The Association of Superannuation Funds of Australia Limited
ABN 29 002 786 290
ASFA Secretariat
PO Box 1485, Sydney NSW 2001
p: 02 9264 9300 (1800 812 798 outside Sydney)
f: 02 9264 8824
w: www.superannuation.asn.au

asfa
the voice of super

2 September 2011

Andrew Allan
Australian Taxation Office
PO Box 900
Civic Square ACT 2608

Email: andrew.allan@ato.gov.au

Dear Mr Allan,

DRAFT TAXATION RULING TR 2011/D3
INCOME TAX: WHEN A SUPERANNUATION INCOME STREAM COMMENCES AND CEASES

The Association of Superannuation Funds of Australia (ASFA) would like to provide this submission in relation to Draft Taxation Ruling TR 2011/D3 - Income tax: when a superannuation income stream commences and ceases (Draft Ruling).

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. We focus on the issues that affect the entire superannuation industry. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

Summary of key comments on the Draft Ruling

ASFA contends that there are a number of key issues associated with the Draft Ruling. A summary of these key issues is discussed briefly below.

1. **Failure to comply with pension rules** - whether or not a superannuation income stream is being paid is not dependent on the pension rules being met in a particular year. Rather, it is a function of whether the rules of the superannuation fund meet the standards of subregulation (9A) of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regs) and do not permit capital to be added to the assets supporting the pension once the income stream has commenced to be paid.

2. **Commutation** - ASFA contends that a superannuation income stream does not cease upon receipt of a valid request from a member or a dependant beneficiary to fully commute their entitlements to future superannuation income stream benefits. Notwithstanding the receipt of a valid request to fully commute an income stream benefit, the superannuation fund continues to have a liability to provide a superannuation income stream until such time as the commutation is effected and a superannuation lump sum paid.

That is, a superannuation income stream ceases upon the actual (full) commutation taking place. Until the commutation occurs, the member (or dependent beneficiary) retains an entitlement to a superannuation income stream – with the ability to commute, which has been exercised but not yet effected.

3. **Death** - we do not agree that a superannuation income stream ceases when there is no longer a member who is entitled, or a dependent beneficiary of a member who is automatically entitled, to be paid a superannuation income stream benefit from a superannuation interest that supports a superannuation income stream. On the death of a member a superannuation income stream still exists, pending determination of the beneficiaries who are to receive some or all of the superannuation interest and the form in which it is to be received.

   In general terms, once an income stream commences, ASFA contends that the income stream continues to exist as an income stream under the SIS Regs until such time as it is commuted to a lump sum or it ceases to exist because the amount in the relevant interest has been completely exhausted.

As an addendum to our submission, Appendix 1 contains our detailed comments on the various paragraphs in the Draft Ruling from a technical perspective, which support our positions as outlined above.

Appendix 2 contains a discussion on some of the practical implications we believe are associated with the Draft Ruling and some suggested legislative amendments.

We thank you for providing us the opportunity to make this submission and trust that the information contained in this submission is of value. We would be happy to provide you with further information or to discuss our submission with you.

* * * * * *

If you have any queries or comments regarding the contents of our submission, please contact either Fiona Galbraith, Senior Policy Adviser on (03) 9225 4021 or Tony Keir, Senior Policy Adviser (02) 8079 0815 or myself on (02) 8079 0858.

Yours sincerely

D. Graus

David Graus
General Manager, Policy and Industry Practice

Appendix 1

Specific comments on Draft Taxation Ruling TR 2011/D3

(Note: References to "paragraph" below are to the respective paragraph of the Draft Ruling.)

What is an 'income stream' and 'superannuation income stream?'

Paragraph 4 states that: -

> *"4. The phrase 'income stream' in the definition of 'superannuation income stream' requires that there is a series of periodic payments that relate to each other. That series of periodic payments that relate to each other is a superannuation income stream (account based pension) if the requirements of subregulation 1.06(1) of the SISR 1994 are met. It is these periodic payments that are superannuation income stream benefits".*

It is important to confine the concept of there needing to be "a series of periodic payments that relate to each other" to the "*concept*" of what is an "income stream" but stop short of requiring a series of periodic payments to be made in practice.

There may be a range of circumstances whereby a series of periodic payments are not made but nevertheless an income stream should be considered to exist. Examples of these circumstances include where the pensioner dies or commutes the pension in the first year, prior to a pension payment having been made. While one pro-rata minimum pension payment will need to be made prior to the commutation of the pension, a "series of periodic payments that relate to each other" will never be made.

