



TR 2004/3 - Income tax: taxation of foreign life assurance

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Taxation Ruling

Income tax: taxation of foreign life assurance policies

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Preamble

The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** 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

Class of Persons/Arrangement

1. This Ruling applies to taxpayers that have acquired an interest in a foreign life insurance policy or 'life insurance bond' with an investment component from a non-resident life insurance company that is not authorised to carry on life insurance business in Australia.

Issues discussed in this Ruling

2. This Ruling provides guidance on issues that may arise under the *Income Tax Assessment Act 1936* (ITAA 1936) in the circumstances outlined in paragraph 1 above, including;

- The application of the foreign investment fund (FIF) measures in Part XI of the ITAA 1936 to certain types of foreign life assurance policies (FLPs);
- The application of section 26AH of the ITAA 1936 to foreign life policies; and
- The operation of section 23AK of the ITAA 1936 to prevent double taxation on amounts received from the foreign life company in relation to the policy.

Paragraph 482(2)(f) and contracts of re-insurance are not dealt with in this Ruling.

All provisions mentioned in this Ruling relate to the ITAA 1936 unless stated otherwise.

Glossary of Terms used in this Ruling

3. 'Endowment insurance' involves the payment by the insurers of a guaranteed sum conditional on the life insured attaining a certain age or on their earlier death.
4. 'Investment component' of a policy at any time is the sum of the premiums paid and the amount of interest or bonuses credited to the policy, less the risk component.
5. 'Life annuity' is a product where in return for the payment of a specified sum (that is, the purchase price) the insurer agrees to pay a regular amount throughout the lifetime of the annuitant.
6. 'Maturity date' is the date when the proceeds of the policy become payable.
7. 'Pure risk policy' is a policy that does not have an investment component.
8. 'Risk component' is that part of the premiums paid that represent the consideration payable to the insurer to cover the risk identified in the policy, for example, death.
9. 'Surrender value' is the value of a policy when it is cancelled by the policyholder before it becomes payable on death or maturity. It is not merely the return of premiums paid.
10. 'Term insurance' is insurance under which the sum insured is payable only on the death of the life insured during the term of the contract. Nothing is payable if the insured person survives to the end of the period specified under the policy.
11. 'Whole of life insurance' is a contract where the sum insured is payable on the death of the life insured. After two or three years a whole of life policy will usually provide a surrender value.

Background

12. The Explanatory Memorandum that accompanied the Income Tax Assessment Amendment (Foreign Investment) Bill 1992 which introduced the FIF rules in Part XI of the ITAA 1936 stated in the 'Purpose of the Bill' section that

'The measures will also apply to certain foreign life assurance policies (FLPs) that have an investment component, such as life bonds.'

13. The intent of the FIF measures is to tax Australian resident taxpayers on an accruals basis on the growth in value of life insurance policies, which have an investment component and are issued by non-resident entities that are not authorised to carry on life insurance business in Australia.

14. However, certain foreign life policies have been marketed in such a way that they purportedly escape accruals taxation under the FIF measures. These policies are typically issued by companies resident in tax haven countries. They have been drafted to provide for the payment of money upon death, where the death of the life insured is the result of an accident or specified sickness. It appears that the policies are structured in this way with a view to arguing that they fall outside the definition of a FLP and thereby are not taxed on an accruals basis under the FIF measures.

15. Because these policies are claimed not to be FLPs, it is also claimed that they permit a tax-free accumulation of wealth outside Australia.

Date of effect

16. This ruling applies to income years both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

Application of the Foreign Investment Fund rules

Meaning of a foreign life assurance policy (FLP)

17. Section 482 defines a FLP. Under subsection 482(1) a FLP is essentially a life assurance policy, other than a policy issued in Australia to a taxpayer.

18. Subsection 482(2) defines a 'life assurance policy' as follows:

'In subsection (1):

'life assurance policy' means a policy insuring payment of money:

- (a) on death (other than death by accident or expressly named sickness only); or
- (b) on the happening of any contingency dependent on the termination or continuance of human life (either with or without provision for a benefit under a continuous disability insurance contract within the meaning of the *Life Insurance Act 1995*);

and includes:

- (c) an instrument evidencing a contract that is subject to payment of premiums or instalments of premiums for a term dependent on the termination or continuance of human life; or
- (d) an instrument securing the grant of an annuity for a term dependent upon human life;

but does not include:

- (e) such a policy or instrument:
 - (i) that provides for the payment of money only on death, or death or permanent disability, and in respect of which the premium, or each of the instalments of premium, is calculated solely by reference to the period:
 - (A) for which the human life concerned is expected to continue; or
 - (B) within which the human life concerned is expected to terminate; or
 - (ii) that was issued before 1 July 1992 but cannot be cancelled, surrendered or redeemed on or after that day and whose terms have not been altered in a material respect on or after that day; or
- (f) a contract between a non-resident and a resident:
 - (i) under which the non-resident reinsures the resident against the whole or a part of the liability of the resident under a policy ('the relevant policy') issued by the resident; and
 - (ii) in respect of which the premium, or each of the instalments of premium, is calculated solely by reference to the period:
 - (A) for which the human life to which the relevant policy applies is expected to continue; or
 - (B) within which the human life to which the relevant policy applies is expected to terminate.'

