


TR 92/D29 - Income tax: Arrangements involving life insurance policies; deductibility of interest

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DRAFT TAXATION RULING TR 92/D29

We invite you to comment on this Draft Taxation Ruling. We are allowing six weeks for comments before we finalise the Ruling. If you want your comments considered, please get them to us within this period.

PLEASE ADDRESS ALL COMMENTS TO THE CONTACT OFFICER LISTED BELOW.

TITLE . Income tax: Arrangements involving life insurance policies; deductibility of interest.

LAST DAY FOR COMMENTS : 26 November 1992

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COMMISSIONER OF TAXATION

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Draft Taxation Ruling

Income tax: Arrangements involving life insurance policies; deductibility of interest

other Rulings on this topic
IT 2434 IT 2504

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What this Ruling is about:

1. This Ruling discusses the deductibility of interest on funds borrowed in connection with an arrangement involving a life insurance policy.
2. Interest on funds borrowed to pay a life insurance premium is not deductible (an exception exists where proceeds are treated as income). The Australian Taxation Office (ATO) has been made aware of arrangements being marketed in which premiums are paid on a life insurance policy and loans are then made to replace the funds used to pay the premiums. The loans are integral to the entry into the life insurance policy. In some cases, the loans are made against the surrender value of the policy; however, other arrangements feature loans that aren't so directly connected to the policy.
3. This Ruling addresses the claims made by those marketing the arrangements that the interest on the loans is deductible for income tax purposes.

Ruling:

4. Interest is not deductible if the loan on which the interest is paid is an integral part of an arrangement under which a life insurance policy is entered into and the purpose of the loan is to fund the payment of the premium or to return the taxpayer to the financial position that existed before the premium was paid. Such interest is no different to interest on other funds borrowed to pay life insurance premiums.
5. Loans are used to pay premiums on a life insurance policy where the money borrowed is used directly to pay the premiums. They are

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also used to pay premiums where the money is later borrowed and is used to replace the funds used to pay the premiums, and this was a part of the arrangement under which the life insurance policy was entered into and the premiums paid.

Date of effect:

6. This Ruling sets out the current practice of the ATO and is not concerned with a change in interpretation. Consequently, this Ruling (i.e. the final Taxation Ruling that is issued based on this EDR) applies (subject to any limitations imposed by statute) for the years of income commencing both before and after the date on which it is issued.

Explanations:

The arrangements of concern

7. Many life insurance policies have been sold as part of financial arrangements or employee remuneration arrangements. In some cases, the policies have been sold on the basis that, after a premium is paid by the taxpayer, an amount will be lent back or otherwise borrowed so that the taxpayer will not be out of pocket (or not substantially out of pocket) as a consequence of paying the premium. Security for these associated loans may be the policy itself, or the loans may be arranged separately by the taxpayer.

8. The intention to borrow to replace a premium paid was clearly intended at the time of entering the arrangements to which this Rulings is directed. The borrowings are an essential feature behind a taxpayer's entering into such an arrangement. In a number of arrangements examined by the ATO, taxpayers could not have paid the premiums without certain access to the associated loan; ordinary business or other expenditures could only continue if the loan were taken, either before payment of the premium or shortly afterwards to replace the premium paid. The arrangement to borrow, and income tax benefits of claiming interest on the loans as deductions, have been essential selling points for the arrangements.

9. Marketers of these arrangements claim that the interest paid on the loans has a different character if the premium is paid first, and the loan then made. The marketers claim that interest is then tax deductible, as the loan funds are used to pay for regular business expenses or other deductible expenditures. The connection to the premium paid is said to be irrelevant.

The ATO position

10. It is not accepted that the interest on the loan funds in these type of arrangements constitute allowable income tax deductions. The circumstances and manner in which the arrangements are sold provide direct connections between the loans and the payment of the premiums on the life insurance policies involved. Where that connection exists, it has long been the practice of the ATO to deny deduction for interest payment (refer, for example, IT 2504). In addition, the Government announced, on 18 August 1992, its intention to amend the *Income Tax Assessment Act 1936* ('the Act') to ensure that income tax deductions are not allowed for interest paid on monies used to finance life insurance premiums.

11. The types of life insurance policies required for these arrangements to operate must have a substantial savings element in addition to a risk element. However, in marketing the arrangements the savings feature is usually ignored as the taxpayers involved have either not had the funds to save or have not intended to put funds aside. In these situations the taxpayers have not had the ability to pay premiums without borrowing the required funds.

12. In relation to the savings element, some promoters have relied on the existence of high gross incomes and suggested that the collateral loan arrangements are not essential. However, the fact that a large gross income may be fully committed to existing expenditures and funds tied up for other purposes is usually ignored; in business, such purposes include stock, debtors or plant. In any case, the attraction of these arrangements is that no resources need be committed to the life insurance policy. The underlying expectation put to those entering into arrangements is that, at the end of 10 years, the proceeds of the life insurance policy will exceed net outlays (including repayment of loans but after taxation savings claimed to be available).

