IT 2620 - Income tax: assessment of eligible termination payments - determination of forgone benefit part of approved early retirement scheme payments and bona fide redundancy payments made to members of pension funds

TITLE

TAXATION RULING NO. IT 2620

INCOME TAX ASSESSMENT OF ELIGIBLE TERMINATION PAYMENTS - DETERMINATION OF FORGONE BENEFIT PART OF APPROVED EARLY RETIREMENT SCHEME PAYMENTS AND BONA FIDE REDUNDANCY PAYMENTS MADE TO MEMBERS OF PENSION FUNDS

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FOI INDEX DETAIL

Reference no.	Subject refs:	Legislative Refs:
I 1012449	CONCESSIONAL COMPONENT	27A
	ELIGIBLE TERMINATION PAYMENTS	27E
		27F
	FORGONE BENEFIT PART	

OTHER RULINGS ON TOPIC: IT 2286 and IT 2490

PREAMBLE

Sections 27E and 27F of the Income Tax Assessment Act 1936 (the Act) provide the basis for determining whether an eligible termination payment (ETP) consists in whole or in part of an approved early retirement scheme payment or a bona fide redundancy payment. Approved early retirement scheme and bona fide redundancy payments, as well as invalidity payments (section 27G), constitute for the purposes of Subdivision AA of Division 2 of Part III of the Act, a "concessional component" of an ETP. Unless rolled over, 5% of the concessional component of an ETP is included in assessable income under subsection 27C(2). Taxation Ruling IT 2286 provided guidelines as to the approval of early retirement schemes and the application of sections 27E and 27F. Taxation Ruling IT 2490 provided examples of the application of subsections 27E(5) and 27F(2) to payments made by lump sum superannuation funds.

2. An ETP paid under an approved early retirement scheme or redundancy arrangements is not a concessional component to the extent that the payment constitutes a forgone benefit within the meaning in subsection 27E(5) or subsection 27F(2). This Ruling deals with the application of subsections 27E(5) and 27F(2) to ETPs paid to members of the current Commonwealth superannuation scheme and other superannuation pension schemes and funds. Together with Taxation Ruling IT2490, which dealt with the application of subsections 27E(5) and 27F(2) to ETPs paid from lump sum superannuation funds, this Ruling will cover the full spectrum of ETPs that may have forgone benefit parts.

BACKGROUND

3. Subsections 27E(5) and 27F(2) were inserted into sections 27E

and 27F by the Income Tax Assessment Amendment Act 1985 (Act No. 129 of 1985) and apply to ETPs paid after 23 May 1985. These subsections exclude from the concessional component of an ETP, that part (referred to as the forgone benefit part) of the ETP made in lieu of superannuation benefits to which the taxpayer may have become entitled at the termination time or at a later time.

4. Under the rules of many superannuation pension funds, including the Commonwealth superannuation scheme and similar schemes, members who retire involuntarily may elect to receive lump sum payments in lieu of a pension. For example, under the rules of the Commonwealth superannuation scheme, members with at least 1 year's contributory service who retire involuntarily at or after age 36 but before attaining 60 years of age may elect to receive either an indexed pension and an unindexed pension calculated according to the rules of the fund, an indexed pension and a lump sum, or a lump sum payment of 3 1/2 times their accumulated basic contributions.

5. The question has arisen in relation to those members of pension funds who receive ETPs to which sections 27E and 27F may apply, as to how much of any lump sum benefit constitutes a concessional component for the purposes of Subdivision AA. In particular, the question arises as to what part, if any, of the 3 1/2 times accumulated basic contributions payment made under the Commonwealth superannuation scheme represents a concessional component. It has been argued, especially by people under age 55 who would not have been entitled to anything other than a lump sum payment of their accumulated basic contributions on ordinary resignation, that the amount of 2 1/2 times accumulated basic contributions should be treated as a concessional component.

