Chapter 34

BUILDING A MORE CONSISTENT REGIME FOR LIFE INSURERS

A case for reform

Current taxation arrangements are complex

34.1 The current taxation arrangements for life insurers are very complex.

34.2 Income and expenses need to be allocated to up to four classes of business:

- each class is subject to a different rate of tax;
- some classes include components that are exempt from tax or are subject to different rates of tax; and
- different calculations are required to determine assessable income for each class of business.

Table 34.1: Classes of business of life insurers and the associated rates of tax

Class of business	Rate of tax
Life insurance companies	
Accident and disability/residual life insurance class	39%
Complying superannuation/rollover annuity class	15%
Non-complying superannuation class	47%
General fund class which is divided into: ▪ the RSA component; and ▪ the standard component — ie amounts not allocated to other classes or RSAs	15% 39% for a mutual life insurance company and 36% for a non-mutual life insurance company
Friendly societies	
Eligible insurance business class	33%
Complying superannuation/rollover annuity class	15%
Non-complying superannuation class	47%

34.3 Australian Taxation Office compliance programs for life insurers provide evidence of the complexity of the current taxation arrangements.

34.4 'Tax planning' opportunities can arise from internal dealings that exploit differences in the taxation rates of each class of business.

34.5 The taxation treatment of the non-life insurance aspects of the business of friendly societies is uncertain, as is the interaction of that treatment with the taxation of the friendly societies' life insurance business.

Current taxation arrangements are inequitable and distortive

34.6 The current taxation arrangements for life insurers can result in inequities in the financial markets:

- the income tax base is narrow and does not include all income from funds management and risk business; and
- similar economic activities are subject to different rates of tax depending on whether the policy is issued by a life insurer or general insurer.

34.7 The current taxation treatment of life insurers is inconsistent with the taxation treatment of other entities that carry on similar types of business.

- Life insurers are not taxed on the profit they make on risk business — that is, underwriting profit. However, general insurers are taxed on underwriting profit.
- Management fees embedded in premiums are not included in the assessable income of life insurers. However, all management fees are included in the assessable income of banks, public unit trusts and general insurers.

34.8 In addition, the different taxation treatment that applies to the investment business of life insurers compared with other entities distorts investment decisions by investors.

A strategy for reform

Apply the company tax rate to taxable income

34.9 It is proposed that the taxable income of life insurers be taxed at the company tax rate. Amounts actually credited by the life insurer to retirement savings account (RSA) policyholders would, as with such amounts credited by other financial institutions, continue to be taxed at the superannuation rate of tax of 15 per cent. The proposals would apply from the 2000-01 income year — that is, generally, from 1 July 2000.

34.10 Taxing a life insurer's income at the company tax rate would be consistent with the objectives of *A Strong Foundation*.

34.11 One consequence of extending the company tax rate to all of the taxable income of life insurers would be to eliminate the wide variety of tax rates and the different classes of assessable income that currently apply to life insurers. The assessable income and allowable deductions of a life insurer would no longer need to be calculated for each class of assessable income to determine the life insurer's taxable income.

34.12 The income that life insurers would be taxed on at the company tax rate would include income derived on amounts held in reserves for purposes of smoothing investment returns — including reserves that relate to superannuation fund investments. Taxing life insurers on these amounts would be equitable with the taxation treatment of income derived on amounts held for the purposes of smoothing investment returns in other entities. The same principle applies to superannuation funds although their income is taxed at a rate of 15 per cent rather than the company tax rate.

34.13 Taxing all the income of life insurers at the company tax rate would:

- improve the efficiency, certainty and administration of the taxation system;
- simplify the taxation arrangements that currently apply to life insurers by removing the need to allocate income and expenses across different classes of business; and
- encourage competitive neutrality with other fund managers and across the insurance market.

34.14 In practice, taxing the income of life insurers would involve:

- allowing a deduction for current expenses incurred for business purposes (including the interest component of immediate annuity payments);
- including in assessable income:
  - the risk component of premiums;
  - management fees;
  - investment income, including capital gains;
  - other income, including fees for advisory services and commissions; and
- assessing the annual change in the value of policy liabilities.