When a superannuation income stream commences

Paragraph 8 states that: -

> *"8. A superannuation income stream commences on the first day of the period to which the first payment of the superannuation income stream relates".*

Under SIS regulation 1.06 superannuation fund rules are not prevented from meeting the payment standards by reason only that the rules provide that, if the commencement day of the pension is on or after 1 June in a financial year, no payment is required to be made for that financial year. It should be clarified that – notwithstanding that the first payment is made after 30 June – the period to which the payment relates is the period commencing on the commencement day and not the period commencing on 1 July, the beginning of the financial year in which the payment was made.

When a superannuation income stream ceases

At paragraph 11 it is stated that: -

> *"11. Once a superannuation income stream commences it is payable (that is, there is an obligation to pay superannuation income stream benefits under that superannuation income stream) until such time as that superannuation income stream ceases".*

The cessation of an income stream is a question of fact, i.e. the payments have ceased being made, notwithstanding that a legal obligation to continue to make the payments may still exist. Given this, it may be preferable to state that a superannuation income stream is payable until such time as the obligation to pay, or entitlement to receive, no longer exists.

Regulation 307-200.05 of the *Income Tax Assessment Regulations 1997* (Income Tax Regs) states as follows: -

> "*307 – 200.05 If a superannuation income stream commences, an amount that supports the superannuation income stream is always to be treated as a separate superannuation interest".*

We submit that the effect of regulation 307-200.05 of the Income Tax Regs is that, once an income stream commences, it will continue to exist until such time as it is commuted to a lump sum or it ceases to exist because the amount in the relevant interest has been exhausted.

At paragraph 79 it is stated that: -

> "79. *The Commissioner considers that the operation of subregulation 307-200.05 of the ITAR 1997 is directed at ensuring that a separate superannuation interest is identified at the time a superannuation income stream commences".*

We submit that the use of the word 'always' connotes that – once a superannuation income stream has been commenced – the amount which supports it is **always** a separate superannuation interest because it relates to a superannuation income stream (as opposed to an accumulation amount).

Indeed, if this interpretation is adopted, the use of the word 'always' when identifying "a separate superannuation interest … at the time a superannuation income stream commences" could be considered otiose – it would have been sufficient to have stated

> "*If a superannuation income stream commences, an amount that supports the superannuation income stream is to be treated as a separate superannuation interest*".

Paragraph 79 goes on to state that: -

> *"It does not by its terms deem the amount supporting the superannuation income stream to be the superannuation income stream".*

The amount supporting the superannuation income stream is a separate superannuation interest and in practice is the account balance from which the superannuation income stream benefit payments are made.

Paragraph 79 concludes that: -

> *"Nor does it deem all payments from the interest, including those made after the superannuation income stream ceases, to be superannuation income stream benefits".*

All payments from the interest – other than post commutation, in which case the payment will be a superannuation lump sum benefit – will be superannuation income stream benefits. Once a superannuation income stream benefit commences it only ceases on commutation or exhaustion of the account.

Other than providing for commutation or exhaustion of the account balance, a superannuation fund's trust deed cannot determine when a superannuation income stream ceases to be payable for superannuation and taxation law purposes.

The SIS Regs state that, provided the rules of a superannuation fund meet certain requirements, the resulting income stream is considered to be a superannuation income stream. Once a superannuation income stream commences it is always a superannuation income stream until commutation or exhaustion of the account.

Failure to comply with the pension rules and the payment standards of the SIS Regs

It is stated at paragraph 16 that: -

> *"16. A superannuation income stream ceases for income tax purposes if any of the requirements of the SISR 1994 relating to the payment of the superannuation income stream are not met in an income year. This is the case even if a member remains entitled to receive a payment from the superannuation fund in relation to the purported superannuation income stream under the terms of the superannuation trust deed, or under general trust law concepts".*

It should be noted in this context that, in regulation 995 - 1.01 of the Income Tax Regs a ***superannuation income stream*** is defined as being: -

"(a) an income stream **that is taken to be**:
(i) …; or
(ii) a pension **for the purposes of the SIS Act** in accordance with subregulation 1.06 (1) of the SIS Regulations; or
(iii) …; or
(b) an income stream that:
(i) **is a**n annuity or **pension within the meaning of the SIS** Act; **and**
(ii) commenced before 20 September 2007" (emphasis added).

In other words: -

- under sub-regulation 995 - 1.01(a) of the Income Tax Regs - a superannuation income stream is an income stream that, in accordance with subregulation 1.06 of the SIS Regs, is considered or deemed, for the purposes of the SIS Act, to be a pension;

- under sub-regulation 995 - 1.01(b) of the Income Tax Regs – a superannuation income stream is any income stream, which is a pension within the meaning of the SIS Act, notwithstanding that it may not be paid in accordance with subregulation 1.06, provided it commenced before 20 September 2007.

A superannuation income stream, per se, does not need to meet the requirements of a pension in subregulation 1.06(1) of the SIS Regs.

