

EXPLANATORY STATEMENT

Issued by authority of the Assistant Treasurer and Minister for Financial Services

Income Tax Assessment Act 1997

Superannuation Industry (Supervision) Act 1993

Treasury Laws Amendment (Military Superannuation Benefits) Regulations 2023

The *Income Tax Assessment Act 1997* (the ITAA 1997) deals with the rules and obligations of taxpayers to pay annual income tax. Section 909-1 of the ITAA 1997 provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

Section 307-125 of the ITAA 1997 sets out the proportioning rule for calculating tax free and taxable components of a superannuation benefit. Subsection 307-125(4) provides that regulations may specify an alternative method for determining the components of a superannuation benefit. Part 1 of the regulations specifies an alternative method for determining the components of the Douglas affected invalidity benefits.

Section 294-130 of the ITAA 1997 sets out the meaning of capped defined benefit income stream (CDBIS). Subsection 294-130(2) provides that a superannuation income stream is also a CDBIS if the income stream is prescribed by the regulations for the purposes of this subsection. Part 2 of the regulations provides that superannuation benefits that are income streams because of the amendments made in the Bill are to be treated as CDBIS.

The *Superannuation Industry (Supervision) Act 1993* (the SIS Act) deals with the prudent management and supervision of certain superannuation entities. Subsection 353(1) of the SIS Act provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

Subsection 31(1) of the SIS Act provides that regulations may prescribe standards applicable to the operation of regulated superannuation funds and to trustees and RSE licensees of the funds. Part 3 of the regulations amends the operating standards to ensure that reversionary pensions from Douglas affected funds can be paid as a series of payments, and are not restricted to being paid as one or two lump sum payments

The purpose of the *Treasury Laws Amendment (Military Superannuation Benefits) Regulations 2023* (the Regulations) is to make consequential amendments to tax and superannuation laws to provide rules for the tax treatment for certain superannuation defined benefits. These changes will complement Schedule 9 of Treasury Laws Amendment (2022 Measures No. 4) Bill 2022 ('the Bill') (if enacted).

On 4 December 2020, the Full Federal Court decision in *Commissioner of Taxation v Douglas* [2020] FCAFC 220 (*Douglas*) determined that invalidity pension payments under the superannuation scheme established under the *Military Superannuation and Benefits Act 1991* (MSB) and invalidity pay under the *Defence Force Retirement and Death Benefits Act 1973* (DFRDB) (collectively referred to as invalidity benefits) commencing on or after 20 September 2007 are not superannuation income streams within the meaning of the ITAA 1997. This meant that the invalidity benefits are taxed as superannuation lump sum payments.

Schedule 9 to the Bill maintains that invalidity benefits under the MSB and DFRDB are superannuation lump sum payments while ensuring all other defined benefit pensions are to be treated as superannuation income streams for the purposes of section 307-70 of the ITAA 1997.

The Regulations amend the *Income Tax Assessment (1997 Act) Regulation 2021* (ITAR 2021) and the *Superannuation Industry (Supervision) Regulations 1994* (SISR) to make consequential amendments to some aspects of tax and superannuation law, including:

- the application of the proportioning rule to invalidity benefits under the DFRDB and MSB;
- treatment as a capped defined benefit income stream for benefits that are superannuation income streams because of Schedule 9 to the Bill; and
- ‘payment standards’ for superannuation lump sum payments relating to reversionary pension benefits under the MSB.

The Authorising Acts specify no conditions that need to be met before the power to make the Regulations may be exercised.

There was public consultation on an Exposure Draft from 5 to 19 May 2023 with submissions received from superannuation funds and individuals, mostly making broader comments about the government’s response to the *Douglas* decision. Following this consultation, changes of a minor and technical nature were made to application provisions.

Details of the Regulations are set out in [Attachment A](#).

The Regulations are a legislative instrument for the purposes of the *Legislation Act 2003*.

