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Family and Community Services Legislation (Simplification and Other Measures) Bill 2001

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Family and Community Services Legislation (Simplification and Other Measures) Bill 2001

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15 June 2001

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Family and Community Services Legislation (Simplification and Other Measures) Bill 2001

Date Introduced: 24 May 2001

House: House of Representatives

Portfolio: Family and Community Services

Commencement: Generally, Royal Assent. The key provisions in Schedules 1 and 2 commence on 20 September 2001. However, item 15 of Schedule 1 is taken to have commenced on 1 July 2000 and items 1 and 24 of Schedule 2 have contingent commencement dates.

Purpose

Primarily to amend the *Social Security Act 1991* (SSA) to:

- update the rules regarding recovery of certain social security payments where recipients receive or are entitled to lump sum or periodic compensation payments;
- strengthen the rules regarding income and assets tests treatment of income streams;
- set out in the social security law the legislative basis for the current treatment of allowable deductions from of gross rental income;
- streamline the deeming exemptions for assets that have been determined as unrealisable under the assets test hardship provisions;
- allow compensation arrears debts that are treated as income to be recovered directly from compensation payers or insurers; and
- change the taper rate for the income cut-out formula used to set the compensation preclusion period for recipients of lump sum compensation payments.

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Background

As there is no central theme to the amendments proposed by this Bill, a background to each major amendment is contained in the Main Provisions section of this Digest

Main Provisions

Schedule 1 – Compensation Recovery

The SSA contains special rules for the treatment of compensation provided as replacement earnings. These special provisions are to ensure that persons, who are able to access income support from compensation, cannot at the same time access assistance from government-provided income support. It has been a long-standing view of successive governments that the compensation system has the first responsibility for the provision of income support to those with a compensable illness or injury, not the taxpayer by way of government support. The foremost concern of governments has been that there should not be any 'double dipping', that is receiving compensation for lost earnings from a wrongdoer or insurer while at the same time receiving government income support.

The special rules are contained in Part 3.14.

Enforcement of Compensation Rights

The Secretary may require claimants or recipients of 'compensation affected payments' to take reasonable action to claim or obtain compensation (section 1164).[1] (The list of 'compensation affected payments' features all of the income support payments provided under the SSA.[2]) Until the action is taken, the 'compensation affected payment' is not payable to the person.

Proposed section 1166 empowers the Secretary to require persons to take actions that s/he considers reasonable. The Secretary will also have the power to disregard any other agreement the person has entered into waiving the right to or withdrawing a claim for compensation.

Receipt of Compensation

Where a person or their partner receives a lump sum compensation payment, subsequently becomes entitled to and claims or receives a compensation affected payment, they or their partner are subject to a preclusion period. During this period, compensation affected payments are not payable to the person or their partner (section 1165). Moreover, any payments received during this period are liable to be recovered (section 1166). However, the lump sum compensation payment is not treated as ordinary income (section 1167).

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Proposed sections 1169 and **1170** correspond to section 1165 but they operate on the basis of a single preclusion period, to which **items 5** and **15** relate (see below).

Similarly, where a person or their partner receives periodic compensation payments, the rate of compensation affected payment (or other benefit or parenting payment) payable to them or their partner is reduced on a fortnightly dollar-for-dollar basis (section 1168). (Unreduced) payments received during this period are liable to be recovered (section 1170). However, the periodic payments are not treated as ordinary income (section 1171).

Proposed sections 1173 and **1174** correspond to section 1168 but the rate is reduced on a *daily* dollar-for-dollar basis to allow more flexibility in matching social security payments to periodic compensation payments where payments periods may differ.

A Person Already Receiving Compensation Affected Payments

In effect, where a person becomes entitled to a compensation affected payment following a compensation award, etc. rather than treating compensation entitlements as receipts for ordinary income purposes, they are treated as a substitute for the affected payment.

Proposed subsection 1173(4) clarifies the operation of the reduction rules where a person is already receiving an affected payment when a compensation award, etc. is made. In effect, the rule is reversed: rather than treating compensation entitlements as substitutes, they are treated as receipts for the purposes of ordinary income under the income test.

It is significant to note that the substitution only occurs during the preclusion period.