It is important to note in this context that what sub-regulation 1.06(1) of the SIS Regs in fact requires is that: -

"1.06(1) A benefit is taken to be a pension for the purposes of the Act if:
(a) it is provided **<u>under rules of a superannuation fund</u>** that:
(i) **meet the standards** of subregulation (9A); **and**
(ii) **do not permit the capital** supporting the pension **to be added to** by way of contribution or rollover after the pension has commenced".

In other words, if **the rules** meet the standards of subregulation (9A) and do not permit capital to be added then the benefit is a pension for the purposes of the SIS Act.

Similarly, sub-regulation (9A) provides as follows: -

> *"(9A) **<u>Rules</u>** for the provision of a benefit (the **pension**) **meet the standards of this subregulation <u>if the rules ensure that</u>** payment of the pension is made at least annually, **<u>and also ensure that</u>** ….."*

Again – the determining factor as to whether, under subparagraph 1.06(1)(a)(i) of the SIS Regs, "*a benefit is taken to be a pension for the purposes of the Act*" is "*if … it is provided under **rules** of a superannuation fund **that** … **meet the standards** of subregulation (9A)*" (emphasis added). Subregulation (9A) provides that ***"[r]ules** for the provision of a benefit (the **pension**) **meet the standards** of this subregulation **if the rules ensure that** payment of the pension is made at least annually, **and also ensure that …..".***

Furthermore – in the case of rules to which paragraph (9A) (a) applies – the rules must also meet the standards of regulation 1.07D with respect to the commutation of the income stream.

At paragraph 17 it is stated that: -

> *"17. Further, the trustee is taken **not** to have been paying a superannuation income stream at any time during the income year in which the relevant requirements are not met".*

It is unclear as to the basis upon which this statement is made. An income stream is a superannuation stream at a particular point in time if the rules of the fund, at that point in time, meet the standards of subregulation (9A) and do not permit capital to be added.

Similarly, it is stated at paragraph 18 that: -

> *"18. If the requirements are again met in the following income year this results in the commencement of a new superannuation income stream".*

Again, whether a superannuation income stream is being paid is not a question of whether the requirements have been met in a particular financial year, it is a function of whether the rules meet the standards of subregulation (9A) and do not permit capital to be added. If the requirements are not met in one financial year, but are met in the following income year, this does not equate to a new income stream having been commenced.

Indeed, paragraph 47 of the Draft Ruling itself states as follows: -

> *"47. As the term 'superannuation income stream benefit' is separately defined, the Commissioner considers that a superannuation income stream refers to the **particular arrangement or product**, as defined by its rules, the agreement between the fund and the member and any other relevant documentation, **rather than the particular payments made** under that arrangement or product".*

This appears to support the interpretation that whether a superannuation income stream exists is a function of the "particular arrangement or product, as defined by its rules, the agreement between the fund and the member and any other relevant documentation" and **not** "the particular payments made under that arrangement or product".

It is stated at paragraph 81 that: -

> *"81. … a superannuation income stream, as relevant to this draft Ruling, must meet the requirements of a pension in 1.06(1) of the SISR 1994. The pension standards contained in the SISR 1994 also do not explicitly prescribe when a pension ceases for regulatory purposes".*

As stated previously, a superannuation income stream, per se, does not need to meet the requirements of a pension in subregulation 1.06(1) of the SIS Regs.

It is stated at paragraph 87 that: -

> *"87. The word 'ensure' is given the meaning in the Macquarie Dictionary as 'to make sure or certain to come, occur, etc'. As the rules of the superannuation fund must 'ensure' that the standards are met it is not enough for the rules of the superannuation fund to simply include a reference to, or reproduce the terms of, those standards. Rather, it is the Commissioner's view that the rules must be met, or given effect to, in practice".*

A "rule", per se, cannot ensure that a particular standard is met in practice.

Had the Parliament intended that an income stream only be considered to be a superannuation pension if it met specified standards in practice, then the legislation would have been drafted to this effect – i.e. "an income stream is a superannuation pension which [in practice does] …..".

Instead, the SIS Regs were drafted such that the definition of a superannuation pension is conceptual and is a function of the rules of the superannuation fund. If a superannuation income stream does not comply with one or more of the prescribed standards, then it does not cease to be a superannuation income stream. Instead, it is simply a superannuation income stream which does not comply with the pension standards.

It is stated at paragraph 88 that: -

> *"88. If a purported superannuation income stream fails to meet these requirements in an income year, the superannuation income stream will be taken to have ceased at the start of that income year for income tax purposes. Therefore, from that time the interest is no longer supporting a superannuation income stream and the benefits paid from that interest are not superannuation income stream benefits".*

If a purported superannuation income stream fails to meet these requirements in an income year, the superannuation income stream will not comply but the superannuation income stream will still exist.