34.15 The taxation treatment of individual investment assets (including the disposal of assets) should be consistent with the taxation treatment of

individual investment assets of other entities. The taxation treatment of investments is discussed in Volume I.

Apply the redesigned imputation system

34.16 *A New Tax System* indicated that the taxation of profit distributions of life insurers would be in line with the redesigned imputation system proposed to apply to other entities. This would be consistent with the policy design objectives of *A Strong Foundation*. Applying the redesigned imputation system to life insurers would significantly simplify the current imputation arrangements that apply to life insurers.

34.17 In addition, because it would be consistent with the imputation system applying to other entities, applying the redesigned imputation system would reduce current distortions and provide greater equity with other investments.

34.18 Consequently, life insurers would attach imputation credits to dividends paid to shareholders. In addition, because life insurance investment policies are considered to be in the nature of equity, life insurers would attach imputation credits to bonuses assigned to life insurance investment policies.

34.19 The redesigned imputation arrangements (Chapter 15), which include refunds for excess imputation credits, would ensure that shareholders and policyholders paid tax on these payments at their marginal tax rates.

Key policy issues

How should the taxable income of a life insurer be calculated?

34.20 When determining the taxable income of life insurers both their risk business and investment business need to be recognised. The taxation system that applies to life insurers must be capable of taxing both of these types of business consistently with competing entities.

34.21 The taxable income of life insurers includes income that is to be assigned to policyholders. The taxation treatment of policyholders is discussed in Chapter 35.

Option 1: Include premiums in assessable income

34.22 Under Option 1:

Taxable income = Premiums + Management fees + Investment income + Other income – Outlays

In this formulation:

- premiums would be all premiums paid for life insurance policies;
- management fees would include fees debited to policies and any other fees such as time-based fees, asset management fees and switching fees but would exclude fees embedded in the above premiums;
- investment income would be all investment income excluding any investment income included in management fees;
- other income would include any other income derived including decreases in the value of policy liabilities (excluding the above investment income allocated to investment policies); and
- outlays would include expenses (including the interest component of immediate annuity payments), policy claims and increases in the value of policy liabilities (excluding the above investment income allocated to investment policies).

34.23 This option would include all life insurance premiums in assessable income and allow a deduction for increases in the value of policy liabilities. Any decrease in the value of policy liabilities would be included in assessable income.

- For the risk component of policies, the change in the value of policy liabilities would be the increase or decrease in the value of policy liabilities in an income year.
- For the investment component of policies, the change in the value of policy liabilities would be the capital component of the premiums paid by policyholders in an income year.

34.24 The formulation of taxable income under this option captures both the risk and investment business of a life insurer.

- Risk business — all premiums received would be included in a life insurer's assessable income and a deduction would be allowed for the change in the value of policy liabilities. Consequently, the underwriting profit would be included in taxable income.
- Investment business — all investment income would be included in taxable income. Including premiums in assessable income and then allowing a corresponding deduction as an increase in policy liabilities would ensure that capital contributions are not taxed.

Advantages

34.25 Advantages of Option 1 are that:

- underwriting profit and losses would be included in taxable income;
- risk business would be taxed on a similar basis to general insurers' and life insurers' accident and disability business; and
- all management income would be taxed.

Disadvantages

34.26 Disadvantages of Option 1 are as follows.

- Some of the calculations used in this option would be complex.
  - The change in the value of policy liabilities would need to be actuarially calculated for taxation purposes.
    - Actuarial assumptions would need to be determined.
- Investment income would need to be excluded from the change in the value of policy liabilities.
- Identifying adjustments to avoid the duplication of income or deductions in the calculation of taxable income may be difficult.
- Taxable income could be overstated or understated because actuarial calculations would be relied upon substantially.

34.27 Canada uses an approach similar to this option and has experienced some difficulties in calculating the deduction allowed for policy liabilities.