Paragraph 482(2)(a) – A policy insuring payment of money on death

19. It has been argued that certain life assurance policies which provide for the payment of money upon death by accident or specified sickness fall outside the definition of life assurance because they fit within the bracketed exception in paragraph 482(2)(a).

20. However, the Commissioner considers that the bracketed exception in paragraph 482(2)(a) should be read as a reference to those policies providing for payment *only* upon death by accident or specified sickness and not for any other purpose (see paragraph 47).

21. Therefore, any foreign life policies that provide for a payment of money at other times such as upon surrender or maturity (that is, a policy with an investment component), in addition to the payment of monies upon death caused by accident or specified sickness, fall within the meaning of a 'life assurance policy' for the purposes of paragraph 482(2)(a).

22. Moreover, as these policies provide for the payment of monies upon surrender, they have an investment component, and do not fall within the paragraph 482(2)(e) exclusion. Consequently, they are FLPs for the purposes of section 482.

Paragraph 482(2)(b) – A policy insuring payment of money on the happening of a specified event relating to the ending or continuing of a human life

23. If it could be successfully argued that such policies fit within the bracketed exception in paragraph 482(2)(a), they will still satisfy the alternate definition of a 'life assurance policy' in paragraph 482(2)(b).

24. Paragraph 482(2)(b) operates independently of paragraph 482(2)(a) and provides a broader definition of life insurance policy, going beyond policies related to death.

25. Included in this definition are

- Endowment policies;
- Insurance bonds; and
- Sickness and accident policies with an investment component.

26. As these policies do not fall within the paragraph 482(2)(e) exclusion, they are FLPs for the purposes of section 482.

Interest in a FLP subject to FIF taxation

27. Where a foreign life assurance policy held by a resident taxpayer is a FLP for the purposes of section 482, the FIF measures operate to attribute income to the taxpayer each year that the policy is held, unless any of the exemption provisions in Divisions 2 to 15 of Part XI apply.

28. The practical effect of the FIF provisions is that the accretion in value of the amount held in the life insurance policy will be included in the assessable income of the Australian resident on an annual basis.

Interest in a FLP that is exempt from FIF taxation

29. The operative provision (section 529) does not include an amount of FIF income in the assessable income of a taxpayer where any of the exemption provisions apply. For a taxpayer with a FLP interest, the most commonly relevant exemption provisions apply where:

- the sum of the values of all interests in FIFs and FLPs held by the taxpayer is AUD\$50,000 or less (see section 515); or
- where the taxpayer is a temporary resident and has been living in Australia for four years or less (see section 517).

Application of section 26AH

30. A foreign life policy is an 'eligible policy' for the purposes of subsection 26AH(1). Therefore, where a taxpayer receives a payment by way of a bonus in respect of a FLP, such amount is included in the taxpayer's assessable income to the extent provided for in subsection 26AH(6), subject to the application of section 23AK.

Application of section 23AK

31. When a taxpayer with an interest in a FLP receives a payment from the life company in relation to the policy, the amount of the payment will be treated as non-assessable non-exempt income to the extent of previously attributed income (section 23AK). For example, where a taxpayer receives a payment relating to a FLP by way of a bonus that would otherwise be assessable under section 26AH, such amount would be treated as non-assessable non-exempt income to the extent that the taxpayer has already been subject to tax under the FIF attribution rules.

Explanation

Application of the foreign investment fund rules

Meaning of a 'foreign life assurance policy' (FLP)

32. A FLP is a life assurance policy that is issued by a non-resident entity. However, a policy will not be a FLP if it was issued by an Australian branch of a foreign life company, where that entity is registered to conduct life business in Australia under the *Life Insurance Act 1995* (see subsection 482(1)).

33. Subsection 482(2) sets out the statutory definition of a 'life assurance policy' for the purpose of subsection 482(1) and Part XI (see paragraph 18). There are a number of elements to this definition.

34. Paragraphs 482(2)(a) and 482(2)(b) contain the two principal definitions of a FLP. These are alternate definitions and a policy will be a FLP if it satisfies either paragraph 482(2)(a) or 482(2)(b).

35. Paragraphs 482(2)(c) and 482(2)(d) provide that certain types of term policies, as well as life annuities, will be FLPs for the purposes of Part XI.