It is important to note in this context that the failure to meet the payment standards may have been minor, inadvertent or possibly not the fault of the member but of the trustee or administrator. Deeming a pension to have ceased for the entire financial year in which the breach of the payment standards occurred, irrespective of how small or inadvertent the breach, could result in tax consequences for the member which are out of proportion to the quantum of the breach. ASFA contends that this is an inappropriate and inequitable outcome for the member.

Commutation of the income stream

Paragraph 20 states that: -

> *"20. A superannuation income stream ceases upon receipt of a valid request from a member or a dependent beneficiary to fully commute their entitlements to future superannuation income stream benefits for an entitlement to a lump sum".*

ASFA contends that a superannuation income stream does not cease upon receipt of a valid request from a member or a dependant beneficiary to fully commute their entitlements to future superannuation income stream benefits. Rather, a superannuation income stream ceases upon the actual commutation taking place – in order to have a commutation you must have an income stream immediately prior to the commutation taking place. You cannot commute an accumulation benefit – it is simply paid out as a lump sum.

Until the commutation occurs, the member (or dependant beneficiary) retains an entitlement to a superannuation income stream – all they have done is give instructions for that (still extant) income stream to be commuted. Until the income stream is actually commuted there remains an entitlement to an income stream (with an ability to commute, which has been exercised but not yet effected).

Furthermore, under the terms of the Trust Deed, and depending on the frequency of pension payments, there could, for example, be an obligation for the provider to pay one or more income stream payments prior to the commutation taking place.

Indeed, under paragraph 1.07A(2)(c) of the SIS Regs, the rules must meet a standard which ensures that the pension cannot be commuted, in whole or in part, unless the pension has paid, in the financial year in which the commutation is to take place, at least the minimum amount under subregulation (3). Often this can necessitate the payment of at least one final income stream payment prior to the commutation being effected and the lump sum being paid out.

Paragraph 95 cites Deputy President Forgie in *Re Hammerton and Comcare Australia [1995]* AATA 63 (Hammerton) at paragraphs 47 and 48 as follows:

> *"It is implicit in this case that the commutation has had the effect of changing the essential nature of periodical pension payments into something else. That seems to me to accord with what happens when a single payment takes the place of an on-going periodic payment of pension. It also accords with the normal meaning of 'commute' i.e. 'to exchange for another or something else ... interchange 2. to change (one kind of payment) into or for another as by substitution ... to make a collective payment, esp. of a reduced amount, as an equivalent for a number of payments...' (Macquarie Dictionary).*
>
> *It follows that Mr Hammerton has received a lump sum benefit under a superannuation scheme as well as being in receipt of ongoing pension payments".*

Based on Deputy President Forgie's statement, it follows that in order for periodical pension payments to be changed into something else (i.e. a lump sum benefit), the periodical pension payments need to exist immediately prior to the change (to a lump sum benefit) occurring. We contend that it cannot be otherwise.

Paragraph 98 states that Member Allen in *Cooper and Commissioner of Taxation* [2003] AATA 296 held, at paragraph 26, that "the relevant payment was not in **substitution** or **exchange** for any right Mr Cooper had" (emphasis added). Again – you cannot substitute or exchange a lump sum for a pension unless the pension exists at the point of exchange or substitution.

Member Allen states that "In my opinion a commutation of a superannuation pension requires a beneficiary to make a conscious decision to **exchange future entitlements**, or a mixture of past and future entitlements, **for some other form of benefit** (usually a lump sum) as permitted by the scheme" (emphasis added). Again – there needs to be future entitlements to superannuation income stream benefits extant, at the point of commutation, in order for there to be a commutation to a lump sum.

It is stated at paragraph 100 that: -

> *"100. Therefore, and consistent with the ordinary meaning of commutation, the Commissioner considers that a member has commuted their superannuation income stream if, consistent with the superannuation fund rules and the relevant requirements of the SISR 1994, they consciously exercise their right to exchange some or all of their entitlement to receive future, periodic (including annual) superannuation income stream benefits for an entitlement to be paid a lump sum".*

We agree that, once a lump sum has been paid, the member should be considered to have commuted their superannuation income stream as the payment of the lump sum occurred as a result of the member's commutation. This does not mean to say that the superannuation income stream ceased to exist at the point when the decision to commute was communicated to the trustee – all this means is that, once the lump sum has been paid, the correct characterisation of that lump sum is that it resulted from the commutation of an income stream.
It is stated at paragraph 101 that: -

> *"101. Whether a commutation has been undertaken is a question of fact, evidenced by the member complying with the conditions attaching to a commutation set out in the superannuation fund rules and/or the agreement between the member and the superannuation fund under which the superannuation income stream is provided".*

We agree that whether a commutation has been undertaken is a question of fact. The fact of a commutation is the payment of a lump sum to the member representing an amount which, under the rules of the fund, is equivalent to the value of the member's entitlement to receive future superannuation income stream benefits.

