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Bills Digest

No. 5 2001–02

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ISSN 1328-8091

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Published by the Department of the Parliamentary Library, 2001

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Superannuation Contributions Taxes and Termination Payments Tax Legislation Amendment Bill 2001

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25 July 2001

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Superannuation Contributions Taxes and Termination Payments Tax Legislation Amendment Bill 2001

Date Introduced: 21 June 2001

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent, however, specific retrospective commencement dates apply to each schedule:

- Schedule 1 is taken to have commenced on 5 June 1997, immediately after the commencement of the *Superannuation Contributions Tax (Assessment and Collection) Act 1997*
- Schedule 2 is taken to have commenced on 7 December 1997, immediately after the commencement of the *Superannuation Contributions Tax (Members of Constitutionally Protected Superannuation Funds) Assessment and Collection Act 1997*
- Schedule 3 is taken to have commenced on 5 June 1997, immediately after the commencement of the *Termination Payments Tax (Assessment and Collection) Act 1997*.

Purpose

The Bill's purpose is three–fold:

- It proposes to amend the *Superannuation Contributions Tax (Assessment and Collection) Act 1997* to ensure that only the post 20 August 1996 amount of an employer eligible termination payment (ETP) taken as cash will be potentially subject to a surcharge.
- It proposes to amend the *Superannuation Contributions Tax (Members of Constitutionally Protected Superannuation Funds) Assessment and Collection Act 1997* to ensure that only a notional amount of an employer ETP is included in the calculation of the employee's adjusted taxable income for the purpose of determining a person's surcharge tax liability.

- It proposes to amend the *Termination Payments Tax (Assessment and Collection) Act 1997* to ensure that taxpayers will not have to pay an effective tax rate greater than the top marginal income tax rate plus Medicare Levy (48.5 per cent) when taking their employer ETP as cash.

Background

This section summarises the terminations payment surcharge, its origin (along with the superannuation contributions surcharge), method of calculating surcharge liabilities, and comments on the surcharge.

Summary of the Terminations Payment Surcharge

The termination payment surcharge is a similar tax to the much maligned superannuation contributions surcharge tax.

Like the superannuation contributions surcharge, the termination payments surcharge came into effect after 7:30 PM legal time in the Australian Capital Territory on 20 August 1996. It is imposed on "golden handshakes" paid on termination of employment of so–called "high income earners."

The superannuation surcharge is "an equity measure to make the level of superannuation taxation concessions available to high income earners more comparable to those available to middle and lower income earners."[1] The termination payments surcharge was introduced with the package of legislation that introduced the superannuation surcharge, and is imposed by the *Termination Payments Tax Imposition Act 1997*. The *Termination Payments Tax (Assessment and Collection) Act 199*7 provides for the assessment and collection of the surcharge.

Termination payments are the retained amounts (ie, amounts not rolled–over or transferred into a superannuation fund) of eligible termination payments[2] made by employers on the termination of employment of an employee. The termination payments surcharge is payable only if the taxpayer's "adjusted taxable income" for the financial year exceeds the "surcharge threshold."

For the 2001–02 financial year, the terminations payment surcharge is imposed at the rate of 1 per cent for each $1,219 of assessable income where the member's assessable income and superannuation contributions is in excess of $85,242. The maximum surcharge is 15 per cent when assessable income and superannuation contributions reach $103,507.

Under existing legislation, transitional arrangements reduce the amount of a termination payment that is subject to the surcharge, based on whether the payment is received between 20 August 1996 and 19 August 2001 (inclusive), or on or after 20 August 2001.

Origin of the Surcharges

The income of a superannuation fund, including member's contributions, is subject to concessional tax treatment if the fund satisfies certain conditions. The principal condition is that the fund satisfies the *Superannuation Industry (Supervision) Act 1993* and it's regulations. The concessional tax treatment means that income is generally taxed at the rate of 15 per cent.