36. However, not all life policies will be FLPs. Paragraphs 482(2)(e) and 482(2)(f) provide for specific exclusions to the primary definitions in paragraphs 482(2)(a) and 482(2)(b) as expanded by paragraphs 482(2)(c) and 482(2)(d).

37. Therefore, a life assurance policy will be a FLP if it meets any of the requirements set out in paragraphs 482(2)(a) to 482(2)(d) of section 482 and is not specifically excluded by paragraphs 482(2)(e) or 482(2)(f).

38. These steps are charted in a decision tree in Appendix A.

Paragraph 482(2)(a) – A policy insuring payment of money on death

39. Paragraph 482(2)(a) includes certain types of life insurance policies, including traditional "whole of life" policies that insure a payment of money upon death. However, a specific exclusion is provided for accident or expressly named sickness policies that provide for a payment of money only upon death, and not at any other time.

40. This view is in line with the common law definition of a policy of life insurance. In *National Mutual Life Association of Australasia Ltd v. FCT* (1959) 102 CLR 29, the majority of the High Court of Australia took the view that a policy of life insurance for the purposes of the ITAA 1936 included whole of life and endowment policies but not death by accident or specified sickness policies. The distinguishing features of the different policies were:

- a. in the case of whole of life policies, death was certain to occur (even though there may be exceptions in the policy), whereas death by accident or by specified sickness was not certain to arise; and
- b. accident and sickness policies do not have a surrender value unlike a whole of life policy.

41. The Commissioner considers that only those foreign life policies that

- insure a payment of money on death, where the death cover is for accident and specified sickness only; **and**
- do not have a surrender value

fall within the bracketed exception under paragraph 482(2)(a).

42. In contrast, some foreign life assurance policies are structured to cover 'death by accident or expressly named sickness only'. However, it is also a feature of these policies that they provide for the payment of monies upon surrender or maturity by the policyholder.

43. It has been argued that such policies fall within the bracketed exception set out in paragraph 482(2)(a) and therefore would be excluded from the definition of a FLP and would not be subject to attribution under the FIF measures (refer to paragraphs 91-95 of this Ruling).

44. This view is based on the contextual meaning of the word "only" in paragraph 482(2)(a). Paragraph 482(2)(a) states as follows:

'In subsection (1):

'life assurance policy' means a policy insuring payment of money:

- (a) on death (other than death by accident or expressly named sickness **only**); or....'
(emphasis added)

45. It has been argued that the word 'only' in that paragraph refers to the type of death cover and not the type of payment.

46. In determining the process of constructing a provision, a court will give substantial emphasis to the 'context' in which words are used. Hill J in *Consolidated Press Holdings Ltd & Anor v. FC of T* 98 ATC at p5009:

'Although judicial views on the principles of construction of taxation statutes have differed over time (see cases referred to in the article by Justice D Graham Hill, 'A Judicial Perspective on Tax Law Reform' (1998) 72 ALJ 685), the modern view, at least generally, would seem to be that the task of construing a taxation statute, like the task of construing any other statute, requires the court to ascertain the meaning of the words used in the context in which they appear and so as to give effect to the purpose of the legislature to be found in the language which it has used, but aided by extrinsic materials to which regard is directed to be had by virtue of s 15AB of the *Acts Interpretation Act 1901* (Cth). Context is used in a broad sense to encompass such matters as the existing state of the law and the mischief, if any, which the legislature sought to remedy: *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 and see *FCT v. Australia & New Zealand Savings Bank Ltd* (1998) 39 ATR 419 at 426; 98 ATC 4850 at 4855-6.

No doubt if one interpretation produces an absurdity, or perhaps even an anomaly, that may lead to another, and presumably less absurd or anomalous interpretation being adopted (cf *Cooper Brookes (Wollongong) Pty Ltd v. FCT* (1981) 147 CLR 297; 11 ATR 949; 81 ATC 4292).

47. In view of the above, the Commissioner considers that the context of the word 'only' in subsection 482(2)(a) refers to those accident or expressly named sickness policies that provide for a payment **only** upon death and not a payment at any other time (such as upon surrender). This interpretation of the subsection gives better effect to the purpose and intent of the provision, which is to subject those FLPs that have an investment component to taxation under the FIF measures. This intent is clearly expressed in the extrinsic material accompanying the introduction of the FIF measures.

48. Therefore, these policies are not excluded from the definition of a life assurance policy in paragraph 482(2)(a).

Paragraph 482(2)(b) – A policy insuring payment of money on the happening of a specified event relating to the ending or continuing of a human life

49. For a foreign life policy to be a FLP in paragraph 482(2)(b), the payment of money must be related to the happening of a 'contingency dependant upon the termination or continuance of human life'.

