BTR/Section14 -

14

LIFE INSURANCE AND POOLED SUPERANNUATION TRUSTS

A consistent taxation regime for life insurers

Recommendation
14.1 Taxable income of life insurers

That the activities of life insurers be taxed neutrally in relation to comparable activities, with taxable income being calculated:

(i) from risk business — on the same basis applying for taxable income of the risk business of general insurers;

(ii) from investment business — on the same basis applying for taxable income of the investment business of other investment entities; and

(iii) from complying superannuation business — on the same basis applying for taxable income of pooled superannuation trusts (PSTs).

Achieving competitive neutrality

Currently, life insurers — that is, life insurance companies and friendly societies — are exempt from tax or are taxed at concessional rates on some management fees, underwriting profit and the profit they derive on immediate annuity business. Income and expenses need to be allocated to up to four different classes of business, each class subject to a different rate of tax (often with exempt components) and requiring different calculations for tax purposes. *A New Tax System* (page 120) and *A Platform for Consultation* (pages 715-716) explain how the current treatment is complex, distortionary and inequitable.

To ensure competitive neutrality and consistency with similar entities, life insurers should be taxed on all the profits they derive, at the company tax rate. Accordingly, in *A New Tax System* (page 120), the Government proposed that the assessable income of a life insurer include all management fees, underwriting profit, profit on immediate annuity business and any other income.

In *A Platform for Consultation* (pages 718-722), the Review canvasses the following three options to achieve this outcome:

- Option 1: Include premiums in taxable income — that is, calculate the taxable income of life insurers on the basis that applies to general insurers.
- Option 2: Identify components of taxable income — that is, calculate the taxable income of life insurers on the basis that applies to other investment entities; and

- Option 3: A combination of Option 1 and Option 2 — that is, calculate the taxable income of life insurers based on the different types of activities of life insurers.

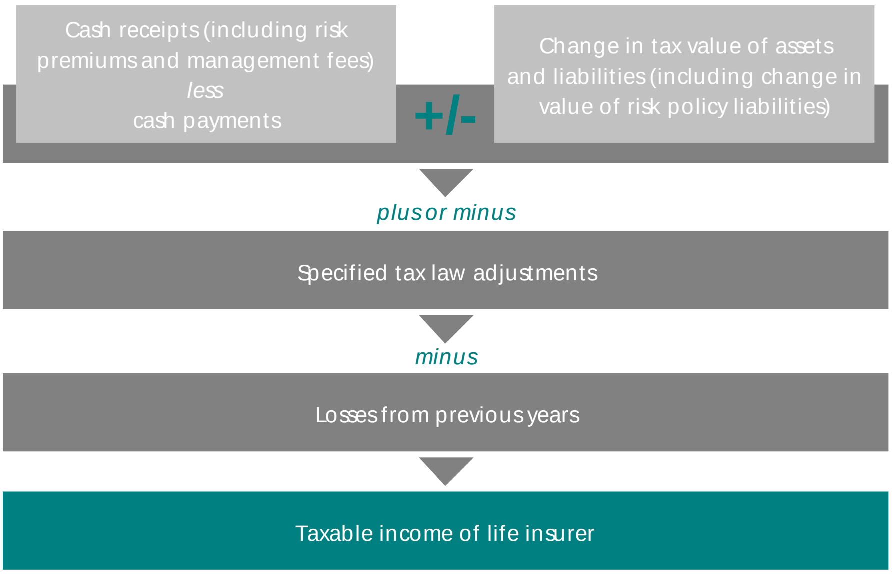
Option 3 is recommended because it appropriately recognises the manner in which the different types of activities of life insurers are taxed in other entities — with products similar in economic substance being taxed in the same way.

- The *risk* business of life insurers will be taxed on the same basis that applies to general insurers. Consequently, risk premiums and changes in the value of policy liabilities that relate to risk business will be included in taxable income — reflecting the fact that life insurers have a continuing liability in relation to risk policies taken out in a particular year.
- The *investment* business of life insurers will be taxed on the same basis that applies to other investment entities (other than collective investment vehicles). Consequently, life insurers will be taxed on the investment income derived from investing net investment premiums. Net investment premiums will be contributed capital and will therefore be excluded from taxable income.
- The *complying superannuation* business of life insurers held in a 'virtual' PST will be calculated on the same basis that applies to calculate the taxable income of PSTs — as discussed in Recommendation 14.8.

Taxable income formula

In practical terms, under this recommendation the taxable income of a life insurer — apart from income relating to its complying superannuation business — would be calculated as shown in Figure 14.1.

Figure 14.1 **Taxable income formula**



The formula for calculating the taxable income of life insurers will ensure that no amounts are double counted: management fees derived by life insurers that are included in their investment income will be included in taxable income only once.

An issue raised by industry in discussions about transitional arrangements for life insurers (see Recommendation 14.7) is that in many cases expenses are incurred up-front with life insurance policies — such as with selling and administration costs — but income from the policies is earned later over the term of the policies. The Review acknowledges that these early expenses are related to earning income over the life of a policy. Consequently, the deduction for these expenses will be spread over the life of the policy — consistent with the cashflow/tax value approach (see Section 4).

The majority of the industry agrees with the principle that the formula for calculating the taxable income of life insurers should be based on the different types of activities of life insurers.

Recommendation
14.2 Taxable income of life reinsurers

That the taxable income of life reinsurers be calculated on the same basis as that of life insurers.

Life insurers can reduce their risk exposure by reinsuring any potential liability on life insurance business with a life reinsurer. As the business of life reinsurers is the same as the risk business of a life insurer, the taxable income of life reinsurers should be calculated on the same basis that applies to determine the taxable income of life insurers.