13. The existence of the insurance cover or risk element in the life insurance policy used has been argued in some cases as providing the need to enter into an arrangement of the type under consideration here. However, usually the cover has been quite an incidental factor in the overall scheme of the arrangements encountered. Moreover, if real insurance needs (that is the 'risk' element) are required then the introduction of a term insurance policy may be supported but not the introduction of a policy with a savings element.

14. Other factors identified have included one or more of the following aspects:

- the purpose of the loans, as stated to the lender, has been to pay premiums on the life insurance policy even though for income tax purposes the interest was claimed to be used for other purposes;

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- the lack of need for risk insurance cover, particularly of the magnitude usually involved in the arrangements, or the availability elsewhere of equivalent term insurance cover at rates which, apart from the taxation benefits otherwise claimed to be available under the arrangement, would be less costly;
- the 'sales pitch' presentation usually highlights the availability of loans to pay the premiums or to replace the funds so used, and it is reported that arrangements would not be sold without the certainty of loans;
- the emphasis in the presentation documentation provided on both the loans and the taxation consequences of the interest paid by the taxpayer;
- the lack of consideration of the availability of funds which are required each year to make annual premium payments, apart from the demonstrated ability to borrow for that purpose.

15. The arrangements have been marketed predominantly in 'one-person' or family company situations but have not been limited to that area. Some have been entered into as part of key-person insurance arrangements. With some arrangements, the parties have gone to great lengths to disguise any connection between the premiums and the loans, yet the predominant features as indicated above have remained present.

16. It is apparent that the arrangements are able to be sold only because of the ability to replace the funds paid out as premiums and the perceived ability to claim interest paid on the replacement funds as income tax deductions. Taxpayers would not enter into the arrangements without the ability to borrow to replace the amounts paid out as premiums. Reports on the selling practices adopted indicate this to be the usual situation.

17. The introduction of permanent life insurance policies has not added to the financial position of the taxpayers involved other than through the creation of income tax deductions and the expectation of a profit on completion of the arrangement. The simple position is that the income producing activities of the taxpayers remain unaltered as a result of the loans and the introduction of the life insurance policies. These situations are demonstrated by the example and explanation at pages 9 and 10.

18. The particular aspects of arrangements in which life insurance policies can be used are many and varied. The application of this Ruling is not intended to be limited to a particular arrangement. It is directed at any arrangement where the introduction of a permanent life insurance policy is not supported by real and substantial commercial reasons or benefits other than providing for apparent taxation advantages.

Arguments for ATO position

19. A deduction for interest expenditure is allowable under subsection 51(1) of the Income Tax Assessment Act 1936 ('the Act') only if the expenditure is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for such a purpose (and is not expenditure of a private, domestic or capital nature).

20. Premiums paid on permanent policies of life insurance (whole of life or endowment policies) are not deductible because they do not produce assessable income for the policy holder and because these types of life insurance policies are primarily affairs of a private or capital nature (see Taxation Ruling IT 2504). Interest arising on loans to pay those premiums is similarly not deductible, the character of the interest following the character of the premiums.

21. In the circumstances under consideration here the loans arise only because of the introduction of the life insurance policies. Although the actual application of the loan monies is, in the usual case, the payment of business expenses, the business operations into which the loan funds are applied existed before the loan and they remain unaltered and intact after the loan. The loan funds may have been applied in the payment of business expenses but the objective purpose of the loans is to place taxpayers back in substantially the same position as they were before the payment of the life insurance premiums. Except for the expected 'net profit' (including tax savings) to be made under an arrangement the net asset position of a taxpayer does not change.

22. In *Ure v FC of T* 11 ATR 484; 81 ATC 4100, Deane and Sheppard J.J. said, at page 494;4109:

"The question whether an outgoing should properly be seen as being wholly or in part "incidental and relevant" to the "end" of gaining or producing the assessable income and the question whether the outgoing is wholly or in part of a private or domestic nature are both questions of characterisation. Where liability to make the outgoing has been voluntarily incurred, those questions of characterisation will ordinarily be determined by reference to the "the object" which the taxpayer had in view (*Latham C.J., W. Nevill & Co. Limited v. F. C. of T.* (1937) 56 C.L.R. 290 at p. 301), the "result aimed at" by the taxpayer (per *Gibbs J., F.C. of T. v. South Australian Battery Makers Pty. Ltd.* 78 ATC 4412 at p. 4420; (1978) 140 C.L.R. 645 at p. 660) in the context of the relevant facts and circumstances."

23. It has been argued that the payment of interest in the present circumstances is not a voluntary one and that the interest is directly incurred in deriving assessable income. However, this ignores the payment of premiums on the life insurance policy involved and the

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loans being part of an integral arrangement and that there is a direct connection between the premiums and the loans. The loans are used either directly to pay premiums or to replace the funds so used. The connection supports the view that the objects or advantages of the loans was not to derive assessable income but to pay premiums on a life insurance policy.