50. In *Fuji Finance Inc v. Aetna Life Insurance Co Ltd* [1996] 4 All ER 608 CA, it was held that a right to surrender a policy was connected to the continuance of life, as it could not be exercised after the death of the life insured.

51. In addition, in *Marac Life Assurance Ltd v. Commissioner of Inland Revenue* [1986] 1 NZLR 694 it was held (at 706) that, if an insurer undertakes from the first day to pay a sum in excess of the premium paid if the life assured dies before the maturity date, the insurer bears a risk dependant on human life and the transaction is one of life insurance despite the presence of a significant investment element in the policy.

52. Therefore the definition in paragraph 482(2)(b) includes policies where payment under the policy may be made on the death of the life insured and/or on the happening of other events such as surrender or maturity of the policy. For example it will include:

- a contract where the benefits are paid on the insured attaining a specified age under an endowment policy; and
- an investment related contract such as an insurance bond where benefits are paid on maturity or surrender, or on earlier death.

Paragraph 482(2)(e) – Exclusions from definition of a FLP

53. A foreign life assurance policy that meets the definition of a life assurance policy under paragraphs 482(2)(a) to 482(2)(d) may still be excluded from the definition if paragraphs 482(2)(e) or 482(2)(f) apply.

54. Paragraph 482(2)(e) excludes a policy or instrument that provides for the payment of money only on death (or death or permanent disability) where the premium is determined solely by reference to actuarial calculation (typically referred to as a 'pure risk' policy).¹

55. The existence of a 'surrender value' and a right to redeem or surrender is not consistent with a policy that is a pure risk policy.

56. Therefore where a taxpayer has a life assurance policy that has been issued by a foreign life company and the policy:

- permits surrender before maturity; and
- monies can be paid out of the policy for reasons other than death;

the policies are life assurance policies under paragraph 482(2)(a) or (2)(b) and are not excluded under paragraph 482(2)(e) and are therefore subject to the FIF rules.

¹ This exclusion may be contrasted with the exception in paragraph 482(2)(a). Paragraph 482(2)(a) excludes sickness and accident policies that fall within the bracketed exception in paragraph 482(2)(a) at the outset whereas paragraph 482(2)(e) excludes policies which are 'pure risk' policies that otherwise meet the definition of a life assurance policy under paragraphs (a) to (d) of section 482.

Meaning of an Interest in a FLP

57. Subsection 483(3) defines an interest in a FLP. Effectively, a taxpayer has an interest in a FLP if they have legal title to the policy. Where two or more persons have legal title to a FLP, each person's entitlement (title) will be an interest in a FLP and the FIF measures will then apply separately to each of those interests.

Interest in a FLP that is subject to FIF taxation

58. The operative provision – section 529 – normally applies to subject a taxpayer to FIF taxation in the relevant income year if they:

- had an interest in a FLP at any time during a FLP's notional accounting period that ends in the income year; and
- were a resident at any time in that income year (subsection 485(4)).

59. However, the operative provision does not apply where the taxpayer qualifies for any of the FIF exemptions.

60. The amount to be included in the assessable income of a resident taxpayer under Part XI is based on the notional accounting period of the FLP that ends in the taxpayer's year of income, not the taxpayer's year of income itself. Normally, the notional accounting period of a FLP is each period of 12 months ending on 30 June (see subsection 487(2)).

61. Also, it is sufficient for the resident taxpayer to hold a FLP interest at any time during the FLP's notional accounting period for the operative provision to be triggered (see subsection 485(4)).

62. The wording can be contrasted with that of paragraph 485(3)(a), which requires that a taxpayer have an interest in a FIF at the end of a year of income in order for the operative provision to have effect.

63. Where the operative provision applies, the amount of FIF income to be included in the relevant taxpayer's assessable income is worked out by multiplying the FIF income by the number of days that the taxpayer was a resident during the notional accounting period and dividing the result by the number of total days in the notional accounting period.

64. There are two methods available for determining FIF income for a taxpayer with an interest in a FLP:

- the deemed rate of return method (section 584); and
- the cash surrender value method (section 595).

65. Subsection 536(1) provides that the deemed rate of return method will be applied unless the taxpayer elects to use the cash surrender value method.

66. There are special rules contained in section 530 that reduce the amount of FIF income that is otherwise included in the taxpayer's assessable income under section 529. Furthermore, Division 17 treats certain FIF losses incurred by a taxpayer under the cash surrender value method as an allowable deduction from that taxpayer's assessable income in the year of income in which the notional accounting period ended.

Some exemptions from FIF taxation relevant to an interest in a FLP

Exemption for FIF or FLP Interests of \$50,000 or less

67. This exemption applies to exclude a taxpayer who is a natural person from taxation on FIF income that would otherwise be taken to accrue from a FIF or a FLP if the value of the interests of the taxpayer and any associates (for example, the taxpayer's spouse) were \$50,000 or less.

