IT 2480 - Income tax : variable annuities

TAXATION RULING NO. IT 2480

INCOME TAX : VARIABLE ANNUITIES

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1183860	ANNUITIES - ASSESSABLE	25
	INCOME - DEDUCTIBLE	27A
	AMOUNT - RESIDUAL	27H
	CAPITAL VALUE	

OTHER RULINGS ON TOPIC IT 2157

PREAMBLE This office has had occasion to examine a number of contracts, or products as they are referred to by the issuers, marketed by life companies as immediate variable annuity contracts or policies.

2. The examination of the contracts was undertaken following requests by certain issuers for a determination of the "deductible amount" (see paragraphs 3 and 5 below) in relation to their products. The determination was initially relevant to the quantum of tax instalments to be deducted from the regular payments made under the contracts. Before a determination could be made it was necessary to establish that the products being sold were annuities. Unless the products are annuities then the question concerning the "deductible amount" is irrelevant and the amendments in Taxation Laws Amendment Act 1988 relating to annuities have no application.

3. The assessment of annuities purchased after 30 June 1983 is covered by Subdivision AA of Division 2, Part III of the Assessment Act (sections 27A to 27J inclusive). Subsection 27H(1) includes in assessable income the amount of any annuity derived by the taxpayer for the year excluding, where it has been purchased, the "deductible amount".

4. The word "annuity" itself is not defined either in the definition section of Subdivision AA (Section 27A) or in section 27H except to include a superannuation pension (subsection 27H(4)). That definition is of no assistance for present purposes.

5. "Deductible amount" is effectively defined in subsection 27H(2) as being, in so far as is relevant for present purposes, the undeducted purchase price (defined in subsection 27A(1)) less the residual capital value if it is specified in the annuity agreement (or nil if not specified), the result being divided by the number of years during which the annuity is

payable. Subsection 27H(2) is subject to subsection 27H(3) which permits the Commissioner to adopt a different deductible amount where he is of the opinion that, having regard to all the relevant facts, the amount calculated under subsection 27H(2) is inappropriate.

6. "Residual capital value" is defined in subsection 27A(1) to mean, and again in so far as is relevant, the capital amount payable on the termination of the annuity. Examples of termination in this context are given in the Explanatory Memorandum to the introductory Bill on Subdivision AA, at p.72, as by death or the expiration of a given period.

7. It should be mentioned also that "eligible annuity" is defined in subsection 27A(1). However the definition is of no relevance for present purposes.

8. As there is no conclusive definition in the Act of an annuity, it is necessary to seek guidance from judicial authorities. Legal dictionaries have an assortment of definitions which generally lead to that given by Baron Watson in Foley v Fletcher (1858) 28 L.J. Ex.100 at p.109. That definition is, as cited with approval by Lord Hanworth, M.R. in Perrin v Dickson [1930] 1 KB 107 at p.116:

> "annuities means, that where the annuity may be purchased with money the capital is gone and ceases to exist, and consequently, the person to be charged (tax) is the person receiving the annuity, that is, the yearly sum, year by year .... No capital is taxed there, because the principal has been converted into an annuity, and the annuity is chargeable (to tax)."

9. An essential characteristic of a purchased annuity is, therefore, that the capital amount paid has been transformed into income. The Australian authorities have recognised this. The Full High Court in Egerton-Warburton v D.F.C. OF T. (1934) 51 CLR 568 stated at p.573:

> "... in the ordinary case of the purchase of a life annuity for cash, the annuity is income into which the capital laid out has been transformed. 'An annuity means where an income is purchased with a sum of money, and the capital has gone and ceased to exist, the principal having been converted into an annuity', (per Watson B, Foley v Fletcher). 'An annuity means generally the purchase of an income and usually involves a change of capital into income, payable annually over a number of years' (per Matthew LJ, Scoble v Secretary of State in Council for India [1903] 1 KB 494, at p.504)."