1996–97 Budget Announcement

The Government announced in the 1996–97 Budget that the concessional tax treatment would be altered and that a "surcharge" would apply to contributions that are subject to a tax deduction (this will include employer contributions and those made by the members where there is no employer contribution and a deduction has been claimed) where the member's assessable income and superannuation contributions exceeds $70,000.

The Budget announced that a "surcharge" would be imposed at the rate of 1 per cent for each $1,000 of assessable income and superannuation contributions to a maximum of 15 per cent when assessable income and superannuation contributions reaches $85,000. These thresholds are indexed to Average Weekly Ordinary Time Earnings. The surcharge applies to both accumulated benefits funds, ie. the "normal" type of superannuation fund where the member's ultimate benefit will depend on the investment performance of the fund, and defined benefits funds, which are funds where the members benefit is calculated using a pre–existing formula, usually based on such the number of years of contributions and final salary. The most common examples of defined benefits funds are those relating to most public servants and Members of Parliament.

"A New Tax System" Reforms

The *A New Tax System (Fringe Benefits Reporting) Act 1999* implemented the "reportable fringe benefits system" so that the fringe benefits of individual employees are reported by employers on group certificates.

Prior to the passage of this Act, an employer had to determine the taxable value of fringe benefits in respect of each employee; however there was no requirement under the *Income Tax Assessment Act 1936* to record fringe benefits on employee group certificates.

Under the *A New Tax System (Fringe Benefits Reporting) Act 1999*, from the year of income 1999-2000, an employer is to record the value of fringe benefits provided to employees on their group certificate where the value of those benefits exceeds $1,000. Since 1999–2000, the so–called "reportable fringe benefits" of an employee are now taken into account in working out superannuation surcharge.

How to Calculate Surcharge Liability

The following steps are involved in calculating the termination payments surcharge.

- Calculate Adjusted Taxable Income (ATI), which comprises
  - Member's taxable income[3]
    plus reportable fringe benefits amount[4]
    plus surchargable contributions
    less the assessable component of all ETPs except unfunded employer ETPs (eg. Golden handshakes and the ETP portion of redundancy payments)
    less lump sum annual leave and long service leave paid as a result of a bona fide redundancy, early retirement scheme or invalidity amount
    plus income that is exempt from tax because it has incurred 48.5 per cent family trust distribution tax.[5]

- Calculate the appropriate surcharge rate
  - If ATI does not exceed the lower threshold ($85, 242), then the surcharge rate is 0 per cent.

    If ATI exceeds the upper threshold ($103, 507), then the surcharge rate is 15 per cent.

    If ATI exceeds the lower threshold, but does not exceed the upper threshold; then calculate the surcharge rate (to 5 decimal places).

- Calculate the amount of termination payment subject to the termination payment surcharge using the following formula:

$$\frac{\text{Post–20 August 1996 service (in days)}}{\text{Total service (in days)}} \quad \times \quad \text{Termination payment}$$

- Calculate the termination payments surcharge payable on the termination payment.

Using these steps, it is possible to demonstrate how to calculate the terminations payment surcharge liability of a hypothetical employee.

Example 1

An employee has 3965 total days service, including 1045 days after 20 August 1996. The employee receives an employer ETP of $55 000 and chooses to take this as a cash payment. The following details apply to the 2001–02 income year:

Taxable income excluding termination payment:	$45 000
Employer superannuation contributions:	$4 500
Assessable termination payment (post June 1983 component)	$55 000

Using the above steps, termination payments surchage is calculated in the following manner.

Calculate Adjusted Taxable Income.

Taxable income excluding termination payment:	$45 000
Employer superannuation contributions:	$4 500
Assessable termination payment	
Pre–July 1983 component	Nil
Post June 1983 component	$55 000
Adjusted taxable income	**$104 500**

As the Adjusted taxable income exceeds the upper threshold, the surcharge rate is 15 per cent.

Calculate the amount of termination payment subject to the termination payments surcharge:

$$\frac{1045 \text{ days}}{3965 \text{ days}} \times \$55\,000 = \mathbf{\$14\,496}$$

Calculate surcharge payable on the termination payment:
$14 496 x 15 per cent = **$2174**

Example 1 applies to termination payment paid during the transition period (ie, between 20 August 1996 and 20 August 2001).