It is stated at paragraph 102 that: -

> *"102. It also follows from this view that, before a commutation can be undertaken, the superannuation fund rules and/or the agreement between the member and the superannuation fund, under which the income stream is provided, must clearly set out in advance the total amount of, and the total number of, periodic superannuation income stream benefits to be made to the member each year".*

This is not necessary with respect to an account based pension, where it would be impossible for the superannuation funds to set out in advance the total amount of, and total number of, periodic superannuation income stream benefits to be made to the member each year.

With respect to an account based pension, the value of the periodic superannuation income stream benefits is determined by the change in value (through earnings) of the account and the member's decisions, having regard to the minimum payment standards, with respect to the amount and frequency of payments.

Commutation of an account based pension is generally straightforward. After having taken into account the requirements of subregulation 1.07D(1)(d) of the SIS Regs, whereby the pension must pay, in the financial year in which the commutation takes place, at least the minimum amount prescribed by subregulation (2), and any additional requirements under the fund rules – the remaining account balance is paid out as a lump sum.

It is stated at paragraph 103 that: -

> *"103 … The amount and number of payments may be altered (subject to superannuation fund rules and the SISR 1994 requirements) but any such alteration will not of itself evidence a commutation having been made".*

An alteration to the amount and number of payments will not constitute a commutation per se – it simply will be an alteration to the pension payments. A commutation is not an alteration to the amount or number of pension payments – it is the exercising of an entitlement to convert some or all of the right to receive an income stream to one or more lump sum payments.

It is stated at paragraph 104 that: -

> *"104. The Commissioner considers that a commutation is not capable of being made if the rules or the agreement, under which the superannuation income stream is provided, provides for no more than an unspecified amount to be paid each year at an unspecified time in an unspecified number of payments. This is because in this case it is not possible to distinguish between a superannuation income stream benefit and a payment made as a result of the commutation of the superannuation income stream".*

In order for there to be a superannuation income stream then, in any given financial year, there must be an agreement for one or more payments of an amount or amounts, which are either agreed expressly or by reference to a formula or other criteria, to be made to the member. It is this agreement which creates a superannuation income stream benefit.

A commutation must be agreed between the member and the trustee to be a commutation.

It is stated at paragraph 105 that: -

> *"105. Once a valid request to fully commute a superannuation income stream is received by the trustee of the superannuation fund, the superannuation fund no longer has a liability to provide a superannuation income stream benefit, as this has been exchanged for the liability to provide a lump sum payment. The superannuation income stream therefore ceases at this time".*

Notwithstanding the receipt of a valid request to fully commute an income stream benefit, the superannuation fund continues to have a liability to provide a superannuation income stream until such time as the commutation is effected, by a superannuation lump sum having been paid. If nothing else, there may be an obligation to make one or more superannuation income stream benefit payments to the member, depending on the timing of receipt of the request to commute and when the commutation can be effected.

Furthermore, under subregulation 1.07A (2)(c) of the SIS Regs, there may be an obligation for at least one final income stream payment to be made in order to ensure that at least the minimum amount under subregulation (3) has been paid as a superannuation income stream benefit prior to the commutation being effected and the lump sum being paid.

It is stated at paragraph 106 that: -

> *"106. As the payment resulting from the full commutation is made after the cessation of the superannuation income stream, it is a superannuation lump sum for income tax purposes and cannot count towards the minimum annual payment requirement set out in paragraph 1.06(9A)(a) of the SISR 1994*".

A payment resulting from the full commutation is - **by definition** - always a superannuation lump. This is not because the superannuation income stream has ceased but because, as stated by Deputy President Forgie in Hammerton at paragraph 47, "the commutation has had the effect of **changing** the essential nature of **periodical pension payments** into **something else**. That seems to me to accord with what happens when a **single payment** takes the place of an **on-going periodic payment of pension".**

The very definition of commutation means that the resulting payment is a lump sum. This is evidenced in paragraph 107 which states that "*A partial commutation payment is a superannuation lump sum for income tax purposes and a lump sum for the purposes of the SISR 1994".*

This is stated to be the case notwithstanding that paragraph 107 also acknowledges that "*As there is still an obligation to continue to pay superannuation income stream benefits (either in that income year or later income years) a partial commutation does not result in the cessation of the superannuation income stream".*

Accordingly, whether or not a superannuation income stream ceases is irrelevant to whether a commutation payment is a superannuation lump sum for income tax purposes and a lump sum for the purposes of the SIS Regs. An amount paid as a result of a commutation will always be a lump sum.

