TR 2001/D14 - Income tax: Life insurance companies: the actuarial determination of fees and charges

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Draft Taxation Ruling
Income tax: Life insurance companies: the actuarial determination of fees and charges

Contents Para

Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling demonstrates how actuarial models are used to determine the amount of fees and charges that are included in the assessable income of a life insurance company[1] under Division 320 of the *Income Tax Assessment Act 1997* ('ITAA 1997').

Background

2. Division 320 was introduced with effect from 1 July 2000. The purpose of Division 320 is to 'ensure that life companies are taxed on all their profits including:

- all management fees (except for management fees that are exempt from tax under transitional arrangements);
- underwriting profit; and
- profit on immediate annuity business.'[2]

Types of policies

3. There is a number of different types of life insurance policies and, for each type, a range of different charging structures.

4. The types of policies include:

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[1] A life insurance company is defined in subsection 995-1 of the ITAA 1997 to mean a company registered under the *Life Insurance Act 1995* and includes a friendly society that carries on life insurance business.
[2] See Paragraph 5.1 of the Revised Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill (No.2) 2000).

- endowment and whole of life policies;
- risk policies;
- investment account policies; and
- investment linked policies.

5. These policies can be bundled or unbundled, participating or discretionary and may have riders attached to them.

6. A bundled policy includes a traditional whole of life or endowment policy. The components of the policy in respect of investment, risk and administration are bundled (that is, not readily identified) in the way the terms of the policy are defined and the manner the business is managed. Segregation of the components of the policy is impractical and inconsistent with the nature and management of the business.

7. An unbundled policy is a policy where the investment, risk and administration components of the policy are separated and the premium in respect of the different components can be clearly identified. The extent of unbundling can vary. Some unbundled policies may not have all their fees and charges clearly identified – that is, they have both explicit and implicit fees.

8. Participating policies are policies that provide participating benefits within the meaning of section 15 of the *Life Insurance Act 1995* (the Life Insurance Act) - see definition of 'participating benefit' in subsection 995-1 of the ITAA 1997. Participating benefits are broadly benefits that include a share in the profit derived from the business. That is, the policyholder is entitled to share in the experience of the participating business of a particular statutory fund, where experience is measured in aggregate across all components of the policy - investment experience, expense experience and underwriting experience. The shareholders' entitlement is limited to the residual profit. Profit for this purpose is that derived from all sources - it is not necessary to identify the components of that profit.

9. Policies issued by friendly societies are not participating policies. In this regard Regulation 2.01A of the Life Insurance Regulations modifies the application of the Life Insurance Act to friendly societies. Item 1 of Schedule 5 of the Regulations omits section 15 of the Life Insurance Act for the purposes of applying that Act to friendly societies. Therefore, policies issued by friendly societies do not provide participating benefits as defined in subsection 995-1 of the ITAA 1997.

10. For tax purposes, the amount of fees and charges for participating business is only that portion of the profit which returns to the shareholder after policyholder entitlements and expenses have

been met. To attribute all profit to the shareholder would not properly reflect the way in which such business is managed.

11. Discretionary policies are essentially investment account policies that are regarded as non-participating[3] for the purposes of the Life Insurance Act solely because of the operation of Prudential Rules No 22 of that Act (see definition of 'discretionary benefit' in subsection 995-1 of the ITAA 1997). These policies are credited with interest according to a prescribed formula but with an element of discretion or smoothing over time that generally requires the establishment and maintenance of a smoothing reserve or investment fluctuation reserve. In the years that the earnings rate of the life insurance company is low (or even negative) funds that have been set aside in the smoothing reserve or investment fluctuation reserve are released to allow the company to declare a higher rate of return than was earned by the pooled fund.

12. The actuarial management of discretionary business is similar to that for participating business even though the strict entitlement to participate in profit sharing is generally not a part of the policy conditions. As Prudential Rules No 22 do not apply to friendly societies, policies issued by friendly societies do not provide discretionary benefits as defined in subsection 995-1.

13. Risk, investment account, traditional endowment and whole of life policies can be participating or discretionary. Investment-linked policies are by definition non-participating.

14. Division 320 makes reference to discretionary policies in the same context as participating policies. Therefore, for simplicity, references in this Ruling to participating policies should be taken to include discretionary policies unless stated otherwise.

15. Policies can also have a rider attached. The rider confers additional benefits in return for the payment of additional premiums.

Types of fees and charges

16. The fee structures of life insurance policies are both diverse and complex. Fees and charges can be in respect of investment, administration or risk and can be deducted from premiums, investment income or account balances. These fees and charges can be explicit or implicit and can be imposed at entry (at the time the policy commences), exit (at the time the policy is terminated) or on a regular basis.

- For the purposes of this Ruling an explicit fee is a fee that is specifically deducted from a policyholder's

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[3] Non-participating benefits are defined in Prudential Rules No 22 in force under section 252 of the *Life Insurance Act 1995*.

premium or account. Examples of explicit fees include premium based fees that reduce the amount of a premium invested, asset fees specifically debited from a policyholder's account, time based fees debited from a policyholder's account and switching fees (that is, the fees payable on investment linked policies when an investor switches investments by selling units in one type of pooled fund (such as Australian equities) and using the proceeds to purchase units in another type of pooled fund (such as property));

- For the purposes of this Ruling an implicit fee is a fee that is implicitly charged to a policyholder rather than explicitly deducted from a policyholder's account. An example of an implicit fee is an asset fee where the investment return credited to a policyholder's account is net of investment management fees – that is, the fee implicitly reduces the value of the policyholder's account. An asset fee is usually expressed as a percentage of the assets backing a particular group of policies. For investment linked policies, the asset fee is removed from the unitised fund on a daily basis so that the growth in the value of units reflects the investment return after allowing for the asset fee.

17. Depending on policy structure and company practice, fees and charges may be applied as:

- a separate premium;
- a deduction from the total premium;
- a deduction from investment income; or
- a deduction from the account balance.

Date of effect

18. This Ruling applies from 1 July 2000. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling and Explanations

Calculation of fees and charges

19. The mechanisms used in Division 320 to bring fees and charges into the assessable income of life insurance companies ensure equitable taxation treatment across different products and fee structures.

20. Fees and charges are included in assessable income and taxed at the company tax rate by:

- including all premiums in assessable income (paragraph 320-15(a));
- allowing a deduction for some or all of those premiums;
- including in assessable income amounts representing excess assets and fees and charges transferred from the company's virtual pooled superannuation trust (PST) and segregated exempt assets (SEA) because of the transfer mechanisms; and
- in limited circumstances, specifically including those fees and charges in assessable income under paragraph 320-15(k).

21. The broad approach to determine the amount of fees and charges that are included in assessable income as a consequence of the deduction and transfer mechanisms is to:

- identify the transfer value of assets - that is, the amount that could be expected to be received from the disposal of an asset in an open market after deducting any costs expected to be incurred in respect of the disposal;
- identify the value of policyholder liabilities; and
- consider the movement in those values over the period.

22. Any cash flow that changes asset values but does not change the value of policyholder liabilities to the same extent (allowing appropriately for investment income allocated to policyholders and the tax thereon) is taken to represent fees and charges for tax purposes. In some cases, the amount determined using this method includes the risk component of a premium. As both fees and charges and the risk component of a premium are included in assessable income, there is no need to further split this amount into the respective components.

23. The value placed on policyholder liabilities is a critical determinant of the amount of fees and charges included in assessable income in a period. The deduction allowed for life insurance

premiums and the transfer mechanisms that includes fees and charges in assessable income in a period depend on this value. To ensure consistency, the basis for determining the value placed on policyholder liabilities is prescribed in Division 320.

24. The method for determining fees and charges depends on whether the policy is:

- discharged from the virtual PST;
- discharged from the SEA;
- a death or disability (other than a participating) policy;
- a participating policy (except where the policy is discharged from the virtual PST or SEA); or
- any other type of policy.

25. The methodology used relies on established techniques for financial management of life insurance business - in particular actuarial standards.

26. It is important to note that a deduction can be claimed in respect of any amount only once. In this regard section 8-10 provides that if two or more provisions of the Act allow a deduction in respect of the same amount (whether for the same income year or different income years), a deduction is allowed only under the provision that is most appropriate.

