Chapter 35

LIFE INSURANCE POLICYHOLDERS

A case for reform

Current taxation arrangements are distortive and inequitable

35.1 The taxation treatment of bonuses paid on life insurance policies that have an investment component affects the investment decisions of individuals.

35.2 Depending on an individual's taxable income and the duration of the investment period, a tax advantage or disadvantage might arise compared with the taxation of alternative investments.

35.3 The current taxation treatment differs from that of companies (assessment on profit distributions at investors' marginal tax rates) and trusts (assessment on presently entitled income at investors' marginal tax rates).

35.4 The taxation treatment of investment returns to life insurance policyholders varies with the period of the investment and rarely applies at investors' marginal tax rates.

- If an investment policy is surrendered or matures in less than 10 years, a rebate of tax paid by the life insurer is allowed but the policy bonuses are not grossed up — the marginal tax rate of the policyholder rarely applies over the life of the policy.
- If an investment policy is surrendered or matures after 10 years, the policyholder is not taxed on the bonuses paid so that the bonuses remain taxed at the life insurer's tax rate — which disadvantages low marginal tax rate taxpayers and advantages high marginal tax rate taxpayers.

A strategy for reform

Change the taxation treatment of bonuses assigned to life insurance investment policies

35.5 Under the redesigned imputation system proposed in *A New Tax System*, the grossed-up amount of bonuses assigned to a new life insurance investment policy would be subject to the policyholder's marginal tax rate in the year they are assigned. The tax payable by the policyholder would be reduced by the amount of imputation credits attached to the bonuses.

- A policyholder with a marginal tax rate less than the company tax rate (including complying superannuation funds) would attract net credits to reduce tax on the policyholder's other income or to be refunded.
- A high marginal tax rate policyholder (including non-complying superannuation funds) would attract additional net tax on the bonuses to the extent that the policyholder's marginal tax rate was higher than the company tax rate.

35.6 *A New Tax System* also proposed that policyholders would have the choice of being taxed on bonuses assigned to a new life insurance investment policy either when they are assigned to the policy or when they are ultimately distributed.

35.7 Allowing policyholders to have the choice of when they would be taxed on bonuses, in conjunction with allowing policyholders to continue to attract the current taxation treatment on bonuses paid on existing life insurance investment policies, would involve some inequities and complexities. Therefore the Review's consultations will consider alternative options that would be more equitable and simpler.

35.8 The Review's consultations will also consider what amount could be assigned to a new life insurance investment policy for taxation purposes.

Apply the redesigned imputation system

35.9 *A New Tax System* proposes taxing profit distributions of life insurers in line with the redesigned imputation system proposed to apply to other entities.

35.10 Consequently, life insurers would attach imputation credits to bonuses assigned to life insurance investment policies.

35.11 This would ensure policyholders are taxed on bonuses at their marginal tax rates.

Retain the current taxation treatment of the risk component of insurance benefits

35.12 Currently, life insurance benefits paid to a policyholder as a lump sum on the death or disability of the insured are generally tax free. However, in some circumstances insurance proceeds are subject to tax. For example:

- the insurance proceeds paid to an employer under a key person insurance policy are generally taxed under the ordinary income provisions of the income tax law; and
- if a policyholder assigns a policy to a third party for consideration, the third party is taxed on the insurance proceeds under the capital gains tax provisions of the income tax law.

35.13 Under the reform arrangements, the current taxation treatment of the risk component of insurance benefits would remain unchanged.

Key policy issues

35.14 Central issues for consultation are:

- the timing of the taxing of new life insurance investment policies; and
- determining the amount assigned to these policies for taxation purposes.

35.15 Consistency with companies and trusts is an important consideration — including the basis adopted for the taxation of unrealised gains.

35.16 The options discussed below offer flexibility in the timing of taxing bonuses and in determining the amount assigned for taxation purposes. Nevertheless, some of the options could result in policyholders being taxed on unrealised gains. An important issue for consultation, therefore, is the extent of possible taxation of unrealised gains under the various options.

