



# ***CR 2002/86 - Income tax: American International Assurance Company (Australia) Limited Statutory Fund No. 3 - Continuation of Life Insurance Policy***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *1 January 2003*



## **Class Ruling**

### **Income tax: American International Assurance Company (Australia) Limited Statutory Fund No. 3 – Continuation of Life Insurance Policy**

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#### ***Preamble***

*The number, subject heading, and the **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains Class Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

## **What this Class Ruling is about**

1. This Ruling sets out the Commissioner’s opinion on the way in which the ‘tax law(s)’ identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

#### **Tax law(s)**

2. The tax law dealt with in this Ruling is section 26AH of the *Income Tax Assessment Act 1936* (‘ITAA 1936’).

#### **Class of persons**

3. The class of persons to whom this Ruling applies are the policyholders of the ‘closed unit-linked investment policies’ in American International Assurance Company (Australia) Limited Statutory Fund No.3 who exercise the option to align their policy with the Variable Universal Life (‘VUL’) policy.

#### **Qualifications**

4. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

5. The class of persons defined in this Ruling may rely on its contents provided the arrangement described below at paragraphs 15

to 20 is carried out in accordance with the details of the arrangement provided in this Ruling.

6. If the arrangement described in this Ruling is materially different from the arrangement that is actually carried out:

- (a) this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled, and
- (b) this Ruling may be withdrawn or modified.

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## Date of effect

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8. This ruling applies from 1 January 2003.

## Withdrawal

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9. The ruling is withdrawn and ceases to apply from 31 December 2003. The ruling continues to apply, in respect of tax law(s) ruled upon, to all persons within specified classes who enter into specified arrangements during the term of the ruling. Thus, the ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to the withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the person's involvement in the arrangement.

## Background

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10. Section 26AH of the ITAA 1936 provides for the taxing of amounts paid as or by way of bonuses under life insurance policies taken out after 27 August 1982, which are not subject to tax under any

other provision of the ITAA 1936 or the *Income Tax Assessment Act 1997* ('ITAA 1997').

11. Section 26AH of the ITAA 1936 states that a taxpayer's assessable income shall include bonuses and some other amounts in the nature of bonuses received under a relevant life insurance policy during the eligible period. The eligible period in respect of a relevant life insurance policy is the first 10 years in the case of a policy with a date of commencement of risk after 7 December 1983.

12. The combined effect of sub-sections 26AH(6) and (14) is that, for 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.

13. Section 26AH mainly applies to amounts actually received as or by way of bonus under an eligible policy. Subsection 26AH(4) of the ITAA 1936, which is subject to subsection 26AH(5), deems a taxpayer to have received a bonus where an amount is re-invested or otherwise dealt with on his or her behalf. This ensures that where an amount of bonus is dealt with on behalf of, or at the direction of the taxpayer, they are taken to have received that amount for the purposes of subsection 26AH(6). Subsection 26AH(5) provides that subsection 26AH(4) does not apply to a bonus that is applied to increase the surrender value of the policy.

14. Under subsection 26AH(13) of the ITAA 1936, the eligible period in respect of a policy recommences at the start of any assurance year in which the premium payable exceeds by more than 25% the amount of the premiums payable under the policy in relation to the immediately preceding assurance year. That is, the 10 year period referred to at paragraph 11 (above) recommences in these circumstances.

## **Arrangement**

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15. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- letter dated 20 September 2002 from Deloitte Touche Tohmatsu requesting the ATO to make a Class Ruling in relation to how section 26AH of the ITAA 1936 applies to the alignment of

the terms of the 'closed unit-linked investment policies' of AIA to the terms of the VUL policies of AIA.

- Variable Universal Life policy document;
- Capital Assured Swiss Bond policy document;
- Managed Investment Plan policy document;
- Insurance Bond life insurance contract and policy document;
- Investment Bond policy document;
- Winston Davis policy document;
- Harvester policy document;
- Super Safe Insurance Bonds policy document; and
- A letter from Deloitte Touche Tohmatsu dated 30 October 2002.

16. Note: certain information received from American International Assurance Company (Australia) Limited has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information Legislation.

17. American International Assurance Company (Australia) Limited ('AIA') maintains a small closed portfolio of ordinary unit-linked business in the Company's Statutory Fund No. 3. This portfolio has been closed to new business since approximately 1998. The closed portfolio of unit-linked business comprises approximately 420 ordinary unit-linked life policies. These unit-linked life policies have each been in existence for 10 years or more. Accordingly the policyholders will not be taxable on bonuses from these investment policies by virtue of section 26AH of the ITAA 1936.

18. On 1 July 2001, AIA launched a new ordinary unit-linked life and investment policy called Variable Universal Life ('VUL'). AIA proposes to rationalise the administration process of Statutory Fund No.3 by moving all the closed ordinary unit-linked business onto VUL's new administration system.

19. To achieve this, AIA proposes to invite policyholders of the 'closed unit-linked policies' to either surrender their policy or to consent to an alignment of the terms of their policy to the terms of the VUL policy. This Class Ruling only deals with the alignment of terms between existing policies and the new VUL policies.

20. Under VUL policies, the policyholders have to pay an additional premium to obtain the 'Optional Protection Benefits'. Likewise, the policyholders of the 'closed unit-linked policies' who

elect to align their policies to VUL policies will also have to pay an additional premium to obtain the 'Optional Protection Benefits'.

## **Ruling**

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21. The alignment of the terms of the 'closed unit-linked policies' to the terms of the VUL policies will not result in an amount being included in assessable income as or by way of bonus under section 26AH of the ITAA 1936.