68. Subsection 515(1), states as follows:

'If:

- (a) a taxpayer who is a natural person (otherwise than in the capacity of a trustee) had an interest or interests in a particular FIF or FLP at the end of a notional accounting period of that FIF or FLP; and
- (b) the sum of:
 - (i) the values of all the interests of the taxpayer and any associates of the taxpayer in FIFs; and
 - (ii) the values of all FLPs in which the taxpayer and any associates of the taxpayer had interests;

at the end of the year of income in which that notional accounting period ended did not exceed \$50,000;

the operative provision does not apply to the taxpayer in relation to that FIF or FLP in respect of that notional accounting period of that FIF or FLP.'

69. A number of steps are involved in working out how the exemption applies. Paragraph 515(1)(a) requires a taxpayer:

- to be a natural person not acting in the capacity of a trustee; and

- to have had an interest in a FLP at the end of the notional accounting period of that FLP.

70. Paragraph 515(1)(b) requires that

‘The sum of

- (i) the values of all the interests of the taxpayer and any associates of the taxpayer in FIFs; and
- (ii) the values of all FLPs in which the taxpayer and any associates of the taxpayer **had** interests; and (emphasis added)

at the end of the year of income in which that notional accounting period ended did not exceed \$50,000.’

71. For this exemption to apply, it firstly requires consideration of whether the taxpayer has an interest in the FIF or FLP at the end of the notional accounting period of the FIF/FLP. A question has arisen as to whether a taxpayer holds an interest in a FLP for the purposes of paragraph 515(1)(a) where there has been a disposal of an interest in a FLP part way through an income year. In this case, the taxpayer is still taken to have an interest in the FLP at the end of the notional accounting period. This is because the notional accounting period is taken to end the moment the disposal takes place (subsection 487(8)).

72. Once it has been established that a taxpayer has an interest in a FLP at the end of a notional accounting period, a summation of the values of all interests in FLPs and other FIF investments is done at the end of the taxpayer’s year of income in which the notional accounting period ends to determine whether the exemption applies.

73. Subsection 515(2) sets out the methods used to determine the value of the FIF or FLP interests of the taxpayer for the purposes of subsection 515(1). It states:

‘For the purposes of subsection (1), the value at the end of the year of income of a person’s interest in a FIF, or of a FLP in which a person has an interest, is taken to be:

- (a) the cost incurred by the person in acquiring the interest in the FIF or FLP, as the case may be; or
- (b) the market value of the interest in the FIF or of the FLP, as the case may be, at the end of the year of income;

whichever is the **greater** amount.’ (emphasis added)

Exempt visitors to Australia

74. A taxpayer is classed as an exempt visitor and therefore exempt from FIF taxation in respect of their FLP interest in relation to a year of income if at the end of the year of income:

- the taxpayer was lawfully in Australia because the person was the holder of a current temporary entry visa granted under the *Migration Act 1958*;
- the period of time from the issue date of the first (or earliest) current temporary entry visa, until its expiry date, is 4 years or less; and
- the taxpayer has not applied for permanent residency under the *Migration Act 1958* (see subsection 517(2)).

75. In the case of a New Zealand citizen who comes to Australia, they are treated as an exempt visitor in relation to a year of income if:

- the relevant person had not been a resident of Australia for a continuous period exceeding 4 years;
- had the person not been a citizen of New Zealand, he or she would have been required to be the holder of a temporary visa; and
- the person has not come to live in Australia permanently (see subsection 517(4)).

Application of section 26AH

76. Subsection 26AH(6) provides that:

'Where, during the eligible period in relation to an eligible policy, a taxpayer receives an amount (in this subsection referred to as the 'relevant amount') under the policy as or by way of a bonus, being an amount that, but for this section, would not be included in the assessable income of the taxpayer of any year of income, the assessable income of the taxpayer of the year of income in which the relevant amount is received shall include:

- (a) if the relevant amount is received during the first 8 years of the eligible period – an amount equal to the relevant amount;
- (b) if the relevant amount is received during the ninth year of the eligible period – an amount equal to two-thirds of the relevant amount; or
- (c) if the relevant amount is received during the tenth year of the eligible period – an amount equal to one-third of the relevant amount.'

77. The term 'eligible policy' is defined in subsection 26AH(1). It means a policy of life assurance in relation to which the date of commencement of risk is after 27 August 1982. As there is no statutory definition of the expression 'policy of life assurance', it takes its ordinary meaning. Hill J in *NM Superannuation Pty Ltd v. Young & Anor* (1993) 41 FCR 182 said at 194:

'There are no definitions of 'policies of life assurance or endowment assurance' contained in the Act and accordingly regard may be had to the ordinary meaning of these expressions as found in the cases.'

