


# ***TR 2003/14 - Income tax: Life insurance companies: the actuarial determination of fees and charges***

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## Taxation Ruling

### Income tax: Life insurance companies: the actuarial determination of fees and charges

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Contents	Para
<b>What this Ruling is about</b>	<b>1</b>
<b>Background</b>	<b>2</b>
<b>Date of effect</b>	<b>19</b>
<b>Ruling and Explanation</b>	<b>20</b>
<b>Examples</b>	<b>53</b>
<b>Detailed contents list</b>	<b>147</b>

#### *Preamble*

*The number, subject heading, **What this Ruling is about**, **Date of effect**, and **Ruling and Explanation** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner of Taxation. 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 Ruling is about

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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<sup>1</sup> under Division 320 of the *Income Tax Assessment Act 1997* (ITAA 1997).

## Background

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

- all management fees (except for certain fees on ordinary investment policies and management fees that are exempt from tax under transitional arrangements);
- underwriting profit; and
- profit on immediate annuity business.<sup>2</sup>

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<sup>1</sup> A life insurance company is defined in subsection 995-1(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.

<sup>2</sup> See Paragraph 5.1 of the Revised Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill (No.2) 2000.

**Types of policies**

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

4. The types of policies include:

- 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 non-participating (including 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.

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(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(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<sup>3</sup> 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(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(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.

15. Policies can also have a rider attached. The rider confers additional benefits usually in return for the payment of additional premiums. Where a risk rider attaches to an investment policy, and that policy is a participating policy, it is common practice for life insurance companies to also classify the risk rider as a participating policy to simplify administration processes. This same classification convention is used in Division 320. That is, for these policies the risk rider is considered as participating for the purposes of applying Division 320.

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

## **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 emerging or defined, 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:

- an emerging fee for the purposes of this Ruling, is a fee that can only be determined as a consequence of an actuarial valuation of the assets and liabilities of the life insurance company; and
- a defined fee for the purposes of this Ruling, is a fee that a life insurance company can ascertain without completing an actuarial valuation of its assets and liabilities.

17. The distinction between emerging fees and defined fees is explained in more detail in the examples for Models A, B and C shown at paragraphs 53-146 of this Ruling.

18. 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**

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19. 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).

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## **Ruling and Explanation**

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### **Calculation of fees and charges**

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

21. Fees and charges are included in taxable 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 the ordinary class of taxable income amounts representing excess assets and fees and charges transferred from the company's virtual PST and segregated exempt assets (SEA) because of the Division 320 transfer mechanisms; and
- if they are not otherwise included in assessable income, specifically including those fees and charges in assessable income under paragraph 320-15(k).

22. The broad approach to determine the amount of fees and charges that are included in taxable 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.

23. The value placed on policyholder liabilities is a critical determinant of the amount of fees and charges included in taxable income in a period. The deduction allowed for life insurance premiums and the transfer mechanisms that include fees and charges in taxable 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.

***Policies discharged from the virtual PST***

26. 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*.

27. Fees and charges on virtual PST life insurance policies can be either emerging or defined. Emerging fees must be transferred from the virtual PST within 30 days of the annual valuation (subsection 320-180(1) of the ITAA 1997 or transferred from the virtual PST following a valuation at another time (paragraph 320-195(3)(c)). Defined fees must be transferred from the virtual PST when they are imposed (paragraphs 320-195(3)(a) and (b)). That is, the defined fees must be transferred within a reasonable time having regard to normal business practice.

28. 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).

29. If the policy is a non-participating policy, the value of virtual PST liabilities is the current termination value of the policy which is defined in subsection 995-1(1).

30. 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 (subsection 995-1(1)) plus retained profits attributable to participating policyholders (paragraph 320-190(2)(a)). This results in all expenses that are attributed to that business being effectively incurred within the virtual PST. This outcome 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.

31. 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)).

32. A deduction is allowed for the value of assets (including cash), not exceeding the amount of premiums received, that are 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)).

33. The death and disability component of the premium is specified in subsection 320-55(3) of the ITAA 1997 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.

34. 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)).

