



CR 2004/14 - Income tax: out of court settlement payment to holders of 'AXA Prosperity Bonds'

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Class Ruling

Income tax: out of court settlement payment to holders of 'AXA Prosperity Bonds'

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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(s) dealt with in this Ruling are
- Section 6-5 of *Income Tax Assessment Act 1997* (ITAA 1997);
 - Section 118-300 of ITAA 1997;
 - Paragraph 26(i) of *Income Tax Assessment Act 1936* (ITAA 1936);
 - Section 26AH of ITAA 1936; and
 - Section 160AAB of ITAA 1936.

Class of persons

3. The class of persons to whom this Ruling applies is investors ('relevant investors') in life insurance policies (known as 'Prosperity Bonds') issued by National Mutual Life Association of Australasia Ltd ('NMLA'), who entered into an out of court settlement with NMLA and AXA Financial Planning Limited, ('AFPL') under which they assigned their policies to AFPL under the settlement agreement.

Qualifications

4. The Commissioner makes this Ruling on the basis of 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 10 to 19 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:
 - 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
 - this Ruling may be withdrawn or modified.
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Date of effect

8. This Class Ruling applies from the year ended 30 June 2001 unless and until it is withdrawn (see paragraph 9). Furthermore this Ruling applies to the extent that the relevant tax laws are not amended.

Withdrawal

9. This Ruling is withdrawn and ceases to have effect after 30 June 2005. The Ruling continues to apply, in respect of the tax laws(s) ruled upon, to all persons within the specified class who enter into the specified arrangement 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 withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the person's involvement in the arrangement.

Arrangement

10. The particulars of the arrangement that is the subject of this Ruling are found in documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with the description of the arrangement as described below. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- application for Class Ruling dated 16 December 2002 with attachments; and
- settlement deeds entered into between various parties including NMLA, AFPL, Coneview Pty Ltd ('Coneview') and each relevant investor.

Note: certain information received from NMLA has been provided on a commercial-in-confidence basis and will not be disclosed or released under the *Freedom of Information Act 1982* (FOI Act) which gives taxpayers a legally enforceable right of public access to documents in possession of Commonwealth agencies, subject to certain exceptions and exemptions.

11. The arrangement that is the subject of this Ruling is set out below.

12. From mid 1999, investors were introduced to Prosperity Bonds by Dr Peter Keller through Coneview.

13. The policies were issued to these investors by NMLA on terms unique to that group of investors, which provided for different investment options and switches between those investment options.

14. The investors also entered into a management agreement with Coneview under which each investor paid annual management and performance fees to Coneview for arranging switches and preparing investment summary information in relation to the investments in the Prosperity Bonds.

15. The premiums paid by these investors were invested in NMLA's No. 5 Statutory Fund.

16. The policies provided that, on the death of the last of the lives insured under each policy, the value of that policy would be paid to the nominated beneficiary or beneficiaries of that person's estate.

17. In August 2000, a dispute arose between Coneview, Dr Keller, AFPL and NMLA as to the interpretation of the terms of the policies and legal proceedings were commenced against AFPL and NMLA by Coneview and Dr Keller.

18. An out of court settlement was reached between the litigants and the relevant investors in October 2001 and it is this settlement that is the subject of this Ruling.

19. As part of the settlement, consideration (the ‘settlement amount’) was paid by AFPL for the assignment of the investors’ policies to AFPL. For the purposes of this Class Ruling the settlement amount has been divided into three parts as described in the application letter. The division of the settlement amount, as described in the settlement deed, is not the same. The difference, however, is not material. We consider, therefore, that the settlement amount was comprised of the following components:

- (a) an amount equal to the premium paid to acquire the Prosperity Bond (‘the original investment amount’);
- (b) an amount equal to the difference between the original investment amount and the book value of the Prosperity Bond at the date of assignment of the Prosperity Bond (‘the basic growth component’); and
- (c) the amount representing the difference between the book value of the Prosperity Bond at the date of the assignment and the settlement amount (‘the additional amount’).

Ruling

20. No part of the settlement amount is assessable income of the relevant investors under section 6-5 of the ITAA 1997 because it is not ordinary income.

21. No part of the settlement amount is assessable income of the relevant investors under paragraph 26(i) of the ITAA 1936.

