SUPERANNUATION AND EMPLOYEE BENEFITS PRACTICE COMMITTEE

Discussion Note:
An Update on Anti-detriment Calculations

September 2009

Purpose

The purpose of this Discussion Note is to:

▸ update members practising in superannuation on the calculation of anti-detriment amounts;

▸ share the views of the Superannuation and Employee Benefits Practice Committee ("SEBPC") on how anti–detriment amounts may be calculated for defined benefit entitlements; and

▸ solicit feedback from members on the method outlined in this Discussion Note.

Brief overview

The Appendix to this Discussion Note provides a more substantial overview and background on the calculation of anti-detriments amounts, from their inception in 1988 until the most recent advice from the Australian Taxation Office ("ATO") in 2007.

While the Tax Acts (both 1936 and 1997) contain a formula for calculating the tax deduction, neither Act contained or contains specific guidance on how to determine the detriment amount (that is, the effect of tax on employer and salary sacrifice member contributions) used in the tax deduction formula.

The Explanatory Memorandum to the amendments to the 1936 Tax Act that introduced the tax deduction stated that the detriment amount for a benefit accrued in a defined benefit fund was the detriment amount certified by an actuary. Alternatively, the amount could be calculated pursuant to a formula set out in the Explanatory Memorandum.

For a benefit accrued in an accumulation fund, the Explanatory Memorandum stated that the detriment amount was the detriment amount certified by an auditor or as calculated pursuant to the formula set out in the Explanatory Memorandum.

Over time, the formula set out in the Explanatory Memorandum, sometimes with adjustment, has been used by actuaries to determine the detriment amounts for death benefit payments to dependants from defined benefit funds. However, the formula may be more difficult to apply because of the superannuation tax changes effective 1 July 2007.

The formula from the Explanatory Memorandum has been superseded by formulae in two ATO interpretative decisions (IDs) issued in 2006 and 2007. These ATO IDs, though, apply only to accumulation funds.

Therefore, the issue this Discussion Note addresses is how anti-detriment amounts should now be calculated in respect of payments from defined benefit funds (in particular, from 1 July 2007 in view of the 2007 ATO Interpretative Decision (ATO ID 2007/219) and the tax changes from 1 July 2007).

In SEBPC's view, the position stated in the Explanatory Memorandum for defined benefit funds continues – that is, the detriment amount in respect of a payment from a defined benefit fund is an amount an actuary certifies is the detriment amount (now referred to as the "tax saving amount").

If the actuary does not believe the circumstances of the fund warrant determining the detriment amount in a specific fashion for the fund, the actuary may use a standard approach.

The standard approach, again consistent with the situation that developed from the original Explanatory Memorandum, should be consistent with the formula for benefits paid from accumulation funds, and hence consistent with the formula in ATO ID 2007/219.

This Discussion Note outlines a standard approach for payments from defined benefit funds that is consistent with ATO ID 2007/219.

Note that ID2007/219 does not specifically say that the formula it specifies for determining the tax saving amount applies to an accumulation benefit, but it does say that the decision is based on facts presented in relation to an accumulation fund. SEBPC believes that it is reasonable to use the ID2007/219 approach in respect of a purely accumulation benefit where the benefit has effectively been reduced for contribution tax, whether it be provided in an accumulation fund or a defined benefit fund.

Standard approach for defined benefit entitlement

The formula outlined in ID 2007/219 is as follows:

$$\frac{0.15P}{R - 0.15P} \times C$$

which can be re-expressed (in the same way the formula in the Appendix is re-expressed) as:

$$\frac{0.15\frac{P}{R}}{1 - 0.15\frac{P}{R}} \times C$$

where:

R = days in service period after 30 June 1983

P = days in service period of R after 30 June 1988

C = taxable component of the lump sum benefit
(excluding insurance component for which tax
deductions have been claimed)

So what this formula is doing (consistent with the formula used in respect of the 1936 Tax Act provisions outlined in the Appendix) is effectively grossing up the taxable component of the benefit with an estimate of the contributions tax paid (by dividing by $[1 - 0.15 P/R]$), and then applying the effective tax rate to the grossed-up taxable component (by multiplying by $0.15 P/R$) in order to estimate the amount of the contributions tax paid.

The taxable component is normally determined as:

Total benefit (excluding insurance component)

Less Tax free component

[As the crystallised component (which includes the pre 83 component under the former tax rules calculated at 1 July 2007) forms part of the tax free component, which is then deducted from the total benefit in determining the taxable component, the taxable component is largely representative of benefits accrued after 30 June 1983, and hence is presumably why R in the formula relates only to service after 30 June 1983.]

Where the benefit is purely an accumulation benefit, the taxable component is effectively based on account balances, and those account balances would reflect (that is, be net of) the contributions tax that has been incurred.