35. 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***

36. Life insurance companies can also segregate assets to support exempt life insurance policy liabilities (section 320-225). Exempt life insurance policy liabilities are liabilities in respect of exempt life insurance policies that are to be discharged out of segregated exempt assets. These 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;
- certain personal injury annuity policies held by an individual;
- certain personal injury lump sums received by an individual; and
- life insurance policies held by another life company where the policy is a segregated exempt asset of that other company.

37. Similar to the virtual PST, fees and charges on exempt life insurance policies can be emerging or defined. Emerging fees must be transferred from the SEA within 30 days of the annual valuation (subsection 320-235(1) or transferred from the SEA following a valuation at another time (paragraph 320-250(2)(c)). Defined fees must be transferred from the SEA when they are imposed (paragraphs 320-250(2)(a) and (b)). That is, the defined fees must be transferred

within a reasonable time having regard to normal business practice. Paragraph 5.156 of the Explanatory Memorandum supports this view.

38. 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 of the policy (as defined in subsection 995-1(1)) ;
- 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 (subsection 995-1(1)) plus retained profits attributable to participating policyholders (paragraph 320-245 (2)(b)); and
- 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 (paragraph 320-245(2)(c)).

39. 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.

40. 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).

***Death and disability policies (other than participating policies)***

41. Premiums received in relation to life insurance policies (other than participating policies) 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)).

42. 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)***

43. 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.

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

45. Division 320 applies similar mechanisms for the purposes of determining the appropriate tax treatment.<sup>4</sup> Consequently, the whole of the premium (net of reinsurance) is deductible (section 320-65)

46. Fees and charges arising from participating policies (other than policies discharged from the virtual PST or SEA) are not included in the assessable income of a life insurance company if they are sourced from investment income or premium income.

***Other policies (section 320-75)***

47. Section 320-75 relates to other life insurance policies - in practice non-participating ordinary investment policies. Section 320-75 only applies to determine premium based fees as the amount allowed as a deduction under section 320-75 is the sum of the net premiums less so much of the net premiums as an actuary determines to be attributable to fees and charges (subsection 320-75(3)). Risk charges, entry fees and exit fees are examples of premium based fees.

48. In determining the amount that is attributable to fees and charges for an income year, 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 subsection 995-1(1)) 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.

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<sup>4</sup> Example 8 at paragraph 138 of this Ruling illustrates the application of Division 320 to ordinary participating policies.

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

49. Fees and charges are only included in assessable income under paragraph 320-15(k) if they are not already included in assessable income under another provision of the taxation law. Paragraph 320-15(k) is a residual provision, which will only apply if a fee or charge is not subject to tax under another provision of the taxation law.

50. On this basis, paragraph 320-15(k) does not apply to:

- premium based fees to which section 320-75 applies;
- fees from ordinary non-participating investment policies that are sourced from premium income or investment income;
- fees from ordinary participating business sourced from investment income or premium income;
- fees from the virtual PST; or
- fees from the SEA included in assessable income under paragraph 320-15(f).

**Timing of fees and charges**

51. Division 320 brings fees and charges relating to non-participating policies into taxable 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, 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.

52. 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.<sup>5</sup> Division 320 provides a pragmatic solution to handling the complexities of fee structures for income tax purposes and provides a robust basis across different policy pricing structures.

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<sup>5</sup> See paragraph 5.36 of the Revised Explanatory Memorandum.

## Examples

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53. 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.<sup>6</sup>

54. This Ruling considers three different models<sup>7</sup> 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 component; and
- Model C - Participating policies.

55. 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 an income year:

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

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<sup>6</sup> See paragraph 5.211 of the Revised Explanatory Memorandum.

<sup>7</sup> In the development of Division 320, the Tax Office consulted with representatives of the Institute of Actuaries. 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 Tax Office 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 insurance company. While this Ruling uses the PriceWaterhouseCoopers model for convenience, the Tax Office does not endorse any particular actuarial models.

56. 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 (treated as 30% for the purposes of these examples); and
- the complying superannuation class of taxable income – which is taxed at a rate of 15%.

57. 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).

58. 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.

59. 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.

60. 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**

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

- Example 1 - Defined policy fees and defined asset fees and no risk component;
- Example 2 - Defined policy fees, emerging asset fees and no risk component; and
- Example 3 - Defined policy fees, defined asset fees and risk fees.