35.17 A further issue for deliberation is the taxation treatment of amounts received from existing life insurance investment policies.

35.18 Policyholders would have purchased existing life insurance policies on the understanding that bonuses would not be subject to assessment until the policy was surrendered or reached maturity. Consequently, amounts assigned under existing life insurance investment policies would continue to be subject to assessment on surrender or maturity of the policy.

When would policyholders be taxed on new life insurance investment policies?

35.19 *A New Tax System* proposed that policyholders would have the choice of being assessed on life insurance bonuses either when they were assigned to their policy or when or before the policy matures and the bonuses are received. This would ensure that policyholders would not be required to pay tax on life insurance bonuses until the bonuses are actually received — but would mean that low marginal rate policyholders who deferred the assessment of tax could not gain early access to the benefit of imputation credits and associated refunds.

35.20 The proposal to defer tax on life insurance bonuses would involve considerable complexity and would be inconsistent with the principle of full integration presented in *A Strong Foundation*.

35.21 Nevertheless, policyholders do not have access to the proceeds of a life insurance policy until the policy is surrendered or reaches maturity. Company shareholders are not — and, under the new entity tax regime, beneficiaries of trusts would not be — taxed on entity income until it is distributed. Therefore, it would be difficult to achieve both annual taxation of life insurance bonuses at investors' marginal tax rates and consistent treatment with other products.

35.22 Three options to allow policyholders to choose when to pay tax on life insurance bonuses are:

- Option 1 — Calculate and pay net tax each year or when bonuses are received;
- Option 2 — Calculate the tax shortfall every year and pay net tax at that time or when bonuses are received; and
- Option 3 — Calculate and pay net tax when bonuses are assigned.

35.23 These options should be considered against the principles of equity, simplicity and consistency with alternative investments. Each option includes reference to the *amount assigned annually for taxation purposes*. The determination of that amount is discussed in the following section.

Option 1: Pay net tax each year or when bonuses are received

35.24 The policyholder could choose to:

- be assessed on the life insurance bonuses assigned for taxation purposes in the year that the bonuses are assigned (allowing scope for low marginal rate policyholders to attract net tax credits and possibly refunds of excess credits); or
- be assessed on the life insurance bonuses assigned when he or she receives or becomes entitled to the bonuses. The policyholder would pay tax at his or her marginal tax rate in the year he or she receives or becomes entitled to the bonuses

(allowing scope to defer any net tax otherwise payable by high marginal rate policyholders).

Advantages

35.25 Advantages of this option are:

- choosing to defer tax would be consistent with the taxation treatment of retained income of companies; and
- imputation credits could be accessed annually if the policyholder chose to be assessed annually.

Disadvantages

35.26 Disadvantages of this option are:

- the ability of policyholders to choose when to be assessed would be inconsistent with the taxation treatment of other products — for example, shares and units in unit trusts;
- choosing assessment on the final lump sum could push the policyholder into a higher marginal tax rate;
- if a policyholder chose to defer tax until a policy is surrendered or matures, problems could arise when attaching imputation credits if the company tax rate changes; and
- potentially there could be large tax liabilities for deceased estates.

Option 2: Calculate the tax shortfall every year

35.27 The policyholder could include the amount assigned for taxation purposes in his or her taxable income in the income year the bonuses are assigned. The net credits or net tax would be calculated in that year.

35.28 The policyholder could choose to:

- pay any net tax on the life insurance bonuses assigned in that income year; or
- defer payment of the net tax on the life insurance bonuses assigned.

35.29 If the policyholder deferred payment of the net tax on the life insurance bonuses assigned, he or she would have to pay the tax deferred when or before the policy is surrendered or reaches maturity.

Advantages

35.30 Advantages of this option are:

- imputation credits would be used annually;
- the marginal tax rate of the policyholder would be applied to the amount assigned year by year as the income accrues;
- no difficulties would arise when attaching imputation credits if the company tax rate changes; and
- problems where life insurance bonuses received as a lump sum push the policyholder into a higher marginal tax rate would be avoided.