The industry agrees with the recommended approach.

Recommendation
14.3 Tax value of policy liabilities

That the tax value of policy liabilities be the Best Estimate Liability calculated using the Valuation of Policy Liabilities Standard (Actuarial Standard 1.01) specified under the *Life Insurance Act 1995.*

By pooling risks of various kinds, life insurance involves different contractual methods for either building up or liquidating statutory investment funds. Because of the long-term nature of their policy liabilities, life insurers concentrate their asset portfolios at the longer end of the maturity spectrum.

That difference aside, as for other financial intermediaries the taxable income of life insurers will consist of two elements:

- cash flows passing to their statutory funds as a result of receiving risk premiums and paying expenses and claims; and
- changes in the tax values of both the assets supporting those funds and the liabilities written against them.

Consistent with this, under the cashflow/tax value approach recommended by the Review (see Section 4), taxable income will be measured in the tax law as receipts less payments adjusted for changes in the tax values of assets and liabilities (along with certain pre-specified adjustments). In this regard, a significant component of calculating the taxable income of life insurers under Recommendation 14.1 is the change in the value of policy liabilities that relate to risk business.

Alternative bases for tax valuations of policy liabilities

In *A Platform for Consultation* (page 723), the Review sought comments from the industry on the appropriate method for valuing policy liabilities for taxation purposes. Comments received suggested that the following bases of valuation could be used:

- The Best Estimate Liability calculated using the Valuation of Policy Liabilities Standard (Actuarial Standard 1.01) specified under the Life Insurance Act — that is, the present value of expected future benefits payable to policyholders and administration expenses less the present value of expected future premiums, calculated using 'best estimate' assumptions. 'Best estimate' assumptions are assumptions about future experience which are made by an actuary using professional judgment, training and experience and having regard to available statistical and other evidence and that are neither deliberately overstated nor deliberately understated.
- The current termination value of policies calculated using the Solvency Standard (Actuarial Standard 2.01) specified under the Life Insurance Act. The current termination value of policies is the sum of:
  - the amount that would be paid to policyholders at a particular time in the event of voluntary termination of all policies; and
  - where no amount would be paid on voluntary termination, the discounted present value of the unexpired risks, future payments and contractual premium refunds.
- The value of solvency liabilities calculated using the Solvency Standard (Actuarial Standard 2.01) specified under the Life Insurance Act. The solvency liability is the present value of the guaranteed liabilities that would be payable under the policies assuming a range of adverse conditions — oriented towards ensuring that a life insurer has adequate funds in the event

that it ceased to write new business. The value of solvency liabilities will always be higher than the value of 'best estimate' liabilities.

- The value of the capital adequacy liabilities calculated using the Capital Adequacy Standard (Actuarial Standard 3.01) specified under the Life Insurance Act. The capital adequacy liability is the present value of the guaranteed liabilities that would be payable under the policies assuming a range of adverse conditions — orientated towards ensuring that a life insurer has adequate funds to cover its obligations under existing and future policies (that is, on a 'going concern' basis) based on current business plans. The value of capital adequacy liabilities will always be no less than the value of solvency liabilities.

Each of these methodologies is required to be determined under the Life Insurance Act and therefore has a high degree of integrity.

The regulatory requirements relating to solvency and capital adequacy are concerned about protecting the interests of policyholders. The values of policy liabilities for solvency and capital adequacy purposes are higher than the Best Estimate Liability — they recognise reserves set aside to meet obligations relating to policies that are very long-term in nature and have an investment element.

Best estimate liability preferred

The industry raised concerns during consultations about using the Best Estimate Liability for valuing policy liabilities for the investment business of life insurers. However, under the recommended approach for determining the taxable income of life insurers, the tax valuation of policy liabilities is relevant only for determining the underwriting profit life insurers make on their risk business.

The Review considers that the tax value of the policy liabilities for risk business should be calculated using 'best estimate' assumptions rather than assumptions that are more conservative and based on a range of adverse conditions. The Best Estimate Liability is used for accounting purposes and produces an outcome broadly equivalent to that which applies to the deduction for outstanding claims allowed to general insurers.

Recommendation

14.4 Immediate annuity and current pension business

Income recognition principle

(a) That life insurers and complying superannuation funds be taxed on the profit they make on immediate annuity business and current pension business.

Calculation of taxable income

(b) That in calculating taxable income derived from such business, life insurers and complying superannuation funds:

(i) include related investment returns; and

(ii) exclude the 'interest' component of immediate annuities and current pensions

- **as based on the annual change in the value of liabilities relating to such business, and**
- **as calculated under paragraph (c).**

Annual change in tax value of policy liabilities

(c) That the calculation of the change in value of liabilities relating to immediate annuity policies and current pensions be determined as follows:

(i) allocated annuities and pensions — based on the amount credited to annuitants or pensioners' accounts;

(ii) fixed-term annuities and pensions — based on the methodology used to determine the change in outstanding principal of a normal (credit foncier) housing loan, using the effective rate of return over the term of the annuity or pension determined at the time the pension or annuity is purchased; and

(iii) lifetime annuities or pensions — based on an actuarial calculation of the actual interest component of the pool of lifetime annuity or pension payments made by a life insurer or complying superannuation fund during a year.

Life insurers and complying superannuation funds are currently exempt from tax on the investment income underlying their immediate annuity business and current pension business — and so are not allowed associated deductions. Consequently, life insurers and complying superannuation funds are not taxed on the profit they make on this business.