Policies discharged from the virtual PST

27. Life insurance companies can segregate assets to support virtual PST liabilities. Virtual PST liabilities are liabilities in respect of virtual PST life insurance policies that are to be discharged out of a life company's virtual PST assets. Virtual PST life insurance policies are, broadly:

- life insurance policies (other than exempt life insurance policies) held by the trustee of a complying superannuation fund, complying approved deposit fund (ADF) or PST;
- deferred annuity policies held by an individual;
- life insurance policies held by another life company where the policy is a virtual PST asset of that other company; and
- superannuation policies held by an individual in the benefit fund of a friendly society where the benefit fund is a regulated superannuation fund under the *Superannuation Industry (Supervision) Act 1993*.

28. Fees and charges imposed on virtual PST life insurance policies can be either explicit or implicit.

- Explicit fees must be transferred from the virtual PST when they are imposed (subsection 320-195(3)).
- Implicit fees are determined by comparing the value of the virtual PST liabilities plus reasonable provisions for tax on unrealised gains on virtual PST assets and unpaid PAYG instalments with the transfer value of assets held in the virtual PST. The total transfer value of any excess assets is an implicit fee. Implicit fees must be transferred from the virtual PST following an annual valuation of virtual PST assets (section 320-180) or following a valuation of virtual PST assets at any other time (subsection 320-195(3)).

29. The value of virtual PST liabilities in respect of a particular policy depends on whether the policy is a non-participating policy or a participating policy (section 320-190).

30. If the policy is a non-participating policy, the value of virtual PST liabilities is the current termination value of the policy as defined in the Solvency Standard[4].

31. If the policy is a participating policy, the value of virtual PST liabilities is the value of supporting assets (as defined in the Valuation Standard[5]) plus retained profits attributable to participating policyholders. The value of liabilities for participating business held within the virtual PST results in all expenses that relate to that business being incurred within the virtual PST. This is consistent with common practice for managing and valuing the liabilities for participating business and the need to determine overall profit prior to sharing between policyholders and shareholders.

32. Life insurance companies include the full amount of any premiums received for virtual PST policies in assessable income (paragraph 320-15(a)). Assets (including cash) having a value equal to some or all of those premiums (including any death and disability components) can be transferred to the virtual PST (subsection 320-185(3)). The value of assets representing premiums transferred to the virtual PST is allocated to the virtual PST component of taxable income (paragraph 320-205(3)(b)).

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[4] Actuarial Standard 2.02 or, in the case of a life insurance company that is a friendly society, Actuarial Standard (Friendly Societies) 2.01 (definition of 'Solvency Standard' in subsection 995-1 of the ITAA 1936).

[5] Actuarial Standard 1.02 or, in the case of a life insurance company that is a friendly society, Actuarial Standard (Friendly Societies) 1.01 (definition of 'Valuation Standard' in subsection 995-1 of the ITAA 1936).

33. A deduction is allowed for the premiums transferred to the virtual PST less the death and disability component of those premiums (section 320-55). The amount allowed as a deduction is reduced by the death and disability component because the superannuation fund can claim a deduction for this amount (section 279 of the *Income Tax Assessment Act 1936* ('ITAA 1936')).

34. The death and disability component of the premium is specified in subsection 320-55(3) to be:

- if the policy specifies the death and disability component of the premium – the amount specified; or
- if the policy does not specify the death and disability component of the premium and:
  - the policy provides participating benefits or discretionary benefits – nil;
  - the policy is an endowment policy – 10% of the premium;
  - the policy is a whole-of-life policy – 30% of the premium; or
  - otherwise – so much of the premium that an actuary determines to be the death and disability component of the premium.

35. The amount allowed as a deduction for life insurance premiums under section 320-55 also reduces the virtual PST component of the complying superannuation class of the life insurance companies taxable income (paragraph 320-205(4)(a)).

36. The transfer mechanisms (sections 320-180 and 320-195) ensure that fees and charges – including those that relate to risk - are taxed at the company tax rate. Any fees and charges transferred from the virtual PST reduce the virtual PST component of the complying superannuation class of taxable income and consequently increase the ordinary class of taxable income.

Policies discharged from the segregated exempt assets

37. Life insurance companies can also segregate assets to support exempt life insurance policy liabilities (section 320-225). Exempt life insurance policy liabilities are defined in section 320-245 to mean, broadly:

- life insurance policies held by the trustee of a complying superannuation fund or PST that relate to the current pension business of the fund or PST;

- life insurance policies held by the trustee of a constitutionally protected superannuation fund;
- immediate annuity policies held by an individual; and
- life insurance policies held by another life company where the policy is a segregated exempt asset of that other company.

38. Similar to the virtual PST, fees and charges imposed on exempt life insurance policies can be either explicit or implicit.

- Explicit fees must be transferred from the SEA when they are imposed (subsection 320-250(2)).
- Implicit fees are determined by comparing the value of the exempt life insurance policy liabilities plus reasonable provisions for tax on unrealised gains on segregated exempt assets with the transfer value of assets in the SEA. The total transfer value of any excess assets is an implicit fee. Implicit fees must be transferred from the SEA following an annual valuation of segregated exempt assets (section 320-235) or following a valuation of segregated exempt assets at any other time (subsection 320-250(2)).

39. The value of exempt life insurance policy liabilities in respect of a particular policy depends on the type of policy (section 320-245).

- If the policy provides for allocated benefits (other than participating benefits), the value of exempt life insurance policy liabilities is the current termination value (as defined in the Solvency Standard) of the policy.
- If the policy is a participating policy, the value of exempt life insurance policy liabilities is the value of supporting assets (as defined in the Valuation Standard) plus retained profits attributable to participating policyholders.
- If the policy is any other type of policy, the value of exempt life insurance policy liabilities is the policy liabilities (as defined in the Valuation Standard) of the policy.

40. Any fees and charges that are transferred from the SEA under subsection 320-235(1) or subsection 320-250(2) are specifically included in assessable income under paragraph 320-15(f) and are taxed at the company tax rate.

41. As the fees and charges relating to exempt life insurance policy liabilities are included in assessable income as a result of the

transfer mechanisms and paragraph 320-15(f), a deduction is allowed for the whole amount of any premiums transferred to the SEA (section 320-60).

42. However, if a life insurance company does not transfer premiums relating to exempt life insurance policies to its SEA at the time they are received, a deduction is not allowed for any portion of the premiums at that time. If the company subsequently transfers assets to its SEA under subsection 320-235(2) or 320-240(1), a deduction is allowed under section 320-105 at the time of transfer.

43. It has been suggested that, in these circumstances, a deduction is allowed under section 320-75 at the time the premiums are received and that a second deduction is allowed under section 320-105 when assets representing the premiums are transferred to the SEA in a subsequent income year. The Commissioner does not agree with this view. In this regard section 8-10 provides that if two or more provisions allow a deduction for the same amount (whether for the same income year or different income years), a deduction is allowable under the provision that is most appropriate. Consequently, in these circumstances a deduction is allowed only when the premiums are transferred to the SEA.

Death and disability policies (other than participating policies)

44. Premiums received in relation to life insurance policies (other than participating) that provide benefits solely on death or disability consist only of fees and risk charges. To ensure these fees are included in assessable income, the full amount of premiums received in relation to these policies is included in assessable income (paragraph 320-15(a)).

45. Consequently, a deduction is not allowed for any part of the premiums received in relation to these policies (section 320-70).

Participating policies (other than policies discharged from the virtual PST or segregated exempt assets)

46. For tax purposes, the amount of fees and charges for participating business is only that portion of the profit which returns to the shareholder after policyholder entitlements and expenses have been met. To attribute all profit to the shareholder would not properly reflect the way in which this business is managed.

47. The Life Insurance Act has robust mechanisms to identify and track profits from participating business and allocate that profit between policyholders and shareholders.

48. Division 320 applies the same mechanisms for the purposes of determining the appropriate tax treatment[6]. Consequently, the whole of the premium (net of reinsurance) is deductible (section 320-65).

Other policies (section 320-75)

49. In the case of other policies – in practice, ordinary non-participating investment policies – the deduction for life insurance premiums under section 320-75 is the critical mechanism to include fees and charges in assessable income.