**TR 2003/14**

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

	<b>Virtual PST</b>	<b>Other (Ordinary)</b>
Premiums received	\$2,000	
Investment income	\$ 700	\$ 70
Unrealised gains	\$ 300	\$ 30
Expenses		\$240

63. 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.

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

***Example 1: Non-participating unbundled virtual PST policy with defined policy fees, defined asset fees and no risk component***

65. This example considers a non-participating unbundled policy discharged from the virtual PST with defined policy fees and defined asset fees and no risk component.

66. Additional assumptions relevant to this example are:

Defined fees on virtual PST policies:

Policy fees	\$ 120
Asset fees	\$ 230
Investment claims	\$ 1,400
Section 275 of ITAA 1936 transfers	\$ 2,000
Current termination value of virtual PST policies at end of period	\$10,868
Provision for tax on unrealised virtual PST gains ( $\$300 \times 15\% \times 2/3$ )	\$ 30

*Calculation of emerging fees*

67. In this example there are no emerging 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	<u>300</u>	3,000
<i>Less</i>		
Policy fees	120	
Asset fees	230	
Investment claims	1,400	
Tax on VPST Taxable Income <sup>1</sup>	<u>352</u>	<u>2,102</u>
Increase in value of assets		<b>898</b>
<i>Plus</i> Value of VPST assets at start		<u>10,000</u>
Value of VPST assets at end		<b>10,898</b>
<i>Less</i>		
CTV of VPST policies at end	10,868	
Provision for tax on unrealised VPST gains		
	<u>30</u>	<u>10,898</u>
<b>Emerging fees transferred from VPST</b>		<u><b>0</b></u>

1. See Calculation of taxable income.

*Total fees and charges*

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

Defined policy fees	\$120
Defined asset fees	\$230
<b>Total fees and charges</b>	<b>\$350</b>

*Calculation of taxable income*

69. The total taxable income and the virtual PST component of taxable income are calculated as follows:



**TR 2003/14**

	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)	<u>2,000</u>	320-205(3)(d)	<u>2,000</u>
Assessable income		4,770		4,700
<i>Less</i>				
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	<u>2,000</u>	320-205(4)(a)	<u>2,000</u>
<b>Taxable Income</b>		<b><u>\$2,530</u></b>		<b><u>\$2,350</u></b>

70. 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).

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

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

***Example 2: Non-participating unbundled virtual PST policy with defined policy fees, emerging asset fees and no risk component***

72. This example is similar to Example 1 except that the asset fees are emerging fees rather than defined fees.

73. Additional assumptions relevant to this example are:

Defined 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 ( $\$300 \times 15\% \times 2/3$ )	\$ 30

*Calculation of emerging fees*

74. In this example the asset fees are emerging fees. 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.

75. The amount of the emerging 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 emerging fees reduced by the provision for tax on those fees. Consequently, the excess assets calculated are net of tax.

**TR 2003/14**

76. Therefore, the emerging 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	<u>300</u>	3,000
<i>Less</i>		
Policy fees	120	
Investment claims	1,400	
Tax on VPST Taxable Income before annual valuation <sup>1</sup>	<u>387</u>	<u>1,907</u>
Increase in value of assets		<b>1,093</b>
<i>Plus</i> Value of VPST assets at start		<u>10,000</u>
Value of VPST assets at end		<b>11,093</b>
<i>Less</i>		
CTV of VPST policies at end	10,868	
Provision for tax on unrealised VPST gains	<u>30</u>	<u>10,898</u>
Excess assets		<b>195</b>
<i>Plus</i> Gross up for 15% tax <sup>2</sup>		<u>35</u>
<b>Emerging fees transferred from VPST</b>		<b><u>\$230</u></b>

1. See Calculation of taxable income ( $\$2,530 \times 15\%$ ).

2.  $\$195 \times 15\% / (1 - 15\%)$ .