The Regulations commence on the later of the start of the day after the instrument is registered and immediately after the commencement of Schedule 9 to *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*. However, the Regulations do not commence if the Bill is not enacted.

The amendments in Parts 2 and 3 of Schedule 1 of the Regulations will have retrospective application to income years from 1 July 2017 onwards. This is necessary to preserve the existing arrangements and treatment of superannuation benefits before the *Douglas* decision. This is consistent with the retrospective application of the amendments in the Bill, which reverse the operation of the *Douglas* decision. The retrospective application of these regulations is not expected to be disadvantageous to those affected by the changes, as in most cases it will preserve current arrangements.

However, if the retrospective application is disadvantageous to a particular taxpayer, the provisions will be disapplied in relation to that taxpayer as a result of subsection 12(2) of the *Legislation Act 2003*.

The Office of Impact Analysis (OIA) has been consulted (OIA23-04687) and considered the proposal unlikely to have a more than minor regulatory impact. The preparation of an Impact Analysis (IA) is not required.

A statement of Compatibility with Human Rights is at [Attachment B](#).

Details of the *Treasury Laws Amendment (Measures for Consultation) Regulations 2023*

Section 1 – Name of the Regulations

This section provides that the name of the Regulations is the *Treasury Laws Amendment (Military Superannuation Benefits) Regulations 2023* (the Regulations).

Section 2 – Commencement

Schedule 1 to the Regulations commence on the later of:

- (a) the start of the day after the instrument is registered on the Federal Register of Legislation; and
- (b) immediately after the commencement of Schedule 9 to the *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*.

However, Schedule 1 to the Regulations does not commence at all if the event mentioned in paragraph (b) does not occur.

Section 3 – Authority

The Regulations are made under the *Income Tax Assessment Act 1997* (the ITAA 1997) and the *Superannuation Industry (Supervision) Act 1993* (the SIS Act)

Section 4 – Schedule

Each instrument that is specified in the Schedules to this instrument will be amended or repealed as set out in the applicable items in the Schedules, and any other item in the Schedules to this instrument has effect according to its terms.

Schedule 1 – Amendments

Part 1—Components of a superannuation benefit

Income Tax Assessment (1997 Act) Regulations 2021

Item 1: At the end of Subdivision 307-C

Under the proportioning rule in Subdivision 307-C of the ITAA 1997, the tax-free and taxable components of a member's superannuation benefit are taken to be paid in the same proportion as the tax-free and taxable components of the member's interest in the super fund.

Under the general proportioning rules in subsections 307-125(1) to (3) of the ITAA 1997, there are differing methods for determining the tax-free and taxable components of a superannuation income stream benefit compared to a superannuation lump sum benefit.

For superannuation income stream benefits, the proportions of the tax-free and taxable components in each benefit payment are determined only once, at the time the income stream commences. The proportion of the components remains constant, and the same proportioning rule applies to all subsequent benefits paid from that income stream.

For a superannuation lump sum benefit, the components are determined immediately before each benefit payment is made. Over time, the general proportioning rule for superannuation lump sums will result in the percentages of the tax-free component of each benefit progressively decreasing and the percentage of the taxable component progressively increasing.

The general proportioning rules outlined above will not apply if the regulations specify an alternative method for determining the components of the benefit.

Invalidity benefits paid under the DFRDB and MSB are superannuation lump sum payments, as determined by the *Douglas* decision, but had previously been treated as superannuation income stream benefits. The intent of new section 307-125.03 is to maintain the historical approach to how the proportions of tax-free and taxable components of invalidity benefits paid under the DFRDB and MSB are determined. This is achieved by prescribing an alternative proportioning methodology, which treats the invalidity benefit lump sum payment as if it were a superannuation income stream benefit.

For the purposes of paragraph 307-125(4)(a) of the ITAA 1997, section 307-125.03 provides an alternative method for determining the components of the invalidity pay or invalidity pension paid as a superannuation lump sum under the DFRDB and MSB, as mentioned in subparagraph 301-275(1)(b)(i) or (ii) in the ITAA 1997.

