Attachment N

BROADENING THE TAXATION BASE OF LIFE INSURERS

To enhance competitive neutrality, consistency with other entities and the integrity of the taxation system, the taxation base for life insurers will be broadened.

Key features

The taxation base of life insurers will be broadened so that all profit from funds management, underwriting and other life insurance and immediate annuity business is taxed. Under the new arrangements:

- risk business will be taxed on the same basis as the risk business of general insurers;
- investment business will be taxed on the same basis as the investment business of other entities — but not like collective investment vehicles; and
- complying superannuation business of life insurers will be taxed on the same basis as pooled superannuation trusts (PSTs).

Consistent with the treatment of other expenses of a similar nature, the deduction that life insurers can claim for policy acquisition expenses will be spread over five years.

The Pay As You Go (PAYG) provisions will be modified to ensure that the additional tax expected to be paid by life insurers as a result of these measures is collected in the 2000-01 income year.

The complying superannuation investment business of life insurers will continue to be taxed at a rate of 15 per cent if the assets relating to this business are segregated into 'virtual' PSTs. Retirement savings account (RSA) business will also continue to be taxed at a rate of 15 per cent. The remainder of the taxable income of life insurers will be taxed at the company tax rate.

Life insurers and complying superannuation funds will include the investment income on immediate annuity and current pension assets in assessable income and be entitled to a deduction for the 'interest' component of immediate annuities and current pensions.

In addition, the mechanism which allows complying superannuation funds to transfer taxable contributions to a PST or a life insurer (the section 275 transfer mechanism) will be improved.

Further details are provided in the appendix to this attachment.

Commencement

1 July 2000. The following transitional arrangements will apply:

- in recognition that management fees derived by a life insurer over the life of a policy are partly designed to cover acquisition expenses, one-third of the management fees derived by life insurers on policies taken out before 1 July 2000 will be exempt from tax for five years — that is, until 30 June 2005.

  - For simplicity, this transitional arrangement will apply to policies taken out before 1 July 2000 rather than being restricted to policies taken out before the date of announcement as proposed in *A Tax System Redesigned*;

- to avoid undue disruption to friendly society policyholders, the tax rate on the life insurance business of friendly societies will be retained at the rate of 33 per cent for the 2000-01 income year; and

  - investment income derived by friendly societies on funeral bonds, scholarship funds and income bonds issued before 11.45 am AEST on 21 September 1999 will continue to be exempt from tax.

Current arrangements

Under the current arrangements life insurers are taxed at four different rates. Life insurers can take advantage of the multiple tax rates by allocating income to low rate classes and expenses to high rate classes. In addition, life insurers are exempt from tax on some funds management profit, underwriting profit and the profit on immediate annuity business.

Why change is needed

Broadening the taxation base of life insurers will enhance competitive neutrality and consistency with other entities and will remove the tax planning opportunities currently available as a result of the complexity of the current taxation arrangements for life insurers.

Broadening the Taxation Base of Life Insurers — Further Details

The taxation base of life insurers will be broadened so that all profit from funds management, underwriting and other life insurance and immediate annuity business is taxed. The complying superannuation business of life insurers will continue to be taxed at a rate of 15 per cent if the assets relating to this business are segregated into 'virtual' pooled superannuation trusts (PSTs). Retirement savings account (RSA) business will also continue to be taxed at a rate of 15 per cent. The remainder of the taxable income of life insurers will be taxed at the company tax rate.

These measures follow Recommendations 14.1 to 14.10 of *A Tax System Redesigned*.

As a consequence of the measures, life insurers and reinsurers will:

- include risk premiums, management fees and investment income — including investment income on assets supporting immediate annuities and current pensions — in assessable income; and
- be allowed a deduction for the increase in the value of risk policy liabilities and for the 'interest' component of immediate annuities and current pensions.

As proposed in *A Tax System Redesigned*:

- the tax value of risk policy liabilities will be the 'Best Estimate Liability' calculated using Actuarial Standard 1.01 (the Valuation of Policy Liabilities Standard) specified under the *Life Insurance Act 1995*;
- the 'interest' component of immediate annuities and current pensions will be determined as follows:
  - for allocated pensions and annuities — based on the amount credited to the accounts of annuitants or pensioners;
  - for fixed-term annuities and pensions — based on the methodology used to determine the change in the outstanding principal of a normal housing loan, using the effective rate of return over the term of an annuity or pension determined at the time it was purchased; and
  - for lifetime pensions and annuities — based on an actuarial calculation of the actual interest component of the pool of lifetime annuity or pension payments made by a life insurer or complying superannuation fund during a year;
- the imputation system relating to life insurers will be modified to reflect the changed taxation arrangements;
- income derived on assets relating to superannuation investment business that are segregated into virtual PSTs will be taxed at 15 per cent; and

- the section 275 transfer mechanism will be improved by:
  - allowing section 275 notices to be changed, provided both the transferor and the transferee agree, by requesting an amendment to the taxation assessments of both the transferor and the transferee for the year to which the section 275 notice relates; and
  - requiring the amount of section 275 transfers that a life insurer or PST includes in its assessable income to be verified by an independent auditor.