*Total fees and charges*

77. The total fees and charges are as follows:

Defined policy fees	\$120
Emerging fees transferred from the virtual PST	\$230
<b>Total fees and charges</b>	<b>\$350</b>

*Calculation of taxable income*

78. The total taxable income and the virtual PST component of taxable income are calculated as follows:

	Total Taxable Income		Virtual PST Component	
	Legislative reference	\$	Legislative reference	\$
<i>Premiums received</i>	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)	<u>2,000</u>	320-205(3)(d)	<u>2,000</u>
Assessable income		4,770		4,700
<i>Less</i>				
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)	<u>2,000</u>
<b>Taxable Income before annual valuation</b>				<b>\$2,580</b>
<i>Less</i> Emerging fees transferred from VPST because of annual valuation (subsection 320-180(1))		—	320-205(4)(c)	230
<b>Taxable Income</b>		<b>\$2,530</b>		<b>\$2,350</b>

79. 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).

**TR 2003/14**

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

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

***Example 3: Non-participating unbundled virtual PST policy with defined policy fees, defined asset fees and risk fees***

81. This example is similar to 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).

82. 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.

83. Additional assumptions relevant to this example are:

Defined 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 ( $\$300 \times 15\% \times 2/3$ )	\$ 30

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

Value at end of previous income year	\$40; and
Value at end of current income year	\$55.

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

*Calculation of emerging fees*

86. In this example there are no emerging 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	<u>300</u>	3,000
<i>Less</i>		
Policy fees	120	
Asset fees	230	
Risk charges	150	
Investment claims	1,300	
Tax on VPST Taxable Income <sup>1</sup>	<u>330</u>	<u>2,130</u>
Increase in value of assets		<b>870</b>
<i>Plus</i> Value of VPST assets at start		<u>10,000</u>
Value of VPST assets at end		<b>10,870</b>
<i>Less</i>		
CTV of VPST policies at end	10,840	
Provision for tax on unrealised VPST gains	<u>30</u>	<u>10,870</u>
<b>Excess assets (emerging fees) transferred from VPST</b>		<b><u>0</u></b>

1. See Calculation of taxable income.

*Total fees and charges*

87. The total fees and charges are as follows:

Defined policy fees	\$120
Defined asset fees	\$230
Defined risk charges	\$150
<b>Total fees and charges</b>	<b>\$500</b>

*Calculation of taxable income*

88. The total taxable income and the virtual PST component of taxable income are calculated as follows:

**TR 2003/14**

	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)	<u>1,850</u>	320-205(3)(d)	<u>1,850</u>
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	<u>1,850</u>	320-205(4)(a)	<u>1,850</u>
<b>Taxable Income</b>		<b><u>\$2,415</u></b>		<b><u>\$2,200</u></b>

89. 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).

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

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

### **Model B – Ordinary non-participating unbundled policies with risk component**

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

- Example 4 - All fees are defined premium based policy fees with a risk charge derived from premiums; and
- Example 5 – Defined premium based policy fees, defined premium based risk charges and emerging asset fees taken out of assessable investment income.

92. Relevant information relating to the life insurance company is as follows:

	<b>Policyholder</b>	<b>Shareholder</b>
Premiums received	\$2,000	
Investment income	\$ 700	\$ 70
Unrealised gains	\$ 300	\$ 30
Deductible expenses		\$240
Risk claims		\$100
Investment claims	\$1,300	

93. The life insurance company only has ordinary life insurance business.

94. The 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.

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

- Current termination value of ordinary policies of \$10,900; and



# TR 2003/14

- Provision for tax on unrealised ordinary policyholder gains of \$90 (that is,  $\$300 \times 30\%$ ).
96. 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
97. 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 defined premium based policy fees and risk charges derived from premiums.***

98. This example considers an ordinary non-participating unbundled policy that has defined premium based policy fees and risk charges derived from premiums.