The alternative method provides that, when determining the components in accordance with subsection 307-125(1), (2) and (3) of the ITAA 1997, assume the invalidity benefit:

- is a superannuation income stream benefit; and
- the superannuation income stream commenced when the invalidity pay or invalidity pension commenced.

This approach means the proportioning rule will be applied only once, at the time the invalidity benefits commence to be paid, consistent with the treatment that applies to superannuation income stream benefits.

This outcome aligns with the Commissioner of Taxation's legislative instruments F2021L00901 (pre-1 July 2021 income years); F2022L00004 (2021/22 income year) and F2022L01347 (2022/23 income year).

Part 2—Capped defined benefit income streams and the transfer balance cap

Items 2 and 3: Section 294-130.01

The amendments in Part 2 are made for the purposes of subsection 294-130(2) of the ITAA 1997, which provides that a superannuation income stream is a capped defined benefit income stream (CDBIS) if the income stream is prescribed by the regulations.

A pension that is a CDBIS has a special value calculated that counts towards the recipient's transfer balance account and specific rules applying in relation to when a person who receives a CDBIS has an excess transfer balance. CDBIS pensions are taxed under the defined benefit income tax regime where an individual exceeds the defined benefit income cap for a financial year.

Items 2 and 3 amend section 294-130.01 of the ITAR 2021 to add a new subsection (7). The amendment prescribes a superannuation income stream as a CDBIS if it is a superannuation income stream because of the amendments made by paragraph 307-70.02(1)(ba) of Schedule 9 to the Bill. Amendments in Schedule 9 mean that that all pensions paid from defined benefit funds (other than invalidity benefits paid from the DFRDB and MSB schemes) will be superannuation income streams, with retrospective effect from 1 July 2007. In most cases, this is how those benefits would have been treated prior to the *Douglas* decision.

Applying the principles of the *Douglas* decision, many defined benefit pensions previously thought to be lifetime pensions are superannuation lump sum benefits. Consequently, those affected pensions would not have been superannuation income streams that could satisfy requirements as a CDBIS, potentially since 1 July 2017 when the framework in Division 294 of the ITAA 1997 was introduced. However, before the *Douglas* decision the managing funds of the affected pensions may have self-assessed and reported many of these pensions as a CDBIS, most likely as lifetime pensions covered in item 1 in the table of subsection 294-130(1) of the ITAA 1997.

Item 3 will cause those affected defined benefit pensions to automatically satisfy CDBIS requirements when their superannuation lump sum payments revert to a superannuation income stream upon enactment of Schedule 9 to the Bill. This means those affected pensions can be valued by valuation rules specific to CDBIS rather than valued using transfer balance cap rules in Subdivision 307-D of the ITAR 2021, which would result in a different value.

The effect of Part 4 of the Regulations will retrospectively deem the affected pensions to satisfy CDBIS requirements immediately before and after 1 April 2021 (see subsection 1000-4.02(2)). As this amendment would have retrospective operation, subsection 12(2) of the *Legislation Act 2003* will mean that the provision will not apply in relation to a person to the extent it would disadvantage the person. For example, if an individual is disadvantaged by having their defined benefit pension retrospectively treated as CDBIS, they will instead be entitled to have that pension treated as if were not a CDBIS.

There is some overlap between subsection (6) of section 294-130.01 of ITAR 2021 and the new subsection (7), which may both apply to some of the affected pensions. The outcome would be the same for these pensions regardless of whether subsection (6) or (7), or both, applies. That is, the relevant superannuation income stream would be a prescribed CDBIS.