50. The amount allowed as a deduction under section 320-75 depends on when the policy is taken out.

51. For policies taken out before 1 July 2001, subsection 320-75(3) allows a deduction for the sum of the net premiums less the amount that an actuary determines to be attributable to fees and charges.

52. For policies taken out after 30 June 2001, subsection 320-75(2) allows a deduction for the lesser of:

- the amount specified in the policy to be the capital component of the premium adjusted for any part of the premium that is reinsured; and
- the sum of the net premiums less the amount that an actuary determines to be attributable to fees and charges.

53. In determining the amount that is attributable to fees and charges, an actuary must have regard to the change over the income year in the sum of the net current termination values of the policies (as defined in the Solvency Standard) and the movements in those values during the year (subsection 320-75(4)). This principle is similar to the principle underlying the annual valuation process as it applies to non-participating unbundled virtual PST policies.

54. The purpose of the Solvency Standard 'is to prescribe the minimum capital requirement [the Solvency Requirement] of a statutory fund to ensure that under a range of adverse circumstances the company would be expected to be in a position to meet (guaranteed) obligations to policy owners and other creditors'[7].

55. In the case of a life company that is not a friendly society, the Solvency Requirement is determined under the Solvency Standard on the basis of the minimum termination value for a related product

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[6] Examples 9 and 10 illustrate the application of Division 320 to ordinary participating and discretionary policies.
[7] See the Introduction to Actuarial Standard 2.02 and Actuarial Standard (Friendly Societies) 2.01.

group and on the current termination value for all policies in a statutory fund (paragraph 3.3 of Actuarial Standard 2.02). For a life company that is a friendly society, the Solvency Requirement is determined on the basis of the current termination value for all policies in a benefit fund (paragraph 3.3 of Actuarial Standard (Friendly Societies) 2.01).

56. Consistent with the principles applied to determine the Solvency Requirement under the Solvency Standard, the section 320-75 deduction is worked out at an aggregate level based on the group of 'other policies' rather than at an individual policy level. In this context, it is recognised that the group of other policies may comprise both regular premium and single premium business. While it is expected that the fees and charges attributable to premiums, at an aggregate level, would not exceed the amount of those premiums, it is acknowledged that this may not always be the case. This could arise, for example, for single premium business where a premium is paid in the year the policy is taken out and fees and charges are deducted in subsequent years.

57. The section 320-75 mechanism applies to determine all fees and charges regardless of whether they are deducted from premiums, investment income or account balances. Implicit fees are identified under the section 320-75 mechanism as a consequence of the comparison between the change in the value of the assets over the income year with the change in current termination value of policies over the income year. Section 320-75 was intentionally structured in this way to provide for consistency across different products and pricing structures and to avoid the complexities of defining different types of fees.

58. Consequently, the mechanism operates to identify different types of fees and charges for tax purposes and include them in assessable income even where, for example, there is no premium in the particular period for an individual policy. The types of fees identified and included in assessable income as a result of applying the section 320-75 mechanism include:

- premium based fees;
- time based fees – that is, policy or account fees that are charged on a regular periodical basis;
- on-going asset fees that are withdrawn from the policyholder's account and effectively reduce the policyholder's capital by, for example, cashing units;
- establishment fees, including establishment asset fees;
- exit fees; and
- switching fees.

59. Concern has been expressed that fees identified by using the section 320-75 mechanism may also be included in assessable income under paragraph 320-15(k) or under the ordinary income provisions. However, section 6-25 provides that if an amount is included in assessable income under more than one provision (including the ordinary income provisions), then the amount is included in assessable income only once.

60. Therefore, section 6-25 ensures that fees are not included in assessable income under paragraph 320-15(k) if they are included in assessable income as a result of applying the section 320-75 mechanism. For example, an explicit premium fee that is included in assessable income as a result of applying the section 320-75 mechanism may also be assessable under paragraph 320-15(k). Section 6-25 applies to ensure that the fee is included in assessable income only once.

61. Section 6-25 also ensures that implicit fees taken out of assessable investment income before the determination of the allocation of bonuses to policyholders are not included in assessable income as a consequence of applying the section 320-75 mechanism. That is, section 6-25 ensures that these fees are not included in assessable income under the ordinary provisions of the law, paragraph 320-15(k) and as a result of applying the section 320-75 mechanism.

62. For example, the implicit on-going asset fee for investment-linked policies is typically extracted from the unitised fund on a daily basis and is effectively built into the unit price. That is, the change in the unit value shows the investment return after allowing for the on-going asset fee.

- If the on-going asset fee is less than the assessable investment income relating to the relevant group of policies, then the section 320-75 mechanism does not apply to include the on-going asset fee in assessable income. This is because the fee is included in assessable income as ordinary investment income.
- If the on-going asset fee exceeds the assessable investment income relating to the relevant group of policies, the value of the units may fall or some of the policyholder's units may be cashed in to pay the fee. That is, the fee is effectively deducted from the policyholder's account. Therefore, the section 320-75 mechanism does apply to include the on-going asset fee effectively deducted from the policyholder's account in assessable income.

Fees and charges included in assessable income under paragraph 320-15(k)

63. Paragraph 320-15(k) applies only in limited circumstances. In most cases the deduction or transfer mechanisms ensure that the total fees and charges are included in assessable income. Fees and charges are included in assessable income under paragraph 320-15(k) only if they are not already included in assessable income under another provision of the taxation law

64. An example of where paragraph 320-15(k) applies is in the case of a discretionary policy where only the investment component of the policy operates via the participation mechanism and the fees and charges for the non-participating components are explicit and operate outside the participation mechanism. The explicit fees and charges are included in assessable income under paragraph 320-15(k)[8].

65. Implicit fees derived outside the participation mechanism can also be included in assessable income under paragraph 320-15(k). To determine the amount of implicit fees that are included in assessable income under this paragraph, the principles of section 320-75 are applied.

Timing of fees and charges

66. Division 320 captures all fees and charges, regardless of how or when they are levied. The fees and charges relating to non-participating policies are brought into assessable income at the time they are reflected in the current termination value of a policy. This timing may not always be the same as the timing of the recognition of receipt of these fees and charges for accounting or other purposes. For example, surrender fees and exit fees designed to recover acquisition costs will be recognised for tax purposes in the year the premium is received (and those fees are reflected in the current termination value of a policy) rather than when they are charged to the policyholder.

67. This difference in timing arises as a result of the prescribed actuarial method for deriving fees and charges – that is, based on the current termination value of policies[9]. Division 320 provides a practical and pragmatic solution to handling the complexities of fee structures for income tax purposes and provides an equitable and robust basis across different policy pricing structures.

[8] Example 10 illustrates a discretionary unbundled ordinary policy where paragraph 320-15(k) applies to include fees and charges in assessable income.
[9] See paragraph 5.36 of the Revised Explanatory Memorandum.

Exempt management fees

68. Section 320-40 provides transitional relief for 5 years in respect of a one-third portion of specified management fees – that is, certain management fees received from some types of policies that were in force as at 30 June 2000. The rationale for the transitional relief is to compensate for management fees included in assessable income as from 1 July 2000 where, prior to that date, expenses relating to those management fees were not deductible, or were only partly deductible[10].

69. The basis for determining specified management fees is not intended to provide an accurate calculation of the relief entitlement. Rather, it is intended as a practical and approximate mechanism for providing relief for a transition period of 5 years.

70. The mechanisms for defining specified management fees are consistent with the mechanisms for calculating fees and charges (see section 320-40). That is:

- for virtual PST and SEA business - the specified management fees for which a one third exemption is provided are defined in terms of the transfers to and from the virtual PST or SEA excluding transfers relating to risk charges;
- for ordinary non-participating business - the specified management fees are defined in terms of the deduction for life insurance premiums allowed under section 320-75.

71. When determining the amount of fees and charges that relate to the virtual PST or SEA, transfers from the virtual PST or SEA to meet the expenses of participating business do not qualify for transitional relief as specified management fees because such transfers are a reimbursement of expenses rather than a payment of management fees.

72. In this regard section 320-40 applies to exempt specified management fees which, so far as is relevant, are reflected by the amount transferred from the virtual PST or SEA. If the amount transferred is inflated to pay for expenses that should be paid directly from the virtual PST under subsection 320-195(4) or from the SEA under subsection 320-250(3), then, to that extent, the amount transferred retains its character. That is, the excess amount transferred represents a reimbursement of expenses rather than a management fee and therefore does not qualify for transitional relief under section 320-40.