During the transition period, only the proportion of the termination accrued after 20 August 1996 is subject to the surcharge (ie, the date of effect of the surcharge legislation). Following the expiry of the transition period, *all* of the termination payment accrued after 30 June 1983 (ie, even entitlements accrued prior to the introduction of the surcharge legislation) is subject to the surcharge.

Example 2 recalculates the surcharge that would be payable after the expiry of the transition period using the same figures from Example 1 assuming the current Bill is not passed.

Example 2

Using the same data from Example 1, post–20 August 2001 termination payments surchage is calculated in the following manner.

Calculate Adjusted Taxable Income.

Taxable income excluding termination payment:	$45 000
Employer superannuation contributions:	$4 500
Assessable termination payment	
Pre–July 1983 component	Nil
Post June 1983 component	$55 000
Adjusted taxable income	**$104 500**

As the Adjusted taxable income exceeds the upper threshold, the surcharge rate is 15 per cent.

Calculate the amount of termination payment subject to the termination payments surcharge:

$\frac{3965 \text{ days}}{3965 \text{ days}} \times \$55\,000 = \mathbf{\$55\,000}$

Calculate surcharge payable on the termination payment:
$55 000 x 15 per cent = **$8 250**

Thus, as a result of the expiry of the transition period, the hypothetical person in our example would pay an additional $6 076, an increase of 369 per cent.

The most revealing feature of these examples is the retrospective application of the termination payment surcharge following the expiry of the transition period. The Bill addresses this very issue by, among other things, removing the retrospectivity.

Criticisms of the Termination Payments Surcharge

The surcharges have received much criticism, which is discussed in considerable detail in another publication by the Department of the Parliamentary Library ('Superannuation Contributions Surcharge (Assessment and Collection) Bill 1997', *Bills Digest 124*, Department of the Parliamentary Library, 1996-97.[6] Interested readers are encouraged to consult that paper.

The termination payment surcharge and superannuation contributions surcharge were also examined in the 23rd report of the former Senate Select Committee on Superannuation, *Superannuation Surcharge Legislation*.[7] Interested readers are encouraged to consult that report for a comprehensive examination of all of the issues raised during the debate over the original surcharge legislation.

Inequities in the Transitional Provisions of the Terminations Payment Surcharge

Particular sections of the 23rd report of the former Senate Select Committee on Superannuation, *Superannuation Surcharge Legislation* are useful for highlighting some of the issues covered by this Bill. These are summarised below.

Definition of "Assessable Income"

The definition of "assessable income" includes certain termination payments or "golden handshakes." The inclusion of termination payments (and a number of other items in the definition of assessable income) could result in lower income persons (not only so called high–income earners) being liable for the surcharge. Persons who had just lost their jobs and received a redundancy payment could find themselves in this category:

> It means that there are going to be a number of people who will be tipped over the $70,000 and will get a surprise in respect of this. People who would otherwise not regard themselves as high income earners will get included because a number of these other payments, redundancy payments, for instance, are included in the adjusted taxable income. There is an allowance for the tax free component, but there will certainly be circumstances where, in respect of the surcharge, somebody who has lost their job becomes a high income earner because of the payment that is made in respect of that and will be subject to additional liability.[8]

The inclusion of ETPs in the definition of "assessable income" also gives rise to a number of anomalies. The treatment of ETPs under surcharge legislation differs from other tax legislation. ETPs and unused leave payments are excluded from the income used in other tax legislation where income is intended to reflect the normal level of income rather than the effect of one-off lump sum payments.[9]

In response to these statements, the ATO clarified the Government's policy decision in the following terms:

> Adjusted taxable income is normal taxable income plus "surchargeable contributions." ETPs are included in the assessable income and become taxable income, however, bona fide redundancy payments were not included in the assessment. If the payment is a bona fide redundancy payment then that is not included in assessable income up to tax-free limits.
>
> 'Golden handshakes' for the purposes of the surcharge, does not include bona fide redundancy and approved early retirement payments to the extent to which they are

> within the income tax exemption levels. For 2001–02, the income tax exemption limits are $5 295 plus $2 648 per year of completed service with the employer.
>
> These limits are designed to ensure that the majority of such payments would be entirely outside the scope of the golden handshake definition. Including the excess of payments over these limits in the definition of "assessable income" is designed to prevent such payments being used as a method of avoiding the surcharge.
>
> The transitional measures were drafted to eliminate retrospective application of the surcharge to golden handshakes received within five years of the budget announcement.