Part 3—Cashing requirements

Superannuation Industry (Supervision) Regulations 1994

Item 4: After paragraph 6.21(2)(a)

Section 6.21 of the SISR sets out how a member benefit in a regulated superannuation fund must be paid out after the member dies. This requires that reversionary pensions are to be paid as superannuation income streams in retirement phase, and that superannuation lump sum benefits must be paid as one or two lump sums.

Item 4 is intended to prevent any unintended negative taxation outcomes for MSB reversionary pensions resulting from the *Douglas* decision.

Before the *Douglas* decision, MSB reversionary pensions satisfied payment standards in subsection 6.21(2) of the SISR because they were treated as a superannuation income stream in retirement phase (see paragraph 6.21(2)(b)). The *Douglas* decision resulted in the payments from MSB reversionary pensions being retrospectively considered superannuation lump sum payments. This causes the pension to not satisfy the payment standards in paragraph 6.21(2)(b) of SISR, potentially from 1 July 2017 when the requirement for pensions to be paid as superannuation income streams in retirement phase was first introduced.

Furthermore, they cannot meet the requirement of paragraph 6.21(2)(a) of the SISR as they are not lump sum payments for SISR purposes.

Item 4 ensures a MSB reversionary pension will satisfy the payment standards set out in subsection 6.21(2) of the SISR and enables the pension to be paid as series of superannuation lump sum payments.

This item refers to superannuation lump sum from pensions mentioned in paragraph 301-275(1)(b) of Schedule 9 to the Bill, which includes invalidity pay and invalidity pensions under the DFRDB and MSB schemes. However, in practice, the item will primarily apply to MSB reversionary pensions as DFRDB is an exempt public sector scheme.

Part 4—Application

Item 5: Part 1000-4—Transitional matters relating to the Treasury Laws Amendment (Military Superannuation Benefits) Regulations 2023

Item 5 inserts new Part 1000-4 into the ITAR 2021 to provide how the amendments made in Parts 1 and 2 of the Regulations are to be applied. These transitional arrangements operate in conjunction with the amendments made by Schedule 9 to the Bill which maintains that invalidity benefits under the MSB and DFRDB are superannuation lump sum payments while ensuring all other defined benefit pensions are to be treated as superannuation income streams for the purposes of section 307-70 of the ITAA 1997.

Section 1000-4.01 defines some terms for this purpose. The term ***old regulations*** means the *Income Tax Assessment Regulations 1997*. The term ***2021 commencement time*** is a reference to when the new ITAR 2021 commenced on 1 April 2021.

Subsection 1000-4.02(1) relates to the components of certain military superannuation benefits in Part 1 of the Regulations and will apply in relation to income years starting on or after 1 July 2023.

Subsections 1000-4.02(2) and (3) relate to the CDBIS and transfer balance cap in Part 2 of the Regulations.

Subsection 1000-4.02(2) means the amendments apply in relation to a superannuation income stream that commenced on or after 1 April 2021 when the ITAR 2021 commenced. The superannuation income stream relates to the defined benefit pension payments mentioned in paragraph 301-70.02(1)(ba) of Schedule 9 to the Bill. Therefore, the amendments made in Part 2 are retrospective in relation to those defined benefit pensions on and after 1 April 2021.

Subsection 1000-4.03 provides for the retrospective application of the superannuation income stream before 1 April 2021. In effect, the provision ensures those defined benefit pensions satisfy CDBIS requirements on and after 1 July 2017 when Division 294 and the CDBIS framework commenced.

Item 6: Part 1000-4—Transitional arrangements arising out of the *Treasury Laws Amendment (Military Superannuation Benefits) Regulations 2023*

Item 6 inserts new Division 14.33 into the SISR 1994 to provide transitional arrangements for matters in Part 3 of the Regulations and ensures MSB reversionary pension payments satisfy cashing requirements. In effect, the amendments in Part 3 will retrospectively apply to the prescribed superannuation lump sums paid on and after 1 July 2017.