RULING

6. Superannuation funds will often provide benefits on redundancy or under an early retirement scheme that are greater than the benefits paid on resignation. Generally, the only reason for the redundancy or early retirement scheme benefit exceeding the resignation benefit is that the member is treated, at the time of termination, as having satisfied the fund's vesting rules even though the member had not actually satisfied them (e.g., because the member had not attained the minimum retiring age). In such cases the rules of a superannuation fund would ordinarily provide a method for determining the benefit that could be expected to have been paid if there was full vesting of the member's accrued entitlements at the termination time. In these circumstances, the excess payment is paid in lieu of benefits that the member would have become entitled to at a later time when vesting occurred.

7. In the circumstances described in paragraph 5 the additional amount paid on redundancy or early retirement would constitute a forgone benefit. For that reason, it is considered that it will be very rare for a redundancy or early retirement scheme payment from a superannuation fund to contain a concessional component. In effect, the payment would have to exceed the member's "vested" interest in the fund (i.e. if the vesting rules were fully satisfied) for there to be any concessional component.

8. To determine whether there is a concessional component requires a comparison of the actual ETP with the amount that could be expected to have been paid if the member had satisfied the vesting requirements in the superannuation fund's rules. In cases of redundancy or early retirement, rules contained in pension funds that would otherwise ensure that there was very little or no pension entitlement may restore the employee to a state of equity with employees who are not forced to retire involuntarily. For instance, a person who is forced to terminate employment before the minimum age at which a pension ordinarily becomes payable from a superannuation fund may become entitled to a discounted value of the pension that would have been payable if the person had attained the minimum age. Alternatively, a lump sum may be available to the member in lieu of the discounted pension. It is considered that, regardless of whether the person is entitled to a pension at the date of termination of employment or not, the pension fund has made a commitment to pay a pension at a later date.

9. To determine whether an ETP received from a superannuation pension fund on redundancy or early retirement has a forgone benefit part, it is necessary to calculate the present value of the pension benefit forgone by the ETP recipient. The forgone benefit part of such an ETP will be the present value of the forgone pension or the amount of the ETP, whichever is smaller, reduced by the amount, if any, that could reasonably have been expected to be paid on ordinary resignation. For that purpose, the forgone pension is the amount of pension that would have been payable at the termination time if -

- where the person has attained the minimum retiring age at which a pension is payable under the fund's rules - the ETP had not been paid to the person; and

- where the person has not reached the minimum retiring age - the person had worked until the minimum retiring age (i.e. assuming that the person's period of service included actual service recognised under the fund's rules plus the period from the time of termination until the person would have reached the minimum retiring age).

10. The present value of a pension is to be calculated using the pension valuation factors in the Attachment to this Ruling. The factors have been prepared by the Australian Government Actuary and are the same as those contained in Schedule 3 of the recent amendments to the Occupational Superannuation Standards (OSS) Regulations (Statutory Rules 1990 No.202). The factors are used to determine the capital value of a superannuation pension for the purposes of the reasonable benefit limits in OSS regulation 4D.

11. Based on the above principles, for members of the Commonwealth superannuation scheme (and other pension schemes) a concessional component will only arise to the extent that any lump sum ETP paid exceeds the present value of any pension benefit that would have crystallised at the termination time based on the minimum retiring age, i.e. age 55 for Commonwealth

superannuation scheme members, if the member had worked until then. Where an actual pension entitlement for someone under 55 is forgone (i.e. where there was an entitlement to a discounted version of the pension payable at the minimum retiring age) it may be easier to calculate the present value of that actual pension first for comparison with the ETP. If the ETP does not exceed the present value of the actual pension it would not be necessary to work out the present value of the (larger) pension that would have been payable to the person if the person had been 55 years old.

Example

- Taxpayer A, aged 49, retires under an approved early retirement scheme after 30 years service with a Commonwealth department.

- A's accumulated basic contributions (which include accumulated earnings) are $53,000.

- A's final salary for superannuation purposes was $35,000 per annum when A retired.

- Under the Superannuation Act 1976, the following rules apply in relation to the calculation of A's retirement benefits at age 49 -

  - A's actual standard pension entitlement is a standard early age indexed pension determined by reference to the standard pension based on a retirement age of 60 and actual years of service (i.e. 30 years), less 3 1/3% of that pension for each year or part year by which the retiree did not attain the age of 60. In A's case the standard early age pension would be 28.5% (45% less 16.5%) of final salary, i.e., $9,975. The reduction of 16.5% is determined from 45% x 3 1/3% x 11.