Therefore, how is this applied to a defined benefit? The benefit accrued from 30 June 1983 up to the date of death needs to be estimated and the result used as "C" in the formula.

A couple of comments:

‣ if the defined benefit has not been reduced for contributions tax then it should not be grossed up for tax (that is, it should not be divided by $1 - 0.15P/R$), and

‣ any insured amount for which a tax deduction has been claimed needs to be excluded.

This suggests that C in the case of a defined benefit should similarly be calculated as:

Total Defined Benefit less Insured Component

Less Tax free component

The Insured Component includes any self insurance for which a tax deduction has been claimed. The notion is that any such insured (or self-insured) component has effectively been funded from untaxed contributions and should therefore be excluded from the anti-detriment calculation. The remainder of the death benefit will be met from fund assets which have been built up, at least in part, from contributions which have been subject to tax.

If the total defined benefit had not been reduced for tax, then the tax saving amount is:

$$0.15 \frac{P}{R} \times C$$

In this situation the employer sponsor will usually receive the benefit of the tax saving and there is no benefit in addition to the standard Trust Deed death benefit paid to the dependants (unless in respect of an accumulation component payable in addition to the defined death benefit – see below).

If the total defined benefit had been reduced for tax then the tax saving amount is:

$$\frac{0.15 \frac{P}{R}}{1 - 0.15 \frac{P}{R}} \times C$$

In this case the tax saving amount must be paid to the dependants.

If the actuary does not believe that this approach best suits the fund's circumstances, then the actuary should determine a different approach.

Members entitled to benefit that is the sum of a defined benefit and accumulation benefit

If a member has a defined benefit plus an accumulation benefit (for example, say from additional salary sacrifice contributions, or roll-overs), the natural response would be to use the above formula for the defined benefit part plus ID2007/219 for the accumulation part. This will not be necessary if the defined benefit has also been reduced for tax so that the anti-detriment formula is the same for the defined benefit and accumulation parts (meaning separate calculations are unnecessary) and the tax saving amount is paid in full to the member.

But in practice the defined benefit is likely not to have been reduced for tax and so different anti-detriment formulae will need to be applied to the defined benefit and accumulation parts of the benefit. This will require the tax components (such as the crystallised component) to be apportioned between the defined benefit part and the accumulation part. Note that this split will affect the distribution of the tax saving between the member's dependants (the accumulation component) and the

fund/employer (the defined benefit component), so it is important that the split is reasonable.

In the absence of the actuary coming up with a specific formula that better reflects the circumstances of the fund, the following apportionment method would be considered appropriate.

If the defined benefit has not been reduced for tax:

▸ the ID 2007/219 method applies to the accumulation component, that is:

$$\frac{0.15\frac{P}{R}}{1 - 0.15\frac{P}{R}} \times C1$$

▸ the adjusted ID 2007/219 method applies to the defined benefit component, that is:

$$0.15\frac{P}{R} \times C2$$

where:

C1	=	Accumulation benefit taxable component (ABTC) less accumulation benefit sum insured (ABSI), if any
C2	=	DB taxable component (DBTC) less DB sum insured (DBSI), if any
ABTC	=	Total accumulation benefit (TAB) – accumulation benefit tax free component (ABTFC)
DBTC	=	Total DB benefit (TDB) – DB tax free component (DBTFC)

The total tax free component (TTFC = Crystallised Component + Non-Concessional Contributions) is split between the accumulation and DB components in proportion to the accumulation /DB make-up of the total benefit excluding insured components, that is:

ABTFC = TTFC × (TAB – ABSI)/(TAB – ABSI + TDB – DBSI)

DBTFC = TTFC × (TDB – DBSI)/(TAB – ABSI + TDB – DBSI)

Again, depending on the circumstances of the fund and the data available from the administration system, the actuary could determine a different apportionment method.

Appendix: Background to anti-detriment calculations

Prior to 30 June 1988, the income of superannuation funds was not subject to tax. Benefits payable from a superannuation fund were (in respect of service after 30 June 1983) taxed at 30% (ignoring Medicare levy). When tax was introduced on superannuation fund income, the government's position was that it was effectively bringing forward, rather than increasing, tax. On the introduction of the 15% tax on fund income, the 30% tax rate on benefits was reduced to 15%.

However, prior to 30 June 1988 lump sum benefits payable to a dependant on the death of the member were not subject to tax. Therefore "bringing forward" benefit tax would result in an increase in tax incurred on such lump sums.

