15 October 2024

Ms Usha Narain
Assistant Commissioner, Superannuation and Employer Obligations
Australian Taxation Office
GPO Box 9845
Canberra, ACT 2600

Email: Usha.Narain@ato.gov.au

Dear Ms Narain,

TR 2013/5A1 - Addendum
Income tax: when a superannuation income stream commences and ceases

Chartered Accountants Australia and New Zealand, CPA Australia, Institute of Financial Professionals Australia, Institute of Public Accountants, and the SMSF Association (together the 'Joint Bodies') welcomes the opportunity to provide feedback on the recent update to *TR 2013/5 Income tax: when a superannuation income stream commences and ceases* (the Ruling), published 26 June 2024.

With around 35 per cent of the current SMSF population in retirement phase (and a further 10 per cent transitioning to retirement), the number of taxpayers affected by this Ruling are significant.

We recognise and welcome the amendments made to incorporate legislative amendments flowing from the introduction of the transfer balance cap regime. The amendments also clarify the application of this ruling to successor fund transfers and remove practical compliance approaches that are no longer current.

However, it should not be the responsibility of taxpayers to bear the consequences of the Commissioner's delays in updating guidance to reflect new law and practices. At a minimum, the Commissioner needs to ensure that updates to TR 2013/5 do not apply retrospectively to disadvantage recipients of account-based income streams.

This situation is further exacerbated by the lack of consultation during the update process which saw changes to the Ruling, particularly in relation to minimum pension underpayments, bypass the consultation on draft TR 2013/5DC1[1].

We are particularly concerned with the change in ATO view that where a pension fails to comply with the pension standards, an account-based income stream ceases for income tax purposes only, but not necessarily for superannuation purposes.

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[1] TR 2013/5DC1 released for consultation on 27 September 2023 to 10 November 2023.

Further, we would like to draw the ATO's attention to the following issues which require urgent attention:

1. The interpretation of the term '*ensure'* in subregulation 1.06(9A) of the *Superannuation Industry (Supervision) Regulations 1994* ("SISR 1994")
2. The meaning of *'valid commutation'*
3. The lack of guidance on the timing and application of the 'separate interest' [2] rule
4. The need for guidance on issues specifically related to death benefit income streams
5. The retrospective application of the ATO views

Please refer to Appendix 1 for further details and discussion on these issues.

TR 2013/5 is a long-standing public ruling, originally published in July 2013 and applying from 1 July 2007. It has shaped industry practice over many years, especially in relation to treating a superannuation income stream as having commenced or ceased for both superannuation and tax purposes. This practice has gone unchallenged by the ATO despite the Commissioner being aware of the practice and begs the question why a change in the legal interpretation is necessary now.

We believe that the latest update may create additional administrative steps which under the previous version of the ruling were considered to have already occurred. These new requirements appear to add unnecessary complexity without providing any practical benefit, as they lead to the same outcome. Ultimately, a new retirement phase income stream must commence, and that income stream needs to meet the pension standards in the SIS Regulations to ensure that the transfer balance credit and retirement phase recipient rules operate as intended.

While the focus of our feedback is on the latest update to TR 2013/5, we believe it is very important to address a broader issue stemming from the original ruling.

The Commissioner's view on when a pension ceases due to the failure to make minimum pension payments remains problematic. TR 2013/5 lacks clear legislative backing, and its reliance on regulation 1.06(9A) appears to be an overreach, adding unnecessary complexity without providing practical benefit.

In our view, a pension is a contractual obligation between a trustee and a member. If minimum payments are missed, the pension does not cease - rather, the trustee is in breach of its contractual obligation, with any unpaid amounts remaining a debt owed to the member.

This interpretation aligns with contract law, and if this fundamental issue were addressed, many of the concerns in this submission would be resolved. Therefore, we urge the ATO to reconsider its stance on this matter.

We welcome the opportunity to further discuss our submission, and the issues raised. Please contact Mary Simmons at MarySimmons@smsfassociation.com to arrange a time on behalf of the signatories.

