IT 2346 - Income tax : bonuses paid on certain life assurance policies - section 26AH - interpretation and operation

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TAXATION RULING NO. IT 2346

INCOME TAX : BONUSES PAID ON CERTAIN LIFE ASSURANCE POLICIES - SECTION 26AH - INTERPRETATION AND OPERATION

F.O.I. EMBARGO: May be released

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OTHER RULINGS ON TOPIC - IT 2147, PARAGRAPH 9

PREAMBLE

The purpose of this Ruling is to explain a number of issues that have been raised in relation to the interpretation and operation of section 26AH of the Income Tax Assessment Act 1936. Section 26AH was inserted in that Act by the Income Tax Assessment Amendment Act 1984 (Act No. 14 of 1984), which received the Royal Assent on 12 April 1984. The section provides for the taxing of amounts paid as or by way of bonuses under life assurance policies taken out after 27 August 1982, and which are not subject to tax under any other provision of the income tax law. Section 160AAB, inserted in the Assessment Act by the same amending Act, provides a rebate of tax at the rate of 30% in respect of amounts included as assessable income under section 26AH.

BACKGROUND

2. Section 26AH provides that a taxpayer's assessable income shall include bonuses, and some other amounts in the nature of bonuses, received under a relevant life assurance policy ("an eligible policy") during a specified period ("the eligible period"). An eligible policy is defined to mean a policy of life assurance in relation to which the date of commencement of risk is after 27 August 1982, while the date of commencement of risk in relation to an eligible policy is -

- the date of commencement of the period to which the first or only premium paid under the policy relates; or
- where the first or only premium does not relate to a particular period, the date of payment of that premium.

The eligible period in respect of an eligible policy is the first 10 years in the case of a policy with a date of commencement of risk after 7 December 1983 or the first 4 years

where the date of commencement of risk is after 27 August 1982 and on or before 7 December 1983.

3. The combined effect of sub-sections 26AH(6) and (14) is that, for an eligible policy taken out after 27 August 1982 and on or before 7 December 1983, amounts received as or by way of bonuses are included in the recipient's asssessable income in full if received within two years of the date of commencement of risk of the policy, and as to two-thirds or one-third if received in the third or fourth year after that date. In respect of an eligible policy taken out after 7 December 1983, amounts received as or by way of bonuses are assessable in full if received in the first eight years after the date of commencement of risk of the policy, and as to two-thirds or one-third if received in the ninth or tenth year after that date.

4. Section 26AH does not subject to tax amounts received under a policy of life assurance where the amount is received as a result of the death of, or an accident, illness or other disability suffered by, the person on whose life the policy was effected. Receipts arising from policies that are part of an exempt superannuation fund or scheme are also outside the scope of the section. In addition, the section does not apply to amounts received as a result of the forfeiture, surrender or other termination of the whole or a part of a policy in circumstances arising out of serious financial difficulties of the taxpayer, unless the policy was effected, purchased or taken on assignment with a view to it being forfeited, surrendered or otherwise terminated, or to it maturing, within ten years (or four years in the case of a policy with a date of commencement of risk after 27 August 1982 and on or before 7 December 1983). These exclusions are specified in sub-section 26AH(7).

5. Section 26AH may apply to amounts received under any form of life assurance policy including those known as unbundled life assurance contracts (referred to in this Ruling as "unbundled policies") and which may be categorised as either investment account or investment-linked policies. Some of the more general features of unbundled policies are as follows:

. Investment account policy

  A contract providing a death benefit plus some type of identifiable savings account or investment account, the balance of which usually becomes the benefit payable in certain circumstances, most commonly after a number of years when a balance has accumulated in the account.

  Source : Life Insurance Commissioner
  Annual Report 1985

. Investment-linked policy

  A contract providing a death benefit, and an investment account the value of which is directly linked to the performance of a specific investment portfolio. The value of the policyholder's interest will rise and fall

with the movements in the value of the portfolio.

Source : Life Insurance Commissioner
Annual Report 1985

6. Premiums in respect of an unbundled policy may be paid in a lump sum or annually, or the policyholder may elect to vary the amount of the premium by making additional payments under the policy at any time. A further feature of these types of policies is that they generally allow the policyholder to surrender a part of the policy at any time (a "partial surrender").