- The deduction allowed in Canada for the change in the value of policy liabilities is calculated for accounting purposes, then discounted by a specified percentage to exclude the margin for prudence.
- Canada imposes a separate tax on policy premiums to overcome concerns about deficiencies in the income tax base.

Option 2: Identify components of assessable income

34.28 Under Option 2:

Taxable income = Management fees + Investment income + Underwriting profit/loss + Other income — Outlays

In this formulation:

- management fees would include fees embedded in premiums, fees debited to policies and any other fees such as time-based fees, asset management fees and switching fees;

- investment income would be all investment income excluding any investment income included in management fees;
- underwriting profit/loss would include the sum of mortality profit/loss and discontinuance profit (losses would be allowed as deductions);
- other income would include any other income derived; and
- outlays would include expenses (including the interest component of immediate annuity payments).

34.29 Under this option management fees and underwriting profit/loss would be separately determined.

34.30 Underwriting profit/loss would be determined using formulas or actuarial calculations. The underwriting profit or loss would be adjusted through the term of a life insurance policy, with a balancing adjustment when the policy is surrendered or matures.

34.31 As the net underwriting profit or loss would be calculated separately, specific taxation deductions for net increases in policy liabilities would not be necessary.

34.32 Provided all income was captured under Option 2, both Option 1 and Option 2 would produce the same outcome for taxation purposes over the term of a life insurance policy.

Advantages

34.33 Advantages of Option 2 are as follows.

- The calculations used would be simpler than under Option 1.
  - Management fees would be calculated directly from policy documentation or from accounting records.
- There would be less reliance on actuarial calculations compared with Option 1.

Disadvantages

34.34 Disadvantages of Option 2 are as follows.

- The calculation of underwriting profit or loss could be arbitrary.
- Identifying adjustments to avoid the duplication of income or deductions in the calculation of taxable income may be difficult.
  - For example, the calculation of underwriting profit or loss would include an element of investment income generated on the risk premiums. As investment income forms part of

assessable income, there would need to be an exclusion from assessable income of that proportion of investment income which would be included in the underwriting profit or loss calculation.

- Underwriting profit/loss would be required to be calculated using actuarial assumptions.
  - Actuarial assumptions would need to be determined.

34.35 New Zealand uses an approach similar to this option and has experienced some difficulties in calculating underwriting profit.

- New Zealand uses an arbitrary formula approach to calculate underwriting profit.

Option 3: A combination of Option 1 and Option 2

34.36 Under this approach:

- the taxable income for risk business would be calculated using Option 1; and
- the taxable income for investment business would be calculated using Option 2.

Advantages

34.37 Advantages of this option are that:

- the different nature of businesses operated by a life insurer would be separately recognised and identified;
- risk business would be taxed on a similar basis to general insurance business; and
- investment business would be taxed like other investment entities.

Disadvantages

34.38 Disadvantages of this option are that:

- it could be difficult to avoid the duplication of income or deductions in the calculation of taxable income;
- the risk component of a life insurance policy or a risk policy would need to be arbitrarily defined;
- premiums or income would need to be split between risk and investment; and

- a different basis of taxation would apply to different parts of a life insurer's business.

Can accounting principles be used by life insurers for taxation purposes?

34.39 The value of policy liabilities is currently calculated for taxation purposes on a solvency basis.

34.40 However, there may be scope to value policy liabilities for taxation purposes using methods based on those employed for prudential regulation and accounting purposes. For example, the value of policy liabilities is calculated using the 'margin on services' method. Policy liabilities are also calculated using different assumptions and modified methods for solvency and capital adequacy purposes.

34.41 The value of policy liabilities calculated for prudential regulation and accounting purposes may not be appropriate for taxation purposes. Consequently, adjustments may need to be made to correctly value policy liabilities for taxation purposes.

34.42 The Review seeks comments on the appropriate method for valuing policy liabilities for taxation purposes.

How should the profit on a life insurer's immediate annuity business be determined?

34.43 The immediate annuity business of a life insurer relates to life insurance policies that are annuities currently being paid.