  - an additional early age non-indexed pension entitlement is calculated by multiplying accumulated basic contributions by a factor provided in the Regulations made under the Superannuation Act 1976. The factor is based on the age of the retiring member. For a 49 year old the factor is .0842.

- On retirement at age 55 A would have been entitled to a standard indexed pension based on a percentage of final salary, age and completed years of contributory service. Had A continued working until 55, with 36 years service, he or she would have been entitled to a pension of 38.625% (46.35% less 7.725%) of final salary, i.e., $13,518. The reduction of 7.725% is determined from 46.35% x 3 1/3%x 5.

- The following options are available to A at the time he or she retires under the approved early retirement scheme (the pensions incorporate reversionary pensions of 67% payable on death and where applicable, are indexed to the Consumer Price Index which, in the example below, is assumed to be at least 7% but less than 8%.) -

(i)	A standard early age indexed pension (.285 x $35,000)	$9,975
	and	
	an additional non-indexed pension (.0842 x $53,000)	$4,462;
(ii)	A standard early age indexed pension	$9,975
	and	
	lump sum payment of accumulated basic contributions in lieu of the additional pension	$53,000; or
(iii)	A lump sum payment of $185,500 being 3 1/2 times the accumulated basic contributions in lieu of the standard and additional pensions (the actual ETP amount may be smaller than the lump sum payment if there is any unused undeducted purchase price)	

12. To determine the forgone benefit part of A's entitlement it is strictly necessary to determine the present value at retirement (age 49 in this example) of the notional pensions that would have been payable if A had attained the minimum retiring age, i.e., age 55. But, as noted in paragraph 10, in a case like this, where A has actual pension entitlements, it may only be necessary to determine the present value of the actual pensions.

13. In the case of the Commonwealth superannuation scheme the amount that would be payable on ordinary resignation is the amount of the member's accumulated basic contributions, i.e. the same amount for which the additional early retirement non-indexed pension may be commuted. In that case it would only be necessary to determine the present value of the standard indexed pension. If the ETP does not exceed the sum of that amount and the amount of accumulated contributions there will be no concessional component. Based on the factor of 19 (corresponding to age 49 and 50 - 75% reversion - see Note 1 of the Attachment) in the table of pension conversion factors for an indexation rate of at least 7% but less than 8%, the present value of A's standard indexed pension of $9,975 is $189,525 ($9,975 x 19).

14. Assume that A takes the lump sum payment under option (iii). In order to determine whether the ETP paid to A contains a concessional component it is necessary to compare that ETP to an amount called the 'termination amount' in the law. The termination amount is made up of the amount that would have been payable as an ETP on ordinary resignation plus any forgone benefit part. A could have expected to receive an ETP of $53,000 on resignation, i.e., a lump sum payment equal to the accumulated basic contributions. The forgone benefit part in this case is $132,500 calculated as :

$185,500 (i.e. the lessor of the present value of the forgone pension and the ETP)	less	$53,000 (i.e. the amount that would have been paid on ordinary resignation)

Since the ETP paid to A (assume that is the whole lump sum of $185,500) does not exceed the termination amount of $185,500 (i.e., $53,000 + $132,500) there will not be any concessional component in the ETP. There will never be a concessional component in a case like this, where the present value of pension benefits forgone exceeds the amount of ETP.

15. Although not relevant to the calculation in this particular example, because the ETP received did not exceed the superannuation benefits forgone at the termination time, regard may also need to be given to superannuation benefits to which the taxpayer may have become entitled at a later time. Based on the same facts as above this would necessitate calculating the present value of a standard indexed pension of $13,518 (i.e., 38.625% of $35,000). This further calculation would be necessary where the ETP exceeds the termination amount calculated by reference to the person's entitlements at the termination time if the person was below the minimum retiring age. In the example above, if the ETP exceeded $242,525 it would be necessary to calculate the present value (at age 49) of the standard indexed pension of $13,518.