Partial commutation

It is stated at paragraph 108 that: -

> *"108. All payments made from a superannuation interest supporting a superannuation income stream count towards the minimum payment requirements in subregulation 1.06(9A) of the SISR 1994, including a payment made as a result of a partial commutation, unless it is rolled over within the superannuation system. This would be the case regardless of whether the partial commutation payment is made in cash or in specie".*

It is ASFA's understanding that a payment made as a result of a partial commutation, as it is a superannuation lump sum (as stated in paragraph 107 of the Draft Ruling), would **not** count towards the minimum payment requirements in subregulation 1.06(A) of the SIS Regs.

In fact, paragraph 1.07A(2)(c) of the SIS Regs states that a pension cannot be commuted, in whole or in part, unless the pension has paid, in the financial year in which the commutation is to take place, at least the minimum amount under subregulation (3). It would not be necessary to specify this with respect to partial commutations if the payment made as a result of a partial commutation counted towards the minimum payment requirements.

Death of the member

Paragraph 24 states that: -

> *"24. A superannuation income stream ceases as soon as the member in receipt of the superannuation income stream dies, unless a dependent beneficiary of the deceased is automatically entitled under the superannuation fund's deed, or the rules of the superannuation income stream, to receive an income stream on the death of the member".*

We consider that a pension does not cease by virtue of there no longer being a member who is entitled, or a dependent beneficiary of a member who is automatically entitled, to be paid a superannuation income stream benefit from a superannuation interest that supports a superannuation income stream.

There is an argument that, on the death of a member, a superannuation income stream still exists, depending on the terms of the trust deed. It is extremely likely that a final pension payment will need to be made after the date of death, representing the pro-rata pension payment liability which had accrued between the last pension payment and the date of death.

In any event the pension will still be on foot until at least the last pension payment is made.

Once the beneficiary or beneficiaries have been determined this can result in a total or partial commutation of the pension to pay a lump sum, a total or partial commutation of the pension to commence another income stream or a total or partial continuation of the same pension.

It is important to note that with APRA regulated funds, and sometimes even with some SMSFs, the trustee may not be aware of the death of the pensioner until some time after it has occurred. On occasions this may occur after year end, and even after the accounts have been finalised and audited and the tax return for the previous year has been submitted.

It should be noted that sub-section 307(3) provides as follows: -

> *"(3) A superannuation benefit is also a* ***superannuation member benefit*** *if:*
>
> *(a) the superannuation benefit arises from the commutation of a superannuation income stream; and*
>
> *(b) it would be a superannuation death benefit apart from this subsection; and*
>
> *(c) the benefit is paid after the latest of the following:*
>
> *(i) 6 months after the death of the deceased person;*
>
> *(ii) 3 months after the grant of probate of that deceased person's will or letters of administration of that deceased person's estate;*
>
> *(iii) if the payment of the benefit is delayed because of legal action about entitlement to the benefit—6 months after the legal action ceases;*
>
> *(iv) if the payment of the benefit is delayed because of reasonable delays in the process of identifying and making initial contact with potential recipients of the benefit - 6 months after that process is completed".*

This enables death benefits whose payment is delayed to be able to be paid tax free.

Paragraph 109 states as follows: -

> *"109. When a member dies they no longer have an entitlement to receive superannuation income stream benefits".*

While this may be the case, this does not in and of itself stop the account from being an account which supports an account based pension.

If there is no entitlement for a superannuation income stream to automatically transfer to a beneficiary on the death of a member the superannuation income stream remains on foot until such time as the trustee determines that it is necessary to commute to a lump sum in order to pay the benefit. Until such time as the potential beneficiaries are determined and their dependency status ascertained it is impossible for a trustee to know to whom, and in what form, a death benefit is going to be paid. Until the income stream is commuted to a superannuation lump sum (if necessary) it remains a superannuation income stream.

Sub-section 295-385(3) defines 'segregated current pension assets' as follows: -

> *"(3) Assets of a complying superannuation fund are* ***segregated current pension assets*** *at a time if:*
>
> *(a) the assets are invested, held in reserve or otherwise dealt with at that time solely to enable the fund to discharge all or part of its* ***liabilities*** *(contingent or not)* ***in respect of*** *superannuation income stream benefits* ***that are payable by the fund at that time****" (emphasis added).*

We submit that a benefit payable as a result of the death of a pensioner and the commutation of their pension is one of the fund's "**liabilities** ... **in respect of**" the superannuation income stream and, accordingly, the underlying assets are segregated current pension assets and remain so until the death benefit is paid.

Had the legislation intended to confine the concept of ‘segregated current pension asset’ to the payment of the superannuation income stream benefits alone it could have been drafted to state that assets are segregated current pension assets if they are invested “to enable the fund to pay [or finance or fund] superannuation income stream benefits”.