Disadvantages

35.31 Disadvantages of this option are:

- it would be inconsistent with the taxation treatment of other products — for example, shares and units in unit trusts;
- it would be administratively cumbersome — a record of the tax deferred by the policyholder would need to be maintained over a very long period; and
- potentially there could be large tax liabilities for deceased estates.

Option 3: Pay net tax when bonuses are assigned

35.32 The policyholder could include the amount assigned for taxation purposes in his or her taxable income in the income year that the bonuses are assigned and would attract the benefits of net imputation credits or pay any net tax payable on the life insurance bonuses in that year.

Advantages

35.33 Advantages of this option are:

- it would be consistent with the taxation treatment of 'dividend' reinvestment arrangements that apply to other products — for example, shares and units in unit trusts;
- it would be administratively simple;
- imputation credits could be used annually; and
- the marginal tax rate of the policyholder would be applied year by year as the income is assigned.

Disadvantages

35.34 A disadvantage of this option is that policyholders whose marginal tax rate exceeds the company tax rate could have to pay tax on bonuses that they do not have access to until the policy is surrendered or reaches maturity. Under the proposed taxation scale, a policyholder's marginal tax rate would exceed the company tax rate of 36 per cent if his or her taxable income were $50,001 or more. Nevertheless, this effect is equivalent to the outcome with dividend reinvestment arrangements (although shareholders have the choice with such arrangements).

35.35 Moreover, this effect could be overcome by life insurers developing products that give policyholders flexibility to choose when amounts would be assigned to their policies. For example, life insurers could develop a product that allows a policyholder to elect each year whether he or she wants the life insurer to assign an amount for taxation purposes to his or her policy. That would provide policyholders with advantages over shareholders and unitholders.

35.36 Alternatively, life insurers could offer two types of policies:

- a policy under which the life insurer assigns bonuses annually (likely to be chosen by policyholders expecting to be on low marginal tax rates over the term of the policy); and
- a policy under which the life insurer assigns bonuses when the policy is surrendered or reaches maturity (likely to be chosen by policyholders expecting to be on high marginal tax rates over the term of the policy).

35.37 If bonuses assigned to a policyholder in a particular year represent amounts accrued over more than one year, the amount assigned would not be averaged. In these circumstances, high marginal tax rate taxpayers would receive an advantage from deferral of the taxation liability on the bonuses assigned to their policies.

What amount would be included in a policyholder's assessable income?

35.38 The amount that would be included in a policyholder's assessable income would be the *amount that is assigned for taxation purposes* in a period by the life insurer to the policyholder under the policy.

35.39 The amount that would be assigned to a new life insurance investment policy could depend on whether the policy is:

- an investment-linked policy;

- an investment account policy; or
- a whole-of-life policy or an endowment policy.

35.40 In practice, as discussed earlier, some methods used to calculate the amount assigned to life insurance policies could include unrealised gains.

Investment-linked policies

35.41 A typical investment-linked policy is a life insurance policy where the policyholder bears the risk. The life insurer does not guarantee the amount invested by a policyholder. An investment-linked life insurance policy is essentially the same as an investment-linked unit trust.

35.42 The investment component of the premium of an investment-linked policy purchases units in a pooled fund. The unit might be linked to a specified asset index or to a specified investment portfolio involving, for example, property, fixed-interest securities or equities, or a combination of all classes of assets. The unit price is recalculated daily to reflect the investment performance of the assets in the fund. The value of the units can both rise and fall.

35.43 A policyholder with an investment-linked policy has no entitlement to the change in value of his or her policy until the policy is surrendered or reaches maturity. The policyholder would receive a profit on the policy only if he or she sells the units at a price higher than the purchase price of the units.