99. Additional assumptions relevant to this example are:

Defined premium based fees and charges on ordinary policies:

Policy fees	\$350
Risk charges	\$150

*Calculation of emerging fees*

100. In this example the following table demonstrates that there are no emerging fees.

	\$	\$
<b>Value of ordinary policyholder assets:</b>		
Premiums for ordinary policies	2,000	
Policyholder investment income	700	
Unrealised gains relating to ordinary policyholders	<u>300</u>	3,000
<i>Less</i>		
Policy fees	350	
Risk charges	150	
Investment claims	1,300	
Tax attributable to ordinary policyholders <sup>1</sup>	<u>210</u>	<u>2,010</u>
Increase in value of ordinary policyholder assets		<b>990</b>
<i>Plus</i> Value of ordinary policyholder assets at start		<u>10,000</u>
Value of ordinary policyholder assets at end		<b>10,990</b>
<i>Less</i>		
CTV of ordinary policies at end	10,900	
Provision for tax on unrealised ordinary policyholder gains at end	<u>90</u>	<u>10,990</u>
<b>Excess assets (emerging fees)</b>		<b><u>0</u></b>

1. See Calculation of taxable income.

*Total fees and charges*

101. The total fees and charges are as follows:

Defined policy fees	\$350
Risk charges derived from premiums	\$150
<b>Total fees and charges</b>	<b>\$500</b>

*Calculation of taxable income*

102. The total taxable income and the amount of taxable income that relates to ordinary policyholders are 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	<u>770</u>	<u>700</u>
Assessable income		2,770	700
<i>Less</i>			
Deductible expenses	8-1	240	
Deduction for ordinary life insurance premiums <sup>1</sup>	320-75	1,500	
Risk component of claims paid	320-80	100	
Increase in value of liabilities under net risk components	320-85	<u>15</u>	
<b>Taxable Income</b>		<b><u>\$915</u></b>	<b><u>\$700</u></b>

1. Deduction for ordinary life insurance premiums = net premiums less amount attributable to premium based fees and charges = \$2,000 - (\$350 + 150) = \$1,500.

103. 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.

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

***Example 5: Ordinary non-participating unbundled policy with defined premium based policy fees, risk charges derived from premiums and emerging asset fees taken out of assessable investment income.***

105. This example considers an ordinary non-participating unbundled policy that has both defined and emerging fees. This example is similar to Example 4 except that some of the fees consist of defined policy fees and emerging asset fees.

106. The emerging fees are not included in assessable income because they are taken out of amounts already included in assessable income. That is paragraph 320-15(k) does not apply as the amounts are otherwise included in assessable income.

107. Additional assumptions relevant to this example are:

Defined premium based fees and charges on ordinary policies:

Policy fees	\$120
Risk charges	\$150

*Calculation of emerging fees*

108. In this example the asset fees are emerging fees. These emerging fees can be determined by an actuary 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.

109. The following table demonstrates how an actuary can determine the emerging fees:

	\$	\$
Premiums	2,000	
Policyholder investment income before the reduction of emerging fees	700	
Unrealised gains relating to ordinary policyholders	<u>300</u>	3,000
<i>Less</i>		
Policy fees	120	
Risk charges	150	
Investment claims	1,300	
Tax attributable to policyholder investment income before the reduction of emerging fees <sup>1</sup>	210	1,780
Increase in value of ordinary policyholder assets		<b>1,220</b>
<i>Plus</i> Value of ordinary policyholder assets at start		<u>10,000</u>
Value of ordinary policyholder assets at end		<b>11,220</b>
<i>Less</i>		
CTV of ordinary policies at end	10,900	
Provision for tax on unrealised ordinary policyholder gains at end	<u>90</u>	<u>10,990</u>
<b>Excess assets (emerging fees)</b>		<b><u>\$ 230</u></b>
<b>Gross up for 30% tax<sup>2</sup></b>		<b><u>\$98.57</u></b>
<b>Emerging fees<sup>3</sup></b>		<b><u>\$328.57</u></b>

1. \$700 × 0%.

2. \$230 × 30%/(1-30%). This gross-up for tax is required solely to work out the emerging fee.

3. Profit transfer to shareholders net of tax.

110. 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 emerging fees are reflected in the current termination value; and
- 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 emerging asset fees. The excess amount (\$230) represents emerging 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.

**TR 2003/14***Total fees and charges*

111. The total fees and charges are as follows:

Defined policy fees	\$120
Defined risk charges	\$150
Emerging asset fees	\$328.57
<b>Total fees and charges</b>	<b>\$598.57</b>

112. The defined policy fees and defined risk charges are subject to section 320-75 as they are premium based fees. The emerging asset fees are not included in assessable income because they are taken out of amounts already included in assessable income for example investment income. That is, paragraph 320-15(k) does not apply as the amounts are otherwise included in assessable income.