In *A New Tax System* (page 120) the Government proposed to tax the profit that life insurers and complying superannuation funds make on immediate annuity business or current pension business by including in assessable income all investment income underlying this business and allowing a deduction for the 'interest' component of the annuitants or pensioners' products.

Consistent with those proposals, the Review's recommendations will tax the profit on immediate annuity and current pension business at:

- the company tax rate if derived by life insurers; or
- a rate of 15 per cent if derived by a complying superannuation fund.

The taxation treatment of recipients of superannuation pensions and immediate annuities will remain unchanged.

In *A Platform for Consultation* (pages 723-726), the Review suggested that the deduction for the 'interest' component of the annuitants or pensioners' products could be determined in accordance with the approach now recommended (see Recommendation 14.4(b)(ii)).

The approach for determining the interest component of fixed-term annuities and pensions reflects the general yield-based accruals methodology for measuring income from financial assets and liabilities explained in *A Platform for Consultation* (pages 31-32) and recommended elsewhere in this report (see Recommendation 9.2).

The approach for determining the interest component of lifetime annuities and pensions requires actuarial calculations to determine the actual interest component of the pool of lifetime annuity or pension payments made by a life insurer or complying superannuation fund during a year. The amount will be determined applying up-to-date 'best estimate' assumptions to the annuity or pension portfolio in force during the year.

Views received by the Review during the consultative process generally agreed that the profit on immediate annuity and current pension business should be taxed and agreed with the recommended approach for determining the deduction for the 'interest' component of immediate annuities and current pensions.

Recommendation
14.5 Life insurers' franking accounts

Separate franking accounts for shareholders and policyholders

(a) That life insurers:

(i) maintain separate franking accounts for shareholders and policyholders; and

(ii) allocate franking credits between these accounts on an equitable basis applying generally accepted accounting principles as required for regulatory purposes.

Franking credits cancelled for existing policies

(b) That life insurers cancel franking credits relating to ordinary life insurance investment policies taken out before 1 July 2000.

Application of imputation system to virtual PSTs

(c) That the imputation system apply to the virtual PSTs of life insurers in the same way that it applies to PSTs.

Currently, life insurers receive franking credits and debits on the same basis as other companies. However, the imputation system does not apply to life insurance policyholders. Therefore, to reflect regulatory requirements that limit the portion of statutory fund income that can be distributed to shareholders, franking credits and debits that relate to statutory fund income are reduced by 80 per cent.

In *A New Tax System* (page 120), the Government proposed to apply the entity tax regime to investment policies issued by life insurers. Consequently, life insurers will no longer cancel 80 per cent of their franking credits and debits that relate to statutory fund income. In addition, bonuses assigned for taxation purposes to investment policyholders will have refundable imputation credits attaching to them for tax paid by life insurers (*A New Tax System,* page 121).

In *A Platform for Consultation* (pages 728-733), the Review discusses some implications of applying the imputation system to life insurers.

Allocation of franking credits between shareholders and policyholders

The first such issue is the allocation of franking credits between shareholders and policyholders. The amount credited to the franking accounts of life insurers will include credits for franked dividends received and for tax paid on income that will be allocated to both policyholders and shareholders.

Timing considerations are important here; income that relates to policyholders may not be assigned for many years. To prevent shareholders inappropriately using franking credits that relate to policyholders, life insurers will need to maintain two franking accounts — one for shareholders and one for policyholders.

Franking credits will be allocated between the shareholder and policyholder franking accounts on an equitable basis applying generally accepted accounting principles as required under the Life Insurance Act for regulatory purposes.

Franking account adjustments in relation to existing ordinary life insurance investment policies

The second issue the Review raised in *A Platform for Consultation* (pages 729-733) is the need to cancel the franking credits relating to existing ordinary life insurance investment policies because those policies will continue to be outside the imputation system.

To ensure that franking credits relating to existing policies are appropriately cancelled, life insurers will debit their policyholders' franking account (operated on a 'tax paid' basis as per Recommendation 11.6) by the amount of franking credits that relate to existing ordinary investment policies calculated using the formula:

Grossed-up amount of bonuses accrued during the income year for existing ordinary life insurance investment policies	X	Company tax rate

Application of the imputation system to the virtual PSTs

Recommendation 14.8 will allow life insurers to segregate the assets relating to complying superannuation investment policyholders into virtual PSTs. The taxation treatment of virtual PSTs will be the same as the taxation treatment of PSTs.

Consequently, life insurers will not generate any franking credits for tax paid by them on their virtual PSTs income, including franked dividends received by their virtual PSTs. Like other 'final' taxpayers, life insurers will, on their virtual PST income, 'gross up' the franked dividends and obtain credits for the attached imputation credits — and obtain refunds for any credits unable to be offset against tax payable on other income.

Recommendation 14.6 Commencement

That the commencement date for the proposed changes for taxing life insurers be 1 July 2000.

A prime concern raised in industry submissions relating to the proposals to change the tax basis of life insurers is the commencement date of the new regime.

Many life insurers have substituted accounting periods. Starting the new system for the policyholder business of life insurers from an income year would create competitive advantages and disadvantages — early balancing companies would have their lead time shortened while late balancing companies would have a longer lead time and a later start date on the new tax basis. In the interests of competitive neutrality, the industry has therefore suggested that the new tax basis for all life insurers should apply from a common start date — that is, from a 1 July date rather than an income year date.

The industry also considers that the new regime should start in 2001 at the earliest — subject to the proviso that the legislation supporting the new regime is passed by 1 July 2000. The industry argues that it needs a minimum of 12 months after the passage of legislation to introduce the new regime, to reflect the workload in altering life insurer practices to cope with the new tax system. This would include the need to completely redesign life insurance policies, develop new systems to administer policies, develop new accounting systems, possibly establish new statutory funds and retrain staff and agents.