[10] See paragraph 5.47 of the Revised Explanatory Memorandum.

73. There are no specified management fees for ordinary participating business and risk only business because the basis of taxation for this business is effectively unchanged. Similarly, fees derived on ordinary non-participating investment policies that are included in assessable income as investment income rather than under the section 320-75 mechanism are not specified management fees because those fees have always been included in assessable income as ordinary or statutory income.

Examples

74. The Explanatory Memorandum included some examples to illustrate the application of Division 320 to life insurance companies by setting out the cash flow transactions for some typical life insurance policies and the taxation treatment of those transactions[11].

75. This Ruling considers three different models[12] to further illustrate how the mechanisms in Division 320 include fees and charges in assessable income and tax them at the company tax rate. The three models are:

- Model A - Non-participating unbundled virtual PST policies;
- Model B - Ordinary non-participating unbundled policies with risk; and
- Model C - Participating and discretionary policies.

76. A number of examples are used to demonstrate each model. For the purposes of these examples, policies that do not qualify as virtual PST life insurance policies or exempt life insurance policies are referred to as ordinary policies. Each example shows, for a 12 month period:

- the amount of fees and charges included in assessable income and taxed at the company tax rate; and

[11] See paragraph 5.211 of the Revised Explanatory Memorandum.

[12] In the development of Division 320 the ATO consulted with representatives of the Institute of Actuaries of Australia. As part of this consultation process, some simple examples were developed to illustrate the outworking of the proposals for different product types. PriceWaterhouseCoopers Actuarial has subsequently developed a more detailed and sophisticated model for a more extensive range of policies and charging structures. PriceWaterhouseCoopers have agreed to make this model available to the ATO for the purposes of this Ruling. In this context, the model and the examples used in this Ruling should be considered as generic and not representative of any particular product of any particular life company. While this Ruling uses the PriceWaterhouseCoopers model for convenience, the ATO does not endorse any particular actuarial models.

- the calculation of taxable income for the period.

77. Consistent with Division 320, the calculation of taxable income for the period divides the taxable income of the life insurance company into two classes:

- the ordinary class of taxable income – which is taxed at the company tax rate (assumed to be 30% for the purposes of these examples); and
- the complying superannuation class of taxable income – which is taxed at a rate of 15%.

78. The complying superannuation class of taxable income of a life insurance company includes the virtual PST component determined under section 320-205. The ordinary class of taxable income of a life insurance company is the total taxable income less the complying superannuation class of taxable income (section 320-140).

79. It is not intended that the examples cover all possible circumstances which may arise in practice. Rather they are intended to illustrate the application of Division 320 in relation to a range of typical life insurance company products. As the examples are based on a number of assumptions, not all life insurance companies will necessarily operate in the manner illustrated in the examples.

80. For the purposes of this ruling, all examples are presented on a net of reinsurance basis. The detailed issues of reinsurance, and the operations of Division 320 for determining net and gross components, are beyond the scope of this Ruling. However, the principles outlined in this Ruling for the determination of fees and charges apply, from the perspective of the reinsurer, consistently to the reinsured portions of policies of the same type.

81. A specific example has not been included in respect of annuity/pension policies discharged from the SEA. In many respects, the mechanisms for determining fees and charges on exempt life insurance policies that are discharged from the SEA are consistent with those that apply for virtual PST policies.

MODEL A – NON-PARTICIPATING UNBUNDLED VIRTUAL PST POLICIES

82. Model A considers three examples of non-participating unbundled policies that are to be discharged from the virtual PST.

- Example 1 - No risk and all fees explicit;
- Example 2 - No risk and both explicit and implicit fees;
- Example 3 - Risk and all fees explicit.

83. The examples demonstrate that if the total fees and charges relating to a policy are the same, then, regardless of whether the fees are explicit or implicit, the life insurance company will include the same amount of fees in its assessable income.

84. In each of the examples using Model A, the relevant information relating to the life insurance company is as follows:

	Virtual PST	**Other (Ordinary)**
Premiums received	$2,000	
Investment income	$700	$70
Unrealised gains	$300	$30
Expenses		$240

85. The life insurance company has at the beginning of the period:

- total assets of $11,000;
- virtual PST assets with a transfer value of $10,000; and
- current termination value plus provisions for tax of virtual PST policies of $10,000.

86. In addition, all transfers from the virtual PST are in cash.

Example 1: Non-participating unbundled virtual PST policy with no risk and all fees explicit

87. This example considers a non-participating unbundled policy discharged from the virtual PST where there is no risk component and all fees and charges are explicit.

88. Additional assumptions relevant to this example are:

- Explicit fees on virtual PST policies:
  - Policy fees $120
  - Asset fees $230
- Investment claims $1,400
- Section 275 transfers $2,000
- Current termination value of virtual PST policies at end of period $10,868
- Provision for tax on unrealised virtual PST gains ($300 x 15% x 2/3) $30

Calculation of implicit fees

89. In this example there are no implicit fees. Consequently, as demonstrated in the table below, at the end of the period the value of assets held in the virtual PST equals the value of virtual PST liabilities plus reasonable provisions for tax on unrealised gains on virtual PST assets and unpaid PAYG instalments.

	$	**$**
Premiums transferred to VPST	2,000	
VPST investment income	700	
Unrealised gains in VPST	300	3,000
Less		
Policy fees	120	
Asset fees	230	
Investment claims	1,400	
Tax on VPST Taxable Income[1]	352	2,102
Increase in value of assets		**898**
Plus Value of VPST assets at start		10,000
Value of VPST assets at end		**10,898**
Less		
CTV of VPST policies at end	10,868	
Provision for tax on unrealised VPST gains	30	10,898
Implicit fees transferred from VPST		0

1. See Calculation of taxable income.

Total fees and charges

90. In this example, the total fees and charges are as follows:

Explicit policy fees	$120
Explicit asset fees	$230
Total fees and charges	**$350**

Calculation of taxable income

91. The total taxable income and the virtual PST component of taxable income is calculated as follows:

	Total Taxable Income		**Virtual PST Component**	
	Legislative reference	**$**	**Legislative reference**	**$**
Premiums received	320-15(a)	2,000		
Investment income	6-5	770	320-205(3)(a)	700
Transfers **to** VPST during period:				
• VPST premiums transferred under subsection 320-185(3)			320-205(3)(b)	2,000
Section 275 transfers	320-15(i)	2,000	320-205(3)(d)	2,000
Assessable income		4,770		4,700
Less				
Transfers **from** VPST during period:				
• Policy fees transferred under subsection 320-195(3)			320-205(4)(c)	120
• Asset fees transferred under subsection 320-195(3)			320-205(4)(c)	230
Deductible expenses	8-1	240		
Deduction for VPST premiums	320-55	2,000	320-205(4)(a)	2,000
Taxable Income		**$2,530**		**$2,350**

92. Therefore:

- total taxable income is $2,530;
- the complying superannuation class of taxable income is $2,350; and
- the ordinary class of taxable income is $180 (that is, $2,530 - $2,350).

93. The total tax payable by the life insurance company is $406.50 which is made up as follows:

- Ordinary Class ($180 x 30%) = $54
- Complying superannuation class ($2,350 x 15%) = $352.50.

Example 2: Non-participating unbundled virtual PST policy with no risk and both explicit and implicit fees

94. This example is the same as Example 1 except that the asset fees are implicit rather than explicit.

95. Additional assumptions relevant to this example are:

- Explicit fees on virtual PST policies
  - Policy fees $120
- Investment claims $1,400
- Section 275 transfers $2,000
- Current termination value of virtual PST policies at end of period $10,868
- Provision for tax on unrealised virtual PST gains ($300 x 15% x 2/3) $30

Calculation of implicit fees

96. In this example the asset fees are implicit. Consequently, as demonstrated in the table below, at the end of the period the value of assets held in the virtual PST exceeds the value of virtual PST liabilities plus reasonable provisions for tax on unrealised gains on virtual PST assets and unpaid PAYG instalments.