35.44 No amount would be assigned to an investment-linked policy for taxation purposes until the policy was sold if the value of the policy was based solely on the current market value of the units. The policyholder would be taxed on the proceeds of the policy only on realisation of the gain or loss from the sale of units.

35.45 The proceeds of the policy would be the amount received on the sale of the units reduced by the investment component of the premiums paid by the policyholder in the period. The investment component of the premiums paid by the policyholder in the period would not be included in the proceeds of the policy because it represents the policyholder's capital contribution during the period.

35.46 As amounts would only be assigned to typical investment-linked policies when the units are sold, policyholders — including superannuation funds — would not be able to get a refund of excess imputation credits annually.

35.47 However, investment-linked policies could be written that assign amounts annually to policyholders for taxation purposes. The Review seeks industry comment on the development of such policies.

Investment account policies

35.48 Under an investment account policy the net premium is added to an investment account that is maintained in a pooled fund. The life insurer declares an interest rate for the pooled fund and credits each policyholder's account with bonuses at that rate each income year.

35.49 The interest rate declared on an investment account policy cannot be negative. Therefore, the balance of a policyholder's account cannot reduce as a result of the life insurer's investment performance.

35.50 The amount that could be assigned for taxation purposes to an investment account policy for a period could be the interest credited to the policy in that period.

Whole-of-life and endowment policies

35.51 Whole-of-life and endowment policies are bundled policies. That is, they have both a risk component and an investment component.

35.52 Under both whole-of-life policies and endowment policies the policyholder pays a fixed regular premium for the duration of the policy and receives a specified sum of risk insurance. The amount paid out on termination of a whole-of-life policy or an endowment policy may increase over time as bonuses accumulate on the policy.

35.53 A whole-of-life policy is paid out on, or shortly before, the death of the insured whereas an endowment policy is paid out on the selected maturity date or the earlier death of the insured.

35.54 The amounts allocated to whole-of-life and endowment policies are called reversionary bonuses. Reversionary bonuses are bonuses credited to the policyholder's account throughout the term of the policy but are not paid to the policyholder until the policy matures or is surrendered. Once reversionary bonuses have been allocated to a policy they cannot be withdrawn.

35.55 Life insurers also pay interim bonuses and terminal bonuses. Interim bonuses and terminal bonuses only accrue to a policyholder when a life insurance policy matures or a death claim arises.

35.56 The amount that could be assigned for taxation purposes to a whole-of-life or endowment policy for a period could be the reversionary bonuses assigned to the policy in that period.

35.57 However, the reversionary bonuses assigned to a whole-of-life or endowment policy are not paid out at face value to the policyholder if the policy is surrendered and do not cover all of the investment returns under the policy. Therefore, the amount assigned for taxation purposes to a whole-of-life or endowment policy for a period could be the increase in the surrender value of the policy over the period reduced by the investment component of the premiums paid by the policyholder in the period.

35.58 The investment component of the premiums paid by the policyholder in the period would not be included in the amount assigned to the policy because it represents the policyholder's capital contribution during the period.

Could policyholders claim a deduction for fees paid to a life insurer?

35.59 The deductibility of fees paid by a policyholder to a life insurer would be determined under the general deduction provision of the income tax law. Therefore, under the current law fees incurred by a policyholder would qualify for an income tax deduction provided that they were not of a capital, private or domestic nature.

- Fees incurred by the policyholder on a regular basis, such as an annual management fee, are likely to be deductible under the general deduction provision of the income tax law in the year that the policyholder includes bonuses assigned to the life insurance policy in his or her assessable income.
- Fees deducted by the life insurer embedded in investment returns — leading to a reduced investment return to the policyholder — are not deductible to the policyholder because no expenditure is incurred by the policyholder.
- The treatment of fees included in the premium — that are likely to be of a 'capital nature' and may, under the current law, be available as a capital deduction when the policy is surrendered or matures — would depend on the approach ultimately taken on the generalised treatment of expenditure discussed in the Overview.

How should existing life insurance investment policies be taxed?