The SIS Regs provide for the residual capital value of some pensions to be a particular amount, while account based pensions provide for the balance of the account to be payable. In any event , these amounts are liabilities in respect of the pension, payable in the event of the death of the pensioner to one or more beneficiaries.

Date of effect

When the final Ruling is issued, it is proposed to apply from 1 July 2007. We appreciate that the nature of a tax ruling is to state the interpretation and application of the law as it currently stands, that income tax assessments can only be reviewed for a period of four years after they are made, and that changes to the superannuation tax laws were made with effect from 1 July 2007. As such, this would appear to be the logical date of effect.

Having said that, trustees of superannuation funds would experience considerable practical difficulties in complying with the Ruling if it were to be finalised in the same terms as the Draft Ruling. This is especially the case if it were to have retrospective effect to 1 July 2007.

The ATO interpretation as outlined in the Draft Ruling differs significantly from that adopted by virtually all trustees of superannuation funds and other pension providers in their administration of pension products.

Accordingly, if the Ruling were to be so finalised, we submit that the practical date of effect should be 1 July 2013 and that transitional relief should be granted from 1 July 2007 until 30 June 2103 to enable superannuation funds to effect the system and process changes necessary to comply.

Further to this, if the Ruling were to be finalised in the same terms as the Draft Ruling, we submit that a number of changes to the legislation should be contemplated to more equitably and effectively achieve the intended policy outcomes. To this end, ASFA respectfully recommends the ATO work closely with Treasury on this issue as it would be worthwhile ensuring regulatory consistency with government policy and that any legislative changes which may be necessary are considered in concert with the finalisation of the Ruling and the granting of transitional relief.

Practical issues and possible legislative changes

Some of the practical issues associated with administering pensions in accordance with the Draft Ruling, and some suggestions as to possible legislative amendments which could give effect to the government’s policy imperatives, have been outlined in Appendix 2.

Appendix 2

Practical implications, and suggested legislative amendments

1. Practical issues

A number of practical difficulties flow from the effectively retrospective nature of the cessation of pension – especially in circumstances where the trustee has subsequently identified a failure to comply with the pension rules or payment standards or been notified of the death of the member. This in turn will create additional compliance costs for trustees of superannuation funds, auditors, tax agents and the ATO itself.

Furthermore, some of our members have indicated that when some funds move a member and assets to pension phase they do not necessarily retain all of the historical information with respect to tax, as the common understanding within the industry was that the assets and income would no longer be subject to tax. To the extent that this is the case this would pose significant issues with respect to determining the capital gains tax (CGT) payable on disposing of the assets.

A) Retrospective tax liability on funds with respect to past pensioners

The retrospective nature of the Draft Ruling means that additional tax liabilities will be incurred by funds which realised assets to fund the commutation of an income stream in the event of death or roll-over.

As the trustee would have considered that the assets were segregated current pension assets the trustee would have made no provision for tax by withholding an amount from the benefit payment. In the event that it were considered that tax were now payable, as the pensioner is no longer a member of the fund the trustee would not be in a position to recoup the tax from the member.

B) Actuarial certificates

Deeming a pension to end prior to commutation and payment may well necessitate the expense and inconvenience of obtaining actuarial certification regarding the tax liability with respect to assets which were previously segregated pension assets to determine which assets, affected by the pension cessation, may be subject to CGT on realisation or transfer.

C) Multiple amendments to tax return data

There will be a number of circumstances which will cause the trustee of the superannuation fund to have to submit multiple amendments to tax return data.

In particular, the fund may not be informed of the pensioner's death for some time after the event. There could be additional delays as the trustee determines whether a reversionary beneficiary is still alive and establishes any necessary proof of identity. It is quite possible that these delays could extend over the period during which the fund lodges its tax return.

This could lead to the trustee needing to obtain a revised or amended actuary's certificate and in any event will necessitate the lodgement of an amended tax return. This is not to say that the process will necessarily end there, as the trustee may find out later still that a further pensioner has died within the same period and therefore a further amendment will be needed.

D) Disproportionate consequences for small breach of payment standards

Many instances of failure to meet the payment standards may be minor, inadvertent or not the fault of the member at all. Deeming a pension to have ceased for the entire financial year in which a breach of the payment standards occurred, irrespective of how small or inadvertent the underpayment may have been, could result in tax consequences for the member which are out of all proportion to the quantum of the breach. This is not good public policy.

