amount on each amount of consideration, as worked out under new subregulation 307-205.02C(2); or
- the amount of superannuation benefits payable from the interest if the holder voluntarily caused the interest to cease at that time.

The notional earnings amount is calculated on an annual basis, using the ‘the above threshold rate’ in subsection 1082(2) of the *Social Security Act 1991*, with an apportionment calculation being made to apply notional earnings amounts for part years.

This method recognises the current value of amounts of consideration paid for a deferred superannuation income stream interest, if the interest is purchased with a single amount, or through instalment amounts, prior to the retirement phase start day. Consideration could be paid through superannuation rollover amounts, or in the case of an interest in a deferred superannuation income stream provided by a superannuation fund through amounts of contributions to the fund.
Subsection 294-25(1) of the ITAA 1997 is also to be modified through separate amendments to enable regulations to prescribe additional circumstances in which a transfer balance credit arises in an individual’s transfer balance account. It is intended that new regulations be made to ensure that the amount of an instalment paid for an interest in a deferred superannuation income stream, after the retirement phase start day, gives rise to a credit in the transfer balance account. A transfer balance credit in these circumstances is necessary to appropriately capture the transfer of assets from accumulation phase to retirement phase in respect of an individual that occurs as a result of the instalment payment.

Example 1.3: Working out the value of a superannuation interest that supports a deferred superannuation income stream, purchased by instalments, on the retirement phase day

Rosie purchases a deferred annuity by making three annual instalment payments of $10,000 commencing from 1 July 2017 from her accumulation superannuation account. Rosie turns 60 on 30 June 2017. The annuity provides for income stream payments to be made to Rosie from age 67. The deferred annuity cannot be commuted, other than within 14 days of the superannuation interest being acquired.

Rosie retires from the workforce on 31 December 2021 after working continually for her employer for 10 years.

For illustrative purposes it is assumed that the *applicable above threshold rate* under subsection 1082(2) of the *Social Security Act 1991* for each *adjustment day*, is 3.75 per cent on 1 July 2018, and 1 July 2019, and 4 per cent on 1 July 2020, 1 July 2021, and also on 31 December 2021.

The value of the superannuation benefits on 31 December 2021 is the sum of each amount of consideration paid and associated earnings on that valuing day.

Step 1

Work out the amount of consideration paid and associated earnings for the first instalment on the valuing day by using the formula in new subregulation 307-205.02C(2) of the ITAR 1997.

This is done by determining *the compounded amount of consideration* just before the earliest adjustment day and then determining the compounded amount of consideration, just before each later adjustment day, by applying the following formula in new subregulation 307-205.02C(2) of the ITAR 1997 on each adjustment day, until the adjustment day is the valuing day:

$$= \text{Compounded amount of consideration just before the adjustment day} \times \left[1 + \text{Applicable above threshold rate for the adjustment day}\right]$$

The *compounded amount of consideration* for the first instalment just before the 1 July 2018 adjustment day (being the earliest adjustment day) is:

$10,000

Then just before the 1 July 2019 adjustment day it is:

$10,000 x 1.0375

Then just before 1 July 2020 adjustment day it is:

$10,000 x 1.0375^2

Then just before 1 July 2021 adjustment day it is:

$10,000 x 1.0375^2 x 1.04

Then just before 31 December 2021 adjustment day it is - with compounding being applied on the 1 July 2021 adjustment day:

$10,000 x 1.0375^2 x 1.04^2

The amount of consideration paid for the first instalment on the valuing day, 31 December 2021, is then:

= $10,000 x 1.0375^2 x 1.04^2 x (1 + (.04 × (182/365))

= $11,874.62

Step 2

Work out the amount of consideration paid for the second instalment and associated earnings on the valuing day using the formula in new subregulation 307-205.02C(2) of the ITAR 1997 where the earliest adjustment day is 1 July 2019, that is:

= $10,000 x 1.0375x 1.04^2 x (1 + (.04 × (182/365))