Despite the Government being made aware of the above problems in the Senate Select Committee on Superannuation Inquiry into the original surcharge legislation, it has taken four years for these issues to be addressed.

Recent Criticisms of the Impending Expiration of Transitional Provisions

Some commentators have noted the retrospective applications of the expiry of the transition period.

> On August 20, 2001, the full 15% super surcharge will apply to most large taxable separation payments received by company executives. This will mean that before the age of 55, normal unfunded super tax of 31.5% for post–1983 benefits and the 15% surcharge – namely 46.5% tax – will apply on taxable separation payments. This is a tax break of only 2% on the top 48.5% tax rate.[10]

Others have noted that these provisions are "the most inequitable provisions of tax law" and that thousands of taxpayers were unfairly caught in the surcharge net after receiving large termination payments, often on being retrenched."[11]

Policy Commitment: 2001–02 Budget

In the 2001–02 Budget, the Government announced changes to be made to the termination payments surcharge. The information contained in the relevant Budget paper is provided below.[12]

Reduction in surcharge on certain termination payments

Revenue ($m)

	2001-02	2002-03	2003-04	2004-05
Australian Taxation Office:	-14.0	-21.0	-17.0	-21.0

Explanation

The Government will amend the Termination Payments Tax (Assessment and Collection) Act 1997 and the Superannuation Contributions Tax (Assessment and Collection) Act 1997:

- to make the existing transitional arrangements permanent, so that after 19 August 2001 only the portion of an employer eligible termination payment that accrued after 20 August 1996 will be liable to the termination payments surcharge if the termination payment is retained by the taxpayer, or the superannuation contributions surcharge if the termination payment is rolled over into a superannuation fund;
- to include only the amount of the employer eligible termination payment divided by the taxpayer's years of service in the taxpayer's adjusted taxable income for surcharge purposes — for such payments less than the upper surcharge threshold ($98,955 for the 2000-01 income year, indexed to average weekly ordinary times earnings); and
- so that the excessive component of an employer eligible termination payment is not liable to the termination payments surcharge, while retaining its liability to the Medicare levy and tax at 47 per cent as the excessive component of taxable income.

The first two amendments will apply from 20 August 1996 and the third will apply from 7:30pm AEST, 22 May 2001.

The Bill implements these initiatives.

Main Provisions

The main provisions of this Bill are divided into 3 schedules:

- Schedule 1 amends the *Superannuation Contributions Tax (Assessment and Collection) Act 1997*
- Schedule 2 amends the *Superannuation Contributions Tax (Members of Constitutionally Protected Superannuation Funds) Assessment and Collection Act 1997*, and

- Schedule 3 amends the *Termination Payments Tax (Assessment and Collection) Act 1997*.

The main provisions of the three Schedules are discussed below.

Schedule 1

Schedule 1 amends the *Superannuation Contributions Tax (Assessment and Collection) Act 1997* by changing the method by which a taxpayer's ATI is determined. **Item 1** inserts two new methods of calculating ATI. The two methods apply in different circumstances, depending on whether a person has received one or more ETPs. Proposed **section 7A** provides the first case of calculating ATI, where a person did not receive any employer ETPs in a financial year or if they did, the sum of the reduced amounts[13] was equal to or greater than the upper surcharge threshold for that year.

Proposed **section 7B** provides the second method of calculating ATI and is used where a person receives one or more ETPs in a financial year and the total of the reduced amounts of the ETP is less than the upper surcharge threshold for that year.