*Calculation of taxable income*

113. The total taxable income and the amount of taxable income that relates to ordinary policyholders are 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	<u>770</u>	<u>700</u>
Assessable income		2,770	700
<i>Less</i>			
Deductible expenses	8-1	240	
Deduction for ordinary life insurance premiums <sup>1</sup>	320-75	1,730	
Risk component of claims paid	320-80	100	
Increase in value of liabilities under net risk components	320-85	15	
Emerging fee included in assessable investment income <sup>2</sup>			<u>328.57</u>
<b>Taxable Income</b>		<b>\$685</b>	<b>\$371.43</b>

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

114. 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 \$371.43.

115. The total tax payable by the life insurance company is \$205.50 (that is,  $\$685 \times 30\%$ ). The amount of that tax attributable to ordinary policyholders is \$111.43 (that is,  $\$371.43 \times 30\%$ ).

116. The split between policyholders and shareholders for tax is for illustration purposes only. The split is not intended to have any implications for the basis of splitting franking credits between policyholders and shareholders.

### **Model C – Participating policies**

117. Participating policies can be either superannuation policies or ordinary policies. Model C considers three examples of participating policies. This section is broken into two parts:

- Part 1 contains two examples of participating policies that will be discharged from the virtual PST; and
- Part 2 contains an example of an ordinary participating policy.

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

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

- Example 6 - Participating unbundled virtual PST policy; and
- Example 7 - Participating bundled virtual PST policy.

**TR 2003/14**

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

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

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

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

121. At the end of the period the company's provision for tax on unrealised virtual PST participating gains is \$30 (i.e.  $\$300 \times 15\% \times 2/3$ ).

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

***Example 6: Participating unbundled policy held within the virtual PST***

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

124. 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 emerging fees*

125. The emerging fees 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	<u>300</u>	3,000
<i>Less</i>		
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 <sup>1</sup>	<u>369</u>	<u>2,009</u>
Increase in value of participating assets		<b>991</b>
<i>Plus</i> Value of VPST participating assets at start		<u>10,000</u>
Value of VPST participating assets at end		<b>10,991</b>
<i>Less</i>		
Policy liability of VPST participating policies at end	10,876	
Provision for tax on unrealised VPST participating gains	<u>30</u>	<u>10,906</u>
	<b>Excess VPST assets</b>	85
Gross up for 15% tax <sup>2</sup>		<u>15</u>
<b>Emerging fees for tax purposes transferred from VPST</b>		<b><u>\$100</u></b>

1. See Calculation of taxable income ( $\$2,460 \times 15\%$ ).

2.  $\$85 \times 15\% / (1 - 15\%)$ .

126. 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*

127. The total net fees and charges are as follows:

Emerging fees transferred from the virtual PST	\$100
<b>Total fees and charges</b>	<b>\$100</b>



**TR 2003/14***Calculation of taxable income*

128. The total taxable income and the virtual PST component of taxable income are calculated as follows:

	Total Taxable Income		Virtual PST Component	
	Legislative reference	\$	Legislative reference	\$
Premiums received	320-15(a)	2,000		123
Investment income	6-5	770	320-205 (3)(a)	700
Transfers <b>to</b> VPST during period:				
• VPST premiums transferred under subsection 320-185(3)			320-205(3)(b)	2,000
Section 275 transfers Assessable income	320-15(i)	<u>2,000</u> 4,770	320-205(3)(d)	<u>2,000</u> 4,700
<i>Less</i>				
Transfers <b>from</b> VPST during period:				
Deductible expenses	8-1	240		240
Deduction for VPST premiums	320-55	2,000	320-205(4)(a)	<u>2,000</u>
<b>Taxable Income before annual valuation</b>				<b>2,460</b>
<i>Less</i> Emerging fees transferred <b>from</b> VPST because of annual valuation (subsection 320-180(1))			320-205(4)(c)	100
<b>Taxable Income</b>		<b><u>\$2,530</u></b>		<b><u>\$2,360</u></b>

129. 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).