In addition, due to other pressures on systems development, such as Year 2000 issues and the introduction of the goods and services tax, the industry has raised concerns about its ability to deliver the new regime by 1 July 2000.

In assessing these concerns, the Review has weighed a number of factors. The entity tax regime proposals are a highly integrated package that will have a significant impact on all businesses. In that context of sharing the burden of reform in order to give early impetus to its benefits, it would inequitable to distinguish one sector of the business community and give it preferential timing treatment.

In addition, the taxation arrangements for life insurers have been under review for several years. The life insurance industry was alerted to the Government's framework of reform for life insurers in August 1998 when the Government released *A New Tax System*.

A delay in the commencement of the new regime for life insurers would also have a significant revenue impact, requiring consequential changes to other measures in order to ensure a satisfactory budgetary profile for the overall package of reforms.

The Review recognises the industry's concerns, in the interests of competitive neutrality, about starting the new system from a common date. On balance, the Review considers that the changes to the taxation of life insurers should commence on 1 July 2000.

Recommendation 14.7 Transitional measures

Management fees partially excluded for existing policies

(a) That, as a transitional measure:

(i) one-third of management fees derived from life insurance policies taken out before the date of announcement be excluded from the taxable income of life insurers; and

(ii) this measure cease to apply from 30 June 2005 — five years after the commencement of the new regime.

Tax rates on ordinary insurance business

(b) That the rate of tax on the ordinary insurance business of life insurance companies be retained at 39 per cent until 30 June 2000.

(c) That the rate of tax on the ordinary insurance business of friendly societies be retained at 33 per cent for the 2000-01 income year.

Income exemption of friendly societies maintained for existing business

(d) That the investment income derived by friendly societies on funeral bonds, scholarship funds and income bonds taken out before the date of announcement continue to be exempt from tax.

Transitional arrangements for existing business of life insurers

A prime concern raised by the industry during the consultative process is the impact of the proposed regime for taxing life insurers on business written before the commencement of the new regime.

In *A Platform for Consultation* (pages 716-717), the Review proposed that life insurers be taxed on management fees, underwriting profit, and the profit on immediate annuity business from the inception of the new regime.

The industry argues that taxing the management fees and profit on existing business at the company tax rate would have a retrospective effect.

Life insurers incur most of the expenses of obtaining life insurance business when policies are taken out. In contrast, the related management fees are derived by a life insurer over the life of the policy and are designed to recover the initial expenses and provide the life insurer with its profit. Under the current law, many expenses are not deductible or are deductible at the 15 per cent rate. To tax the life insurer on current management fees derived on life insurance business at the company tax rate — when the life insurer was unable to obtain a deduction at the same rate for the prior expenses incurred — is therefore argued to be inequitable.

Including in taxable income only two-thirds of management fees derived on life insurance policies taken out before the date of announcement, for a period of five years from the commencement of the new regime, represents a fair and reasonable approach to alleviating the industry's concerns. The Review's approach recognises that some up-front expenses incurred in respect of these policies are still being recouped and provides some broad equivalence to amortisation of the expenses over the lives of the policies in determining taxable income.

Taxation rate on ordinary insurance business of life insurers

In *A New Tax System* (page 120), the Government proposed to tax life insurance companies and friendly societies on all their income (apart from amounts allocated to retirement savings accounts) at the company tax rate from the 2000-01 income year.

The Review is recommending that the company tax rate be reduced to 34 per cent for the 2000-01 income year and to 30 per cent for the 2001-02 income year.

The ordinary life insurance business and accident and disability business of life insurance companies are currently taxed at 39 per cent. Reflecting Recommendation 14.6 to start the new arrangements for life insurers from 1 July 2000, the Review considers that the rate of tax on this business should be retained at the current rate of 39 per cent until 30 June 2000. This business will be included in the ordinary business of a life insurer from 1 July 2000 and will be taxed at the company tax rate.

Since the 1994-95 income year, the 33 per cent rate of tax for the ordinary life insurance business of friendly societies and other registered organisations has been maintained while the taxation arrangements of life insurers have been under review.

The proposed changes to the taxation of life insurers will apply from 1 July 2000. To avoid undue disruption to the policyholders of friendly societies and other registered organisations that would be caused by an increase in the rate of tax on ordinary insurance business from 1 July 2000, followed by a decrease in 2001-02, the Review considers that the rate of tax on this business should be retained at 33 per cent for the 2000-01 income year. This rate will be changed to the company tax rate for the 2001-02 and subsequent income years.

Taxation of the non-insurance activities of friendly societies

Friendly societies are specifically exempt from tax on activities other than their dispensary and insurance activities.

Concerns have been raised about the implications of the reform proposals on the taxation treatment of the following products offered by friendly societies that currently are exempt from tax:

- funeral bonds;
- scholarship funds; and

- income bonds.

As a consequence of the proposals for taxing life insurers, the investment income derived by friendly societies on these products will be included in taxable income. This outcome is appropriate because these products are essentially investment products that should be taxed consistently with other investment products offered by life insurers.

Policyholders who currently hold funeral bonds, scholarship funds and income bonds would have purchased those products on the basis that friendly societies were exempt from tax on investment income derived on the investment. That treatment will remain in place for such products taken out prior to the date of announcement.

Taxing superannuation business consistently

Recommendation

14.8 Life insurers to establish virtual PSTs

Complying superannuation and deferred annuity assets eligible

(a) That life insurers be permitted to segregate assets relating to complying superannuation investment business and deferred annuity business by establishing virtual PSTs.