Items 2 and **3** insert new **subparagraph 8(2)(c)(iii)** and **subsection 8(2A)** and have the effect of limiting the application of the surcharge tax to portion of the termination payment that accrues after 20 August 1996. The portion of the ETP subject to the surcharge is calculated using the new formula provided by **item 1**.

Item 4 inserts a definition of "reduced amount of an ETP."

Items 6, 7 & 8 repeal the definitions of "ATI," "rolled over," and "specified roll–over amount" in **section 43** that have been replaced by the new meanings provided in **clause 1**.

Item 9 inserts an anti–detriment provision that is intended to maintain taxpayers' financial position (ie, a person should not to be in a worse position as a result of this Bill). This item enables the Commissioner of Taxation to amend a tax assessment to reduce a person's liability to the surcharge as a result of amendments provided by this Bill. An assessment cannot be amended to increase a person's surcharge liability if the increase is only as a result of amendments made by this Bill.

Schedule 2

Schedule 2 amends the *Superannuation Contributions Tax (Members of Constitutionally Protected Superannuation Funds) Assessment and Collection Act 1997* by making existing transitional arrangements permanent where they relate to the portion of a surcharge termination payment that is subject to surcharge.

Items 1, 2 and **3** provide that for members of constitutionally protected superannuation funds, only the "reduced amount" of an ETP is to be used in the calculation to determine the surchargable amount. The effect is that only the part of the employer ETP accrued after 20 August 1996 will be subject to the surcharge.

Item 5 inserts a new definition of ATI, which results in it having the same meaning as provided by **Schedule 1 item 1**.

Item 6 inserts a new definition of "rolled-over" and **item 7** repeals the definition of "specified roll–over amount" in **section 38**.

Item 8 inserts an anti–detriment provision that is intended to maintain taxpayers' financial position (ie, a person should not to be in a worse position as a result of this Bill). This item enables the Commissioner of Taxation to amend a tax assessment to reduce a person's liability to the surcharge as a result of amendments provided by this Bill. An assessment cannot be amended to increase a person's surcharge liability if the increase is only as a result of amendments made by this Bill.

Schedule 3

Schedule 3 amends the *Termination Payments Tax (Assessment and Collection) Act 1997* to exempt the excessive component of an employer ETP from liability to the termination payments surcharge.

Item 2 inserts a new subsection to exclude an "excessive component" of an employer ETP from being subject to the terminations payment surcharge. An "excessive component" is an amount determined by the Commissioner of Taxation under subsection 140R(1) of the *Income Tax Assessment Act 1936*, generally understood to be the amount of an ETP in excess of a person's reasonable benefit limit (RBL).

The amount of concessionally taxed superannuation benefits a person is allowed to receive over his or her lifetime is limited by RBLs. The table below[14] shows the lump sum and pension RBLs for the 2001–02 financial year. The pension RBL is available provided that at least 50 per cent of the total benefit received by a person is taken in the form of a pension or annuity that satisfies the pension and annuity standards.

Reasonable Benefit Limits	**$**
Lump sum	**529 373**
Pension	**1 058 742**

Item 3 inserts a new **section 9** to ensure that existing transitional arrangements are made permanent, ie that only the portion of a termination payment accrued after 20 August 1996 is subject to the surcharge. New **subsection 9(2)** sets out the method of determining the amount of the termination payment made before 7:30pm legal time in the Australian Capital Territory on 22 May 2001 which is subject to the surcharge. New **subsection 9(3)** sets out the method of determining the amount of the termination payment made after

7:30pm legal time in the Australian Capital Territory on 22 May 2001 which is subject to the surcharge.

Item 4 exempts the excessive component from the terminations payments tax on ETPs received after 7:30pm legal time in the Australian Capital Territory on 22 May 2001.

Item 5 inserts an anti–detriment provision that is intended to maintain taxpayers' financial position (ie, a person should not to be in a worse position as a result of this Bill). This item enables the Commissioner of Taxation to amend a tax assessment to reduce a person's liability to the surcharge as a result of amendments provided by this Bill. An assessment cannot be amended to increase a person's surcharge liability if the increase is only as a result of amendments made by this Bill.