RULING The meaning of "received"

7. Section 26AH primarily applies to amounts actually received by a taxpayer as or by way of a bonus under an eligible policy. However, sub-section 26AH(4) operates, subject to sub-section 26AH(5), to ensure that where an amount of bonus is dealt with on behalf of or at the direction of the taxpayer, he or she is taken to have received that amount. It is important to note, however, that the mere crediting of a bonus to a policy of life assurance is not to be taken as the receipt by the taxpayer of the bonus. In this regard, sub-section 26AH(5) provides that sub-section 26AH(4) does not apply to a bonus or similar amount that is applied to increase the surrender or maturity value of a life assurance policy.

The meaning of "bonus"

8. The term bonus is not defined. In relation to the more traditional policies (e.g. endowment policies - the proceeds of which are payable on survival to the maturity date stated in the policy or on prior death), a bonus is a guaranteed addition to the sum insured which is payable when the sum insured is payable. This additional amount paid in respect of a life assurance policy represents a form of participation by the policyholder in the issuing company's profits. It represents a share in the surpluses derived by the issuing company during the period the policy is in force. Such a bonus received under a policy that was taken out after 27 August 1982 and that matures or is surrendered, forfeited or otherwise terminated in whole or part within the eligible period (i.e. 4 years or 10 years after commencement) falls within the scope of section 26AH.

9. In the case of unbundled policies, the concept of bonuses representing the profit or gain element passed on to the policyholder is maintained for the purposes of section 26AH. For example, where a policy is linked to the purchase and sale of investment units, the profit derived on the sale of those units is, when paid to the policyholder, regarded as a payment by way of a bonus. Similarly, interest derived in respect of an investment account policy is, when paid to the policyholder, regarded as a payment by way of a bonus. Sub-section 26AH(9) is relevant in this regard. Under that sub-section, an amount received otherwise than as or by way of a bonus is nevertheless

deemed to have been received as or by way of a bonus where the Commissioner considers that the amount represents an existing or reasonably expected future bonus.

Commissioner's discretion - sub-section 26AH(8)

10. Sub-section 26AH(8) provides a discretion to exclude from assessable income the whole or part of an amount received as or by way of a bonus (including an amount deemed to have been so received by virtue of sub-section 26AH(9)) by reason of the forfeiture, surrender or other termination of the whole or a part of an eligible policy, and which would otherwise be included in assessable income by the application of sub-section 26AH(6). The object of this discretion is to ensure that bonuses or other amounts in the nature of bonuses are not subject to tax unless the total amount received by the holder or holders of the policy exceeds the premiums paid under the policy. In deciding whether the discretion should be exercised, regard is to be had to certain matters specified in sub-section (8). These matters are the total amount of the premiums paid, any amounts previously received by any person under the policy (including any amounts of bonuses), the surrender value of the policy at the time of forfeiture, surrender or other termination and any other relevant matters.

11. As a general rule, where a policyholder forfeits, surrenders or otherwise terminates, in whole or in part, a policy of life assurance in relation to which the date of commencement of risk is after 27 August 1982, the "relevant amount" to be included in assessable income under sub-section 26AH(6) - having regard to the terms of sub-section (8) - is to be calculated in accordance with the formula:

$$(A / B) \times [(B + C) - (D + E)]$$

where -

A = the amount withdrawn from the policy.

B = the surrender value of the policy immediately prior to the withdrawal.

C = the sum of any earlier amounts paid out under the policy.

D = the total gross (i.e., without deduction of charges such as commissions and management fees) premiums paid to the date of withdrawal.

E = the sum of previous "relevant amounts" plus the sum of any previous bonuses taxed under any other provision of the Act - e.g., paragraph 26(i).

The gain [(B + C) - (D + E)] represents the difference between the policy value and the gross premiums paid with an adjustment in respect of earlier withdrawals.

12. The following very broad example illustrates the above formula. A taxpayer takes out after 7 December 1983 a life assurance policy with an annual premium of $1,200 payable at the commencement of each assurance year. Assume that immediately before the end of the eighth year the policy is worth $10,139, determined as follows:

Premiums	$ 9,600
Less Management costs	2,333
	$ 7,267
Plus Bonuses	$ 2,872
Value of eligible policy	$10,139

The policyholder effects three partial surrenders each of $2,500 immediately before the close of the eighth, ninth and tenth years.

8th year

By applying the formula (A / B) x [(B + C) - (D + E)], the "relevant amount" under sub-section 26AH(6) is :

(2,500 / 10,139) x [(10,139 + 0) - (9,600 + 0)]

= $132 (in whole dollars).