Dollar-for-Dollar Reductions and Partners

If a person and their partner both receive or claim a compensation affected payment, the reduction is split equally between them (subsection 1168(3B)). If the partner receives or claims another social security benefit or parenting payment, the reduction is made initially against the person and subsequently against their partner (subsection 1168(5)).

In effect, any excess of periodic compensation payment will also reduce a partner’s income support payment on a dollar-for-dollar basis. This treatment has been in place for a considerable period, and has been criticized as being too harsh. It would be common for a person's periodic compensation payments, which are based on their normal weekly earnings, to exceed the partnered rate of most social security payments and to result in a significant reduction in income support made to the person's partner.

For example, as at May 2001 the partnered rate of newstart allowance was $322.80 per fortnight. A periodic compensation paid at a rate of $450 per fortnight would reduce the partner’s income support payment by the excess of $127.20 per fortnight. The net rate than paid to the partner would be $322.80 minus $127.20 leaving $195.60 per fortnight.

Proposed section 1174 splits this rule, applying a dollar-for-dollar reduction to the person entitled to the compensation payments and the ordinary income test for the partner.

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The effect of the proposed legislative change is to treat any excess payment as ordinary income and the appropriate income test free areas and tapers are then applied. The results achieved will vary, depending on what sort of income support payment the partner is receiving. Most will be allowee partners, receiving one of the allowance payments, the main ones being newstart allowance, partner allowance, parenting payment (partnered).

Where the partner is on an allowance payment, any excess partner income reduces the payment rate by 70 cents in the dollar. A different result applies to pension recipients.[3]

In the example set out above, the excess of $127.20 would be reduced to $89.04. The net rate then payable is $322.80 minus $89.04 leaving $233.76 per fortnight. This is substantially more than the current rate result of $195.60 per fortnight.

Preclusion Periods

The SSA currently prescribes two 'preclusion periods'. The 'old preclusion period' – for payments made before 20 March 1997 – is determined by the 'compensation part' of the lump sum payment (the part attributable to lost earnings or lost capacity to earn) divided by average weekly earnings. In effect the period was the number of weeks which the compensation part of the lump sum payment could have been distributed as average weekly earnings. The 'new preclusion period' – for payments made after 20 March 1997 – is determined by the compensation part divided by an 'income cut-out amount'. This amount is based on the maximum basic (single) rate and the pharmaceutical allowance, plus the income free area for a single person. Given the disparity between average weekly earnings and pension rates, this will always be less than average weekly earnings. Thus, a 'new preclusion period' would always be longer than an 'old preclusion period'.

Items 5 and **15** seek to replace these periods with a single preclusion period, based on the 'new preclusion period' but with a more generous 'income cut-out amount'. As the Explanatory Memorandum indicates, the new 'income cut-out amount' formula is now consistent with the 40% pension income taper introduced as part of the GST changes.[4] This has the effect of shortening preclusion periods for new lump sum payments.

The new 'income cut-out amount' in **item 15** will be deemed to have commenced on 1 July 2000, before the other relevant amendments commence on 20 September 2001. The retrospective commencement relates to the new 'income cut-out amount' formula. As indicated this is beneficial and is thus unobjectionable from the standpoint of welfare recipients. However, it might be expected to have some financial impact, which does not appear to have been separately quantified in the Explanatory Memorandum.

Recovery from Partners

As indicated above, where a person receives a lump sum compensation payment, the lump sum or the compensation affected payments are liable to be recovered, whichever is the smaller (section 1166). Similarly, where a person receives periodic compensation payments, compensation affected payments are also liable to be recovered (section 1170).

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Significantly, where a person receives these compensation payments, compensation affected payments are also liable to be recovered from *partners*.

Proposed sections 1178–1181 correspond to sections 1166 and 1170 but they do not expressly permit recovery from partners.

Recovery from Compensation Payers and Insurers

Alternative to recovery from persons and partners, the SSA permits recovery from potential compensation payers or insurers (but not both). The rules for compensation payers are contained in Division 4 and substantially duplicated for insurers in Division 5.

Proposed Subdivision C replaces Divisions 4 and 5 with a single set of rules applicable separately to compensation payers and insurers.