97. The amount of implicit fees is determined at the time the company does a valuation of its assets and liabilities. If a valuation is done after the end of the income year, the value of virtual PST assets at the end of an income year can include an undetermined amount of implicit fees reduced by the provision for tax on those fees. Consequently, the excess assets calculated are net of tax.

98. Therefore, the implicit fee that must be transferred from the virtual PST is the amount of excess assets grossed up for tax – that is, by 15%.

	$	$
Premiums transferred to VPST	2,000	
VPST investment income	700	
Unrealised gains in VPST	300	3,000
Less		
Policy fees	120	
Investment claims	1,400	
Tax on VPST Taxable Income before annual valuation[1]	387	1,907
Increase in value of assets		**1,093**
Plus Value of VPST assets at start		10,000
Value of VPST assets at end		**11,093**
Less		
CTV of VPST policies at end	10,868	
Provision for tax on unrealised VPST gains	30	10,898
Excess assets		**195**
Plus Gross up for 15% tax[2]		35
Implicit fees transferred from VPST		**$230**

1. See Calculation of taxable income ($2,580 x 15%)
2. $195 x 15%/(1 – 15%).

Total fees and charges

99. The total fees and charges are as follows:

Explicit policy fees	$120
Implicit fees transferred from the virtual PST	$230
Total fees and charges	**$350**

Calculation of taxable income

100. The total taxable income and the virtual PST component of taxable income is calculated as follows:

	Total Taxable Income		Virtual PST Component	
	Legislative reference	**$**	**Legislative reference**	**$**
Premiums received	320-15(a)	2,000		
Investment income	6-5	770	320-205(3)(a)	700
Transfers **to** VPST during period:				
• VPST premiums transferred under subsection 320-185(3)			320-205(3)(b)	2,000
Section 275 transfers	320-15(i)	2,000	320-205(3)(d)	2,000
Assessable income		4,770		4,700
Less				
Transfers **from** VPST during period:				
• Policy fees transferred under subsection 320-195(3)			320-205(4)(c)	120
Deductible expenses	8-1	240		
Deduction for VPST premiums	320-55	2,000	320-205(4)(a)	2,000
Taxable Income before annual valuation				**$2,580**
Less Implicit fees transferred **from** VPST because of annual valuation (subsection 320-180(1))			320-205(4)(c)	230
Taxable Income		**$2,530**		**$2,350**

101. Therefore:

- total taxable income is $2,530;
- the complying superannuation class of taxable income is $2,350; and
- the ordinary class of taxable income is $180 (that is, $2,530 - $2,350).

102. The total tax payable by the life insurance company is $406.50 which is made up as follows:

- Ordinary Class ($180 x 30%) = $54
- Complying superannuation class ($2,350 x 15%) = $352.50

Example 3: Non-participating unbundled virtual PST policy with risk and all fees explicit

103. This example is the same as Example 1 except that:

- the policy includes a risk component; and
- the superannuation fund has reduced the amount of premiums covered under the section 275 transfer agreement by the risk component of the premium that it has claimed as a deduction under section 279 of the ITAA 1936. Consequently, the section 275 transfers in this example is $1,850 (that is, $2,000 - $150).

104. In this example the risk charges are deducted from the policyholders account throughout the period and transferred from the virtual PST at the time they are imposed.

105. Additional assumptions relevant to this example are:

- Explicit fees and charges on virtual PST policies:
  - Policy fees $120
  - Asset fees $230
  - Risk charges $150
- Risk claims $100
- Investment claims $1,300
- Current termination value of virtual PST policies at end of period $10,840
- Provision for tax on unrealised virtual PST gains ($300 x 15% x 2/3) $30

106. The value of liabilities under net risk components is:

- Value at end of previous income year $40
- Value at end of current income year $55

107. Consequently, the value of liabilities under net risk components increased in the current year by $15 (that is, $55 - $40).

Calculation of implicit fees

108. In this example there are no implicit fees. Consequently, as demonstrated in the table below, at the end of the period the value of assets held in the virtual PST equals the value of virtual PST liabilities plus reasonable provisions for tax on unrealised virtual PST assets and unpaid PAYG instalments.

	$	$
Premiums transferred to VPST	2,000	
VPST investment income	700	
Unrealised gains in VPST	300	3,000
Less		
Policy fees	120	
	230	
Asset fees		
Risk charges	150	
Investment claims	1,300	
Tax on VPST Taxable Income[1]	330	2,130
Increase in value of assets		**870**
Plus Value of VPST assets at start		10,000
Value of VPST assets at end		**10,870**
Less		
CTV of VPST policies at end	10,840	
Provision for tax on unrealised VPST gains	30	10,870
Excess assets (implicit fees) transferred from VPST		**0**

1. See Calculation of taxable income.

Total fees and charges

109. The total fees and charges are as follows:

Explicit policy fees	$120
Explicit asset fees	$230
Explicit risk charges	$150
Total fees and charges	**$500**

Calculation of taxable income

110. The total taxable income and the virtual PST component of taxable income is calculated as follows:

	Total Taxable Income		**Virtual PST Component**	
	Legislative reference	**$**	**Legislative reference**	**$**
Premiums received	320-15(a)	2,000		
Investment income	6-5	770	320-205(3)(a)	700
Transfers **to** VPST during period:				
• VPST premiums transferred under subsection 320-185(3)			320-205(3)(b)	2,000
Section 275 transfers	320-15(i)	1,850	320-205(3)(d)	1,850
Assessable income		4,620		4,550
Less				
Transfers **from** VPST during period:				
• Policy fees transferred under subsection 320-195(3)			320-205(4)(c)	120
• Asset fees transferred under subsection 320-195(3)			320-205(4)(c)	230
• Risk charges transferred under subsection 320-195(3)			320-205(4)(c)	150
Deductible expenses	8-1	240		
Deductible risk claims	320-80	100		
Increase in value of liabilities under net risk components	320-85	15		
Deduction for VPST premiums	320-55	1,850	320-205(4)(a)	1,850
Taxable Income		**$2,415**		**$2,200**

111. Therefore:

- total taxable income is $2,415;
- the complying superannuation class of taxable income is $2,200; and
- the ordinary class of taxable income is $215 (that is, $2,415 - $2,200).

112. The total tax payable by the life insurance company is $394.50 which is made up as follows:

- Ordinary Class ($215 x 30%) = $64.50
- Complying superannuation class ($2,200 x 15%) = $330.

MODEL B – ORDINARY NON-PARTICIPATING UNBUNDLED POLICIES WITH RISK

113. Model B considers three examples of ordinary non-participating unbundled policies that have a risk component.

- Example 4 - All fees are explicit.
- Example 5 – Implicit fees that are not taken out of assessable investment income and Explicit fees.
- Example 6 – Implicit fees that are taken out of assessable investment income and Explicit fees.

114. In each of the examples using Model B, the company only has ordinary life insurance business.

115. Relevant information relating to the company is as follows:

	Policyholder	**Shareholder**
Premiums received	$2,000	
Investment income	$700	$70
Unrealised gains	$300	$30
Deductible expenses		$240
Risk claims		$100
Investment claims	$1,300	

116. The life insurance company has at the beginning of the period:

- Ordinary policyholder assets with a transfer value of $10,000; and
- Current termination value plus provisions for tax of ordinary policies of $10,000.

117. At the end of the period the company has:

- Current termination value of ordinary policies of $10,900; and
- Provision for tax on unrealised ordinary policyholder gains of $90 (that is, $300 x 30%).

118. The value of liabilities under net risk components is:

- Value at end of previous income year $40
- Value at end of current income year $55

119. Consequently, the value of liabilities under net risk components increased in the current year by $15 (that is, $55 - $40).

Example 4: Ordinary non-participating unbundled policy with risk and all fees explicit

120. This example considers an ordinary non-participating unbundled policy that has a risk component and where all fees and charges are explicit. The example is the same as Example 3 except that the policy is an ordinary life insurance policy.

121. Additional assumptions relevant to this example are:

- Explicit fees and charges on ordinary policies:
  - Policy fees $120
  - Asset fees $230
  - Risk Charges $150

Calculation of implicit fees

122. In this example there are no implicit fees. Consequently, as demonstrated in the table below, the mechanism in section 320-75 for working out the deduction for life insurance premiums is critical in bringing the fees and charges into assessable income.