As the "relevant amount" was received during the first 8 years of the eligible period, the assessable income of the taxpayer of the year of receipt includes an amount equal to the relevant amount - i.e., $132 (paragraph 26AH(6)(a) applies).

9th year

At the end of the ninth year and immediately before the partial surrender in that year (i.e., withdrawal of $2,500), the value of the policy is $9,382 after accounting for a further premium payment of $1,200 at the commencement of the ninth year and the crediting of bonuses of $543 for that year.

By applying the formula in paragraph 11, the "relevant amount" under sub-section 26AH(6) is :

(2,500 / 9,382) x [(9,382 + 2,500) - (10,800 + 132)]

= $253 (in whole dollars).

As the "relevant amount" was received during the ninth year of the eligible period, paragraph 26AH(6)(b) operates to include in the assessable income of the taxpayer of the year of receipt 2/3rds of the relevant amount - i.e., $168.

10th year

At the end of the tenth year and immediately before the partial surrender (i.e., withdrawal of $2,500), the value of the policy is $8,556 - a further premium payment of $1,200 having been made at the beginning of the tenth year and bonuses of $474 having been credited for that year.

By applying the formula in paragraph 11, the "relevant amount" under sub-section 26AH(6) is:

(2,500 / 8556) x [(8,556 + 5,000) - (12,000 + 132 + 253)]

= $342 (in whole dollars).

Under paragraph 26AH(6)(c), the amount to be included in assessable income is 1/3rd of the "relevant amount" - i.e., $114.

Year 11

If a further withdrawal had taken place, or the whole of the policy had been forfeited, surrendered or otherwise terminated, any amounts received as or by way of bonuses would not be subject to tax.

13. The above method of calculating the "relevant amount" is illustrated by reference to a policy taken out after 7 December 1983. The same approach is applicable to policies taken out after 27 August 1982 and on or before 7 December 1983 where the 4 year rule applies.

Restructured policies

14. Where a policyholder decides to discontinue premium payments and is issued with a paid-up policy in lieu of the original policy, sub-section 26AH(2) operates to deem the paid-up policy to be a continuation of the existing policy. However, where existing eligible policies are consolidated by applying cash surrender values and accumulations in respect of those policies into a new life assurance policy, or where a policy is converted to a different policy table (e.g., whole of life to endowment assurance), a new eligible policy is created. As mentioned in paragraph 7, by virtue of sub-section 26AH(4), the value to be attached to an existing eligible policy on termination shall be taken to have been received by the taxpayer even though the amount may not be paid to the taxpayer but re-invested on the taxpayer's behalf to obtain a new life assurance policy. The amount to be included in the taxpayer's assessable income as a consequence of the termination of the eligible policy is to be determined in accordance with the principles outlined in paragraphs 10-13 of this Ruling.

15. In relation to unbundled policies which involve the purchase of units in specified investment classes, the sale of one class of units for the purpose of re-investing the amount derived into units in another class is to be regarded as a partial surrender and, by virtue of sub-section 26AH(4), the

principles outlined in paragraph 10-13 are to be applied. Sub-section 26AH(5) would, however, exclude the operation of sub-section (4) where the re-investment of the relevant amount increases the amount that might reasonably be expected to be received under the eligible policy on surrender or maturity. It should be noted that sub-section 26AH(13) may operate in these cases to create a new eligible period if the amount re-invested plus the amount of any other premium paid in that same assurance year exceeds by more than 25% the premium paid under the policy in relation to the immediately preceding assurance year - see paragraphs 18 to 20. In this regard, the premium payable in relation to an assurance year in respect of these types of policies is the total amount paid into the policy during that year.

16. Related to the application of section 26AH to restructured policies is the assessability of bonuses accrued on an eligible policy that are applied to pay premiums under the policy. Unless sub-section 26AH(5) applies (see paragraph 7), the use of bonuses to pay premiums is to be treated as a partial surrender and assessable in accordance with the principles outlined in paragraphs 10-13 of this Ruling.

17. Where the conditions attaching to an eligible policy are varied (e.g., an increase in the sum insured or a change in its term), the rearrangement of the policy conditions does not give rise to a new eligible policy. However, an increase in the amount of premiums payable under the policy, while not giving rise to a new eligible policy, could have the effect of recommencing the eligible period in respect of the policy - see paragraphs 18 to 20.