35.60 A life insurance investment policy could be taxed as an existing life insurance investment policy provided:

- the risk commenced under the policy before 1 July 2000; and

- the premiums payable in a particular year did not exceed the premiums payable in the immediately preceding year by more than 25 per cent (the current '125 per cent rule').

35.61 It would be logical to allow policyholders to elect to treat an existing life insurance investment policy as a new life insurance investment policy. That would mean that policyholders would not face unnecessary transaction costs.

35.62 If an existing life insurance investment policy becomes a new life insurance investment policy for taxation purposes, the policyholder would be required to include in his or her assessable income — in the income year that he or she breached the '125 per cent rule' or made the election — the bonuses that would be payable on the policy if the policy had been surrendered. The amount included in assessable income would attract the taxation treatment applying to existing life insurance investment policies.

35.63 *A New Tax System* proposed that, as a transitional measure, an individual policyholder would continue to attract the current taxation treatment on bonuses paid on an existing life insurance investment policy when the policy is surrendered or matures.

35.64 This transitional measure would not apply to existing life insurance investment policies held by superannuation funds, approved deposit funds (ADFs) or pooled superannuation trusts (PSTs) because the superannuation business of life insurers would no longer be taxed at the rate of 15 per cent.

35.65 However, as discussed in Chapter 34, the refund mechanisms for dealing with the refund of excess imputation credits could apply to ensure that investment returns assigned to policies held by superannuation funds, ADFs or PSTs in a year would be taxed at the rate of 15 per cent.

35.66 Taxing bonuses paid on existing life insurance investment policies on a different basis to bonuses paid on new life insurance investment policies would add complexity to the administration of the taxation law and would increase compliance costs for life insurers. Therefore, other options to tax bonuses paid on existing life insurance investment policies should be considered.

35.67 Three options for the taxation of bonuses paid on existing life insurance investment policies are:

- Option 1 — Continue to apply the current taxation treatment to bonuses paid on existing life insurance investment policies;
- Option 2 — Apply the redesigned imputation system to bonuses paid on existing life insurance investment policies terminated within 10 years and the current taxation treatment to bonuses paid on existing policies terminated after 10 years; and

- Option 3 — Apply the redesigned imputation system to bonuses paid on all existing life insurance investment policies. The rate of tax on bonuses paid on existing policies terminated after 10 years would be capped at the company tax rate.

35.68 Consistent with the Government's proposals in *A New Tax System*, these options would only assess a policyholder on reversionary bonuses received on an existing life insurance investment policy when the policy is surrendered or reaches maturity.

Option 1: Apply the current taxation treatment

35.69 Under Option 1 a policyholder would be taxed on reversionary bonuses paid on an existing life insurance investment policy as follows:

- if the policy was held for eight years or less, the reversionary bonuses would be included in the policyholder's assessable income and the policyholder would be entitled to a rebate;
- if the policy was held for nine years, two-thirds of the reversionary bonuses would be included in the policyholder's assessable income and the policyholder would be entitled to a rebate;
- if the policy was held for 10 years, one-third of the reversionary bonuses would be included in the policyholder's assessable income and the policyholder would be entitled to a rebate; and
- if the policy was held for more than 10 years, the policyholder would not be taxed on reversionary bonuses paid on the policy.

Rebate rate would be the company tax rate

35.70 The rate of tax paid by life insurance companies on amounts allocated to existing life insurance investment policies that are included in the accident and disability/residual life insurance class of assessable income is currently 39 per cent. Therefore, it could be argued that the rebate on bonuses paid on life insurance policies issued by a life insurance company should be:

- 39 per cent on the amount accumulated up to 30 June 2000; and
- the company tax rate on the amount accumulated after 30 June 2000.

35.71 The rate of tax paid by friendly societies on amounts allocated to existing life insurance investment policies that are included in the eligible insurance business class of assessable income is currently 33 per cent. Therefore, it could be argued that the rebate on bonuses paid on life insurance policies issued by friendly societies should be:

- 33 per cent on the amount accumulated up to 30 June 2000; and
- the company tax rate on the amount accumulated after 30 June 2000.