10. Another quality or characteristic of an annuity is that it is of a sum certain. When considering this aspect in FCT v Knight, 83 ATC 4096, at p.4106; 14 ATR 1 at pp.12-13, Kelly J. referred to the following words of Barton J. in D.F.C. of Land Tax, Sydney v Hindmarsh (1912) 14 CLR 334 at p.338:

> "What then is the meaning of 'annuity' as a legal or technical term? According to Co. Litt., 144b, an annuity is 'a yearly payment of a certain sum of money granted to another in fee for life or years, charging the person of the grantor only'. Viner's Abridgment, vol.II.,p.504, repeats the definition, with further passages showing that the sum need not be payable each year if only it is a yearly sum. Bacon's Abridgment, vol. 1., p. 233, says that 'an annuity, strictly taken, is a yearly payment of a certain sum of money granted to another in fee simple, fee tail, or life or years, charging the person of the grantor only : if payable out of lands, it is properly called a rent-charge; but if both the person and estate be made liable, as they most commonly are, then it is generally called an annuity'.
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> "The text books generally adopt the definition in Co. Litt.; no case was found in which any other definition was offered; nor any case in which an indeterminate sum was held to be an annuity.
>
> "It is therefore a characteristic of an annuity that it be of a sum certain."

Kelly J. went on to say in respect of the matter before him:

> "The element of certainty in the sum payable is sufficiently satisfied, I think, because by calculation and upon the happening of certain events it becomes certain even though it may vary from year to year. The basic figure is certain." [p.4106 ATC; p.13 ATR]

Clearly, these comments do not provide for other than the possible variation of payments in later years calculated by application of a stated basis to the basic sum payable under the contract. An annuity indexed at a stated rate (e.g., the CPI rate) is an example of an acceptable variation.

11. Even in a situation where many of the characteristics of an annuity exist it may still be necessary to determine whether what is being paid is an annuity or involves the payment of instalments of a capital sum. To do this the courts have had regard to the true nature of the transaction. The following words of Sir Wilfrid Greene M.R. in Sothern-Smith v Clancy [1941] 1 KB 276 at p.282 highlight this:

> "It is clear that an annuity or other annual payment falls to be struck with tax as being an 'annual profit or gain' and this is the reason why it becomes necessary to examine the nature of an annual payment in order to see whether it is in truth an income or a capital payment - a question which cannot be answered merely by pointing to the fact that it is annual. Questions of this kind are notoriously difficult and give rise to distinctions of a highly artificial character. The present case is no exception.
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> "It is no doubt true to say that in order to answer the question the real nature of the transaction must be

> ascertained."

In the same case, Goddard LJ said, at p.293:

> "The fine distinction between an annuity properly so called for tax purposes and an annual payment which is in truth a capital payment, whether in discharge of a pre-existing debt or not , has repeatedly been emphasized, and no sure or simple test has or can be laid down for the solution of this problem. The only principle that I can deduce from the cases is that the court must have regard to the true nature of the transaction from which the annual payment arises and ascertain whether or not it is the purchase of an annual income in return for the surrender of capital."

The reasoning in the Sothern-Smith case was followed by the High Court of Australia in Atkinson v FCT (1951) 84 CLR 298 and would appear to be the approach to be adopted in Australia.

12. More recently, the legal nature of an annuity vis-a-vis a loan was discussed by the Full High Court of Australia (Mason ACJ Wilson Brennan Deane and Dawson JJ) in FCT v Myer Emporium Ltd (1987) 71 ALR 28; 61 ALJR 270:

> "A covenant to pay interest on a principal sum may, according to the terms of the lending agreement, be independent of or accessory to a covenant to repay the principal sum or the covenants may be integral parts of a single obligation, but it is of the essence of interest that it be referable to a principal sum : per Rand J in Reference as to the Validity of Section 6 of the Farm Security Act 1944, of the Province of Saskatchewan [1947] S.C.R. 394 at 411-412. The source of interest is never the mere covenant to pay. Interest is not like an annuity. Annuity payments are not derived from the money paid for the annuity; they are derived solely from the annuity contract. And so, when a contractual right to be paid an annuity is sold for a price, the proceeds of sale are ordinarily capital in the hands of the vendor : Paget, at 35, 44-45; cf Kelsall Parsons & Co. v Commissioners of Inland Revenue (1938) 21 T.C. 608 at 624." [p. 38 ALR; p. 276 ALJR]

13. Going to the products themselves, the main features of one basic type of contract are:

(a) The purchase price forms part of the vendor's statutory funds and is credited to an investment account maintained by the vendor in the purchaser's name.

(b) Administration charges and policy fees, the latter subject to periodic review, are to be debited to the account.

(c) Interest is to be credited each year to the investment account, the rate depending upon the performance of the underlying statutory fund in the preceding year.

(d) Liability of the vendor is limited to the balance of the funds in the purchaser's account.

(e) At commencement of the contract the purchaser may nominate the amount to be drawn as the annuity each year.

(f) The annual payment may be varied from time to time upon notice being given by the purchaser.

(g) Each annual payment is debited to the purchaser's account.

(h) Upon death before the expiration of the "annuity" term, the balance in the investment account is payable to the purchaser's estate.

(i) At the end of the annuity term the balance in the investment account is payable to the purchaser.

(j) Should debits in the investment account exceed credits, the contract ends and no further "annuity" amounts are payable.

14. Investment in some other products marketed as variable annuities is represented by units the value of which fluctuate with investment results. The regular payments are obtained by cashing in units. Overall, however, little turns on the method of recording an investment. The essential requirement is that the payments arise from an obligation under an annuity contract.

RULING

15. Despite the terminology used, contracts that display the above features do not provide for the payment of annuities. The authorities show that the description given to a contract under which an annuity is purported to be purchased is not conclusive that it is an annuity:

> "The name given to payments by the parties to the transaction is of course not conclusive as to their true nature and in considering whether they are of an income or of a capital character the court is entitled to have regard not only to the contractual documents, but to all the facts which are relevant for determination of the question."
>
> Lord Fraser of Tullybelton in Inland Revenue Commissioners v Plummer [1979] 3 All ER 775 at p.793)

16. The essential feature of the contracts examined is that the capital sum invested is never lost sight of. It is contained in an account the balance of which at any time represents that investment plus the purchaser's share of the issuer's actual performance (based on the investment balance) less any withdrawals previously made by the purchaser (or loss of capital where it is not guaranteed) and any charges or fees levied. The liability of the issuer is, at all times, referable to and limited to the balance of the funds at the particular time. Once the investment account is exhausted the contract is

terminated. Furthermore, the level of payments made out of the fund is at the investor's discretion. The amount of a payment is not determinable from the contract. The arrangements are not materially different to a term deposit, subject to variable interest rates, the sums drawn therefrom depending upon agreement between the parties.

Acceptance as an Annuity

17. For a contract to be accepted as providing for a purchased annuity it must possess the characteristics of an annuity described in paragraphs 8 to 12 above. In response to requests from the life insurance industry the following comments are provided as additional guidance on the features which it is considered a purchased annuity contract should contain in order to be accepted as an annuity for income tax purposes.

18. The fundamental feature of an annuity is the certainty of the payments to be received under the contract. The contract must state what the annuitant's annual entitlement is and the period for which it is payable and, if that stated entitlement can be varied, the contract must state the basis on which variation can be made. A contract without this underlying feature cannot be accepted as an annuity.