34.44 In *A New Tax System* the Government proposed to tax the profit a life insurer makes on its immediate annuity business by including in its assessable income all investment income underlying its immediate annuity business (including pension business paid from RSAs) and allowing a deduction for the 'interest' component of the annuitants' products.

34.45 The amount a life insurer could claim as a deduction for the interest component should be calculated consistently with the methodology outlined in Volume I for estimating the annual change in value of financial assets.

34.46 This would result in the profits from life insurers' annuity business being taxed on a sound basis.

34.47 There are three types of immediate annuities:

- allocated annuities;

- fixed-term annuities; and
- lifetime annuities.

34.48 The methodology for variable interest debt should apply to allocated annuities. The methodology for any asset that has an anticipated stream of future payments should apply to fixed-term annuities.

34.49 The methodology for lifetime annuities could be determined using the actual interest component of the pool of lifetime annuity payments made by a life insurer during a year.

Allocated annuities

34.50 An allocated annuity is an account based product that can only be purchased with eligible termination payment (ETP) monies. Minimum and maximum payment rules require annuitants to draw down an amount annually and ensure that the annuity is payable until annuitants are at least age 80. Annuitants can elect to receive different amounts each year within these limits. The annuity is payable until the account balance is nil.

34.51 A key issue in relation to allocated annuities is whether the interest component accrued but not credited would be taken into account in determining a life insurer's profit. Unlike bank accounts, allocated products do not generally have a defined or specified accrual rate. Therefore, the interest component of an allocated annuity in a year could be the amount credited to the account in that year.

Example 34.1: Calculation of a life insurer's profit on an allocated annuity

Melissa rolls over an ETP of $80,000 to purchase an allocated annuity. The life insurer's investment return on this amount in the first year is $5,800. However the life insurer only credits $5,000 to Melissa's account. If Melissa draws down an allocated annuity of $4,500 the balance in Melissa's account would be $80,500 (that is, $80,000 + $5,000 - $4,500).

The life insurer would include the investment return of $5,800 in its assessable income and would be allowed a deduction for the interest credited to Melissa's account of $5,000. As a result, the life insurer's profit of $800 would be included in its taxable income (that is, $5,800 - $5,000).

Fixed-term annuities

34.52 A fixed-term annuity is a fixed income stream payable for a specified period — for example, 10 years. A fixed-term annuity can be indexed.

34.53 Fixed-term annuity payments initially consist mainly of 'interest' with the capital component (corresponding to the annual change in value) increasing in later years — as with mortgage repayments associated with a normal housing loan.

34.54 Life insurers determine the rate of return on fixed-term annuities at the time annuitants purchase annuities.

Example 34.2: Calculation of a life insurer's profit on a fixed-term annuity

Samuel rolls over an ETP of $80,000 to purchase a fixed-term annuity of $10,000 per annum (A) for a period of 10 years (t). The effective rate of return over the term of the annuity (r) is 4.28 per cent. The life insurer's investment return on this amount in the first year is $4,800.

In the first year, the life insurer would include the investment return of $4,800 in assessable income and would be allowed a deduction for the interest component of Samuel's annuity of $3,422. As a result, the life insurer's profit of $1,378 would be included in its taxable income (that is, $4,800 — $3,422).

The following table illustrates the interest and capital components of Samuel's annuity payments.

Payment (t) (Year)	Capital balance (1) $	Interest component [(1) x r]=(2) $	Capital component [A — (2)]=(3) $	Payment (A) $
1	80,000	3,422	6,578	10,000
2	73,422[(a)]	3,141	6,859	10,000
3	66,563	2,847	7,153	10,000
4	59,410	2,541	7,459	10,000
5	51,951	2,222	7,778	10,000
6	44,173	1,890	8,110	10,000
7	36,063	1,543	8,457	10,000
8	27,605	1,181	8,819	10,000
9	18,786	804	9,196	10,000
10	9,590	410	9,590	10,000

(a) (1) – (3) for year 1, and consistent with this in subsequent years.