To give effect to the government's position, a tax deduction was introduced to offset the negative impact of the introduction of contributions tax on the payment of a benefit on a member's death to a dependant. Section 279D was introduced to the 1936 Tax Act which provided a deduction calculated as:

$$\frac{\text{Notional payment reduction due to contribution tax}}{\text{Complying superannuation tax rate}}$$

"Notional payment reduction due to contributions tax" was defined to be the difference between:

1.   the amount that would have been the amount of the actual payment if:

    (a)   no amounts were included in the accessible income in relation to taxable contributions made to a complying fund, and

    (b)   it had been expected that no deduction would be allowable under this section in respect of the actual payment, and

2.   the amount that would have been the amount of the actual payment if it had been expected that no deduction would be allowable under this section in respect of the payment.

In other words, the Notional payment reduction due to contributions tax is the difference between what the benefit would have been if contributions were not taxable and the actual benefit payable as affected by tax.

"Complying superannuation tax rate" was the rate of tax imposed on the standard component of taxable incomes of complying superannuation funds (that is, 15%).

The conditions required for this tax deduction to be allowed were:

1.   the fund must be a continuously complying superannuation fund at all times since 1 July 1988 (or a later date of inception) to the end of the income year in which

the payment was made;

2.   the benefits must be paid to a dependant, or if paid to the estate, the ATO must be satisfied that a dependant will benefit from the estate; and

3.   The benefit must be increased by the amount of the tax benefit in respect of the deduction (or the benefit must not have been reduced as a result of the introduction of contributions tax) and the full increase (if applicable) must be paid in respect of the benefit.

Section 279D did not specify how the notional payment reduction was to be calculated. However, the Explanatory Memorandum that accompanied the amending legislation provided some guidance. The Explanatory Memorandum stated the following would generally be acceptable amounts:

1.   where the benefit accrued in a defined benefit fund – an amount certified by the fund's actuary as being the amount of the benefit reduction due to the tax on taxable contributions, or

2.   where the benefit accrued in the fund other than defined benefit fund – an amount certified by the fund's auditor as being the amount of benefit reduction due to the tax on taxable contributions, or

3.   an amount calculated according to the following formula:

$$\frac{0.15P}{T - 0.15P} \times A \times \frac{T}{T + \text{Future Service Days}}$$

where:

T   =   the total number of days in the accrual period of the benefit

P   =   the number of days that occurred after 30 June 1988

A   =   the amount of the actual payment less the undeducted contributions of the deceased member

"Future service days" had the same meaning in respect to the payment as in section 159SP of the Tax Act. That section relates to payments of a pension or annuity, rather than a lump sum payment, but says future service days can be taken to be the number of days in the period commencing when entitlement to the payment arises and ending with the deceased's last retirement date. The last "retirement date" is defined in the Tax Act and was generally taken to be age 65.

A perhaps instructive way of re–expressing this formula is as follows:

$$\frac{0.15\frac{P}{t}}{1 - 0.15\frac{P}{t}} \times A \times \frac{T}{T + \text{Future Service Days}}$$

The term $0.15 \frac{p}{t}$ represents the "effective tax rate" on company contributions paid over the member's past membership. If P equals T then this formula produces 15% – as expected. For example, say there were ten years of membership prior to 30 June 1988 and ten years after 30 June 1988. This formula produces an effective tax rate on company contributions over that 20 year period of 7.5% (that is, nil in respect of the first ten years and 15% in respect of the second ten years) – a simple, but reasonable, approximation.

The term A × T/(T + Future Service Days) represents the portion of the death benefit in relation to past membership (that is, A is the total death benefit, including surcharge account, less any undeducted contributions, as undeducted contributions, of course, are not subject to contributions tax).

Therefore, what this formula does is gross-up an estimate of the accrued benefit by the effective rate of tax that has applied to taxable contributions that are included in the accrued benefit, through dividing by [1 – the effective tax rate]. This then produces an estimate of what the benefit would have been had contributions tax not applied. The amount of tax incurred is then estimated by multiplying this grossed up Accrued Benefit by the effective tax rate of estimate of what the benefit would have been had contributions tax not applied. The amount of tax incurred is then estimated by multiplying this grossed up Accrued Benefit by the effective tax rate of estimate of what the benefit would have been had contributions tax not applied. The amount of tax incurred is then estimated by multiplying this grossed up Accrued Benefit by the effective tax rate of $0.15 \frac{p}{t}$.

Therefore, this formula assumes the accrued benefit is net of contributions tax.

If a benefit design was not changed on or after 1 July 1988 (for example, as may have occurred in a defined benefit arrangement), then "A" may, in fact, not be the net amount after contributions tax. Therefore, if A is not net of contributions tax, it would be inappropriate to gross up A by the effective rate of tax.

If there has been no reduction in A due to contributions tax, then in the above formula, the term (1 – the effective tax rate) is not necessary. The detriment amount is then the effective tax rate times the accrued benefit.

