

***TD 94/D82 - Income tax: does section 26AH of the Income Tax Assessment Act 1936 apply when investment options are switched under an eligible policy?***

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This document has been finalised by TD 94/82.

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## Draft Taxation Determination

### **Income tax: does section 26AH of the *Income Tax Assessment Act 1936* apply when investment options are switched under an eligible policy?**

1. Switching can be defined as a facility which allows policy holders of unbundled life insurance policies to reclassify or vary the class or classes of assets supporting the policy. For example, policy holders may choose to switch between units backed by ordinary shares, property, fixed interest or cash. The policy holder has the flexibility to select her/his preferred investment strategy based on the risks and profitability of different assets and, therefore, to change the way in which the future value of the policy is calculated. After the switching option has been exercised, the rights or entitlements under the insurance policy are calculated by reference to different assets - the earnings expectation of the policy has been altered.

2. Some life insurance products include a switching option in the terms of the contract, while others do not. If switching has occurred, it is a question of fact as to whether there has been a mere variation in the terms of the contract or the discharge of an existing contract and the creation of a new one. The intention of the parties is relevant but not necessarily easy to determine. From the facts, it must be determined whether the variation in the terms has created a new contract which is so inconsistent with the original contract that it is obvious that the original one is extinguished.

3. Generally speaking, switching does not involve the payment of any new or additional premiums, a change in the value of the policy, a surrender of any part of the policy or a re-application of money. As such it involves the mere variation in the calculation base of the existing policy and, therefore, the provisions of section 26AH do not apply. Taxation Ruling IT 2346 (paragraph 17) recognises that a variation in conditions attaching to an eligible policy does not necessarily terminate the policy and give rise to a new one. If the original contract contains a switching clause or if it contains a variation clause and the contract is varied to add a switching clause, it is easier to conclude that there has been a mere variation in the contract when the policyholder exercises the switching option. However, the absence of a switching clause or of a variation provision does not prevent the addition of a switching clause and the subsequent exercise of the switching option from being considered as a mere variation of the contract for section 26AH purposes.

4. However, if from a consideration of the relevant contract it appears that the policy does not provide for switching or for variations to the contract, and that the policyholder is

only able to change his or her preferred investment options by surrendering the existing policy and entering into a new policy, subsections 26AH(4) and (13) would operate (the operation of subsection 26AH(4) is however subject to subsection 26AH(5)). That would be the case if the policy certificate was cancelled and a replacement issued, or if existing policies were converted or consolidated into one, or if the underlying risk insured against was changed. This conclusion is consistent with paragraph 15 of IT 2346 which refers to the sale of units in specified investment classes in relation to unbundled policies and which states that the sale of one class of units and the reinvestment of the amount derived into units of another class is a partial surrender to which subsection 26AH(13) applies.

However, switching amounting to a mere variation of the existing contract does not involve the sale of units of one class and the purchase of units of another class.

5. Under the *Friendly Society Act 1986 (Vic)*, a friendly society's benefit funds are constituted by rules. Under that Act, the rules constitute the terms of the contract between the society and individual policyholders. If a friendly society which is permitted by its rules to invest in a limited range of investments issues an eligible policy and later amends its rules to permit a wider range of investments (e.g. to include equities) and to allow switching by policyholders, such changes and any subsequent switching under the new rules represent mere variations of the contract between the policyholder and the friendly society. In that case subsections 26AH(4) and (13) do not apply if a policyholder opts to switch to a different investment option.

#### *Example*

*A friendly society changes its rules by adding the clause 'each member contributing to Fund X shall (a) nominate the proportions by which her or his contributions are to be allocated to each of the investment account and (b) be entitled to vary her or his allocation to each investment account from time to time by written notice to the Society'. If the holder of a policy entered into before the change in the rules opts to exercise the option under (b), the exercise of the option is not sufficient to trigger the operation of subsections 26AH (4) or (13).*

#### **Commissioner of Taxation**

4/8/94

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Related Determinations:

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