22. The ‘basic growth component’ of the settlement amount is assessable income of the relevant investors (other than trustees of complying superannuation funds) under section 26AH of the ITAA 1936. The Commissioner is of the opinion that the ‘basic growth component’ is attributable to a bonus which has accrued in respect of the Prosperity Bonds. This amount has, therefore, been received as or by way of a bonus under subsection 26AH(9) and is included in the assessable income of each investor (other than a trustee of a complying superannuation fund) under paragraph 26AH(6)(a).

23. The relevant investors (other than trustees of complying superannuation funds) are entitled to a rebate of tax under section 160AAB of the ITAA 1936 for the bonus included in assessable income under paragraph 26AH(6)(a).

24. Any capital gain or capital loss derived by relevant investors on the assignment of the Prosperity Bonds is disregarded if the relevant investor was the original beneficial owner of the Prosperity Bond under section 118-300 of the ITAA 1997.

Explanation

Ordinary Income

25. An amount is included in ordinary income under section 6-5 of the ITAA 1997 if it is received in the ordinary course of business, or if it occurs outside the ordinary course of business and the relevant investor has the requisite profit making purpose.

26. Whether an amount is included in assessable income under subsection 25(1) of the ITAA 1936, (the predecessor to section 6-5 of the ITAA 1997) was examined in *FCT v. Myer Emporium Ltd (1987) 163 CLR 199; 18 ATR 693* ('Myer') which was discussed in Taxation Ruling TR 92/3. *Myer* is authority for the proposition that if the relevant transaction occurs outside the scope of the taxpayer's business activities, the profit making purpose must be determined by looking at the facts and circumstances leading up to the transaction.

27. An examination of the arrangement as specified in this ruling does not show the requisite profit making purpose. No part of the settlement amount, therefore, is assessable as ordinary income under section 6-5 of the ITAA 1997.

Paragraph 26(i) of the ITAA 1936

28. Paragraph 26(i) of the ITAA 1936 includes in the assessable income of a taxpayer a bonus other than a reversionary bonus under a life insurance policy.

29. As the term 'bonus' is not defined under either the ITAA 1936 or the ITAA 1997, the definition therefore takes its ordinary meaning. In the context of insurance, the Macquarie Dictionary 3rd Edition defines 'bonus' as 'a. dividend b. free additions to the sum assured. See reversionary bonus, terminal bonus.' The Macquarie Dictionary defines 'reversionary bonus' as 'a periodic free addition to the sum insured under a life insurance policy; made from surplus earned on the insurer's investments and 'terminal bonus' as a 'free addition to the sum assured on a policy to reflect the excess of the market value of the

life assurance company's assets over their book value; paid once only when the policy matures.'

30. Further assistance is provided in *AAT Case 7133, 1991*, where Deputy President Dr P Gerber contrasted a reversionary bonus with an annual bonus when he considered that: '... the 'bonus' in the instant case is a reversionary bonus, that is, a bonus paid on maturity, forfeiture or surrender, as opposed to, for example, an annual bonus payable *in praesenti* in cash: cf (1965) 12 CTBR(NS) Case 34; Case Q74 (1965) 15 TBRD 346.'

31. The original investment amount is not included in assessable income under paragraph 26(i) as this amount is of a capital nature, and not a bonus.

32. The basic growth component paid to the relevant investors is not a bonus as it does not fall within the ordinary meaning of the word.

33. The additional amount is not included in assessable income under paragraph 26(i) as it does not fall within the ordinary meaning of the word 'bonus'.

Section 26AH of the ITAA 1936

34. Section 26AH includes in the assessable income of a taxpayer bonuses or amounts as or by way of bonuses received under a life assurance policy, where the date of commencement of risk is after 27 August 1982, and the amounts are received within 10 years of the date of commencement of the risk of the policy.

35. The Prosperity Bonds are life assurance policies and the date of commencement of risk of the Prosperity Bonds was on or after 27 August 1982.

36. Subsection 26AH(12) deems the amount of consideration received for the assignment of an eligible policy to be an amount to which for subsection 26AH(9) applies.

37. For the purposes of subsection 26AH(9), the Commissioner is of the opinion that the basic growth component received by the investors on the assignment of the Prosperity Bonds is attributable to bonuses that have accrued in respect of each policy. As a result, that amount is deemed to have been received under the policy as or by way of a bonus. Accordingly, it is included in the assessable income of the investors (other than trustees of complying superannuation funds) under paragraph 26AH(6)(a). As the policies were assigned within eight years of the commencement of the Prosperity Bonds, the whole of the basic growth component is assessable.