78. In *National Mutual Life Association of Australasia Ltd v. Federal Commissioner of Taxation* (1959) 102 CLR 29, Windeyer J said at p 43, quoting *Bunyon on Life Insurance*:

'The contract of life insurance may be further defined to be that in which one party agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another.'

79. A foreign life insurance policy satisfies this view of the meaning of a 'policy of life assurance' and is therefore an eligible policy for the purposes of section 26AH where the date of commencement of the risk is after 27 August 1982.

80. Where a taxpayer receives a bonus in relation to a FLP, it is possible that the amount otherwise assessable under subsection 26AH(6) may be treated as non-assessable non-exempt income for the purposes of section 23AK.

Section 23AK – Exemption of Amounts Paid Out of Attributed Foreign Investment Fund Income

81. Section 23AK of the ITAA 1936 treats certain amounts as non-assessable non-exempt income² where the amounts were previously assessed to the taxpayer under the FIF attribution rules. The effect of treating an amount as non-assessable non-exempt income is that it is not assessable income and is also treated as not being exempt income for all purposes of the Act (subject to the exception in subsection 23AK(2)). Section 23AK therefore exists to prevent double taxation rather than as an exempting provision.

² Section 23AK was amended by *Tax Laws Amendment Act (No.4) 2003*. Essentially it substitutes all references to exempt income with references to non-assessable non-exempt income. The effect of the changes is to treat amounts that fall within section 23AK as non-assessable income and income that is not exempt income. Previously, amounts that fell within section 23AK were treated as exempt income, although they were treated as excluded exempt income for the purposes of Division 36 of the *Income Tax Assessment Act 1997* (Division dealing with tax losses of earlier income years). The treatment of the relevant amount as non-assessable non-exempt income has effect for all purposes of the Act (unless otherwise stated) and applies for the 2004 income year onwards.

82. For taxpayers with a FLP interest or interests, the relevant extracts from section 23AK are as follows:

'If:

...(a)(i) a FIF attribution account payment of a kind referred to in ...paragraph 603(1)(g) is made to a taxpayer; and

...(b) on the making of the payment, a FIF attribution debit arises, for the FIF attribution account entity making the payment, in relation to the taxpayer;

the following provisions have effect:

...(h) if the payment is of a kind referred to in paragraph 603(1)(g) – the payment is non-assessable non-exempt income to the extent of the debit.'

The reference to paragraph 603(1)(g) is a reference to a payment made by the person who issued a FLP to a person who has an interest in the FLP.

83. Therefore, the operation of section 23AK is dependent on the taxpayer satisfying a number of criteria. Firstly, the taxpayer needs to establish a 'FIF attribution account' for the 'FIF attribution account entity'. A FIF attribution account entity includes a FLP (subsection 601(d)) in respect of which an amount of FIF income is included in the assessable income of the taxpayer under section 529.

84. Secondly, Section 23AK applies when a FIF attribution account debit is made to the FIF attribution account maintained for an entity that makes a FIF attribution account payment to a taxpayer. The circumstances in which a FIF attribution account payment is taken to have been made to a taxpayer with a FLP are dealt with in paragraph 603(1)(g). It refers to a payment made by the person who issued the FLP to a person who has an interest in the FLP.

85. No special rules about the timing of such a payment are stated in subsection 603(2). The payment is taken to have been made when the life company paid it.

86. Lastly, paragraph 23AK(1)(h) ensures that the amount of the attribution account payment is not included in the taxpayer's assessable income to the extent of the FIF attribution debit.

87. For the purposes of section 23AK, the term 'FIF attribution debit' has the same meaning as in Part XI (section 23AK(3)). Section 606 of Part XI deals with the circumstances that give rise to an attribution debit. In this context, an attribution debit arises when an eligible entity (the FLP) makes a FIF attribution account payment (payment to the taxpayer from the issuer of the FLP) and, immediately before the payment, there is a FIF attribution surplus for the eligible entity in relation to the taxpayer.

88. A FIF attribution surplus is defined at section 604 and essentially arises for a FIF attribution entity in relation to a taxpayer at a particular time where the sum of the attribution credits in relation to the taxpayer exceeds the attribution debits.

89. A FIF attribution credit essentially arises for an attribution account entity (the FLP) in relation to a taxpayer where an amount has been included in the taxpayer's assessable income under section 529 in respect of the FIF income that relates to the eligible entity (see section 605). The amount of the credit is generally equal to the amount so included in the taxpayer's assessable income.

90. Although the above paragraphs of this Ruling contain a number of defined terms that underpin the operation of section 23AK, the concept is quite clear; that is the section treats payments made by a FLP to the taxpayer as non-assessable non-exempt income to the extent that the payment relates to an amount to which the taxpayer has been previously subject to FIF taxation.