Schedule 2 – Simplification Package

Income Streams

The proposed changes to the SSA presented in Schedule 2 refer to income stream products and were a part of the Simplification Package announced in the 2000–2001 Budget.[5]

Background – Income Stream Products

There are two main types of lifetime income stream products: lifetime pensions and lifetime annuities. A lifetime *pension* is provided by a superannuation fund and can only be purchased with superannuation monies.[6] A lifetime *annuity* can be purchased with any monies. Lifetime income streams are payable for the person's lifetime, paying income payments at least annually. Purchase involves exchanging a lump sum superannuation amount in return for a guaranteed series of future periodic payments.

Separate to lifetime products, which are paid during the purchaser's life, there are also life expectancy products, in which the full dollar amount is paid to the purchaser over the term of the product. The term of the product is usually set to the estimated life expectancy of the purchaser, at the time of purchase. Life expectancies are taken from the latest Australian Life Tables published by the Australian Government Actuary.

Popularity of lifetime pensions and annuities

Since the early 1990s allocated pensions and annuities (income stream products) have become the most popular structured private retirement income stream plans in the financial market. Literally billions of superannuation funds (and other funds) have been rolled into (or used to purchase) income stream funds. Also, there are rapidly increasing numbers of self-managed superannuation funds that are being designed to switch from accumulating benefits to income streams. The advantage of income streams is that:

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- they can be designed to meet individual needs
- moneys can be pooled into a diverse range of managed investments, responsive to market fluctuations and trends
- savings can be made to last longer
- account balances can rise and fall with fluctuations in pooled fund earnings and market value of investments
- money is not necessarily locked away and there is scope to make capital withdrawals and taxed under lump sum tax rules
- there is capacity to vary income received
- there are tax advantages for income withdrawals if taken at a steady pace, and
- investment income earned is not taxable.

The income stream fund balance mainly reduces by the regular income payments, any capital withdrawals and ordinary fees and charges.

Income and Assets Testing

In the 1997–98 Budget, the Government announced changes to the pensions and benefits income and assets tests treatment of income stream products.[7] The reforms were mainly in response to the burgeoning use of income stream products by persons of retired age and the increased diversity, design and complexity of these products. The main concern was that some people were able to organise substantial assets into mechanisms that circumvented the income and assets testing arrangements. The other issue was to provide some favourable treatment of income and assets testing towards those investments that were long-term and genuinely providing an income stream in retirement.

The changes were introduced with the passage of the *Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Act 1997*.[8]

Currently, most investments are subject to the income and assets tests. Under the current rules, income stream products are generally caught by both income and assets tests, with some exceptions. For the income test, special rules apply as the income stream payments generally include a return of a part of the capital used to purchase the product. Mostly, it is only the income part, which is counted under the income test. In brief the features of the current treatment arrangements are:

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Income stream type	**Income test**	**Assets test**
Long-term Complying life time/life expectancy with no residual capital*	Gross annual payment less a deduction based on purchase price	Exempt**
Medium-term Terms >5yrs Some residual capital value	Gross annual payment less a deduction based on purchase price	Subject to assets test
Short-term Terms of <5yrs	Subject to income test under extended Deeming	Subject to assets test

* The prohibition on residual capital value was based on the view that it would be unreasonable to expect taxpayers to support the use of the product for purposes other than a retirement income stream, eg to intentionally leave a lump sum to the purchaser's estate.

** The asset test exemption for long-term products was aimed at providing an incentive for people to use lump sums to purchase an income stream that could be expected to last for the duration of their retirement, rather than relying on the age pension.

Reliability and Dependability of Income Stream Products

In January 1999, the Australian Prudential Regulation Authority (APRA) issued a modification to the Superannuation Industry (Supervision) (SIS) Regulations. The modification introduced tighter prudential requirements for superannuation funds paying pensions. All superannuation funds paying pensions (other than allocated pensions or those backed wholly by life company annuities) are now generally required to produce an annual actuarial certificate. This certificate must state that there is a 'reasonable degree of probability' that the fund will be able to pay those pensions for the specified term of the product (or as required under the fund's governing rules).

The modification was largely in response to the burgeoning use of superannuation funds into income stream products. The modification had a direct impact on how products are assessed under the income and asset testing rules. Under the SSA, to be defined as an income stream under the means testing rules, products must be provided under one of a number of prudential arrangements (subsection 9(1)). The *Superannuation Industry (Supervision) (SIS) Act 1993* is one of these arrangements. Products provided under the SIS legislation must meet the requirements of that legislation, including the new prudential requirements. If the new prudential requirements are met, this will also go some way to ensuring that the product is regarded as an income stream under the SSA.