Concluding Comments

The superannuation contributions and termination payments surcharge are important sources of revenue for the Government. In 1999–2000 surcharge collections alone amounted to $577 million.[15]

Nonetheless, the history of the superannuation contributions and termination payments surcharge now appears to have gone full circle in a rather "Kafka–esque" manner. These surcharges were introduced as "equity measures" to make the level of superannuation taxation concessions available to high income earners more comparable to those available to middle and lower income earners." On the brink of the expiration of the transitional provisions, the surcharge legislation is being amended to remove the "the most inequitable provisions of tax law" that could potentially and unfairly (but legally) catch taxpayers in the surcharge net after receiving large termination payments, often on being retrenched."[16]

Despite amending these so–called "inequitable" provisions, the surcharge legislation remains on the statute books. Many of the witnesses to the 23rd report of the former Senate Select Committee on Superannuation provisions will still be dealing with the complex administration, clumsy assessment procedures and on-going administration costs that are born not just by high income earners, but all superannuation fund members.[17]

The measures in this Bill will remove some of the inequities in the surcharge legislation, which is commendable. The broader issues of reform of the on–going inequality in Australia's system of superannuation taxation have again be left for another day.[18]

Endnotes

1 The Hon. Peter Slipper, MP, House of Representatives, *Debates*, 12 August 1999, Second Reading Speech to the Superannuation Contributions and Termination Payments Taxes Legislation Amendment Bill 1999.

2 Eligible termination payments (ETPs) are lump sums usually paid on retirement or resignation from a job and include 'golden handshakes', payments from superannuation funds, approved deposit funds (ADFs), and RSAs. ETPs are taxed differently from other income. ETPs are comprised of several components (although not all ETPs have every component). Each component of an ETP is taxed in a different manner and may be subject to various rebates.

3 Includes franking credits, realised capital gains and lump sums paid on termination of employment (eg. long service leave and annual leave).

4 From 1999–00 a person's reportable fringe benefits amount is added. This is the grossed–up value of employer–provided fringe benefits other than meals, entertainment and parking.

5 Under section 271–105(1) of Schedule 2F of the *Income Tax Assessment Act 1936*.

6 Available via the following link: http://www.aph.gov.au/library/pubs/bd/1996-97/97bd124.htm .

7 This report can be accessed via the following link: http://www.aph.gov.au/senate/committee/super_ctte/report_23/index.htm .

8 23rd report of the Senate Select Committee on Superannuation, *Superannuation Surcharge Legislation*, Canberra, March 1997, p. 49.

9 Ibid., p. 50.

10 Daryl Dixon, " Over the Top," *The Bulletin*, 27 February 2001.

11 Michael Laurence, "Tax Surcharge Pain Eased," *Business Review Weekly*, 25 May 2001, p. 15.

12 The Hon. Peter Costello, MP, Budget Paper No. 2, *Budget Measures 2001–02*, Canberra, 22 May 2001, p.32.

13 ie, the employer ETP less any CGT exempt component, post –June 1994 invalidity component and any part payment made from an employee share acquisition scheme.

14 Source: Commissioner of Taxation, *Taxation Determination TD 2001/15– Income Tax: What Are The Thresholds and Limits for Superannuation Amounts in 2001–2002*, 20 June 2001.

15 Commissioner of Taxation, *Annual Report 1999–2000*, Canberra 2000, p. 32.

16 Michael Laurence, "Tax Surcharge Pain Eased," *Business Review Weekly*, 25 may 2001, p. 15.

17 See the 23rd report of the former Senate Select Committee on Superannuation, *Superannuation Surcharge Legislation*, especially Chapter 4: The Proposed Collection Mechanism.

18 See David Kehl, 'Superannuation: Taxation Issues and Discussion of Proposals for Reform', *Research Paper 22 2000-01*, Department of the Parliamentary Library, 27 February 2001.