123. If the fees and charges are explicit, the determination of the amount of the premium attributable to fees and charges is relatively clear.

124. If the fees and charges are implicit, an actuary determines the amount of the premium that relates to those implicit fees and charges by comparing the change in the value of assets for ordinary policyholders over the income year with the change in current termination value for those policies over the income year. This principle is similar to that underlying the annual valuation process as it applies in Model A – Non-participating unbundled virtual PST policies. For ordinary non-participating investment policies, the value of assets at the start of an income year is the sum of:

- the current termination value for those policies at the end of the previous income year; and
- any reasonable provision made by the company in its accounts at the end of the previous income year for liability for tax on unrealised gains in respect of assets held for those policyholders.

	$	$
Value of ordinary policyholder assets:		
Premiums for ordinary policies	2,000	
Policyholder investment income	700	
Unrealised gains relating to ordinary policyholders	300	3,000
Less		
Policy fees	120	
Asset fees	230	
Risk charges	150	
Investment claims	1,300	
Tax attributable to ordinary policyholders[1]	210	2,010
Increase in value of ordinary policyholder assets		**990**
Plus Value of ordinary policyholder assets at start		10,000
Value of ordinary policyholder assets at end		**10,990**
Less		
CTV of ordinary policies at end	10,900	
Provision for tax on unrealised ordinary policyholder gains at end	90	10,990
Excess assets (implicit fees)		**0**

1. See Calculation of taxable income.

Total fees and charges

125. The total fees and charges are as follows:

Explicit policy fees	$120
Explicit asset fees	$230
Explicit risk charges	$150
Total fees and charges	**$500**

Calculation of taxable income

126. The total taxable income and the amount of taxable income that relates to ordinary policyholders is calculated as follows:

	Total Taxable Income		**Taxable income that relates to ordinary policyholders**
	Legislative reference	**$**	**$**
Premiums received	320-15(a)	2,000	
Investment income	6-5	770	700
Assessable income		2,770	700
Less			
Deductible expenses	8-1	240	
Deduction for ordinary life insurance premiums[1]	320-75	1,500	
Risk component of claims paid	320-80	100	
Increase in value of liabilities under net risk components	320-85	15	
Taxable Income		**$915**	**$700**

1. Deduction for ordinary life insurance premiums = net premiums less amount attributable to fees and charges (including implicit fees and charges) = (120 + 150+ 230) = $1,500.

127. Therefore:

- the ordinary class of taxable income (which is the same as total taxable income) is $915; and
- the taxable income attributable to ordinary policyholders is $700.

128. The total tax payable by the life insurance company is $274.50 (that is, $915 x 30%). The amount of that tax attributable to ordinary policyholders is $210 (that is, $700 x 30%).

Example 5: Ordinary non-participating unbundled policy with Risk, Implicit fees not taken out of assessable investment income and Explicit fees

129. This example considers an ordinary non-participating unbundled policy that has a risk component and both explicit and implicit fees. This example is the same as Example 4 except that the policy fees are implicit.

130. Additional assumptions relevant to this example are:

- Explicit fees and charges on ordinary policies:
  - Asset fees $230
  - Risk charges $150

Calculation of implicit fees

131. In this example the policy fees are implicit. Implicit policy fees can arise, for example, where there is a penalty on the surrender of a policy that is recognised only when the policy is actually terminated. This results in the current termination value being less than the member's account. As demonstrated in the table below, the mechanism in section 320-75 for working out the deduction for life insurance premiums is critical in bringing implicit fees into assessable income.

132. The implicit fees for tax purposes are determined as follows:

	$	$
Value of ordinary policyholder assets:		
Premiums for ordinary policies	2,000	
Policyholder investment income	700	
Unrealised gains relating to ordinary policyholders	300	3,000
Less		
Asset fees	230	
Risk charges	150	
Investment claims	1,300	
Tax attributable to ordinary policyholders[1]	210	1,890
Increase in value of ordinary policyholder assets		**1,110**
Plus Value of ordinary policyholder assets at start		10,000
Value of ordinary policyholder assets at end		**11,110**
Less		
CTV of ordinary policies at end	10,900	
Provision for tax on unrealised ordinary policyholder gains at end	90	10,990
Excess assets (implicit fees)		**$120**

1. See Calculation of taxable income.

133. The above table shows that in this example:

- the value of ordinary policyholder assets at the end of the period ($11,110) is not reduced by the policy fees - these implicit fees are reflected in the current termination value;
- the value of the assets at the end of the period ($11,110) exceeds the current termination value plus the value of deferred tax on unrealised gains at that time ($10,990) by the amount of the implicit policy fees. The excess amount ($120) represents the implicit fees and is included in assessable income and taxed at the company tax rate.
  - The implicit fee which is derived is the gross fee in this example because the life insurance

company is not entitled to a deduction for the amount of those fees.

Total fees and charges

134. The total fees and charges are as follows:

Explicit asset fees	$230
Explicit risk charges	$150
Implicit policy fees	$120
Total fees and charges	**$500**

Calculation of taxable income

135. The total taxable income and the amount of taxable income that relates to ordinary policyholders is calculated as follows:

	Total Taxable Income		**Taxable income that relates to ordinary policyholders**
	Legislative reference	**$**	**$**
Premiums received	320-15(a)	2,000	
Investment income	6-5	770	700
Assessable income		2,770	700
Less			
Deductible expenses	8-1	240	
Deduction for ordinary life insurance premiums[1]	320-75	1,500	
Risk component of claims paid	320-80	100	
Increase in value of liabilities under net risk components	320-85	15	
Taxable Income		**$915**	**$700**

1. Deduction for ordinary life insurance premiums = net premiums less amount attributable to fees and charges (including implicit fees and charges) = (230 + 150+ 120) = $1,500.

136. Therefore:

- the ordinary class of taxable income (which is the same as total taxable income) is $915; and
- the taxable income attributable to ordinary policyholders is $700.

137. The total tax payable by the life insurance company is $274.50 (that is, $915 x 30%). The amount of that tax attributable to ordinary policyholders is $210 (that is, $700 x 30%).

Example 6: Ordinary non-participating unbundled policy with Risk, Implicit fees taken out of assessable investment income and Explicit fees

138. This example considers an ordinary non-participating unbundled policy that has a risk component and both explicit and implicit fees. This example is the same as Example 5 except that the implicit fees are taken out of assessable investment income prior to the allocation of investment returns to policyholders. Therefore, although the section 320-75 mechanism identifies the implicit fees, section 6-25 operates to ensure that the mechanism does not apply to include those fees in assessable income. That is, section 6-25 ensures that these fees are not included in assessable income under the ordinary provisions of the law, paragraph 320-15(k) and as a result of applying the section 320-75 mechanism.

Calculation of implicit fees

139. In this example the asset fees are implicit fees taken out of assessable investment income prior to the allocation of investment returns to policyholders. Nevertheless, the section 320-75 mechanism applies to identify the implicit asset fees.

140. The implicit fees for tax purposes are determined as follows:

	$	$
Value of ordinary policyholder assets:		
Premiums for ordinary policies	2,000	
Policyholder investment income before the reduction of implicit fees	700	
Unrealised gains relating to ordinary policyholders	300	3,000
Less		
Policy fees	120	
Risk charges	150	
Investment claims	1,300	
Tax attributable to policyholder investment income before the reduction of implicit fees[1]	210	1,780
Increase in value of ordinary policyholder assets		**1,220**
Plus Value of ordinary policyholder assets at start		10,000
Value of ordinary policyholder assets at end		**11,220**
Less		
CTV of ordinary policies at end	10,900	
Provision for tax on unrealised ordinary policyholder gains at end	90	10,990
Excess assets (implicit fees)		**$230**

1. $700 x 30%.

141. The above table shows that in this example:

- the value of ordinary policyholder assets at the end of the period ($11,220) is not reduced by the asset fees - these implicit fees are reflected in the current termination value;
- the value of the assets at the end of the period ($11,220) exceeds the current termination value plus the value of deferred tax on unrealised gains at that time ($10,990) by the amount of the implicit asset fees. The excess amount ($230) represents implicit fees that are deducted from the investment income attributable to policyholders before the allocation of that investment income to policyholders – that is, the investment return allocated to the policyholder is net of fees.
    - The implicit fee which is derived is the gross fee in this example because the life insurance company is not entitled to a deduction for the amount of those fees.