The APRA modification pertains to the reliability and dependability of income stream products. Effectively, the Government in recognising certain classes of investments and

providing concessional or favourable income and assets test treatment is also concerned with the amount or level of payments. Arguably, it is in the best interests of both government and individuals to encourage people to use their savings to obtain the best possible retirement income, subject to the level of risk involved being acceptable.

However, where people wish to transfer some of their savings, including their retirement savings, to others (for example, members of their family), the policy is that this should not be at the expense of the taxpayer.

Continued and Increasing Diversity of Income Stream Products

Income stream products continue to be a very popular form of investment for the retired aged. One of the features of this popularity has been the increased incidence of self-managed income streams. This feature poses new problems for decisions about product classification and, flowing from this, the appropriate income and assets test treatment under the SSA. Where an income stream is purchased commercially, the APRA rules need to be complied with and as a result it is far more likely that the product will run for its intended duration, ie. for the remainder of the investor's life or life expectancy at the time of purchase.

This security and surety about the product not changing may not apply in relation to self-managed products. These are products where the purchaser of the income stream is also the trustee of the product. With these products, there is far more scope and freedom for the purchaser/trustee to dissolve and re-organise the product at any time. In such cases, the purchaser/trustee may have already received the benefits of assets test exemption for some period, but, the product or products have not run for their originally intended duration, and arguably, did not properly warrant such an asset concession at all. The amendments proposed in **items 2–15** will apply some increased rigour about products that meet, and continue to meet, requirements to gain access to concessional asset test treatment.

Commuted or Dissolved Products: Debts and Hardship

Currently, in order to be an 'assets-test exempt income stream', the contract or the governing rules for the product must contain a number of features. These features include a prohibition on residual capital value (as indicated), upper and lower limits on indexation of payment amounts and limits on transfer, commutation and dissolution. The key features for present purposes are that the income stream may only be transferred on the death of the person to a reversionary beneficiary (ie, a person entitled under the contract or governing rules to the remainder of the income stream on the death of the purchaser, etc.).[9] Also the income stream may only be commuted within 6 months of its commencement, or to the person's estate or a reversionary beneficiary (within 10 years of the person's death), or to the extent necessary to cover superannuation contributions surcharge liabilities.[10]

Item 22 provides for the creation of a debt, where an income stream product, which has had concessional asset test treatment, is commuted or dissolved contrary to the contract or

governing rules applying to the product. In effect, this will ensure that the taxpayer's interest in any asset test concessions is protected.

Hardship

Items 5 and **8** seek to add an exception to the general prohibition on commutation to allow a person to commute an income stream to the extent necessary to pay a 'hardship amount'. This exception will only operate in very limited cases:

- A person must apply in writing to the Secretary because of 'extreme financial hardship'
- The Secretary must be satisfied that
  - the circumstances are 'exceptional' and 'could not be reasonably foreseen'
  - the person has insufficient 'liquid assets' that could be realised, and
  - the amount to be commuted is required to meet 'unavoidable expenditure'.

'Unavoidable expenditure' includes 'essential medical expenses', 'essential repairs to the person's principal home' and 'essential household goods'.

'Liquid assets' include shares, managed investments and insurance policies. They also include financial deposits 'whether or not the amount can be withdrawn or repaid immediately' and amounts due 'and able to be paid' by a person's former employer.

To some extent, the latter forms of 'liquid assets' are subject to time and resource obstacles, which are or may be beyond the person's control. These obstacles are significant in the context of the time limits implicit in the definition of 'unavoidable expenditure'.

The approach to hardship in **items 5** and **8** may be contrasted with the approach to hardship elsewhere in the SSA. For example, a person applying for newstart allowance may be able to claim exemption from a waiting period if they are in 'severe financial hardship'. Their circumstances need not be exceptional and there is no concern over the nature of the proposed expenditure. Hardship can be shown to exist if their liquid assets are 'less than the fortnightly amount at the maximum payment rate of the payment or allowance that would be payable to the person if the person's claim was granted'.[11]

While the two approaches to hardship are distinguishable, because one deals with availability of money for major lump sum payments and the other deals with availability of money for minor living expenses etc., it is still significant that a far higher threshold has been set for social security recipients accessing income stream assets than for would be social security recipients accessing social security payments. The gap would seem to be the measure of the disincentive to 'hide' assets in the form of income stream products. However, it may operate too harshly in relation to some bona fide welfare recipients.