34.55 Life insurers could use this rate of return and the methodology used for a normal housing loan to calculate the deduction that would be allowed for the interest credited to the annuitant's account in respect of a fixed-term annuity. The calculations reflect the yield-based accruals methodology in the section of the Overview concerned with measuring income from assets and liabilities.

Lifetime annuities

34.56 A lifetime annuity is a fixed income stream which may be indexed and is payable for the annuitant's life.

34.57 The deduction a life insurer could claim for interest that relates to its lifetime annuities could be the actual interest component of the pool of lifetime annuity payments made by the life insurer during a year. This amount could be determined each year on an actuarial basis applying up-to-date 'best estimate' assumptions to the annuity portfolio in force during the year.

How would life reinsurance be taxed?

34.58 A life insurer can reduce its risk exposure by reinsuring any potential liability it has on its life insurance policies with another life insurer (the reinsurer).

34.59 The current taxation treatment of life reinsurance is complex. To overcome the current complexities, and to provide equity, life reinsurance should be taxed on the same principles that would apply to the taxation of life insurance.

What are the tax rate implications of the proposals on the superannuation business of life insurers?

34.60 Life insurers would be taxed on income derived on investments that relate to superannuation funds at the company tax rate.

34.61 However, as with superannuation fund investments in other entities, the mechanisms for dealing with the refund of excess imputation credits (in Chapter 15) could apply. Accordingly, any investment returns that are assigned to a superannuation fund in a year would be taxed at the rate of 15 per cent. The refund mechanisms would overcome any potential delays in bringing down the tax rate on the assigned income from the company tax rate to 15 per cent.

34.62 Under some types of policies — including superannuation policies — life insurers hold reserves in excess of the amount already allocated to life insurance policies. The reserves could be held for prudential reasons. Some of the reserves represent benefits that are likely to be distributed to policies some time in the future. These reserves are retained to smooth returns to policyholders.

34.63 The application of the entity tax regime would result in these reserves being taxed at the company tax rate. As noted, this would be consistent with the taxation treatment of similar amounts retained by other entities — including superannuation funds, although their income is taxed at a rate of 15 per cent — and with the policy objectives of *A Strong Foundation*.

34.64 There is the question, nevertheless, whether the investment income on reserves held by life insurers for the purpose of smoothing investment returns assigned to superannuation policies should be taxed at the rate of 15 per cent. On the one hand, this departure would provide life insurers an advantage in competing for superannuation fund business. On the other hand, it would involve complex calculations and could result in the same complexities and tax planning opportunities that arise under the current taxation system.

What are the tax rate implications of the proposals on the deferred annuity business of life insurers?

34.65 In the absence of other changes, extending the entity tax regime to life insurers would have the effect of taxing deferred annuity business at the company tax rate.

34.66 Deferred annuities are not really annuities. Theoretically, deferred annuities are life insurance policies that require an immediate annuity to be payable at some time in the future. However, in practice, most deferred annuities are life insurance policies that provide a lump sum (rather than an immediate annuity) to be paid when a policyholder turns age 65. When a policyholder receives the lump sum he or she has the option of taking the lump sum, which would be taxed as an ETP, or rolling it over to purchase an immediate annuity.

34.67 Deferred annuities were created to allow life insurers to hold benefits paid from a superannuation fund and other ETPs between the time a superannuation benefit or an ETP was paid and the time a taxpayer turned age 65. Superannuation funds are now allowed to retain benefits between the time a taxpayer ceases gainful employment and the time he or she attains 65 years of age.

34.68 The company tax rate would be higher than the 15 per cent rate of tax that would apply to the ETP business of complying superannuation funds, RSAs and approved deposit funds (ADFs). Consequently, individuals would not roll over ETPs to deferred annuities after 30 June 2000.

34.69 However, life insurers would want to continue to offer arrangements that would be taxed at the superannuation rate of tax. As with other entities, life insurers could set up superannuation funds or ADFs to accept rolled over ETPs. This would be consistent with other entities and would overcome the allocation and tax planning opportunities that can arise under the current system.