Taxable income of virtual PSTs

(b) That the taxable income of virtual PSTs be determined consistently with the determination of the taxable income of PSTs — with investment income taxed at the rate of 15 per cent.

Taxation of payments by virtual PSTs

(c) That amounts paid from virtual PSTs:

(i) if paid to complying superannuation policyholders — be exempt from tax; and

(ii) if paid to deferred annuity policyholders — be taxed as eligible termination payments.

Operation of virtual PSTs subject to consultation

(d) That the rules relating to the operation of virtual PSTs continue to be developed in consultation with the life insurance industry.

The Government proposed in *A New Tax System* (page 120) to tax all of the income of life insurers at the company tax rate — with amounts allocated to Retirement Savings Accounts (RSAs) continuing to be taxed at the rate of 15 per cent. Under the proposal, life insurers would be taxed consistently with other entities under the entity tax regime. The tax paid at the life insurer level would be credited to investment policyholders (including superannuation funds taxed at 15 per cent) — with refunds available for any excess credits. Policyholders would be taxed on the income from their investment at their marginal tax rate.

In *A Platform for Consultation* (page 726), the Review noted the implications of the proposals on the superannuation business of life insurers and suggested a mechanism for dealing with the refund of excess imputation credits. That mechanism would have ensured that investment returns assigned by life insurers to complying superannuation funds were taxed at a rate of 15 per cent without incurring the cash flow disadvantages of first taxing at the company tax rate and then reducing the tax effect to 15 per cent.

The Review also proposed transitional arrangements to ensure that existing deferred annuity business continued to be taxed at the rate of 15 per cent (*A Platform for Consultation,* page 728).

Maintaining the current treatment of superannuation business offered through RSAs would ensure that all income — including tax-preferred income — allocated to RSAs was taxed at 15 per cent.

Industry concerns about entity tax benchmark

The prime concern raised by industry about the Review's proposals in *A Platform for Consultation* is their potential impact on superannuation business. Industry has indicated that about 80 per cent of the business of life insurers consists of complying superannuation business, with $123 billion of assets under management — almost one-third of total superannuation assets under management. The Review has been advised that this business would be transferred to PSTs or master superannuation trusts if the proposals remained unchanged with significant transaction and administrative costs thereby entailed.

The essence of the industry's concern is the potential impact on tax-preferred income of the Government's proposals in *A New Tax System*. The industry's view is that tax-preferred income derived by life insurers on complying superannuation business should continue to be passed on untaxed to complying superannuation fund policyholders, as is the case for complying superannuation funds that invest in PSTs.

What the industry questioned is the appropriateness of applying the entity benchmark to the superannuation business of life insurers. It argued that the complying superannuation business of a life insurer should be taxed as a complying superannuation (or related) fund — that is, a life insurer should be taxed under the superannuation regime on its superannuation business and under the ordinary entity regime on the remainder of its business.

In general, the Review considers that the entity benchmark is the most appropriate benchmark for life insurers. A life insurer is an entity that carries on pooled investment business for its customers — a large number of whom happen to be superannuation funds. Investments with a life insurer tend to be held for reasonably long periods of time and are based on the principle that no amounts are distributed until a policy is surrendered or matures.

Notwithstanding its acceptance of the general benchmark, the Review recognises the industry's concerns about the impact of applying the entity benchmark to life insurers' superannuation business. It also recognises that, if the entity benchmark were applied to the superannuation business of life insurers, complying superannuation funds that invest in life insurers would be disadvantaged compared with complying superannuation funds that invest directly or through PSTs.

Tax recognition of virtual PSTs

Life insurers will continue to be taxed at a rate of 15 per cent on their superannuation business as a 'final' taxpayer if they segregate the assets relating to complying superannuation business and deferred annuity business into virtual PSTs. Amounts paid from virtual PSTs operated by life insurers to complying superannuation fund policyholders, complying ADF policyholders and PST policyholders will be exempt from tax. Thus, tax-preferred income derived by life insurers on complying superannuation business, held in virtual PSTs, will be passed through untaxed to complying superannuation policyholders.

A virtual PST will effectively be treated as a separate, 'final' taxpaying entity within a life insurer with separate financial records. It will consist of only those assets of the life insurer that relate to:

- investment policies held by complying superannuation funds;
- investment policies held by complying approved deposit funds (ADFs);
- investment policies held by PSTs; and
- deferred annuity policies.

The taxable income of virtual PSTs will be determined consistently with the determination of the taxable income of PSTs. Amounts, including assets, transferred between virtual PSTs and the ordinary part of life insurers' business will be taxable.

Amounts paid from existing deferred annuities held in virtual PSTs will continue to be taxed as eligible termination payments.

The rules relating to the operation of virtual PSTs, including the basis for determining the amount life insurers can hold in virtual PSTs, will be further developed in consultation with the life insurance industry.

Recommendation 14.9 Treatment of PSTs

Taxation treatment retained

(a) That the current taxation treatment of PSTs be retained — taxed at a rate of 15 per cent as the final taxing point.

Eligible investors in PSTs

(b) That investors in PSTs be limited to complying superannuation funds, complying ADFs, other PSTs, and the virtual PSTs of life insurers.

PSTs are a dedicated pooling vehicle for complying superannuation (and related) funds and are regulated under the *Superannuation Industry (Supervision) Act 1993*. Consequently, the Review considers that:

- PSTs should be taxed consistently with complying superannuation funds; and
- complying superannuation funds that hold investments through PSTs should be taxed consistently with complying superannuation funds that hold investments directly.