19. The Courts have clearly indicated that the regular payments must arise from the annuity contract. It is also clear that the amount of a payment must be of a sum certain. In relation to a sum certain, annuity cases to date have been concerned solely with a stated sum, that is an actual dollar amount or, in some instances, a dollar amount that is determinable either from existing facts or, in relation to some further payments, the happening of a contingency of a stated kind. In each case there has been a known amount payable, an amount that is clearly ascertainable from the contract, and there is an obligation placed on the issuer to pay that known amount. It is the existence of that known amount and the term over which it is stated to be payable that gives rise to the certainty of the payments.

20. A basic annual payment obligation expressed as a dollar amount would be expected to be stated in a purchased annuity contract; it is difficult to accept that those contracts sighted to date which do not contain a stated dollar amount provide the certainty required of an annuity contract. Therefore contracts which provide merely for the payment of amounts based on the actual earnings performance of the issuer or the value of the units cashed in are not considered to provide for sums certain. In these situations the risk associated with the liability to pay a sum certain which is normally placed on an issuer under an annuity contract is largely transferred to the investor.

Bonus

21. A contract that provides for the payment to the annuitant of a bonus in the event that the issuer has better than expected investment results could still be acceptable as an annuity.

Certain amendments to the taxation law which are contained in the Taxation Laws Amendment Act 1988 acknowledge the existence of bonuses payable in addition to regular guaranteed annuity payments. Where the basic liability of the issuer is set out with certainty in the contract and the additional amounts paid out are truly in the nature of a bonus and are not significant relevant to the total amounts expected to be paid out each year, the undertaking to pay the additional amounts would not be seen as detracting from the existence of an underlying annuity contract.

22. The question of what is a significant amount cannot be precisely determined by reference to the decided cases or the Taxation Laws Amendment Act 1988. A number of insurance companies wishing to market annuity products which contain undertakings to pay bonuses based on investment performance have sought guidance on the matter. Discussions have been held with industry representatives. As a guide, a product which provides for a minimum guaranteed annuity based on 70% of the rate used at the time by the particular company to determine the payments to be made under a purely traditional annuity which the company competitively offers on the market will not be disputed by this office as constituting an annuity merely because of the existence of the obligation to pay bonuses. It is understood traditional annuities are backed by investment in appropriate Commonwealth Government securities and therefore any company which does not offer a traditional annuity product may use the Commonwealth bond rate most applicable to the period for which an annuity discussed in this paragraph will be issued. A Taxation Ruling concerning the provisions of the Taxation Laws Amendment Act 1988 relevant to the timing of the payment of both bonuses and guaranteed payments of an annuity is to issue shortly.

Residual Capital Value

23. It was stated in paragraph 2 that the examination of contracts arose in connection with the determination of a deductible amount. That determination involves the ascertainment of the residual capital value payable under the annuity contract. The presence of a residual capital value is provided for in Subdivision AA and is not seen as being in conflict with the concept that an annuity involves the conversion of a principal sum into an income stream. Essentially, annuity agreements with residual components represent the substitution of a purchase price for two things. Part of the purchase price goes towards the provision of an income stream and part to purchase a lump sum in the future, viz. the "residual capital value". Subject to the Taxation Laws Amendment Act 1988, these annuities would be acceptable as eligible annuities for the purposes of Subdivision AA and should not be confused with the variable annuity products outlined in paragraph 13.

24. While situations may arise where it will be necessary to consider the application of subsection 27H(3) to determine a deductible amount, that is unlikely to be the normal situation.

The requirement for certainty to exist under an annuity contract must apply equally to the issuer's liability to pay any residual capital value. If the actual amount of residual capital value is not specified in the contract the contract would be unlikely to possess the certainty required for acceptance as an annuity.

Commutation

25. An annuity contract may provide for the annuitant to vary his or her entitlements by fully or partially commuting the annuity. A partial commutation will result in the annuity payment or term or both being varied. In some cases it may result in the amount of residual capital value payable being varied. Subdivision AA clearly contemplates that annuities are capable of being commuted. Paragraph (g) of the definition of an "eligible termination payment" in subsection 27A(1) refers to a situation where an annuity is commuted. The ability of an annuitant to commute or partially commute will not of itself result in the contract failing to be accepted as an annuity contract. However, any commutation payment must be based on the present value of the annuitant's rights, to the extent they are commuted. In the case of a contract which provides for partial commutation the remaining entitlements of the annuitant, or their basis of calculation, must be ascertainable from the contract.