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

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

**Example 7: Participating bundled policy held within the virtual PST**

131. This example is similar to Example 6 except that the policy is a bundled endowment policy.

132. 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 emerging fees*

133. The emerging fees 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	<u>300</u>	3,000
<i>Less</i>		
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 <sup>1</sup>	<u>339</u>	<u>1,979</u>
Increase in value of participating assets		<b>1,021</b>
<i>Plus</i> Value of VPST participating assets at start		<u>10,000</u>
Value of VPST participating assets at end		<b>11,021</b>
<i>Less</i>		
Policy liability of VPST participating policies at end	10,906	
Provision for tax on unrealised VPST participating gains	<u>30</u>	<u>10,936</u>
	<b>Excess VPST assets</b>	85
Gross up for 15% tax <sup>2</sup>		<u>15</u>
<b>Emerging fees for tax purposes transferred from VPST</b>		<b><u>\$100</u></b>

1. See Calculation of taxable income ( $\$2,260 \times 15\%$ ).

2.  $\$85 \times 15\% / (1 - 15\%)$ .

**TR 2003/14***Total fees and charges*

134. The total net fees and charges are as follows:

Emerging fees for tax purposes transferred from the virtual PST	\$100
<b>Total fees and charges</b>	<b>\$100</b>

*Calculation of taxable income*

135. The total taxable income and the virtual PST component of taxable income are calculated as follows:

	<b>Total Taxable Income</b>		<b>Virtual PST Component</b>	
	<b>Legislative reference</b>	<b>\$</b>	<b>Legislative reference</b>	<b>\$</b>
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 Assessable income	320-15(i)	<u>1,800</u> 4,570	320-205(3)(d)	<u>1,800</u> 4,500
<i>Less</i>				
Deductible expenses	8-1	240		240
Deduction for VPST premiums	320-55	2,000	320-205(4)(a)	<u>2,000</u>
<b>Taxable Income before annual valuation</b>				<b>\$2,260</b>
<i>Less</i> Emerging fees transferred from VPST because of annual valuation (subsection 320-180(1))			320-205(4)(c)	100
<b>Taxable Income</b>		<b><u>\$2,330</u></b>		<b><u>\$2,160</u></b>

136. 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).

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

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

## **Part 2 - Ordinary participating policies**

### ***Example 8: Participating bundled ordinary policy***

138. This example considers an ordinary participating endowment policy. The relevant information during the year is as follows:

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

139. 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.

140. At the end of the period the life insurance company has:

- policy liabilities of ordinary participating policies of \$11,050;
- provision for tax on unrealised gains of \$90 ( $\$300 \times 30\%$ ); and
- deductible expenses relating to participating business \$240.

**TR 2003/14***Calculation of emerging fees*

141. The emerging fees are determined as follows:

	\$	\$
<b>Value of ordinary policyholder assets:</b>		
Premiums on ordinary participating policies	2,000	
Participating investment income	700	
Unrealised gains for participating business	<u>300</u>	3,000
<i>Less</i>		
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 <sup>1</sup>	<u>138</u>	<u>1,778</u>
Increase in value of ordinary participating assets		<b>1,222</b>
<i>Plus</i> Value of ordinary participating policyholder assets at start		<u>10,000</u>
Value of ordinary participating assets at end		<b>11,222</b>
<i>Less</i>		
Policy liability of ordinary participating policies at end	11,050	
Provision for tax on unrealised ordinary participating gains at end	<u>90</u>	<u>11,140</u>
<b>Excess assets</b> <sup>2</sup>		82
Gross-up for 30% tax <sup>3</sup>		<u>35</u>
<b>Emerging fees</b>		<b><u>\$117</u></b>

1. See Calculation of taxable income.

2. Profit transfer to shareholder net of tax.

3.  $\$82 \times 30\% / (1 - 30\%)$ . This gross-up for tax is required solely to work out the emerging fee for tax purposes.

*Total fees and charges*

142. The total net fees and charges are as follows:

Emerging fees	\$117
<b>Total fees and charges</b>	<b>\$117</b>

143. The emerging fees are not included in assessable income because they are taken out of amounts already included in assessable income. That is paragraph 320-15(k) does not apply as the amounts are otherwise included in assessable income.