22. The alignment of the terms of the 'closed unit-linked policies' to the terms of the VUL policies will not result in the re-commencement of the eligible period under section 26AH of the ITAA 1936.

## **Explanations**

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23. A taxpayer does not have to receive a bonus under a life insurance policy for the amount to be included in his or her assessable income under section 26AH. Subsection 26AH(4) of the ITAA 1936, which is subject to subsection 26AH(5), deems a taxpayer to have received a bonus where an amount is re-invested or other wise dealt with on his or her behalf. Subsection 26AH(5) provides that subsection 26AH(4) does not apply to a bonus that is applied to increase the surrender value of the policy.

24. For subsection 26AH(4) to apply so that an amount would be included in assessable income, a new eligible policy must be issued. That is, a new contract must be entered into as distinct from a mere variation of an existing contract.

25. In *Tallerman & Co Pty Ltd v. Nathan's Merchandise (Vic) Pty Ltd* (1956) 98 CLR 93 Kitto J. stated at 135:

'An agreement which deals with subsisting rights and obligations of the same parties under an earlier contract may vary that contract without terminating it. Whether it effects a variation on the one hand or a discharge on the other is a question depending on the intention of the parties.'

26. The following terms and features of the closed unit-linked investment policies as compared with VUL policies, indicate that the policyholders of the closely-linked policies do not intend to enter into a new policy:

- (a) The VUL policies will have the same policy number as the closed unit-linked investment linked policies;

- (b) The benefit clauses of the VUL policies and the closed unit-linked investment policies are similar; and
- (c) The surrender and withdrawal clauses of the VUL policies and the closed unit-linked investment policies are similar.

27. Secondly, all the VUL policies have a variation clause. Five of the six types of 'closed unit-linked investment policies' have a switching clause or a provision for variation in the terms of the policy. The fact that the sixth type of policy does not have a switching clause or variation clause does not mean that a new contract has been entered into.

28. The Commissioner expressed a view at paragraph 3 of Taxation Determination TD 94/82 that:

'If the original contract contains a switching clause or if it contains a variation clause and the contract is varied to add to a switching clause, we accept that if the policyholder has exercised the switching option, there has been a mere variation in the contract. However, the absence of a switching clause or a variation provision does not prevent the addition of a switching clause, and the subsequent exercise of the switching option from being considered to be a mere variation of a contract for section 26AH purposes.'

29. The VUL policies have the following features which are not present in all of the closed unit-linked investment policies:

- (a) more investment choices;
- (b) unit pricing is conducted more regularly; and
- (c) 'optional protection benefits' are available.

The implications of these features are discussed below.

30. The choice of more investment choices is a mere variation of a contract as it involves the switching of investment options. Paragraph 3 of Taxation Determination TD 94/82 states that:

'Generally speaking, switching does not involve the payment of any new or additional premiums, a change in the present 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 of the calculation base, of the existing policy, and therefore the provisions of subsections 26AH(4) and 26AH(13) do not apply.'

31. The fact that unit-pricing is conducted on a more regular basis under VUL policies is not in our view a relevant factor in determining whether a new contract is entered into, or there is a mere variation of an existing contract as unit pricing is an internal company mechanism.

32. A difference between some of the closed unit-linked investment policies and the VUL policies is that the VUL policies have 'optional protection benefits' available.

33. An optional protection benefit is where the policyholder has the option to pay additional premiums to insure for death, terminal illness or permanent disablement.

34. The policyholders of the closed unit-linked investment policyholders who take the option to align with the terms of the VUL policies will be required to pay additional premium(s) to exercise these options.

35. These optional protection benefits in our view are policies in their own right as they create different contractual arrangements. In *National Mutual Life Association of Australasia Ltd. v. FC of T* (1959) 102 CLR 29 Windeyer J. affirmed the Commissioner's view that a life policy with an accident and disability rider are separate contracts. His Honour stated at page 48:

‘All this shows that the company's obligations to pay the sum assured at maturity date, the ordinary obligation under a life policy, was separate from its additional obligation in relation to permanent disablement benefits. The amount of the total premium attributable to the additional insurance was recorded and ascertainable.’

36. A comparison of the features and terms of the closed-linked investment policies and the VUL policies in our opinion shows that there is a mere variation of the existing policy. Subsection 26AH(4) of the ITAA 1936 does not apply. There is not a re-commencement of the eligible period for the purposes of section 26AH of the ITAA 1936.

## **Detailed contents list**

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37. Below is a detailed contents list for this Class Ruling:

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## Detailed contents list

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### Commissioner of Taxation

11 December 2002

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*Previous draft:*

Not previously released in draft form.

*Related Rulings/Determinations:*

TR 92/1, TD 94/82, TR 97/16,  
CR2001/1

- ITAA 1936 26AH(5)
- ITAA 1936 26AH(6)
- ITAA 1936 26AH(13)
- ITAA 1936 26AH(14)
- ITAA 1997
- TAA 1953 Part IVAAA

*Case references:*

*Subject references:*

- Life insurance policies
- Investment linked policies

- National Mutual Life Association of Australasia Ltd. v FC of T (1959) 102 CLR 29
- Tallerman & Co Pty Ltd v Nathan's Merchandise (Vic) Pty Ltd (1956) 98 CLR 93

*Legislative references:*

- Copyright Act 1968
- ITAA 1936 26AH
- ITAA 1936 26AH(4)

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ATO References

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