To achieve this outcome, PSTs will continue to be taxed under the superannuation regime at the rate of 15 per cent.

Investors in PSTs will be limited to other funds that are taxed at the 15 per cent rate. These include complying superannuation funds, complying ADFs, other PSTs and the virtual PSTs of life insurers.

PSTs will be the final taxing point, so that investors in PSTs will not be taxed on returns they receive from PSTs.

A significant impact of taxing PSTs as superannuation funds will be that the tax-preferred income derived by PSTs will be passed on untaxed to investors in PSTs. This can be justified on the basis that PSTs were established to enable small and medium size complying superannuation funds and complying ADFs to pool their investments with a view to generating higher returns and removing direct tax responsibilities. It will also be consistent with the taxation treatment of complying superannuation funds or complying ADFs that invest directly.

Submissions received by the Review during the consultative process have unanimously argued that PSTs should be taxed in accordance with the recommended approach.

Recommendation
14.10 Section 275 transfers

Transfers of taxable contributions continued

(a) That complying superannuation funds and complying ADFs continue to be able to transfer taxable contributions to life insurers and PSTs (section 275 transfers).

Transfers to be revocable and certified

(b) That the section 275 transfer mechanism be modified for transfers made after 30 June 2000, so that:

(i) the amount covered by section 275 notices could be changed, provided that both the transferee and the transferor agree, by requesting an amendment to the taxation returns of both the transferor and transferee for the year to which the section 275 notice relates — that is, section 275 notices be revocable; and

(ii) the amount of section 275 transfers that a life insurer or PST includes in its taxable income for a year must be supported by a statement from an independent auditor — that is, section 275 notices be certified.

The income of a complying superannuation fund and a complying ADF includes taxable contributions. Taxable contributions include:

- contributions paid to the fund by an employer;
- contributions paid to the fund by a member that are allowed as an income tax deduction; and
- eligible termination payments paid from an employer or from an untaxed superannuation fund that are rolled over to a complying superannuation fund or complying ADF.

Usage of section 275 transfers

Section 275 of the *Income Tax Assessment Act 1936* allows the trustee of a complying superannuation fund or a complying ADF to enter into an agreement with a life insurer or PST so that taxable contributions covered by the agreement are included in the income of the life insurer or PST rather than in the income of the fund. The trustee of the fund can enter into only one agreement with a particular life insurer or PST in relation to a particular year. The agreement must be in writing and is irrevocable.

Section 275 transfers were introduced to allow small and medium size superannuation funds and ADFs to pass on their taxation responsibilities to life insurers and PSTs.

In June 1997 there were 151,300 complying superannuation funds in Australia (*Annual Report of the Insurance and Superannuation Commission,* 1996-97). A total of 143,222 superannuation funds lodged taxation returns in 1996-97 (*Taxation Statistics* 1996-97). The value of section 275 transfers in the 1996-97 income year was at least $3.8 billion.

This suggests that relatively few complying superannuation funds use the section 275 transfer mechanism to avoid having to lodge taxation returns. Rather, the mechanism is predominantly used by large funds (including master superannuation funds) to transfer contributions to life insurers.

Problems with section 275 transfers

In *A Platform for Consultation* (page 765), the Review identified a range of practical difficulties that arise with section 275 transfers. These are:

- the transferring fund needs to retain sufficient taxable contributions to offset any deductible expenses incurred by the fund because deductible expenses cannot be transferred — yet the associated calculations duplicate much of what would be required for the fund to complete a tax return;
- the irrevocable nature of the agreement to transfer; and
- some life insurers experience difficulties in identifying the amount of taxable contributions that are transferred from superannuation funds and ADFs that need to be included in assessable income.

In addition, tax on taxable contributions may be deferred if a superannuation fund with a normal accounting period transfers taxable contributions to a life insurer or PST with a substituted accounting period.

Consequently, the Review suggested (A *Platform for Consultation,* page 766) that complying superannuation funds and complying ADFs no longer be able to transfer taxable contributions to life insurers or PSTs.

Submissions received by the Review during the consultative process unanimously argued that the section 275 transfer mechanism should be maintained.

Section 275 transfers retained but improved

On balance, the Review recommends that the section 275 transfer mechanism should remain but be changed to address current shortcomings. Thus, taxable contributions will be able to be transferred to the virtual PSTs of life insurers or to PSTs. The transfer mechanism will be improved by removing the requirement that section 275 notices are irrevocable. Consequently, the amount covered by a section 275 notice will be able to be modified provided that the transferee and the transferor agree.

If the amount covered by a section 275 notice is modified, an amendment will need to be made to the taxation returns of both the transferor and transferee for the year to which the section 275 notice relates. The modification will need to be made and an amendment to their returns requested within the time limits for amending assessments of both the transferor and the transferee — generally four years from the due date for payment of tax under an assessment.

In addition, to reduce compliance difficulties and having regard to the unique nature of section 275 transfers, the amount of section 275 transfers that a life insurer or PST includes in its taxable income for a year will need to be supported by a statement from an independent auditor.

Fair treatment of life insurance policyholders

Recommendation
14.11 Treatment of bonuses on new investment policies

Policyholder taxation of assigned bonuses on new policies

(a) That in calculating their income tax payable, ordinary policyholders:

(i) include in taxable income the amount of bonuses grossed up by the imputation credits when assigned for taxation purposes to life insurance investment policies taken out after 30 June 2000 — that is new life insurance investment policies; and

(ii) offset refundable imputation credits attached to those bonuses against tax payable for individual taxpayers.