Alternative views

91. It has been argued that on a literal interpretation of subsection 482(2), the reference in the bracketed exception in paragraph 482(2)(a) to the word 'only' should be read as a reference to those policies that provide for payments upon death, other than death by accident or expressly named sickness. That is, the word 'only' relates to the type of death cover and not the type of payment.

92. On this argument a foreign life policy that insures a payment of money at other times such as upon surrender or maturity, in addition to providing for a payment of money upon death caused by accident or specified sickness, will still fall within the bracketed exception set out in paragraph 482(2)(a).

93. It is considered that this is too narrow a reading of subsection 482(2) and that the Commissioner's interpretation of the subsection gives better effect to the purpose and intent of the provision (see paragraph 47 above) which is to subject those FLPs that have an investment component to FIF taxation. In determining the process of constructing a provision, a court will give substantial emphasis to the 'context' in which words are used –see judgement of Hill J in *Consolidated Press Holdings* quoted in paragraph 46 above, and also in *MLC Limited & Anor v. DFC of T 2002 ATC 5105* at pp.5112-5113.

94. An examination of the expression 'policy of insuring payment of money (other than by death by accident or expressly named sickness only)' in paragraph 482(2)(a), in conjunction with paragraph 482(2)(e), shows the intention of section 482 is to exclude accident and sickness policies which are payable only on death.

95. In the view of the Commissioner, policies marketed that claim to be excluded by the specific wording of paragraph 482(2)(a) also fall within 482(2)(b) and are not excluded by paragraph 482(2)(e). The Commissioner's view on the application of paragraph 482(2)(b) to such policies is set out in paragraphs 23-26 of this ruling.

Examples

Example 1

96. Mark migrates permanently to Australia and becomes a resident in 2003. Prior to coming to Australia Mark had purchased a life insurance policy in the UK from a UK life company in 2000. The policy has a term of 20 years. The policy will only pay a sum of money, the death benefit, on Mark's death. If the policy is surrendered early, the premiums are forfeited and Mark will receive no amount.

97. When Mark becomes a resident of Australia, he becomes liable to pay Australian tax on his worldwide income. This will include any income from investments Mark holds offshore that are subject to FIF taxation. Mark's life insurance policy is a policy issued by a non-resident life company and insures the payment of money on death. Therefore, the policy satisfies the definition of a 'life assurance policy' under paragraph 482(2)(a).

98. However, Mark's policy is a policy that pays out only on Mark's death. Although it can be surrendered, the policy will not pay out a surrender value. Subparagraph 482(2)(e)(i) specifically excludes such a policy from the operation of the FIF measures.

Example 2

99. John purchased an endowment policy in 1989 from a foreign life insurance company that is not registered under the *Life Insurance Act 1995* to conduct life business in Australia. The policy insures payment of a guaranteed sum when John turns 55. If John dies before his 55th birthday, the policy will pay an amount as a death benefit. John's policy can be surrendered at any time and a surrender value equal to the sum of accumulated bonuses and premiums is paid. John surrenders the policy on 30 June 2000, which is before his 55th birthday.

100. Payment under John's policy is contingent on the continuation of his life and therefore will be a foreign life policy under paragraph 482(2)(b).

101. Although John's policy was purchased before 1 July 1992, it is not excluded from being a FLP under subparagraph 482(2)(e)(ii) because it can be surrendered after that date.

Example 3

102. Susan purchases a life insurance policy from a foreign life insurance company that is not registered under the *Life Insurance Act 1995* to conduct life business in Australia. The policy provides that it will pay a sum of money if Susan (as the life insured) dies as a result of an accident or one of the specified sicknesses listed in an annexure to the policy. The policy does not have a maturity date, and Susan can surrender the policy at any time. The policy will pay a cash surrender value to Susan, calculated in accordance with a formula stipulated in the policy.

103. Although Susan's policy states that it will insure payment of money on death by accident and specified sickness only, it is not an accident and sickness policy that is excluded from the definition of a FLP by virtue of the bracketed exception in paragraph 482(2)(a). This is because the bracketed exception in paragraph 482(2)(a) refers to those policies which provide for payment only upon death caused by accident or expressly named sickness.

104. In this case, a payment can also be made on surrender. Therefore, the policy is one that qualifies as a life assurance policy for the purposes of paragraph 482(2)(a), being a policy insuring payment of money on death. The policy is not excluded under paragraph 482(2)(e) and is therefore a FLP. The policy also qualifies as a foreign life assurance policy for the purposes of paragraph 482(2)(b).

Example 4

105. Lynette, an Australian resident, purchases a life insurance policy on 1 July 1998 from a foreign life insurance company that is not registered under the *Life Insurance Act 1995* to conduct life business in Australia. The value of the policy is greater than \$50,000. The policy has a surrender value and contains a death benefit clause that is payable to Lynette's nominated beneficiary upon her death. The policy qualifies as a FLP for the purposes of section 482 and is subject to FIF taxation.