2 Regulation 307-200.05 of the ITAR (1997 Act) 2021

Yours sincerely,

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Appendix 1

1. The interpretation of the term '*ensure*' in Subregulation 1.06(9A) of the SISR 1994

Where a trustee has failed to comply with the pension rules and the super income stream ceases, we do not agree with the change in the ATO's view that the income stream cannot recommence after meeting the SIS Reg requirements in a future year (para 20 TR 2013/5).

We do not believe that the term '*ensure*' in Subregulation 1.06(9A) of the SISR 1994 imposes such a strict duty on a trustee that cannot be rectified.

New para 101 of TR 2013/5:

> *A new superannuation income stream can only commence from the superannuation interest where the rules of the superannuation fund* ***ensure*** *the payment is made at least annually and that the other requirements in subregulation 1.06(9A) of the SISR 1994 are met. To achieve this, any previous income stream payable from the interest must cease (for example, by commutation), and a new superannuation income stream must commence under the principles in paragraphs 9 to 13 of this Ruling. The proportioning rule[47] must be applied to that new superannuation income stream when it commences.[47A]*

We submit that paragraph 101 places undue significance on the term *"ensure"* as it appears in subregulation 1.06(9A), particularly when the Commissioner's interpretation of "ensure", for the purposes of this Ruling, has remained unchanged[3].

While we acknowledge that the term "ensure" conveys a continuous obligation to meet specific rules, it does not guarantee the continuous obligation will be met administratively, or that a breach necessarily precludes future compliance with those rules. In various legal contexts, a breach might attract penalties or increased scrutiny, but it does not permanently bar trustees from achieving compliance again, especially if corrective action has been taken.

The pension payment rules in the SIS Regulations are integral to the operating standards as outlined under s31(1) of the SIS Act. Failure to meet the minimum pension standards is considered a breach of an operating standard under s34 of the SIS Act, which attracts penalties as appropriate. Notably, s34 of the SIS Act also uses the term 'ensure' and imposes a high duty on trustees to take all necessary and reasonable steps to comply with the superannuation laws. Section 34(1) states:

> *Each trustee of a superannuation entity must* ***ensure*** *that the prescribed standards applicable to the operation of the entity are complied with at all times…*

Yet, a breach of any of the operating standards does not automatically render an SMSF incapable of ever achieving compliance with those standards again.

In fact, the administrative penalty regime, introduced from 1 July 2014, is explicitly designed to handle breaches of the operating standards in a graduated manner. This regime allows the

[3] Paragraph 99 of TR 2013/5

Commissioner to consider the nature and seriousness of a breach and apply penalties accordingly.

PS LA 2020/3 further confirms that where trustees have either rectified the breach or are actively making efforts to meet their obligations, the Commissioner will work with the trustees to remedy the contraventions wherever possible.

Furthermore, in the superannuation context, no higher obligation exists than compliance with the sole purpose test under section 62 of the SIS Act, which mandates:

> *(1) Each trustee of a regulated superannuation fund must **ensure** that the fund is maintained solely…*

To adopt the ATO's view on "ensure" as set out in TR 2013/5 would suggest that any fund breaching the sole purpose test must be wound up, as the trustees could never meet the sole purpose test on a prospective basis. However, it is well established that the ATO has adopted a much more sensible approach in administering compliance with the sole purpose test.

It is a fundamental principle of statutory interpretation that the same term, when used within the same legislative context, must be interpreted consistently. It cannot be assigned varying degrees of obligation unless the context clearly dictates otherwise.

We believe the term "ensure" needs to be applied with uniform meaning and cannot impose an absolute obligation solely with respect to the minimum pension standards.