Increased premiums

18. Under sub-section 26AH(13) of the Act, the eligible period in respect of a policy recommences at the start of any assurance year in which premiums payable exceed by more than 25% the amount of the premiums payable under the policy in relation to the immediately preceding assurance year.

19. Where the premium payable is at the policyholder's discretion, the premium payable in relation to an assurance year is the total amount paid on the policy during that year.

20. Where a policyholder is contractually obligated to make a fixed premium payment, the relevant amount for the purposes of sub-section 26AH(13) is the amount of premium payable in relation to the relevant assurance year. If such a policyholder failed to meet a particular premium payment and in a subsequent assurance year paid the overdue premium together with that subsequent year's premium, the payment is not to be taken to represent an increased premium for the purposes of sub-section 26AH(13). However, the sub-section would apply in such a case if the premium paid in respect of the subsequent year exceeded by more than 25% the amount of the premium payable in respect of the immediately preceding year.

Interest free or low interest loans

21. Sub-section 26AH(11) deals with amounts received by a taxpayer by way of an interest free, or low interest, loan (or advance) in connection with an eligible policy, either from the assurer or from a third party associated with the assurer. A low interest loan (or advance) for the purposes of the sub-section (11) is one in respect of which interest is payable at a rate lower than that which could reasonably be expected if the parties were dealing at arm's length.

22. The effect of sub-section 26AH(11) together with sub-section 26AH(9) is that, where the Commissioner forms the opinion that the whole or a part of the low or interest free loan represents the whole or a part of a bonus under the policy, the amount is deemed to have been received as or by way of a bonus and so is within the scope of sub-section 26AH(6). The circumstances surrounding the making of a loan, its amount in relation to the bonuses credited and the taxpayer's financial position are among the factors that would need to be taken into account in deciding whether or not to treat a loan as being in the nature of a bonus.

23. Where an interest free or low interest loan against an eligible policy represents a partial surrender of the policy - e.g., where the amount borrowed clearly consists of accrued bonuses as well as some part of the capital component of the policy or where there is no intention that the loan or advance be repaid - the principles outlined at paragraphs 10-13 apply in determining the "relevant amount" for the purposes of sub-section 26AH(6) - the loan being reflected in the paragraph 11 formula as an amount withdrawn from the policy. Similarly, those principles would apply where, subsequent to the receipt by the taxpayer of an interest free or low interest loan, the eligible policy is the subject of another such loan, is partially surrendered or is terminated. If part of a loan had been repaid, only the net amount outstanding would be included as component C of the paragraph 11 formula. If the loan or some part of the loan has previously been deemed to have been received as or by way of a bonus and included in assessable income of an earlier year of income that amount will be taken into account (component E of the formula) in arriving at the amount (if any) of assessable bonus subsequently received.

Sale or assignment of eligible policy or benefits under that policy

24. Where a policy taken out after 27 August 1982, or any right to receive any benefits under such a policy, is sold or assigned during the eligible period of the policy, and the Commissioner forms the opinion that the amount of, or some part of the amount of, any consideration received by the taxpayer in respect of the sale or assignment is attributable to a bonus, that amount is deemed by virtue of sub-sections 26AH(9) and (12) to have been received by the taxpayer as or by way of a bonus and is within the scope of sub-section 26AH(6).

25. Where the sale or assignment of the policy is akin to the policy being forefeited, surrendered or terminated in whole or part - e.g., where the policyholder disposes of for consideration his or her interest in the policy to a third party - the amount deemed to have been received as or by way of a bonus is to be calculated in accordance with the principles outlined at paragraphs 10-13.

Taxation Ruling No. IT 2147 - paragraph 9 modified

26. Taxation Ruling No. IT 2147 (at paragraph 9) states that the proceeds of a policy of life assurance, taken out as a personal guarantee in the circumstances outlined in that Ruling, will not be assessable income in the hands of the guarantor or the guarantor's estate. Paragraph 9 of Ruling IT 2147 is modified by this Ruling in that section 26AH may operate to tax bonuses received by the guarantor during the eligible period - i.e., the first 10 years of a policy of life assurance with a date of commencement of risk after 7 December 1983 or the first 4 years where the date of commencement of risk is after 27 August 1982 and on or before 7 December 1983. Amounts received by the guarantor's estate in consequence of the death of the guarantor on whose life the policy was effected will not, however, be taxable. Sub-section 26AH(7) would apply - see paragraph 4 of this Ruling.

COMMISSIONER OF TAXATION
31 July 1986