E) Impact on Centrelink entitlements

A specific example of disproportionate consequences is the possible loss of Centrelink benefits. While we appreciate that the Draft Ruling is primarily focussed on account based pensions it is stated at paragraph 3 that: -

> *"3. A product that satisfies [the above] provisions is referred to as an 'account based pension' or a superannuation income stream in this draft Ruling. However, the principles discussed in this draft Ruling will typically apply to other pension types payable under the SISR 1994".*

There is a possibility that a minor or inadvertent error, or even one which was not the fault of the member, could result in a lifetime pension being deemed to have ceased with retrospective effect. This could result in members irretrievably, and permanently, losing their entitlement to an assets test exemption – possibly as a result of an administrator's error. This is a consequence – incapable of being rectified - out of all proportion to the breach which may have occurred.

F) Acquiring and realising investments

There are a number of difficulties for trustees in not knowing - until sometime after the event - that what the trustee believed to be a pension payment was in fact not a pension payment.

One example of such a issue is where a trustee may have sold an asset or purchased one assuming that the income from those transactions would be exempt from tax. The trustee quite possibly may not have pursued that particular course of action had they known that, subsequently, the pension would be deemed to have ceased.

It is possible that the fund will not know for a considerable period of time, possibly the whole of the subsequent year, whether the pension has been considered to have recommenced. This will impact on a number of functions of the fund.

Accordingly, this means that trustees will always be susceptible to what is shaping up to be an unacceptable level of retrospectivity in their usual daily business.

G) Inequities between funds and inefficient behaviours

If the Ruling were to be finalised in these terms, this would result in funds with liquid assets realising and acquiring assets in a legitimate attempt to minimise CGT, whereas funds with illiquid assets would be unable to adopt this strategy. Not only would this produce inequities between funds, it would result in inefficient and costly investment and trading behaviours within those fund with liquid assets.

H) Imposition of penalties by the ATO

The retrospective nature of a pension ceasing – especially in circumstances where it is subsequently identified that the pension failed to comply with the pension rules or payment standards – raises the question as to whether trustees will be penalised for not withholding an appropriate amount of tax? Given that the withholding tax, if any, was calculated in the belief that the trustee was making a pension payment, only to have it deemed later to have been a lump sum, it would appear inequitable to subject the trustee to a withholding tax penalty.

2. Suggested legislative amendments

A) Failure to comply with the payment standards of the SIS Regs

In the event that the pension fails to meet the payment standards, say by failing to pay the minimum amount in a given financial year, it would be preferable if such a breach were met with a direct administrative or tax penalty, as opposed to determining that the pension had ceased with effect from the beginning of the financial year. A direct administrative or tax penalty would not only be equitable, in that the quantum could be commensurate with the "harm" that such a breach represented, it would also be significantly more efficient to administer for both the superannuation fund and the ATO.

Granting the ATO power to impose direct penalties would also have the benefit of enabling the ATO to exercise discretion not to impose a penalty in circumstances where the breach was minor, inadvertent or was not the fault of the member.

B) Commutation of the income stream

There would be little, if any, harm resulting from adopting a policy position that a superannuation income stream was considered to continue until commutation to an income stream.

Generally there would only be a period of some days to weeks between when a request for commutation was received and when it was actioned, in the absence of any issues with respect to realising underlying investments.

In an arm's length fund there is little commercial incentive to unduly delay fulfilling a member's request to commute, as to do so would run the risk of incurring reputational damage. In an SMSF the member trustee has complete control over the timing of making the commutation request.

Accordingly we submit that, if necessary, the legislation be amended to confirm that a pension continues until it is commuted by being paid as a lump sum.

C) Death

If there is any suggestion or concern that, in the event of the death of a pensioner, there may be undue delay in paying out the death benefit we submit that one possible alternative may be for the legislation to specify a period of time, say six months, during which assets can be considered to be segregated current pension assets.

For non reversionary pensions in an SMSF the period could commence when one or more trustees first become aware of the death.

In the case of a non-reversionary pension in an APRA regulated fund, the commencement of the period would be a function of whether the ‘claim-staking period’ revealed any dependant beneficiaries who may be eligible for a death benefit pension (‘eligible dependant beneficiaries’): -

- if there were no eligible dependant beneficiaries - the period could commence after the end of the ‘claim-staking’ process had been completed and the pool of potential beneficiaries determined;
- where one or more eligible dependant beneficiaries had been identified - the period would commence once the final, non reviewable, trustee decision as to the beneficiaries and proportions had been made: -
    - to the extent that there were beneficiaries who were not eligible to receive a pension – the trustee would have a period in which to partially commute the pension to pay one or more lump sums to those beneficiaries;
    - the remaining pension would stay in place until such time as the eligible dependant beneficiaries indicated whether they wished to receive a pension or a lump sum. If the latter, the fund would have a period in which to commute the remaining pension to a lump sum.

There would need to be consultation with industry as to what would constitute a suitable period for the assets to remain segregated current pension assets and precisely when such periods would commence, having particular regard to the claim-staking and appeals process with respect to the payment of death benefits.