34.70 Policyholders with existing deferred annuities should, however, not be disadvantaged by the changed arrangements. Therefore, life insurers could transfer their existing deferred annuity business to RSAs, complying superannuation funds or ADFs. To facilitate this, rollover relief may need to be considered.

34.71 Requiring existing deferred annuity policyholders to transfer their investment to another entity could, nevertheless, cause undue costs and confusion for those policyholders. An alternative would be to allow, as a transitional measure, life insurers to continue to be taxed on amounts assigned to existing deferred annuity policies at a rate of 15 per cent.

How would franking credits be allocated between shareholders and policyholders?

34.72 The amount credited to life insurers' franking accounts would relate to tax paid on income that would be allocated to both shareholders and policyholders. However, income that relates to policyholders may not be assigned to them until a later year.

34.73 To prevent shareholders inappropriately using franking credits that relate to policyholders, life insurers would need to maintain two franking accounts — one for shareholders and one for policyholders.

34.74 The franking credits would need to be allocated between the shareholder and policyholder franking accounts on an equitable basis.

34.75 One option is to allocate franking credits on the same basis that tax is allocated for regulatory purposes. Alternatively, the franking credits could be allocated on the same basis that investment income is allocated between shareholders and policyholders.

What franking account adjustments would need to be made in relation to existing life insurance investment policies?

34.76 Chapter 35 discusses three options for taxing bonuses paid on existing life insurance investment policies. The options are:

- continuing the current taxation treatment;
- applying the redesigned imputation system to bonuses paid on existing policies terminated within 10 years and the current taxation treatment to bonuses paid on existing policies terminated after 10 years; and
- applying the redesigned imputation system to bonuses paid on all policies.

34.77 Under each of these options, policyholders would not be taxed until the policies are surrendered or reach maturity.

34.78 Currently, life insurers cancel franking credits that relate to life insurance policies. Therefore, life insurers would not have any franking credits that relate to bonuses accrued on existing policies before 1 July 2000.

34.79 However, the amount credited to life insurers' franking accounts after 30 June 2000 would relate to tax paid on income derived on all life insurance investment policies.

34.80 Consequently, life insurers would need to adjust their franking accounts. However, the adjustments that need to be made would depend on whether:

- the current taxation treatment applied to bonuses paid on existing life insurance investment policies; or
- the redesigned imputation system applied to bonuses paid on existing life insurance investment policies.

If the current taxation treatment applied to bonuses

34.81 If the current taxation treatment continued to apply to bonuses paid on existing life insurance investment policies, policyholders would not be entitled to imputation credits.

34.82 As life insurers would retain all their franking credits after 30 June 2000, they would need to reduce their franking accounts by the amount of franking credits that relate to existing policies. The adjustments would need to be made annually as the bonuses accrue.

34.83 If the franking account was maintained on a tax-paid basis, life insurers could debit their franking accounts each year for existing policies by the amount calculated using the formula:

Grossed-up amount of bonuses accrued in the year for existing policies x company tax rate

34.84 As policyholders would not be entitled to imputation credits, life insurers would not attach any credits when the bonuses are paid to policyholders.

If the redesigned imputation system applied to bonuses

34.85 If the redesigned imputation system applied to bonuses paid on existing life insurance investment policies, policyholders would be entitled to imputation credits.

34.86 As life insurers would have cancelled franking credits that relate to life insurance policies before 1 July 2000, an adjustment would need to be made to reinstate franking credits that relate to bonuses accrued before 1 July 2000.

34.87 Two options to determine the franking credits that relate to bonuses accrued on existing life insurance investment policies before 1 July 2000 are:

- Option 1 — Create notional franking credits for bonuses accrued before 1 July 2000; and
- Option 2 — Calculate the franking credits for bonuses accrued before 1 July 2000 when policies are surrendered or reach maturity.

Option 1: Create notional franking credits

34.88 Life insurers could calculate the notional franking credits that relate to bonuses accrued on existing life insurance investment policies at 30 June 2000 and increase their franking account by this amount.