35.72 However, for simplicity the level of rebate for existing life insurance investment policies issued by both life insurance companies and friendly societies could be the same as the company tax rate.

35.73 The change to the level of the rebate would apply to bonuses paid one year after the change in the rate of tax that would apply to life insurers — that is, to bonuses paid after 30 June 2001 — the current level of rebate would apply to bonuses paid before 1 July 2001. The one year delay in changing the rate of the rebate would be consistent with changes to the rate of the rebate when the rate of tax payable by life insurers in respect of life insurance policies has changed previously.

Advantages

35.74 Advantages of this option are:

- the current taxation treatment for bonuses paid on existing life insurance investment policies would be unchanged; and
- a policyholder who held an existing life insurance investment policy for more than 10 years would not have any taxation obligations in relation to the policy.

Disadvantages

35.75 The disadvantages of this option are:

- a policyholder would need to consider whether he or she is better off electing to treat an existing policy as a new policy to take advantage of the redesigned imputation system;
- the life insurer would have to distinguish between new life insurance investment policies and existing life insurance investment policies when attaching imputation credits; and
- the taxation treatment of bonuses paid on new life insurance investment policies and existing life insurance investment policies would be different.
  - This would cause administrative difficulties and increase compliance costs. For example, the taxation law, the taxation system and taxation returns would need to distinguish between bonuses paid on new life insurance investment policies and existing life insurance investment policies to ensure that the correct taxation treatment applied.

Example 35.1: Applying Option 1

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

If Natasha held the policy for eight years or less, the bonuses of $10,000 would be included in her taxable income and, if the company tax rate were 36 per cent, she would be entitled to a rebate of $3,600 (that is, $10,000 x 36 per cent).

The net tax payable on the bonuses Natasha received would depend on her marginal tax rate.

If Natasha held the policy for nine years, two-thirds of the bonuses of $10,000 (that is, $6,666) would be included in her taxable income and she would be entitled to a rebate of $2,400 (that is, $6,666 x 36 per cent).

If Natasha held the policy for 10 years, one-third of the bonuses of $10,000 (that is, $3,333) would be included in her taxable income and she would be entitled to a rebate of $1,200 (that is, $3,333 x 36 per cent).

If Natasha held the policy for more than 10 years, the bonuses would not be included in her taxable income and she would not be entitled to a rebate.

The following table illustrates Natasha's net tax payable if she holds the policy for eight years or less.

Other income $	Taxable income $	Gross tax payable $	Net tax payable[(a)] $
8,000	18,000	2,040	0
25,000	35,000	6,880	3,280
55,000	65,000	17,380	13,780
80,000	90,000	28,430	24,830

(a) Gross tax payable less rebate on bonuses.

Option 2: Apply the redesigned imputation system to existing policies terminated within 10 years

35.76 Under Option 2 a policyholder would be taxed on reversionary bonuses paid on an existing life insurance investment policy as follows.

- If the policy was held for 10 years or less, the grossed-up amount of the reversionary bonuses received would be included in the policyholder's assessable income and he or she would be entitled to imputation credits for the tax paid by the life insurer.

  - The imputation credits would replace the existing rebate that applies to bonuses paid on these policies.

- If the policy was held for more than 10 years, the current taxation treatment would continue to apply. That is, the policyholder would not be taxed on reversionary bonuses paid on the policy. The policyholder would not be entitled to any imputation credits for the tax paid by the life insurer.

Advantages

35.77 Advantages of this option are:

- a policyholder who has held an existing life insurance investment policy for 10 years or less could receive a refund of imputation credits;
- a policyholder who has held an existing life insurance investment policy for more than 10 years would not have any taxation obligations in relation to the policy; and
- the taxation treatment of bonuses paid on new life insurance investment policies and existing life insurance investment policies held for less than 10 years would be the same, except that bonuses received on an existing life insurance investment policy would only be taxed when the policy is surrendered or reaches maturity.
  - This would reduce administrative difficulties and compliance costs. For example, the taxation system and taxation returns would not need to distinguish between bonuses paid on new life insurance investment policies and existing life insurance investment policies.