Assignment periodically or on surrender or maturity

(b) That the policy contract determine when bonuses are assigned for taxation purposes — with life insurers able to offer investment policies that assign amounts for taxation purposes:

(i) periodically; or

(ii) only on the surrender or maturity of the policy.

Determination of assigned amounts

(c) That the amount assigned periodically for taxation purposes to new life insurance investment policies be determined as follows:

(i) investment-linked policies — no amount be assigned until the policy is surrendered or matures, at which time the amount assigned be determined in accordance with paragraph (d);

(ii) investment account policies — the amount assigned be the interest credited to the policy in that period; and

(iii) whole-of-life policies or endowment policies — the amount assigned be the increase in the surrender value over the period reduced by the investment component of the premiums paid by the policyholder in that period.

Taxable amount on surrender or maturity

(d) That the amount included in taxable income on the surrender or maturity of policies or on the occurrence of the insured event be the amount received, reduced by:

(i) the investment component of the premiums paid by the policyholder over the life of the policy and any expenses included in the tax value of the policy;

(ii) the total of amounts previously assigned for taxation purposes; and

(iii) the risk component of the benefit.

Taxation treatment of risk component unchanged

(e) That the taxation treatment of the risk component of life insurance benefits remain unchanged.

As explained in *A New Tax System* (page 121) and *A Platform for Consultation* (page 737), the current taxation treatment of bonuses paid on life insurance investment policies differs from that of distributions from companies and trusts — with the treatment of bonuses varying with the period of the investment and rarely applying at the investor's marginal rate. Tax advantage or disadvantage arises compared with the taxation of alternative investments. For example, if an investment policy is surrendered or matures after 10 years, the policyholder is not taxed on the bonuses paid. The bonuses remain taxed at the life insurer's tax rate — which disadvantages low marginal rate taxpayers and advantages high marginal rate taxpayers.

In *A New Tax System* (page 121), the Government proposed that policyholders receive a credit for tax paid at the life insurer level (with refunds for excess credits if necessary) consistent with the imputation arrangements for members of companies and trusts. Bonuses would be taxed at the marginal rate of the policyholder. The Review endorses those proposals. The Government also proposed that policyholders have a choice of being assessed on life insurance bonuses either when the bonuses are assigned to their policy or when the bonuses are paid on the surrender or maturity of the policy.

In *A Platform for Consultation* (pages 743-746), the Review suggested that the amount assigned to a new life insurance policy periodically for taxation purposes depend upon the type of policy — consistent with the approach of Recommendation 14.11.

This proposal will apply only to ordinary policyholders — that is, policyholders whose life insurance policies are not held in the virtual PST of life insurers — who take out a life insurance policy after 30 June 2000.

The recommended option is administratively simple and will provide choice through selection from alternative policies offered by life insurers. The terms of the policy selected will determine whether amounts are assigned for taxation purposes periodically or when the policy matures or is surrendered.

- Policyholders who acquire a policy that assigns amounts periodically for taxation purposes will be able to access refundable imputation credits annually — low marginal tax rate policyholders are most likely to choose policies of this nature.
- High marginal rate policyholders will be likely to acquire a policy that assigns amounts for taxation purposes only on maturity or surrender of the policy. By doing so, they will be able to defer paying tax at their marginal rate on bonuses until they are actually received — consistent with the taxation of long-term investments via entities included in the entity tax regime.

In *A Platform for Consultation* (pages 740-743), the Review canvasses two additional options for taxing policyholders. Both of these options would have required life insurers to make annual assignments of amounts to policyholders for taxation purposes. Policyholders would have been required to advise the Australian Taxation Office of their decision to defer payment of tax. Both of these options would be administratively cumbersome and would involve significant record keeping requirements.

The amount assigned for taxation purposes on the surrender or maturity of policies or on the occurrence of the insured event will not be averaged. Any lumpiness of the final payment arises as a consequence of the product acquired by the policyholder.

Submissions received by the Review during the consultative process agreed with the recommended approach for determining when amounts will be assigned for taxation purposes. Industry representatives argued, however, that amounts assigned from life investment policies should be taxed in the same way as amounts paid from Collective Investment Vehicles (CIVs).

However, there are some fundamental differences between life insurers and CIVs — in particular, CIVs will distribute all income annually whereas life insurers distribute income only when a policy is surrendered or matures. Life insurers will need to establish a separate entity that qualifies as a CIV if they wish to offer a product that is subject to the CIV taxation arrangements.

In *A Platform for Consultation* (pages 738-739), the Review also suggested that the taxation treatment of the risk component of life insurance benefits remain unchanged (Recommendation 14.11(e)). The Review endorses this approach.

Recommendation 14.12 Allowable deductions for expenses relating to new investment policies

Immediate deductibility of annual fees

(a) That annual or regular fees paid by policyholders to life insurers that relate to new life insurance investment policies be deductible when they are paid.

Fees of a capital nature included in policy tax value

(b) That fees of a 'capital' nature paid by policyholders to life insurers that relate to new life insurance investment policies be included in the tax value of the policy.

Immediate deductibility of interest expenses

(c) That interest expenses on monies borrowed to finance premiums on new life insurance investment policies be deductible when paid.

Policyholders are currently exempt from tax on bonuses paid on life insurance investment policies where the policies are held for more than 10 years. Generally policyholders are not entitled to a tax deduction for fees paid to life insurers because they are not expenses incurred in producing assessable income and/or they are expenses of a 'capital' nature. Where the policyholder surrenders the policy within 10 years, the bonuses received are reduced by the fees paid by the policyholder to determine the taxable amount.