Total fees and charges

142. The total fees and charges are as follows:

Explicit policy fees	$120
Explicit risk charges	$150
Implicit fees	$230
Total fees and charges	**$500**

Calculation of taxable income

143. The total taxable income and the amount of taxable income that relates to ordinary policyholders is calculated as follows:

	Total Taxable Income		Taxable income that relates to ordinary policyholders
	Legislative reference	**$**	**$**
Premiums received	320-15(a)	2,000	
Investment income	6-5	770	700
Assessable income		2,770	700
Less			
Deductible expenses	8-1	240	
Deduction for ordinary life insurance premiums[1]	320-75	1,730	
Risk component of claims paid	320-80	100	
Increase in value of liabilities under net risk components	320-85	15	
Implicit fee included in assessable investment income[2]		—	230
Taxable Income		**$685**	**$470**

1. Deduction for ordinary life insurance premiums = net premiums less amount attributable to explicit fees and charges = 2000 - (120 + 150) = $1,730.
2. This amount is not an income tax deduction.

144. Therefore:

- the ordinary class of taxable income (which is the same as total taxable income) is $685; and
- the taxable income attributable to ordinary policyholders is $470.

145. The total tax payable by the life insurance company is $205.50 (that is, $685 x 30%). The amount of that tax attributable to ordinary policyholders is $141 (that is, $470 x 30%).

7. MODEL C – PARTICIPATING AND DISCRETIONARY POLICIES

146. Participating policies can be either superannuation policies or ordinary policies and hence may operate under Model A - Virtual PST policies or Model B - Ordinary policies as described above. Therefore, Model C considers four examples of participating and discretionary policies. This section is broken into two parts.

- Part 1 contains two examples of policies that will be discharged from the virtual PST.

- Part 2 contains two examples of ordinary policies.

Part 1 - Participating policies that will be discharged from the virtual PST

147. The two examples of participating policies that will be discharged from the virtual PST are:

- Example 7 - Participating unbundled virtual PST policy.
- Example 8 - Participating bundled virtual PST policy.

148. In both of these examples the relevant information during the year is as follows:

	Participating virtual PST business	**Other (Ordinary)**
Premiums received	$2,000	
Investment income	$700	$70
Unrealised gains	$300	$30
Deductible expenses relating to participating business	$240	
Total participating claims	$1,400	

149. The life insurance company has at the beginning of the period:

- Virtual PST participating assets with a transfer value of $10,000; and
- Policy liability plus provisions for tax of virtual PST policies (that is, value of supporting assets plus policy owners retained profit) of $10,000.

150. At the end of the period the company's provision for tax on unrealised virtual PST participating gains is $30 (ie, $300 x 15% x 2/3).

151. All transfers from the virtual PST are in cash.

Example 7: Participating unbundled policy held within the virtual PST

152. This example considers a participating investment account policy held in the virtual PST that is unbundled and has no risk component.

153. Additional assumptions relevant to this example are:

- Policy liability of virtual PST participating policies at the end of period of $10,876.
- Section 275 transfers of $2,000.

Calculation of implicit fees for tax purposes

154. The implicit fees for tax purposes are determined as follows:

	$	**$**
Premiums on participating policies transferred to VPST	2,000	
VPST participating investment income	700	
Unrealised gains in VPST for participating business	300	3,000
Less		
Deductible expenses relating to participating business	240	
Total claims on participating policies	1,400	
Tax on VPST Taxable Income from participating business before annual valuation[1]	369	2,009
Increase in value of participating assets		**991**
Plus Value of VPST participating assets at start		10,000
Value of VPST participating assets at end		**10,991**
Less		
Policy liability of VPST participating policies at end	10,876	
Provision for tax on unrealised VPST participating gains	30	10,906
Excess VPST assets		85
Gross up for 15% tax[2]		15
Implicit fees for tax purposes transferred from VPST		**$100**

1. See Calculation of taxable income ($2,460 x 15%).
2. $85 x 15%/(1 – 15%).

155. In this example, the value of the virtual PST assets at the end of the period ($10,991) need to be reduced so that they do not exceed the value of virtual PST liabilities ($10,876) plus the amount of deferred tax on unrealised gains on virtual PST assets ($30) at that time. The excess amount ($85) is grossed-up by 15% to reflect the tax treatment of the transfer. That grossed-up excess amount ($100) must be transferred from the virtual PST.

Total fees and charges

156. The total net fees and charges for tax purposes are as follows:

Implicit fees for tax purposes transferred from the virtual PST	$100
Total fees and charges	**$100**

Calculation of taxable income

157. The total taxable income and the virtual PST component of taxable income is calculated as follows:

	Total Taxable Income		**Virtual PST Component**	
	Legislative reference	**$**	**Legislative reference**	**$**
Premiums received	320-15(a)	2,000		
Investment income	6-5	770	320-205(3)(a)	700
Transfers **to** VPST during period:				
• VPST premiums transferred under subsection 320-185(3)			320-205(3)(b)	2,000
Section 275 transfers	320-15(i)	2,000	320-205(3)(d)	2,000
Assessable income		4,770		4,700
Less				
Transfers **from** VPST during period:				
Deductible expenses	8-1	240	320-205(4)(d)	240
Deduction for VPST premiums	320-55	2,000	320-205(4)(a)	2,000
Taxable Income before annual valuation				**$2,460**
Less Implicit fees transferred **from** VPST because of annual valuation (subsection 320-180(1))			320-205(4)(c)	100
Taxable Income		**$2,530**		**$2,360**

158. Therefore:

- total taxable income is $2,530;
- the complying superannuation class of taxable income is $2,360; and
- the ordinary class of taxable income is $170 (that is, $2,530 - $2,360).

159. The total tax payable by the life insurance company is $405 which is made up as follows:

- Ordinary Class ($170 x 30%) = $51
- Complying superannuation class ($2,360 x 15%) = $354

Example 8: Participating bundled policy held within the virtual PST

160. This example is the same as Example 7 except that the policy is a bundled endowment policy.

161. Additional assumptions relevant to this example are:

- Policy liability of virtual PST participating policies at the end of period of $10,906.
- Section 275 transfers of $1,800 (reflecting that the superannuation fund has claimed a deduction for $200 (10% of the premium) under section 279 of the ITAA 1936).

Calculation of implicit fees for tax purposes

162. The implicit fees for tax purposes are determined as follows:

	$	**$**
Premiums on participating policies transferred to VPST	2,000	
VPST participating investment income	700	
Unrealised gains in VPST for participating business	300	3,000
Less		
Deductible expenses relating to participating business	240	
Total claims on participating policies	1,400	
Tax on VPST Taxable Income from participating business before annual valuation[1]	339	1,979
Increase in value of participating assets		**1,021**
Plus Value of VPST participating assets at start		10,000
Value of VPST participating assets at end		**11,021**
Less		
Policy liability of VPST participating policies at end	10,906	
Provision for tax on unrealised VPST participating gains	30	10,936
Excess VPST assets		85
Gross up for 15% tax[2]		15
Implicit fees for tax purposes transferred from VPST		**$100**

1. See Calculation of taxable income ($2,260 x 15%).
2. $85 x 15%/(1 – 15%).

Total fees and charges

163. The total net fees and charges for tax purposes are as follows:

Implicit fees for tax purposes transferred from the virtual PST	$100
Total fees and charges	**$100**

Calculation of taxable income

164. The total taxable income and the virtual PST component of taxable income is calculated as follows:

	Total Taxable Income		**Virtual PST Component**	
	Legislative reference	**$**	**Legislative reference**	**$**
Premiums received	320-15(a)	2,000		
Investment income	6-5	770	320-205(3)(a)	700
Transfers **to** VPST during period:				
• VPST premiums transferred under subsection 320-185(3)			320-205(3)(b)	2,000
Section 275 transfers	320-15(i)	1,800	320-205(3)(d)	1,800
Assessable income		4,570		4,500
Less				
Deductible expenses	8-1	240	320-205(4)(d)	240
Deduction for VPST premiums	320-55	2,000	320-205(4)(a)	2,000
Taxable Income before annual valuation				**$2,260**
Less Implicit fees transferred **from** VPST because of annual valuation (subsection 320-180(1))			320-205(4)(c)	100
Taxable Income		**$2,330**		**$2,160**

165. Therefore:

- total taxable income is $2,330;
- the complying superannuation class of taxable income is $2,160; and
- the ordinary class of taxable income is $170 (that is, $2,330 - $2,160).