Disadvantages

35.78 Disadvantages of this option are:

- the taxation treatment of bonuses paid on a life insurance investment policy would depend on whether the policy was a new policy or an existing policy;
- a policyholder who intended to hold a life insurance investment policy for 10 years or more would need to consider whether he or she is better off electing to treat an existing policy as a new policy to take advantage of the redesigned imputation system;

- when a life insurer attaches franking credits to bonuses assigned it would have to identify existing life insurance investment policies held for more than 10 years; and
- there would be a cost to revenue involved (see Chapter 39).

Example 35.2: Applying Option 2

In Example 35.1, if Natasha held the policy for 10 years or less, she would include the grossed-up amount of $15,625 (that is, $10,000 + $5,625) in her taxable income and would be entitled to an imputation credit of $5,625.

The net tax payable on the bonuses Natasha received would depend on her marginal tax rate.

If Natasha held the policy for more than 10 years, the bonuses would not be included in her taxable income and she would not receive any imputation credits.

The following table illustrates Natasha's net tax payable if she holds the policy for 10 years or less.

Other income $	Taxable income $	Gross tax payable $	Net tax payable[(a)] $
8,000	23,625	3,467	-2,158
25,000	40,625	8,567	2,942
55,000	70,625	19,630	14,005
80,000	95,625	31,074	25,449

(a) Gross tax payable less refundable imputation credits attached to the bonuses.

Option 3: Apply the redesigned imputation system to all existing policies

35.79 Under Option 3 a policyholder would be taxed on reversionary bonuses paid on an existing life insurance investment policy as follows.

- If the policy was held for 10 years or less, the grossed-up amount of the reversionary bonuses received would be included in the policyholder's assessable income and he or she would be entitled to imputation credits for the tax paid by the life insurer.
  - The imputation credits would replace the existing rebate that applies to bonuses paid on these policies.
- If the policy was held for more than 10 years, the grossed-up amount of reversionary bonuses received would be included in

the policyholder's assessable income and would be taxed at a rate not exceeding the company tax rate. The policyholder would be entitled to imputation credits for the tax paid by the life insurer.

- The imputation credits would replace the exemption that applies to bonuses paid on policies held for more than 10 years.

35.80 As a consequence, a policyholder who held an existing life insurance investment policy for more than 10 years:

- would be entitled to a refund of imputation credits if his or her marginal tax rate was less than the company tax rate; and
- would not be liable to any additional tax on the bonuses received if his or her marginal tax rate was higher than the company tax rate.

Advantages

35.81 Advantages of this option are:

- the life insurer would not have to distinguish between new life insurance investment policies and existing life insurance investment policies;
- a policyholder could receive a refund of imputation credits on an existing life insurance investment policy;
- imputation credits would be attached to all life insurance investment policies; and
- the taxation treatment of bonuses paid on new life insurance investment policies and existing life insurance investment policies held for less than 10 years would be the same, except that bonuses received on an existing life insurance investment policy would only be taxed when the policy is surrendered or reaches maturity.
  - This would reduce administrative difficulties and compliance costs. For example, the taxation system and taxation returns would not need to distinguish between bonuses paid on new life insurance investment policies and existing life insurance investment policies held for 10 years or less.

Disadvantages

35.82 Disadvantages of this option are:

- a policyholder who has held an existing life insurance investment policy for more than 10 years would have taxation obligations in relation to the policy (but high marginal rate taxpayers would be no worse off and low marginal rate taxpayers would be better off);
- the taxation system and taxation returns would need to identify bonuses paid on existing life insurance investment policies held for more than 10 years to ensure that the correct taxation treatment applied; and
- there would be a cost to revenue involved (see Chapter 39).

