

TD 94/82 - Income tax: does section 26AH of the Income Tax Assessment Act 1936 apply when investment options are 'switched' under an eligible policy?

 This cover sheet is provided for information only. It does not form part of *TD 94/82 - Income tax: does section 26AH of the Income Tax Assessment Act 1936 apply when investment options are 'switched' under an eligible policy?*

This Determination, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the *Taxation Administration Act 1953*, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Determination is a public ruling and how it is binding on the Commissioner. Unless otherwise stated, this Determination applies to years commencing both before and after its date of issue. However, this Determination does 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 Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Taxation Determination

Income tax: does section 26AH of the *Income Tax Assessment Act 1936* apply when investment options are 'switched' under an eligible policy?

1. 'Switching' can be defined as a facility which allows policy holders of unbundled life insurance policies (described in Taxation Ruling IT 2346, paragraph 5) to reclassify or vary the class or classes of assets supporting the policy. For example, policy holders may choose to switch between investments in ordinary shares, property, fixed interest or cash. The policy holder has the flexibility to select her/his preferred investment strategy based on the risks and profitability of different assets and, therefore, to change the way in which the future value of the policy is calculated. After the switching option has been exercised, the rights or entitlements under the insurance policy are unchanged except that the future value of the policy will be calculated by reference to different assets.
2. Some life insurance products include a switching option in the terms of the contract, while others do not. If switching has occurred, whether there has been a mere variation in the terms of the contract or the discharge of an existing contract and the creation of a new one, is a question of fact. From the facts, it must be determined whether the variation in the terms has created a new contract which is so inconsistent with the original contract that it is obvious that the original contract is extinguished.
3. Generally speaking, switching does not involve the payment of any new or additional premiums, a change in the present value of the policy, a surrender of any part of the policy or a re-application of money. As such, it involves the mere variation in the calculation base of the existing policy and, therefore, the provisions of subsections 26AH(4) and (13) do not apply. Taxation Ruling IT 2346 (paragraph 17) recognises that a variation in conditions attaching to an eligible policy does not necessarily terminate the policy and give rise to a new one. If the original contract contains a switching clause or if it contains a variation clause and the contract is varied to add a switching clause, we accept that if the policy holder has exercised the switching option, there has been a mere variation in the contract. However, the absence of a switching clause or of a variation provision does not prevent the addition of a switching clause and the subsequent exercise of the switching option from being considered as a mere variation of the contract for section 26AH purposes.
4. If the policy holder is only able to change his or her preferred investment options by surrendering the existing policy and entering into a new policy, subsection 26AH(6) applies and a

new eligible period commences. That would be the case, for example, if the policy certificate was cancelled and a replacement issued, or if existing policies were converted or consolidated into one, or if the underlying risk insured against was changed.

5. Switching amounting to a mere variation of the existing contract does not involve the sale of units of one class and the purchase of units of another class. Paragraph 15 of Taxation Ruling IT 2346 is relevant to that issue.

6. Benefit funds of friendly societies are constituted by rules. The rules constitute the terms of the contract between the society and individual policy holders. If a friendly society which is permitted by its rules to invest in a limited range of investments issues an eligible policy and later amends its rules to permit a wider range of investments (e.g., to include equities) and to allow switching by policy holders, such changes and any subsequent switching under the new rules represent mere variations of the contract between the policy holder and the friendly society. In that case subsections 26AH(4) and (13) do not apply if a policy holder elects to switch to a different investment option.

Example 1

A friendly society changes its rules by adding the clause 'each member contributing to Fund X shall (a) nominate the proportions by which her or his contributions are to be allocated to each of the investment accounts and (b) be entitled to vary her or his allocation to each investment account from time to time by written notice to the society'. If the holder of a policy entered into before the change in the rules opts to exercise the option under (b), the exercise of the option does not trigger the operation of subsections 26AH(4) or (13).

Example 2

A life insurer issued insurance bonds backed by a capital guaranteed investment fund. At the time of issue, no other investment funds were available so policy documents did not contain switching provisions. The life insurer decides to amend the early policies to allow those policy holders to switch investment options. The variation of the policies (which retain the same policy number, commencement date and policy terms and conditions) does not trigger the operation of subsections 26AH(4) or (13).

Commissioner of Taxation

6/10/94

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