34.89 The notional franking credits created could only be used for bonuses paid on existing policies.

34.90 If the franking account was maintained on a tax-paid basis (Chapter 17), the notional franking credit would be the grossed-up amount of unpaid bonuses accrued on life insurance investment policies as at 30 June 2000 multiplied by the company tax rate. That is, if the company tax rate were 36 per cent, the life insurer would credit its franking account by

$36 for every $64 of bonuses accrued to existing life insurance investment policies as at 30 June 2000.

34.91 When bonuses were paid to a policyholder with an existing life insurance investment policy, life insurers could debit their franking account by the amount calculated using the formula:

Grossed-up amount of total bonuses paid on the policy x company tax rate

34.92 As policyholders would be entitled to imputation credits, life insurers would attach these credits to the bonuses paid to policyholders.

Advantages

34.93 Advantages of this option are that:

- the debits to life insurers' franking accounts would be the same for new investment policies and existing investment policies when bonuses are paid; and
- notional franking credits for all existing life insurance investment policies would be calculated at 30 June 2000.

Disadvantages

34.94 Disadvantages of this option are that:

- it could be difficult to determine the amount of bonuses accrued for taxation purposes on existing investment policies as at 30 June 2000; and
- limiting the use of notional franking credits to bonuses paid on existing investment policies could add complexity and increase compliance costs.

Example 34.3: Calculation of notional franking credits

Assume Natasha receives bonuses of $10,000 in June 2003 on maturity of an existing life insurance investment policy. The bonuses accrued at 30 June 2000 were $8,000.

Assuming a company tax rate of 36 per cent, the notional franking credits that relate to the bonuses assigned prior to 1 July 2000 would be $4,500 (that is, $8,000 x 36/64). The total franking credit that relates to this policy would be $5,625 — that is, $4,500 + ($2,000 x 36/64). When the life insurer pays Natasha the $10,000 it would debit its franking account by $5,625.

The life insurer would attach imputation credits of $5,625 to the bonuses paid to Natasha.

Option 2: Calculate the franking credits on bonuses accrued before 1 July 2000

34.95 Life insurers could calculate the franking credits that relate to bonuses accrued on existing life insurance investment policies before 1 July 2000 when policies are surrendered or reach maturity and increase their franking account by this amount.

34.96 If the franking account was maintained on a tax-paid basis, life insurers could reinstate franking credits by crediting their franking account when an existing life insurance policy is surrendered or reaches maturity by the amount calculated using the formula:

Grossed-up amount of bonuses accrued on the policy as at 30 June 2000	x	company tax rate

34.97 To attach imputation credits to the bonuses paid to policyholders, life insurers could then debit their franking account by the amount calculated using the formula:

Grossed-up amount of total bonuses paid on the policy	x	company tax rate

34.98 As policyholders would be entitled to imputation credits, life insurers would attach these credits to the bonuses paid to policyholders.

Advantages

34.99 An advantage of this option is that the debits to life insurers' franking accounts would be the same for new investment policies and existing investment policies when bonuses are paid.

Disadvantages

34.100 Disadvantages of this option are that:

- the adjustments to the franking account would need to be determined every time an existing life insurance investment policy is surrendered or reaches maturity; and
- it could be difficult to determine the amount of bonuses accrued on existing life insurance investment policies as at 30 June 2000.

Example 34.4: Calculation of franking credits on bonuses accrued before 1 July 2000

Assume Natasha receives bonuses of $10,000 in June 2003 on maturity of an existing life insurance investment policy. The unpaid bonuses accrued at 30 June 2000 were $8,000.

Assuming the company tax rate was 36 per cent, to reinstate the franking credits previously cancelled, the life insurer would credit its franking account by $4,500 (that is, $8,000 x 36/64) when it pays Natasha the $10,000.

The life insurer would then debit its franking account by $5,625 (that is, $10,000 x 36/64).

The life insurer would attach imputation credits of $5,625 to the bonuses paid to Natasha.