Example 35.3: Applying Option 3 if policy is held for 10 years or less

In Example 35.1, if Natasha held the policy for 10 years or less, she would include the grossed-up amount of $15,625 (that is, $10,000 + $5,625) in her taxable income and would be entitled to an imputation credit of $5,625.

The net tax payable on the bonuses Natasha received would depend on her marginal tax rate.

The following table illustrates Natasha's net tax payable if she holds the policy for 10 years or less.

Other income $	Taxable income $	Gross tax payable $	Net tax payable[(a)] $
8,000	23,625	3,467	-2,158
25,000	40,625	8,567	2,942
55,000	70,625	19,630	14,005
80,000	95,625	31,074	25,449

(a) Gross tax payable less refundable imputation credits attached to the bonuses.

Example 35.4: Applying Option 3 if policy is held for more than 10 years

In Example 35.1, if Natasha held the policy for more than 10 years, she would include the grossed-up amount of $15,625 (that is, $10,000 + $5,625) in her taxable income and would be entitled to an imputation credit of $5,625.

The net tax payable on the bonuses Natasha received would depend on her marginal tax rate.

The following table illustrates Natasha's net tax payable if she holds the policy for more than 10 years.

Other income $	Taxable income $	Gross tax payable $	Net tax payable[(a)] $
8,000	23,625	3,467	-2,158
25,000	40,625	8,567	2,942
55,000	70,625	19,005	13,380
80,000	95,625	29,355	23,730

(a) Gross tax payable less refundable imputation credits attached to the bonuses.

Comparison of the options

Policies held for 10 years or less

35.83 Table 35.1 illustrates the difference in the tax payable on bonuses paid on existing life insurance investment policies held for 10 years or less under Options 2 and 3 compared with the current taxation treatment (Option 1).

35.84 Table 35.1 and Table 35.2 compare Options 2 and 3 with the current taxation treatment of bonuses paid on a life insurance investment policy held for eight years or less. Under the current taxation treatment, bonuses paid on a life insurance investment policy held for nine or 10 years are only partly assessable. The difference in the tax payable under Options 2 and 3 compared with the current taxation treatment (Option 1) if the policy is held for nine or 10 years would be between the amounts shown in Table 35.1 and Table 35.2.

35.85 Table 35.1 shows that a low marginal tax rate policyholder would be significantly better off if the redesigned imputation system applied to existing life insurance investment policies terminated within 10 years — that is, under Option 2 or Option 3.

35.86 When a policyholder's marginal tax rate is 40 per cent or more, he or she would be marginally better off if the current system continued to apply — that is, under Option 1. Under the proposed taxation scale, a policyholder's marginal tax rate would be 40 per cent or more if his or her taxable income were $50,001 or more.

Table 35.1: Difference in the net tax payable on policies held for 10 years or less under Options 2 and 3 compared with the current treatment (Option 1)

Other income $	Option 2 $	Option 3 $
8,000	-2,158	-2,158
25,000	-338	-338
55,000	225	225
80,000	619	619

Policies held for more than 10 years

35.87 Table 35.2 illustrates the difference in the tax payable on bonuses paid on existing life insurance investment policies held for more than 10 years under Options 2 and 3 compared with the current taxation treatment (Option 1).

35.88 Table 35.2 shows that a low marginal tax rate policyholder would be significantly better off if the redesigned imputation system applied to existing life insurance investment policies terminated after 10 years — that is, under Option 3.

35.89 When a policyholder's marginal tax rate is 40 per cent or more, the amount of tax payable under all of the options would be the same. Under the proposed taxation scale, a policyholder's marginal tax rate would be 40 per cent or more if his or her taxable income was $50,001 or more.

Table 35.2: Difference in the net tax payable on policies held for more than 10 years under Options 2 and 3 compared with the current treatment (Option 1)

Other income $	Option 2 $	Option 3 $
8,000	0	-2,498
25,000	0	-938
55,000	0	0
80,000	0	0