We reject the ATO's suggestion at Issue 1 of the Compendium for TR 2013/5DC1, that a new superannuation income stream **automatically** commenced in a future year. This suggests that a new pension could start on its own without specific intentional action by a member and/or trustee. The original Ruling was quite clear that there was a need for deliberate action to be taken, and that processes like recalculating the tax components was required:

> *101. If in the following year the relevant rules are again complied with this in effect results in the commencement of a new superannuation income stream and the proportioning rule must be applied to that new superannuation income stream when it commences.*

We propose rectification is possible and compliance with the pension rules in the SIS Regulations can be restored, making the need for a 'commutation' superfluous. This would balance regulatory requirements with practical considerations and allow the status quo to be restored, in accordance with the original Ruling:

> *20. If the requirements are again met in the following year this results in the commencement of a **new** superannuation income stream.*

We accept that a **new** superannuation income stream is a necessary condition for the transfer balance credit and retirement phase recipient rules to operate as intended. However, a commutation is not necessarily required.

2. The meaning of a *'valid commutation'*

In paragraph 112, the Commissioner accepts that the timing and validity of a commutation is a question of fact. We agree - the question of whether a member and/or trustee's actions following the cessation of a superannuation income stream for tax purposes can amount to a commutation, depends on the specific actions taken.

Where the member/trustee takes deliberate steps - such as revaluing pension assets, recalculating tax-free and taxable components, putting in place new pension paperwork – this is analogous to a commutation. We believe the member's acknowledgement that the pension has stopped and their conscious decision to start a new pension with the same superannuation interest, demonstrates that the member has surrendered any rights they had to their previous pension in exchange for new rights to receive new superannuation income stream benefits.

When looking at the totality of actions taken by the member and trustee, we believe it would be open to the courts to interpret the cessation of the old pension as the functional equivalent of a commutation. We do not agree that the meaning of 'commute' can only be met if you exchange superannuation income stream benefits for a lump sum. We would argue that an exchange of rights to receive one income stream for rights to receive a new income stream would also satisfy the meaning of 'commute'.

However, should the Commissioner insist on the need to 'commute' the income stream for superannuation purposes into a lump sum, industry will require further clarity as to what constitutes a 'valid commutation' particularly as paragraphs 111 – 114 of TR 2013/5 have not been updated.

For example, ordinarily a fund trustee would comply with SIS Reg 1.07D to pay a minimum amount prior to the commutation of an account-based income stream. However, as it is the ATO's view that an underpayment causes the income stream to fail the requirements of subregulation 1.06(9A) of the SIS Regs, it is unclear whether there is a need to pay a minimum amount in order for there to be a 'valid commutation'.

3. The lack of guidance on the timing and application of the "separate interest" rule in reg 307-200.05 of the ITAR (1997 Act) 2021

Paragraph 88 of the Ruling states that:

> *Section 307-200.05 of the ITAR (1997 Act) 2021 relevantly states that if a superannuation income stream is **payable**, an amount that supports the superannuation income stream is always to be treated as a separate superannuation interest.*[42A] *Section 307-200.05 applies for the purposes of the proportioning rule*[42B] *to ensure all payments made from the superannuation interest that supports the superannuation income stream have the same proportions of tax-free component and taxable component.*

Compliance with the obligation to make a minimum annual pension payment, as mandated by the SIS Regulations, cannot be definitively assessed prior to the end of the relevant year. Therefore, for the duration of that year, there must be a presumption that a superannuation income stream is in place, unless and until a failure to meet the minimum pension payment occurs. It is only upon such a failure that the superannuation income stream ceases to be regarded as 'payable'.

As the superannuation income stream remains 'payable' until the end of the relevant year, Regulation 307-200.05 of the Income Tax Assessment (1997 Act) Regulations 2021 allows the superannuation interest supporting that income stream to continue to be treated as a separate superannuation interest throughout the relevant year.

The separate treatment of the superannuation interest is essential for the proper application of the proportioning rule under Section 307-125 of the ITAA 1997 which applies at the time a superannuation benefit is paid. This means any superannuation benefits withdrawn during the relevant year – while the income stream remains 'payable' – must reflect the taxable and tax-free components in the same proportions established when the income stream commenced.