= $11,445.41

Step 3

Work out the amount of consideration paid for the 3rd instalment and associated earnings on the valuing day using the formula in new subregulation 307-205.02C(2) where the earliest adjustment day is 1 July 2020, that is:

= $10,000 x 1.04^2 x (1 + (.04 × (182/365))

= 11,031.73

Step 4

Add up the amount of consideration and associated earnings for each instalment on the valuing day to determine the value of the superannuation interest, that is:

= $11,874.62 + $11,445.41 + $11,031.73

= $34,351.76

Step 5

Determine whether the amount in Step 4 is greater than the amount payable to Rosie if she was to voluntarily cease the income stream on the valuing day. As the income stream cannot be commuted on the valuing day, this later amount is nil. The value of the superannuation interest in the deferred superannuation income stream is therefore $34,351.76 on the valuing day.

A credit for the amount of $34,351.76 would then arise in Rosie's transfer balance account, under item 2 of the table in subsection 295-25(1) of the ITAA 1997, on 31 December 2021.

Value of certain pooled investment income stream

New subregulation 307-205.02D(1) of the ITAR 1997 sets out a method for determining the value of an individual's superannuation interest that supports a pooled investment pension for the purposes of paragraph 307-205(1)(a) of the ITAA 1997. This value will be the value at a particular point in time of so much of a collective pool of assets attributed to the individual, under the rules of the superannuation fund, as certified by an actuary.

New subregulation 307-205.02D(2) of the ITAR 1997 sets out a definition of a pooled investment pension (PIP). A PIP is a pension provided under the rules of a superannuation fund where those rules ensure once income stream payments start, they continue for the remainder of an individual's life. For a product to be a PIP, payments must be determined having regard to the age, life expectancy or other factors relevant to the mortality of each individual who has that kind of interest in the fund, and the pool of assets in the fund held for the collective benefit of those individuals.

While investment returns, investment losses, expenses of the fund and fees may all affect the amount of payments to which an individual is entitled; such impacts are relevant to determining the amount of payments. This is because things of this nature will ultimately affect the pool of assets in the fund that are held for the collective benefit of individuals, and will therefore be covered by the requirement that the amount of payments be determined by having regard to the pool of assets. Additionally, there is no requirement that the amount of payments be based strictly on the pool of assets at the time of the payment. For example, it would be acceptable for the amount of payments to be determined by having regard to the returns that the fund also expects to receive from its investments.

New subregulation 307-205.02E(1) of the ITAR 1997 sets out a method for determining the value of an individual's superannuation interest that supports a pooled investment annuity for the purposes of paragraph 307-205(1)(a) of the ITAA 1997. This value will be the value at a particular point in time of so much of a collective pool of assets held by a life insurance company attributed to the individual, under the contract for the provision of the annuity, as certified by an actuary.

A pooled investment annuity (PIA) is a comparable product to a PIP but is instead provided by a life insurance company. New subregulation 307-205.02E(2) of the ITAR 1997 sets out a definition of a PIA. A PIA is a superannuation annuity provided under a contract, where the contract ensures that once annuity payments start, they continue for the remainder of the individuals life. For a product to be a PIA, annuity payments must be determined having regard to the age, life expectancy or other factors relevant to the mortality of each individual who has that kind of interest with the life insurance company, and the pool of assets held for the collective benefit of those individuals.

The same considerations outlined above in respect of the requirements about payments being determined by having regard to the pool of assets for PIPs also apply in respect of PIAs.

Relevant mortality factors for a PIP or a PIA could include a beneficiary's age, their life expectancy determined by the Australian Life Tables or an alternative measure, their gender, occupation or risk factors relating to their health.

To be a PIA, the life insurance company that offers the annuity must provide annuities to at least 50 entities. This requirement reflects the equivalent requirement in Division 9.2B of the SISR 1994 that requires superannuation funds providing PIPs to have at least 50 members. This requirement does not preclude a PIA-like product being provided as an innovative income stream by a life insurance company that provides annuities to fewer than 50 entities. However the like product would not be valued under the special rules in new subregulation 307-205.02E (1) of the ITAR 1997.