38. Subsection 26AH(6) does not apply to those relevant investors who are trustees of complying superannuation funds or within any of the categories listed in subsection 26AH(7).

39. The reasons for the Commissioner's opinion are that:

- (i) the consideration received upon assignment of the policies that relates to the basic growth component is attributable to the Prosperity Bonds; and
- (ii) in applying subsections 26AH(9) and 26AH(12), the basic growth component of the consideration received upon assignment of the policies represents bonuses accrued on the policies.

40. The terms 'attributable to' or 'accrued' in subsections 26AH(9) and 26AH(12) are not defined in the ITAA 1936 or the ITAA 1997. Therefore the ordinary meaning of the term applies. The term 'accrued' is defined in the Macquarie Dictionary 3rd Edition as 'to accumulate in the course of time.' The verb attribute (and its adjective 'attributable') is defined as '(sometimes followed by *to*) to consider as belonging; regard as owing, as an effect to a cause.'

41. The basic growth component of the settlement amount was calculated to reflect the earnings (i.e. bonuses) an investor could have received on the Prosperity Bonds had the policy continued in its original form up to the date of assignment. The term 'bonus' is discussed above at paragraph 29.

42. The original investment amount is not included in assessable income under section 26AH as this amount is of a capital nature, and not deemed to be a bonus under subsection 26AH(9).

43. The additional amount is not included in assessable income under section 26AH as the Commissioner is of the opinion that such an amount does not represent a bonus for the purposes of subsections 26AH(9) and 26AH(12) as it was not calculated to reflect the earnings (i.e. bonuses) an investor could have received on the Prosperity Bonds had the policy continued in its original form up to the date of assignment.

Rebate under section 160AAB of the ITAA 1936

44. The relevant investors (other than trustees of complying superannuation funds) are entitled to a rebate under section 160AAB for amounts included in assessable income under paragraph 26AH(6)(a) as the requirements of section 160AAB have been satisfied.

That is:

- (a) An amount ('the basic growth component') has been included in the assessable income of each investor (other than a trustee of a complying superannuation fund) under section 26AH in relation to the Prosperity Bonds;
- (b) The date of commencement of risk of the Prosperity Bonds was after 27 August 1982; and
- (c) The Prosperity Bonds were issued by NMLA, an Australian resident life insurance company.

Capital Gains

45. The capital gain or loss made by the investor on the assignment of their Prosperity Bond is disregarded if the investor is the original beneficial owner of the Prosperity Bond, as each investor's rights under the Prosperity Bond is the asset underlying the settlement amount received by the investor.

46. Paragraph 4 of Taxation Ruling TR 95/35 states that:

'if an amount of compensation is received by a taxpayer wholly in respect of the disposal of an underlying asset, or part of an underlying asset of the taxpayer, the compensation represents consideration on the disposal of the asset.'

47. The Prosperity Bond is a life insurance policy. As each investor's rights under the Prosperity Bond is the underlying asset, the investor has disposed of his or her rights under the policy (CGT event A1), and, as he or she is the original beneficial owner of the life insurance policy, any capital gain or loss on the assignment of the Prosperity Bond is disregarded under subsection 118-300(1) Item 3 of the ITAA 1997.

Detailed contents list

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Commissioner of Taxation

4 February 2004

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/1; TR 92/3; TR 92/20;
TR 95/35; TR 97/16; CR 2001/1

Legislation references:

- ITAA 1936 25(1)
- ITAA 1936 26AH
- ITAA 1936 26AH(6)
- ITAA 1936 26AH(6)(a)
- ITAA 1936 26AH(7)
- ITAA 1936 26AH(9)

- ITAA 1936 26AH(12)
- ITAA 1936 26(i)
- ITAA 1936 160AAB
- ITAA 1997 6-5
- ITAA 1997 118-300
- ITAA 1997 118-300(1) item 3
- Copyright Act 1968
- Freedom of Information Act 1982
- TAA 1953 Part IVAAA

Case references:

- *FCT v. Myer Emporium Ltd (1987)*
163 CLR 199; 18 ATR 693
 - *AAT case 7133, 1991*
-

ATO references:

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