The application of the proportioning rule needs to remain consistent, irrespective of whether the withdrawal is ultimately classified as a superannuation income stream benefit or a superannuation lump sum, as per the ATO's interpretation in TR 2013/5. This approach aligns with established industry practices.

Moreover, this approach results in a tax-neutral outcome. Members receiving an account-based superannuation income stream must be at least of preservation age (currently 60 as of 1 July 2024), which is the age at which superannuation benefits can be accessed tax-free, whether it be as a lump sum or as an income stream payment.

Furthermore, maintaining the treatment of the interest supporting the superannuation income stream as a separate interest aligns with the assumptions in section 294-50(2) of the ITAA 1997. This section prescribes that for the purposes of the transfer balance account, the interest supporting the income stream remains distinct from other superannuation interests in the fund, per the rules of Regulation 307-200.05.

Adopting an inconsistent application of the separate interest rules for the proportioning rule and the transfer balance account would introduce unnecessary administrative complexity, making it difficult, if not impossible, to implement in practice.

Reference to paragraph 84 of TR 2013/5 suggests that it is possible that our interpretation may be consistent with the Commissioner's view:

> *"... For superannuation lump sums from an interest that has never supported a superannuation income stream, the relevant time is just before the benefit is paid. "*

However, the current explanation lacks sufficient clarity. To avoid any ambiguity and ensure consistent application across industry, we seek further guidance, including practical examples to demonstrate the interaction of the various provisions.

4. The need for guidance on issues specifically related to death benefit income streams

We accept that the ATO's view on a superannuation income stream ceasing on the death of a member has not changed however, there are consequences that flow on from other amendments to TR 2013/5 that need to be considered. We seek clarity with respect to how:

1. failing to meet the pension standards interacts with the compulsory cashing requirements in the SIS Regulations; and
2. the separate superannuation interest provisions operate with respect to a death benefit

<u>4.1 Death benefit pension fails the pension standards</u>

The issues that arise for a death benefit income stream where there is an underpayment, mirror those raised earlier for any account-based pension. However, we have concerns with how the cessation of the income stream will be treated under the compulsory cashing requirements in SIS Regulation 6.21.

In accordance with the amended TR 2013/5 a failure of the pension rules will cause the death benefit income stream to cease at the start of the year and every pension payment will be treated as a superannuation lump sum benefit instead, for tax purposes.

If these amounts are also treated as lump sums for superannuation purposes, the multiple death benefit lump sum payments that exceed the maximum two limit cashing restriction, will be a breach of the compulsory cashing requirements in subregulation 6.21(2)(a). This is not a breach that a trustee can fix.

In addition, SIS Reg 6.21(1) requires that benefits "*must be cashed as soon as practicable after the member dies"*.

To date, the ATO has accepted that an SMSF trustee could meet the 'as soon as practicable' requirement on a go-forward basis in the limited circumstance where the trustee failed to meet the minimum pension requirements, and the death benefit income stream had stopped. It was acknowledged that although it was not possible to fix the breach resulting from the SMSF's failure to meet the compulsory cashing requirements, the ATO accepted that trustees could prevent future contraventions by acting swiftly after becoming aware of the breach.

This allowed the superannuation death benefit to still be considered cashed 'as soon as practicable' by cashing the benefit as either:

- a new death benefit pension in retirement phase, or
- a lump sum (limited by the maximum two payments); or
- by rolling over to a complying fund for immediate cashing as a new death benefit pension

We seek confirmation that this remains the ATO's administrative approach with respect to the underpayment of a death benefit superannuation income stream.

Acknowledging the limitations of public rulings in addressing taxation law matters, we encourage the ATO to explore alternative guidance material to address these issues and provide industry with the clarity needed to promote compliance.