*Calculation of taxable income*

144. 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. The split is not intended to have any broader implications affecting the calculation of the total taxable income of the company nor is it 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	<u>770</u>	<u>700</u>
Assessable income		2,770	700
<i>Less</i>			
Deductible expenses	8-1	240	240
Deduction for ordinary life insurance premiums	320-65	2,000	—
<b>Taxable Income from participating business before determination of emerging fees</b>			<b>460</b>
<i>Less</i> Emerging fees		<u>    </u>	<u>117</u>
<b>Taxable Income</b>		<b><u>\$530</u></b>	<b><u>\$343</u></b>

145. 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.

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

**Detailed contents list**

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

	<b>Paragraph</b>
<b>What this Ruling is about</b>	<b>1</b>
<b>Background</b>	<b>2</b>
Types of policies	3
Types of fees and charges	16
<b>Date of effect</b>	<b>19</b>
<b>Ruling and Explanation</b>	<b>20</b>
Calculation of fees and charges	20
<i>Policies discharged from the virtual PST</i>	26
<i>Policies discharged from the segregated exempt assets</i>	36
<i>Death and disability policies (other than participating policies)</i>	41
<i>Participating policies (other than policies discharged from the virtual PST or segregated exempt assets)</i>	43
<i>Other policies (section 320-75)</i>	47
<i>Fees and charges included in assessable income under paragraph 320-15(k)</i>	49
Timing of fees and charges	51
<b>Examples</b>	<b>53</b>
Model A – Non-participating unbundled virtual PST policies	61
<i>Example 1: Non-participating unbundled virtual PST policy with defined policy fees, defined asset fees and no risk component</i>	65
<i>Calculation of emerging fees</i>	67
<i>Total fees and charges</i>	68
<i>Calculation of taxable income</i>	69
<i>Example 2: Non-participating unbundled virtual PST policy with defined policy fees, emerging asset fees and no risk component</i>	72
<i>Calculation of emerging fees</i>	74
<i>Total fees and charges</i>	77
<i>Calculation of taxable income</i>	78
<i>Example 3: Non-participating unbundled virtual PST policy with defined policy fees, defined asset fees and risk fees</i>	81
<i>Calculation of emerging fees</i>	86

<i>Total fees and charges</i>	87
<i>Calculation of taxable income</i>	88
Model B – Ordinary non-participating unbundled policies with risk component	91
<i>Example 4: Ordinary non-participating unbundled policy with defined premium based policy fees and risk charges derived from premiums</i>	98
<i>Calculation of emerging fees</i>	100
<i>Total fees and charges</i>	101
<i>Calculation of taxable income</i>	102
<i>Example 5: Ordinary non-participating unbundled policy with defined premium based policy fees, risk charges derived from premiums and emerging asset fees taken out of assessable investment income</i>	105
<i>Calculation of emerging fees</i>	108
<i>Total fees and charges</i>	111
<i>Calculation of taxable income</i>	113
Model C – Participating policies	117
Part 1 - Participating policies that will be discharged from the virtual PST	117
<i>Example 6: Participating unbundled policy held within the virtual PST</i>	123
<i>Calculation of emerging fees</i>	125
<i>Total fees and charges</i>	127
<i>Calculation of taxable income</i>	128
<i>Example 7: Participating bundled policy held within the virtual PST</i>	131
<i>Calculation of emerging fees</i>	133
<i>Total fees and charges</i>	134
<i>Calculation of taxable income</i>	135
Part 2 - Ordinary participating policies	138
<i>Example 8: Participating bundled ordinary policy</i>	138
<i>Calculation of emerging fees</i>	141
<i>Total fees and charges</i>	142
<i>Calculation of taxable income</i>	144
<b>Detailed contents list</b>	<b>147</b>



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## Commissioner of Taxation

19 November 2003

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*Previous draft:*

Previously released in draft form as TR 2001/D14

*Related Rulings/Determinations:*

TR 92/1; TR 92/20; TR 97/16

*Subject references:*

- actuarial examples
- fees and charges
- friendly societies
- Life insurance companies

*Legislative references:*

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- ITAA 1997 6-5
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