166. The total tax payable by the life insurance company is $375 which is made up as follows:

- Ordinary Class ($170 x 30%) = $51
- Complying superannuation class ($2,160 x 15%) = $324.

Part 2 - Ordinary participating and discretionary policies

167. The two examples of ordinary participating policies are:

- Example 9 - Ordinary participating bundled policy;

- Example 10 - Ordinary discretionary unbundled policy and all fees explicit.

168. In both of these examples the relevant information during the year is as follows:

	Participating / discretionary business	Shareholders
Premiums received	$2,000	
Investment income	$700	$70
Unrealised gains	$300	$30
Total claims	$1,400	

169. The life insurance company has at the beginning of the period:

- Ordinary policyholder assets with a transfer value of $10,000; and
- Policy liabilities plus provisions for tax of ordinary policies of $10,000.

Example 9: Participating bundled ordinary policy

170. This example considers an ordinary endowment policy.

171. Additional assumptions relevant to this example are:

- Deductible expenses relating to participating business $240;
- At the end of the period the company has:
  - Policy liabilities of ordinary participating policies of $11,050; and
  - Provision for tax on unrealised gains of $90 ($300 x 30%).

Calculation of implicit fees for tax purposes

172. The implicit fees for tax purposes are determined as follows:

	$	$
Value of ordinary policyholder assets:		
Premiums on ordinary participating policies	2,000	
Participating investment income	700	
Unrealised gains for participating business	300	3,000
Less		
Deductible expenses relating to participating business	240	
Total claims on participating policies	1,400	
Tax attributable to income from participating business before determination of implicit fees for tax purposes[1]	138	1,778
Increase in value of ordinary participating assets		**1,222**
Plus Value of ordinary participating policyholder assets at start		10,000
Value of ordinary participating assets at end		**11,222**
Less		
Policy liability of ordinary participating policies at end	11,050	
Provision for tax on unrealised ordinary participating gains at end	90	11,140
Excess assets[2]		82
Gross-up for 30% tax[3]		35
Implicit fees for tax purposes		**$117**

1. See Calculation of taxable income.
2. Profit transfer to shareholder net of tax.
3. \$82 x 30%/(1 – 30%). This gross-up for tax is required solely to work out the implicit fee for tax purposes.

Total fees and charges

173. The total net fees and charges for tax purposes are as follows:

Implicit fees for tax purposes	$117
Total fees and charges	**$117**

Calculation of taxable income

174. The following table shows how to calculate total taxable income and the amount of taxable income that relates to ordinary participating policyholders. The table splits tax between shareholders and policyholders for illustration purposes only. That split is not intended to have any broader implications – for example, it is not intended to have any implications on the basis for splitting franking credits between shareholders and policyholders.

	Total Taxable Income		Taxable income that relates to ordinary participating policyholders
	Legislative reference	**$**	**$**
Premiums received	320-15(a)	2,000	
Investment income	6-5	770	700
Assessable income		2,770	700
Less			
Deductible expenses	8-1	240	240
Deduction for ordinary life insurance premiums	320-65	2,000	—
Taxable Income from participating business before determination of implicit fees for tax purposes			**460**
Less Implicit fees calculated for tax purposes			117
Taxable Income		**$530**	**$343**

175. Therefore:

- the ordinary class of taxable income (which is the same as total taxable income) is $530; and
- the taxable income attributable to ordinary participating policyholders is $343.

176. The total tax payable by the life insurance company is $159 (that is, $530 x 30%). The amount of that tax attributable to ordinary participating policyholders is $103 (that is, $343 x 30%).

Example 10: Discretionary unbundled ordinary policy and all fees explicit

177. This example considers an ordinary discretionary unbundled policy.

178. For such a policy structure, the operation of Model C that applies to participating business under Division 320 will not appropriately bring into assessable income those fees and charges relating to the non-participating components of the policy.

179. Therefore, to achieve a tax result that is consistent with the principles of Division 320, the participating component of the policy should be taxed in accordance with Model C - Participating business and the non-participating component taxed in accordance with the Model B – Ordinary business.

180. This principle is achieved under Division 320 through the application of paragraph 320-15(k) which brings into assessable income the non-participating components of fees and charges that are not otherwise assessable.

181. This example describes one type of discretionary policy – where some of the fees are explicit and operate outside the participation mechanism. In practice, discretionary policies may operate as a participating policy in the full sense, despite some or all of the fees being explicit. That is, all components of the policy – the investment, risk and administration components - operate through the participation mechanism. For such a policy, the Model for participating business under Division 320 applies to achieve the appropriate tax outcome.

182. Additional assumptions relevant to this example are:

- Policy fees of $150.
- Deductible expenses:
  - $140 relating to the participating component of the discretionary business; and
  - $100 relating to the non-participating component of the discretionary business and consequently allocated to shareholders.
- At the end of the period the company has:
  - Policy liabilities of ordinary discretionary policies of $10,900; and
  - Provision for tax on unrealised gains of $90 (that is, $300 x 30%).

Calculation of implicit fees for tax purposes

183. The implicit fees for tax purposes are determined as follows:

	$	$
Value of ordinary policyholder assets:		
Premiums on ordinary discretionary policies	2,000	
Discretionary investment income	700	
Unrealised gains relating to discretionary business	300	3,000
Less		
Policy fees	150	
Deductible expenses relating to discretionary business	140	
Total claims on discretionary policies	1,400	
Tax attributable to income from discretionary business before determination of implicit fees for tax purposes[1]	168	1,858
Increase in value of ordinary discretionary assets		**1,142**
Plus Value of ordinary discretionary policyholder assets at start		10,000
Value of ordinary discretionary assets at end		**11,142**
Less		
Policy liability of ordinary discretionary policies at end	10,900	
Provision for tax on unrealised ordinary discretionary gains at end	90	10,990
Excess assets[2]		152
Gross-up for 30% tax[3]		65
Implicit fees for tax purposes		**$217**

1. See Calculation of taxable income.
2. Profit transfer to shareholders net of tax.
3. $152 x 30%/(1 – 30%). This gross-up for tax is required solely to work out the implicit fee for tax purposes.

Total fees and charges

184. The total fees and charges for tax purposes are as follows:

Policy fees assessable under paragraph 320-15(k)	$150
Implicit fees for tax purposes	$217
Total fees and charges	$367

Calculation of taxable income

185. The following table shows how to calculate total taxable income and the amount of taxable income that relates to ordinary discretionary policyholders. The table splits tax between shareholders and policyholders for illustration purposes only. That split is not intended to have any broader implications – for example, it is not intended to have any implications on the basis for splitting franking credits between shareholders and policyholders.

	Total Taxable Income		**Taxable income that relates to ordinary discretionary policyholders**
	Legislative reference	**$**	**$**
Premiums received	320-15(a)	2,000	
Investment income	6-1	770	700
Policy fees	320-15(k)	150	—
Assessable income		2,920	700
Less			
Deductible expenses	8-1	240	140
Deduction for ordinary life insurance premiums	320-65	2,000	—
Taxable Income from discretionary business before determination of implicit fees for tax purposes			**560**
Less Implicit fees calculated for tax purposes			217
Taxable Income		**$680**	**$343**

186. Therefore:

- the ordinary class of taxable income (which is the same as total taxable income) is $680; and
- the taxable income attributable to ordinary discretionary policyholders is $343.

187. The total tax payable by the life insurance company is $204 (that is, $680 x 30%). The amount of that tax attributable to ordinary discretionary policyholders is $103 (that is, $343 x 30%).

Detailed contents list

188. Below is a detailed contents list for this draft Ruling:

Your comments

189. If you wish to comment on this draft Ruling, please send your comments promptly by **11 January 2002** to:

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Commissioner of Taxation
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Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
TR 92/20

Subject references:
- actuarial examples
- fees and charges
- friendly societies
- Life Insurance companies

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