<u>4.2 Treatment of a death benefit as a separate superannuation interest</u>

With the repeal of sec 307-5(3), (3A) and (3B) of the ITAA 1997 from 1 July 2017, the ATO's interpretation of the law as expressed in Law Companion Ruling (LCR) 2017/3 is that all benefits paid because of the death of a member will indefinitely be treated as a death benefit in the hands of the beneficiary. This means that once a death benefit, always a death benefit and continually subject to the cashing rules in the SIS Regulations.

From a practical perspective, the only way to apply this interpretation is for SMSF trustees to treat any death benefit amount as a separate superannuation interest.

For example, where a trustee fails to meet the pension standards, the superannuation income stream stops for income tax purposes, but an SMSF trustee needs to ensure that those death benefits do not mix with a beneficiary's other superannuation entitlements. This was permitted under the previous wording of Regulation 307-200.05 of the ITAR 1997. However, from 1 July 2017 it is now unclear how a trustee can achieve this outcome, if a separate superannuation interest is not maintained, until such time as the death benefit is 'cashed' as either a lump sum death benefit or a new death benefit pension is commenced. At a practical level, separate interests must be maintained to calculate tax components as required by section 307-125.02 of the ITAR 1997.

Another example is where on the death of a member, the superannuation income stream ceases because there is no automatic (i.e. reversionary) transfer to a dependant beneficiary. Under the old regulation, a trustee was able to maintain a separate superannuation interest which ensured that the proportioning rules operated effectively, and appropriate tax was paid by a beneficiary. From 1 July 2017, industry needs clarity on how the Commissioner with administer the interaction of these provisions.

For added complexity, in the example where a death benefit income stream does not automatically transfer/revert to a dependant beneficiary, the definition of a superannuation income stream[4] is expanded for ECPI[5] purposes. This allows the separate superannuation interest to be maintained and also enables the correct operation of the transfer balance cap regime.

These examples underscore the practical difficulties SMSF trustees face when trying to ascertain whether a separate superannuation interest can be maintained or whether the default single superannuation interest[6] in an SMSF needs to be applied on a strict basis.

We have identified real, practical issues that illustrate potential conflicts between different provisions in the tax legislation. To promote compliance, it is essential that the ATO provide clarity on how the Commissioner will administer the interaction of these provisions which may be in the form of practical compliance guidelines.

5. The retrospective application of the ATO views as outlined in updated TR 2013/5

First and foremost, we do not believe that the Commissioner can rely on web content (QC 54354) to amend para 20 and 101 of TR 2013/5, especially when the changes were not incorporated in the draft Ruling, circulated for consultation. Web content is not legally binding and should not bypass the consultative and formal drafting processes required when developing and maintaining a public ruling.

We strongly urge the ATO to re-open consultation on this Ruling to ensure that all relevant stakeholders can provide input and that alternative views are robustly considered.

Further dialogue is also necessary to ensure that the practical implications of the Ruling are fully understood, and an appropriate date of effect is determined that allows taxpayers a reasonable time to become aware of, and act upon, the new interpretation.

In the interest of fairness and good administration, we do not support a retrospective application of the ATO's view which would result in amending SMSF annual returns, individuals' tax returns, re-reporting TBA events, or re-calculating tax components for pension underpayments that occurred many years ago.

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[4] Section 307-70.02(1)(d) ITAR (1997 Act) 2021

[5] Subdivision 295-F of the ITAA 1997

[6] Section 207-200.02 ITAR (1997 act) 2021

To apply the updated ATO views retrospectively would require appropriate relief for those who have relied on the views previously expressed in TR 2013/5 in good faith. There is a risk that many members and trustees with a pension that stopped lack the new 'valid commutation' requirement and therefore, do not have a new superannuation income stream. This translates to years of:

- incorrect claims to exempt current pension income
- incorrect treatment of superannuation benefits as pension payments instead of lump sum withdrawals
- incorrect payment and taxation of superannuation death benefits
- early access to superannuation where it relates to a transition to retirement income stream that is not in retirement phase.

Prospective application of this Ruling also overcomes confusion with the practical application of changes to Regulation 307-200.05 of the ITAR 1997 which can only apply from 1 July 2017.