Retrospective application in items 5 and 6

The transitional application arrangements prescribed for the Part 2 and Part 3 amendments purposely deal with historical and complex matters flowing from the *Douglas* decision, and the retrospective application of Schedule 9 to the Bill that made defined benefit pensions (except pensions under the DFRDB and MSB schemes) superannuation income streams for income years starting on or after 2007 (see paragraph 301-70.02(1)(ba) of Schedule 9 to the Bill).

The retrospective application prescribed in Part 4 is appropriate and necessary to mitigate adverse superannuation outcomes.

The retrospective application to the defined benefit pensions mentioned in paragraph 301-7.02(1)(ba) has direct bearing on the superannuation income stream status of those pensions for the purposes of CDBIS requirements in Division 294 of the ITAA 1997, which commenced 1 July 2017.

Part 2 is intended to mitigate potential adverse consequences arising from the *Douglas* decision resulting in some defined benefit pensions being considered lump sum payments and losing their CDBIS status, including their historical CDBIS treatment for past income years. The amendments in Part 2 ensure affected defined benefit pension payments will retrospectively satisfy CDBIS requirements and be treated for tax purposes in a like manner before the *Douglas* decision.

In relation to the Part 3 amendments, the *Douglas* decision resulted in the payments from MSB reversionary pensions to be retrospectively considered superannuation lump sum payments. Consequently, the MSB reversionary pensions did not satisfy the payment standards in paragraph 6.21(2)(b) of SISR, potentially from 1 July 2017 when the requirement for pensions to be paid as superannuation income streams in retirement phase was first introduced.

Furthermore, as discussed above, because the usual payment cycle for MSB reversionary pensions is fortnightly over the lifetime of the pension, the payment cycle as a superannuation lump sum did not meet the payment standard for lump sums prescribed in paragraph 6.21(2)(a) of the SISR, which only provides for a maximum of two lump sum payments.

The transitional arrangement provided in item 6 ensures a MSB reversionary pension retrospectively satisfied the payment standards set out in subsection 6.21(2) of the SISR as a series of lump sum payments.

Statement of Compatibility with Human Rights

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

Treasury Laws Amendment (Military Superannuation Benefits) Regulations 2023

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

The purpose of the *Treasury Laws Amendment (Military superannuation benefits) Regulations 2023* (the Regulations) is to make consequential amendments to tax and superannuation laws to provide rules and clarify tax treatment for certain superannuation defined benefits. These changes complement Schedule 9 of Treasury Laws Amendment (2022 Measures No. 4) Bill 2022 ('the Bill') introduced into Parliament on 23 November 2022.

These Regulations will not commence if the Bill does not receive the Royal Assent.

On 4 December 2020, the Full Federal Court decision in *Commissioner of Taxation v Douglas* [2020] FCAFC 220 (*Douglas*) determined that invalidity pension payments under the superannuation scheme established under the *Military Superannuation and Benefits Act 1991* (MSB) and invalidity pay under the *Defence Force Retirement and Death Benefits Act 1973* (DFRDB) (collectively referred to as invalidity benefits) commencing on or after 20 September 2007 were not superannuation income streams within the meaning of the ITAA 1997. This meant that the invalidity benefits were taxed as superannuation lump sum payments.

Schedule 9 to the Bill maintains that invalidity benefits under the MSB and DFRDB are superannuation lump sum payments while ensuring all other defined benefit pensions are to be treated as superannuation income streams for the purposes of section 307-70 of the ITAA 1997.

These Regulations amend the *Income Tax Assessment (1997 Act) Regulation 2021* (ITAR 2021) and the *Superannuation Industry (Supervision) Regulations 1994* (SISR) to make consequential amendments to some aspects of tax and superannuation law, including:

- the application of the proportioning rule to invalidity benefits under the DFRDB and MSB;
- treatment as a capped defined benefit income stream for benefits that are superannuation income streams because of Schedule 9 to the Bill; and
- payment standards for superannuation lump sum payments relating to reversionary pension benefits under the MSB.

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.