So, in summary, this is effectively saying that the anti-detriment amount is calculated as:

Effective Tax Rate × Accrued Benefit Grossed Up for Effective Tax Incurred

This formula became the typical formula that actuaries would use for defined benefit entitlements in the absence of having any other means of determining the Notional payment reduction due to contributions tax for a defined benefit entitlement. In many cases actuaries used the same formula (as the original Explanatory Memorandum seemed to permit) where a defined benefit had not been reduced for contribution tax. However, following an ATO audit of a particular fund, the ATO refused to accept this

formula where benefits had not been reduced. In effect, the ATO indicated that the formula should be adjusted to remove the division by 1- .15 p/t.

ATO Interpretative Decision 2006/290

The ATO issued an Interpretative Decision (ID) 2006/209 which summarised the Tax Commissioner's view of an alternative method for estimating the "Notional payment reduction due to contributions tax amount" for an accumulation fund.

That method was the formula:

$$\frac{0.15P}{R - 0.15R} \times C$$

where:

> P = the number of days in component R that occurred after 30 June 1988
>
> R = the total number of days the eligible service period that occurred after 30 June 1983
>
> C = the amount of the post June 1983 component of the actual payment referred to in paragraph 279D(2)(b) calculated in section 27AA of the 1936 Tax Act after excluding the actual, if any, insured amount for which deductions have been claimed under sections 279 or 279 B of the 1936 Tax Act

In other words, this is basically the same as the formula covered in the Explanatory Memorandum, except that rather than apportioning A to determine the accrued amount, the accrued amount is effectively simply the member's account balance (excluding any sum insured component). A further adjustment reflects the fact that C only includes post June 1983 components, and hence R only reflects service after 30 June 1983.

This seems a logical way of interpreting the law that is consistent with the original Explanatory Memorandum but recognises that for an accumulation fund, the best measure of the accrued benefit is of course the member's account balance.

ATO 2 Interpretative Decision 2007/219

Due to the introduction of the Better Super tax changes, sections of the 1936 Tax Act were rewritten in the 1997 Tax Act. The anti-detriment amount in the 1997 Tax Act is contained in section 295—485 (3) and defines the anti-detriment tax calculation amount as:

$$\frac{\text{Tax Saving Amount}}{\text{Low Tax Component}}$$

This section carried over the provisions of section 279 of the 1936 Tax Act, though with a few changes. The deduction applies when a complying super fund pays a lump sum because of the death of a person to an individual who was a spouse, former spouse or child of the deceased at the time of making payment and increases the lump sum amount, or does not reduce the lump sum by an amount ("the tax saving amount") so the amount of the lump sum is the amount that the fund could have paid if no tax were payable on amounts included in assessable income under Sub-division 295C of the 1997 Tax Act and section 274 of the 1936 Tax Act. In other words, a fund can get a deduction to ensure that the amount of the lump sum death benefit paid (directly or indirectly via an estate) to a spouse, former spouse or child of the deceased is not reduced as the result of contributions being taxed.

The Low Tax Component rate is the rate imposed on the low tax component of a fund's taxable income for the year (that is, 15%).

Not only did the provisions need to change to reflect the rewriting in the 1997 Tax Act, but also to reflect changes made by Better Super (for example, undeducted contributions no longer existed). The formula from ATOID 2006/290 remained the same, that is:

$$\frac{0.15P}{R - 0.15R} \times C$$

and while P remained the same as in ID2006/290, R and C changed as follows:

R = the total number of days in the service period as defined section 307−400 of the 1997 Tax Act that occur after 30 June 1983

C = the taxable component of the lump sum calculated under section 307−125 of the 1997 Tax Act as if no deduction under subsection 295−485(2) of the 1997 Tax Act were allowed, after excluding the actual (if any) insured amount for which deductions have been claimed under sections 295−465 or 295−470 of the 1997 Tax Act

New Defined Benefit funds

Following the re-write of the anti-detriment provisions as part of the Simpler Super changes, it now appears clear that a defined benefit fund which commenced after 1 July 1988 can claim an anti-detriment tax deduction without augmenting the member's benefit where the death benefit has not been reduced for contribution tax.

This may be easy to demonstrate where the new DB fund replicates the benefits in a predecessor fund which was in existence prior to 1 July 1988.

Where there was no predecessor fund, it would presumably be necessary to justify any claim, based on the benefit design (for example, the death benefit is based on a suitably higher benefit accrual than the retirement benefit).

Dependants

Prior to Simpler Super, anti-detriment payments were only applicable if the benefit was paid to certain of the member's dependants. This included the member's spouse, a child of any age and a financial dependant. However it did not include payments to a person who only qualified as a beneficiary due to an interdependency relationship with the deceased.

However, following the introduction of Simpler Super, the legislation has clearly been changed (despite comments in the Explanatory Memorandum to the contrary), to restrict anti-detriment payments to payments made to the spouse, former spouse or child (of any age) of the deceased. Following subsequent changes effective from 1 July 2008 (same-sex legislation), the definitions of spouse and child have been broadened.