Section 67AAA of the *Income Tax Assessment Act 1936* specifically denies a deduction for financing costs — that is, interest expenses and borrowing expenses — incurred in relation to monies borrowed to finance premiums paid for a life insurance policy unless the policy is a pure risk policy and the policyholder is assessable on all amounts paid out under the policy.

In *A Platform for Consultation* (page 746), the Review suggested that, because policyholders would include amounts assigned on new life insurance investment policies in their taxable income, fees incurred by policyholders in relation to new life insurance investment policies on a regular basis, such as annual management fees, should be deductible in the year they are paid. In terms of the new core rules of the tax law specifying taxable income, regular fees will be a payment that reduces the current taxable income of policyholders.

New life insurance investment policies will be an asset under the new core rules for the policyholder. For the policyholder, fees that are of a 'capital' nature (that is, give rise to an asset at the end of the year of payment), such as policy establishment fees, will be included in the tax value of the policy and hence will reduce the taxable income derived on the surrender or maturity of the policy, or when the insured event occurs.

Policyholders will not be entitled to a deduction for any fees that life insurers deduct from investment returns on these policies because the policyholders do not incur the expenditure. Policyholders effectively obtain a deduction for these fees because the taxable investment returns on these policies are reduced by such fees.

The recommended treatment is consistent with that which applies to fees paid to the trustee of a unit trust. Where paid on a regular basis, such fees are generally deductible in the year they are incurred. Establishment fees are included in the cost base of the units and the unit holder effectively gets a deduction for the fees when the units are sold.

Similarly, as bonuses on new life insurance policies will be included in taxable income as and when they are assigned, the current restrictions on obtaining a deduction for financing costs should be removed. As a result, policyholders will be entitled to a deduction for any interest expenses on monies borrowed to finance the investment component of premiums on new life insurance policies. In terms of the new core rules, interest expenses on monies borrowed to finance any investments, including the investment component of premiums on new life insurance policies, will be a payment that reduces the taxable income of policyholders.

Industry agrees with the principle that the deductibility of fees should be determined applying the same principles that apply to other investments and, in particular, that the restrictions on obtaining a deduction for financing costs should be removed.

Separately, the industry argues that the deduction for fees incurred by the policyholder should be available to the life insurer rather than to the policyholder. The Review does not agree with this suggestion as it would be inconsistent with the deductibility of fees paid to other entities. In addition, under ordinary taxation principles a deduction is available only to the taxpayer who incurs the expenditure — in this case, the policyholder. The industry's suggestion will effectively be the outcome for any fees deducted from investment returns but is not appropriate for fees incurred by the policyholder.

Recommendation
14.13 Treatment of existing policies

Tax treatment of bonuses retained for existing policies

(a) That the current taxation treatment of bonuses paid on existing life insurance policies be retained.

Rate of rebate adjusted with one year delay

(b) That the rate of the rebate on existing life insurance policies be changed to the company tax rate one year after the rate of tax that applies to life insurers in respect of ordinary life insurance business changes.

Treatment where 125 per cent rule breached

(c) That where the policyholder breaches the current 125 per cent rule on an existing policy — so that the premiums paid in a particular year exceed the premiums paid in the immediately preceding year by more than 25 per cent:

- **(i) the existing policy be deemed to have been surrendered — and the bonuses that would be payable on surrender be taxed as though those bonuses were paid; and**
- **(ii) the policy thereafter be taxed as a new policy (see Recommendation 14.11).**

In *A New Tax System* (page 121), the Government proposed that the taxation treatment of existing life insurance policies — that is, life insurance policies taken out before 1 July 2000 — remain unchanged.
Recommendation 14.13(a) supports that proposal.

Where an existing policy is held for eight years or less, bonuses paid on the policy will continue to be included in taxable income (or partly included in taxable income if the bonuses are paid in the ninth or tenth year after the policy was taken out) at the time the policy is surrendered or reaches maturity.

Taxpayers will continue to be compensated for the tax paid by the life insurer on the income on existing policies by a rebate (Recommendation 14.13(b)). The rate of the rebate will be the tax rate that applies to life insurers in respect of ordinary life insurance business but will be phased in one year after any change to the rate of tax — see Recommendations 14.7(b) and 14.7(c). The one year delay in changing the rate of the rebate is consistent with changes to the rate of the rebate when the rate of tax payable by life insurers in respect of life insurance policies has changed previously.

If the policy is held for more than 10 years, bonuses paid on existing policies will continue to be exempt from tax — that is, bonuses will effectively be taxed at the company tax rate.

Assets relating to existing investment policies held with life insurers by complying superannuation funds, complying ADFs and PSTs will be included in a life insurer's virtual PST. The life insurer will be the final taxpayer on this business. Bonuses paid on these policies to complying superannuation funds, complying ADFs and PSTs will continue to be exempt from tax (Recommendation 14.8).

Submissions received by the Review during the consultative process have argued unanimously that the current tax treatment should be maintained for bonuses paid on existing life insurance investment policies. Industry representatives have argued that it will be administratively simpler to leave the taxation treatment of bonuses paid on existing policies unchanged. As a result there will be no need to educate a large number of policyholders, many of whom are elderly, about the changes — particularly as many policyholders purchased existing policies with the knowledge that they are 'tax paid' products. While the policies are 'tax paid', with the amounts received on the policies tax exempt in policyholders' hands, those amounts have been taxed at the life insurer's tax rate — currently 39 per cent in the case of life insurance companies and 33 per cent in the case of friendly societies. Policyholders who instead wish to be taxed under the new regime — which results in tax being paid on the income on the policies at the marginal tax rate of the policyholder — could take out a new policy or deliberately breach the 125 per cent rule — see Recommendation 14.13(c).

The Review endorses this approach.