Unacceptable Contracts - Taxation Treatment

26. It was stated at paragraph 15 that contracts of the type outlined at paragraphs 13 and 14 do not provide for the payment of annuities. Those contracts based on an investment account are considered to be virtually the same as term deposit contracts. The income arising from them should be similarly treated. Therefore, subject to paragraphs 29 and 30, the amounts credited to an investor's account for the year ending 30 June 1988 and subsequent years will be included in the assessable income of the investor in the year the amount is credited. As a general rule, it is not proposed to disturb earlier years' assessments.

27. Unit based contracts provide for payments similar to those to be made under investment account contracts. In most cases the initial investment is preserved. Consequently, subject to paragraphs 29 and 30, investors in such products are to be assessed on amounts they receive under the contracts.

28. Section 27H has no application to either type of contract and therefore there is no undeducted purchase price or deductible amount in terms of subsection 27H(2) or 27H(3). Furthermore, tax instalment deductions are not relevant to payments received under these contracts.

29. It has been claimed that investors in products that have been marketed as variable annuities have done so in good faith and in the expectation of the taxation results claimed to be available by the issuers, that much of the money invested has been eligible termination payment money, and that many investors

are retired persons. Because of this, the action proposed in paragraphs 26 and 27 will not be taken for the year ended 30 June 1988 and subsequent years in respect of any particular investor where, within 90 days of the date of this Ruling, that investor terminates his/her existing contract and invests the total proceeds in an annuity that is the subject of an "eligible policy" within the meaning of the Taxation Laws Amendment Act 1988.

30. In this situation the investor will be assessed in the year ended 30 June 1988 (and in the year ending 30 June 1989 where a transfer is not effected by 30 June 1988) on the actual amount received during the year except to the extent, if any, that the amounts so received represent repayments of the capital invested. The allowance of any deductible amount (as such) for that year remains inappropriate. Payments received under the new contract will be assessed in accordance with section 27H except, where the amount paid over into the new contract exceeds the investment made initially, the deductible amount applicable to the new contract will be based on the initial investment. Investors who invest in an annuity product in accordance with this paragraph should include with their returns of income for the year ended 30 June 1988 details of their initial investment, the amounts received and credited each financial year, and the amount transferred upon termination of their initial investment contract. For administrative reasons, the investment in an annuity product of a part only of the proceeds of the terminated contract will not be treated as indicated above for transfers of total investments.

Roll-over Moneys

31. Persons who invested roll-over moneys in the variable annuity products discussed in this Ruling and who do not transfer their investment into an acceptable annuity product will be treated as having failed to roll-over their eligible termination payments at the time they were first received. Consequently, the relevant income tax assessments of those persons will be amended to tax the eligible termination payments in the appropriate manner.

32. The action outlined in paragraph 31 will not apply where persons under 65 years of age terminate their contracts and transfer their payments into a deferred annuity and/or an approved deposit fund within the 90 day period referred to in paragraph 29. Persons of any age terminating their contracts who are already covered by the extended roll-over period provided in the Acting Treasurer's press release of 23 January 1987 (or any additional extension of the period that may be granted) have until the later of that extended date and the 90 day period just referred to, to roll over their payments.

New Products

33. Those companies which marketed a product of the type discussed in this Ruling and which are to provide a new product into which their clients can transfer should refer a copy of their proposed new contract to the National Taxation Office in

Canberra to obtain consideration of the contract as an annuity product. Other companies should refer their enquires and requests for consideration of contracts to the Taxation Office at which they lodge their taxation returns.

COMMISSIONER OF TAXATION
16 June 1988