Similarly there are no special rules to value other income stream products that may be provided under the new standards. In these cases the existing valuation rules in regulations made for the purposes of paragraph 307-205(1)(a) of the ITAA 1997 continue to apply. For example, an immediate annuity would be valued using the historic purchase price of the annuity under regulation 307-205.02A of the ITAR 1997.

Schedule 1 to the Regulations does not contain amendments to determine the accumulation phase value of an interest in a deferred superannuation income stream, PIP or PIA for the purposes paragraph 307-205(2)(a) of the ITAA 1997. The accumulation phase value of such interests is the default value determined under paragraph 307-205(2)(b) of the ITAA 1997.

<u>Preservation rules – new condition of release</u>

Schedule 1 to the SISR 1994 contains conditions of release and cashing restrictions for preserved and restricted non-preserved superannuation benefits from superannuation and approved deposit funds. Schedule 2 of the RSAR 1997 contains those conditions for retirement savings accounts.

Items 10, 24 and 25 of Schedule 1 introduce a new condition of release that permits an interest in a deferred superannuation income stream that meets the standards of new subregulation 1.06A(2) of the SISR 1994 to be acquired by a fund member or RSA holder, with preserved and restricted non-preserved superannuation benefits. This enables deferred superannuation income streams to be purchased while a member is still in the accumulation phase, on potentially more attractive terms than those available when a member reaches retirement age.

<u>Transitional arrangements</u>

Item 23 inserts Division 14.14 into the SISR 1994. This Division ensures that the amendments to the SISR 1994 that are made by Schedule 1 to the Regulations apply to a benefit arising under a contract entered into on or after 1 July 2017, and a benefit provided under rules made on or after 1 July 2017.

Schedule 2

Schedule 2 prescribes, for the purposes of subsection 294-130(2) of the ITAA 1997, 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 the SISR 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 strictly meet the 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 specified period following the death of a primary beneficiary.

Lifetime pensions that do not meet the strict standards of subregulation 1.06(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, for pensions paid under rules in existence at 29 June 2007, 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 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.

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 capped defined benefit income streams. 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 a 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, Schedule 2 now also covers 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, Schedule 2 expands 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.

In the case of a successor fund transfer when the members of one fund are transferred to another, for example as a result of a merger, a new interest is created and the pension will be provided under the rules of the successor fund. Since subregulation 294-130.01(2) applies to pensions provided under rules in existence at 1 July 2007, new subregulation 294-130.01(3) provides that capped defined benefit treatment will continue to be extended to such pensions when they are subject to a successor fund transfer.

<u>Expanding the definition of capped defined benefit income stream to include certain pensions paid on the grounds of invalidity</u>

In addition, new subregulation 294-130.01(4) 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(4) 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, or when they reach a certain age).

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.

They may also cease when the individual reaches a compulsory retirement age. For example, judges of the Federal Circuit Court must retire at age 70, therefore invalidity pensions will only be paid until they reach that age.

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 regulations 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 regulations 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

Insert Title of Regulation

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 consists of two schedules. Schedule 1 amends a number of superannuation regulations to enable new innovative retirement income stream products to be offered from 1 July 2017. The new rules are intended to cover a range of innovative income stream products including deferred products, investment-linked pensions and annuities and group self-annuitised products, with the aim of enabling retirees to better manage consumption and longevity risk in retirement.

Schedule 2 expands the definition of capped defined benefit income streams to include those defined benefit pensions (including defined benefit invalidity pensions) that do not fit within the rules of subregulation 1.06(2) of the SISR 1994 as required by item 1 of the table in subsection 294-130(1) of the ITAA 1997. These pensions may allow for variation, suspension or cessation of invalidity pension payments, or be 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 or ceased on the basis of changing levels of incapacity or age, 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.