16. Because it is not possible to cover all permutations of pension entitlements and retrenchment arrangements, where the above principles do not provide sufficient guidance as to the application of subsections 27F(5) and 27E(2) the trustee of the pension fund can request an advance opinion on particular arrangements in accordance with IT 2500. Such requests should provide firm details of the benefits payable on redundancy or early retirement and valuations of the pension benefits forgone.

Redundancy and early retirement scheme payments paid by employers

17. Often when employees are made redundant or retire under an early retirement scheme, an employer will make severance payments to the employees. In some cases the severance payments may be required under an award or a contract of employment, while in other cases the payments may be made gratuitously by the employer. These types of payment will not constitute forgone benefits unless, from the terms governing their payment, it is clear they are made in substitution for superannuation benefits that had accrued at the time of redundancy or early retirement or that would be payable at a later time if the persons remained in employment. Such a conclusion might be reached if, for instance, a payment by an employer was calculated by reference to superannuation benefits that would have been payable from a superannuation fund at the termination time but for the employer payment, or at a later time if the person had continued in employment.

COMMISSIONER OF TAXATION
15 November 1990

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PENSION VALUATION FACTORS

Notes

1. A reference in the tables to "Age" is a reference to the age of the recipient on the commencement day of the relevant pension. If the age of a person on that day falls between 2 of the ages specified in a table, the pension valuation factor is to be determined by reference to the factors specified under the next greater age group in the table.

2. If a pension has no reversion, the pension valuation factor for the pension is to be the relevant factor specified in the relevant table in the "Below 50%" group.

3. If the rules of a superannuation fund provide that a pension is indexed to movements in salary, the pension valuation factor for the pension is the relevant factor specified in the table relating to an indexation rate of 8%.

4. If a pension is indexed by reference to movements in the Consumer Price Index published by the Australian Statistician, the pension valuation factoor for the pension s the relevant factor applicable under the table into which the standard indexation rate falls.

TABLES

Indexation rate of 8%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	33	31	29	27	25	23	21	18	16	14	12
50% - 75%	34	33	31	29	27	25	22	20	18	15	13
Above 75%	35	34	32	30	28	26	24	21	19	16	14

Indexation rate of at least 7% but less than 8%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	26	25	24	23	21	20	18	16	14	13	11
50% - 75%	27	26	25	24	23	21	19	18	16	14	12
Above 75%	28	27	26	25	24	22	20	19	17	15	13

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Indexation rate of at least 6% but less than 7%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	22	21	20	19	18	17	16	14	13	12	10
50% - 75%	22	22	21	20	19	18	17	16	14	13	11
Above 75%	23	22	22	21	20	19	18	16	15	13	12

Indexation rate of at least 5% but less than 6%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	18	18	17	17	16	15	14	13	12	11	10
50% - 75%	19	18	18	17	17	16	15	14	13	12	10
Above 75%	19	19	18	18	17	17	16	15	13	12	11

Indexation rate of at least 4% but less than 5%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	16	15	15	15	14	13	13	12	11	10	9
50% - 75%	16	16	15	15	15	14	13	13	12	11	10
Above 75%	16	16	16	15	15	15	14	13	12	11	10

Indexation rate of at least 3% but less than 4%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	14	14	13	13	13	12	11	11	10	9	8
50% - 75%	14	14	14	13	13	13	12	11	11	10	9
Above 75%	14	14	14	14	13	13	12	12	11	10	9

Indexation rate of at least 2% but less than 3%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	12	12	12	12	11	11	10	10	9	9	8
50% - 75%	12	12	12	12	12	11	11	10	10	9	8
Above 75%	12	12	12	12	12	12	11	11	10	9	9

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Indexation rate of at least 1% but less than 2%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	11	11	11	11	10	10	10	9	9	8	7
50% - 75%	11	11	11	11	11	10	10	10	9	8	8
Above 75%	11	11	11	11	11	10	10	10	9	9	8

Indexation rate of less than 1%

Reversion	Age										
	20	25	30	35	40	45	50	55	60	65	70
Below 50%	10	10	10	10	9	9	9	8	8	8	7
50% - 75%	10	10	10	10	10	9	9	9	8	8	7
Above 75%	10	10	10	10	10	10	9	9	9	8	8