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Rental Income

Item 17 proposes to insert into the SSA a description of how rental income deductions are to be assessed for the purposes of the income test.[12] It is proposed to directly link legislative definition of allowable rental income deductions in the SSA to the general definitions of allowable income deductions provided in sections 51[13] of the *Income Tax Assessment Act 1936* and 8-1[14] of the *Income Tax Assessment Act 1997*. In both of these provisions, the general definitions of allowable income deductions target those directly incurred in earning or producing the income. Being general, there is some scope to interpret what the expenses have been. They include:

- all losses and outgoings to the extent to which they are
  - incurred in gaining or producing the assessable income
- expenses necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

For rental properties some examples are rates, property maintenance, agents fees.

Some rental income deductions allowed under the Income Tax Assessment Acts (ITAA) may not be allowed under the SSA. An example is capital depreciation. The main reason for differences in allowable deductions between the SSA and ITAA, largely stems from the different treatment and measurement of income between the two Acts. The ITAA assesses income in order to determine a level of tax liability to provide revenue, regardless of a person's need. The SSA assesses income as one means of measuring need for welfare assistance.

Endnotes

1 Compensation includes common law damages or statutory insurance or compensation, for lost earnings or lost capacity to earn: subsection 17(2).

2 Subsection 17(1).

3 Where the partner is on a pension payment, eg. age pension, disability support pension, carer payment, the result is different because pension payments have a different income test. For pension, the income test free area is $94 per fortnight and income above this limit reduces the maximum pension rate by 40 cents in the dollar (May 2001). Therefore, excess compensation of $127.20 would be reduced by the free area of $94 to $33.20. Affecting income is 40 cents in the dollar of $33.20, ie. $13.28. The maximum partnered pension rate of $335.50 per fortnight (May 2001), would be reduced by $13.28 to arrive a net pension rate payable of $322.22. This is substantially more than the rate currently payable of $208.30 ($335.20 minus $127.20 = $208.30).

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4 Explanatory Memorandum, p 1.

5 Family and Community Services - Portfolio Budget Statements, *Budget Related Paper No 1.8*, page 168.

6 Superannuation money commonly means within a superannuation fund and can also refer to lump sums paid as 'eligible work termination payments', for example long-service leave.

7 Department of Social Security - Portfolio Budget Statements, Budget Related Paper No 1.14, pages 59 and 60.

8 For background on this Bill see Susan Downing, Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Bill 1997, *Bills Digest No. 136 1997–98* at http://www.aph.gov.au/library/pubs/bd/1997-98/98bd138.htm [14/06/01].

9 Paragraph 9A(2)(i).

10 Paragraph 9A(2)(h).

11 Sub-section 19C(2).

Meaning of 'in severe financial hardship': person who is not a member of a couple

19C.(2) A person who is not a member of a couple and who makes a claim for parenting payment, austudy payment or one of the following allowances:

(a) newstart allowance

(b) widow allowance

(c) mature age allowance

(d) sickness allowance

(e) youth allowance

is in severe financial hardship if the value of the person's liquid assets (within the meaning of subsection 14A(1)) is less than the fortnightly amount at the maximum payment rate of the payment or allowance that would be payable to the person:

(f) if the person's claim were granted.

12 This proposal was announced in the 2000–2001 Budget as a part of the Simplification Package: Family and Community Services, op. cit., p. 168.

13 Section 51 of the *Income Tax Assessment Act 1936* relevantly provides:

(1AA) Subsection (1) does not apply to the 1997–98 year of income or a later year of income.

(1) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

14 Section 8-1 of the *Income Tax Assessment Act 1997* provides:

(1) [Deductible losses and outgoings]

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You can deduct from your assessable income any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.

Note: Division 35 prevents losses from non-commercial business activities that may contribute to a tax loss being offset against other assessable income.

(2) [Exclusions]

However, you cannot deduct a loss or outgoing under this section to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; or

(b) it is a loss or outgoing of a private or domestic nature; or

(c) it is incurred in relation to gaining or producing your *exempt income; or

(d) a provision of this Act prevents you from deducting it.

For a summary list of provisions about deductions, see section 12-5.

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