106. Lynette includes in her assessable income an amount under section 529 for each of the income years ending 30 June 1999 to 30 June 2003 in respect of her FLP interest (she has no other FIF or FLP interests). The total of these amounts is \$60,000.

107. On 1 July 2003 an amount of \$50,000 is paid to Lynette in respect of the life policy by the foreign life company which, but for section 23AK, would be fully assessable to her in the 2004 year of income under section 26AH of the ITAA 1936. Assume that the notional accounting period of the FLP, which gives rise to an amount being included in Lynette's assessable income under section 529 ends at the same time as Lynette's year of income, that is, 30 June each year.

108. To work out how much of the \$50,000 would be treated as non-assessable non-exempt income under section 23AK in respect of Lynette's 2004 year of income, we need to go through the following steps:

109. Step 1: work out whether there has been a FIF attribution account payment from a FIF attribution account entity to a person with a FLP interest. In this case, the FIF attribution account payment is the amount of \$50,000 paid by the foreign life company (the FIF attribution account entity-see section 601) to Lynette in respect of her policy (see paragraph 603(1)(g)).

110. Step 2: work out whether, at the time of the payment of \$50,000, there is an attribution surplus in the FIF attribution account for the FLP in relation to Lynette. The surplus is the excess of credits over debits in the FIF attribution account.

111. Step 3: work out when and how much to credit the attribution account for the FLP in relation to Lynette. An attribution account credit arises for the FLP (a FIF attribution account entity) in relation to Lynette at the end of the notional accounting period, which is 30 June for each of the 1999 to 2003 years of income. The amount of the attribution credit is equal to the sum of the amounts included in Lynette's assessable income for the 1999 to 2003 years of income under section 529, or \$60,000 (see subsection 605(3)). As the credit is the only amount recorded in the relevant attribution account, there is a surplus in the attribution account for the FLP in relation to Lynette of \$60,000 at 30 June 2003.

112. Step 4: work out how much of the FIF attribution account payment of \$50,000, being the bonus, qualifies as non-assessable non-exempt income under section 23AK at the time of the payment. A bonus is not assessable under section 23AK to the extent that, at the time of the payment, it gives rise to an attribution debit (see paragraph 23AK(1)(h)). The FIF attribution debit at the time of the payment, that is, 1 July 2003, is the lesser of the FIF attribution surplus (\$60,000) and the FIF attribution account payment (\$50,000). Therefore, the entire amount of \$50,000, that would otherwise be assessable under section 26AH, is treated as non-assessable non-exempt income of Lynette for the 2004 year of income.

Detailed contents list

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5 May 2004

*Previous draft.*Previously released as
TR 2003/D10.*Related Rulings/Determinations:*

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

Subject references:

- foreign investment fund
- foreign life assurance policy

Legislative references:

- ITAA 1936 Div 17
- ITAA 1936 23AK
- ITAA 1936 23AK(1)(h)
- ITAA 1936 23AK(2)
- ITAA 1936 26AH
- ITAA 1936 26AH(1)
- ITAA 1936 26AH(6)
- ITAA 1936 482
- ITAA 1936 482(1)
- ITAA 1936 482(2)
- ITAA 1936 482(2)(a)
- ITAA 1936 482(2)(b)
- ITAA 1936 482(2)(c)
- ITAA 1936 482(2)(d)
- ITAA 1936 482(2)(e)
- ITAA 1936 482(2)(e)(i)
- ITAA 1936 482(2)(e)(ii)
- ITAA 1936 482(2)(f)
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- ITAA 1936 485(3)(a)
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- ITAA 1936 487(2)
- ITAA 1936 487(8)
- ITAA 1936 515
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- TAA 1953 Pt IVA

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- Consolidated Press Holdings Ltd & Anor v. FC of T 98 ATC 5009
- Cooper Brookes (Wollongong) Pty Ltd v. FCT (1981) 147 CLR 297; 11 ATR 949; 81 ATC 4292)
- FCT v. Australia & New Zealand Savings Bank Ltd (1998) 39 ATR 419 at 426; 98 ATC 4850 at 4855-6
- Fuji Finance Inc v. Aetna Life Insurance Co Ltd [1996] 4 All ER 608 CA
- Marac Life Assurance Ltd v. Commissioner of Inland Revenue (1986) 1 NZLR 694

- MLC Limited & Anor v. DFC of T (2002) ATC 5105; (2002) 51 ATR 253
- National Mutual Life Association of Australasia Ltd v. FCT (1959) 102 CLR 29
- NM Superannuation Pty Ltd v. Young & Anor (1993) 41 FCR 182
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