24. In his judgment in *F.C. of T. v. Ilbery* 12 ATR 563;81 ATC 4661, Toohey J. made the following comment at page 571;4668 (Northrop and Sheppard J.J. were in complete agreement with the reasons given by Toohey J.) which is considered to be authority for looking past the direct application of the loans funds in order to determine income tax deductibility:

'While it may not be for the Commissioner to tell a taxpayer how much he should spend on outgoings in the course of gaining an assessable income or whether he should incur those outgoings in one or more than one tax years, a question may still arise whether in respect of a particular year an outgoing incurred by a taxpayer can truly be said to have been incurred in gaining or producing the assessable income.'

The objective circumstance behind the entering into of the loans involved in the arrangements of concern here is not to derive assessable income but, rather, to off-set the loss of the monies outlaid in the payment of premiums on a life insurance policy.

25. The view that a direct connection between the loans and the payment of premiums on a life insurance policy should be recognised is supported by two unanimous decisions of the Full High Court, namely *FC of T v The Myer Emporium Ltd*(1987) 18 ATR 693; 87 ATC 4363 (*Myer Case*) and *Fletcher & Ors v F C of T* (1991) 22 ATR 613; 91 ATC 4950 (*Fletcher Case*).

26. In the *Myer Case*, it was said at page 701;4370:

"By no stretch of the imagination is it possible to describe the transactions, or the assignment standing on its own, as the mere realisation of a capital asset. As we have seen, the assignment was not unrelated to and independent of the loan agreement. The two transaction were interdependent in the sense that Myer would not have entered into the loan agreement unless it knew that Citicorp would shortly thereafter take an assignment of the moneys due or to become due for a sum approximating the amount payable in consideration of the assignment. Indeed, from the viewpoint of Myer the two transactions were essential and integral elements in an overall scheme.."

A similar situation exists in the cases to which this Ruling is directed; the life insurance policies are taken out only as part of overall schemes which rely, as integral parts of the schemes, on loans to replace the funds used to pay the premiums.

27. In the *Fletcher Case*, the Court looked "to a common-sense appreciation of the overall factual context in which the outgoings were incurred" (see page 624;4959) to decide the income tax deductibility of the interest payment involved there. In their judgment at page 621-2;4957, the Court stated that:

"The question whether an outgoing was, for the purposes of s.51(1), wholly or partly "incurred in gaining or producing the assessable income" is a question of characterisation".

The Court went on to state that:

"At least in a case where the outgoing has been voluntarily incurred, the end which the taxpayer subjectively has in view in incurring it may, depending upon the circumstances of the particular case, constitute an element, and possibly the decisive element, in characterisation of either the whole or part of the outgoing for the purposes of the sub-section. In that regard and in the context of the sub-section's clear contemplation of apportionment, statements in the cases to the effect that it is sufficient for the purposes of s.51(1) that the production of assessable income is "the occasion" of the outgoing or that the outgoing is a "cost of a step taken in the process of gaining or producing income" are to be understood as referring to a genuine and not colourable relationship between the whole of the expenditure and the production of such income".

28. A common sense appreciation of the facts of circumstances against which this Ruling is directed is that the arrangements were entered into with the intention that loans would occur, either shortly after the arrangements had been entered into or at some time in the future, to replace the funds used to pay the life insurance premiums and to obtain income tax deductions. There is a clear relationship between the payment of premiums and the loans. The relationship between the interest payments and the derivation of assessable income as claimed by those marketing the arrangements is a 'colourable' one only; having regard to all the objective circumstances behind the arrangements, the purpose of the loans is to pay premiums on life insurance policies.

Application of Part IVA of the Income Tax Assessment Act

29. The circumstances behind the arrangements against which this Ruling is directed means that consideration also needs to be given to the

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application of Part IVA of the Act. Part IVA contains the general anti-avoidance provisions of the tax law.

30. The manner in which the arrangements are structured, marketed and entered into, plus the significance of income tax advantages in providing for the overall success of the arrangements, are considered to constitute the type of circumstances against which Part IVA was intended to be applied. The effect of the application of Part IVA is that the interest deductions claimed would be disallowed.

31. As indicated earlier, this Ruling is directed to arrangements which have as integral components the introduction of a life insurance policy and the intention to take out loans either to pay the premiums on the life insurance policy or to place the taxpayer in substantially the same position as before the payment of the premiums. The question whether there is a relationship between the payment of premiums on the life insurance policy and the loans is one that must be determined from a common sense appreciation of all the facts of a particular case. In the event that it was considered that disallowance of interest deductions would not be supported under subsection 51(1), the ATO would seek to rely on the provisions of Part IVA where, on the consideration of the particular facts of any case, it was considered such action to be warranted.

Example:

32. Set out below is a basic example of the type of arrangement against which this Ruling is directed. An explanation of the cash flows involved is also provided to assist in the understanding of the difference in net outlays. As indicated earlier, there are many variations and adaptations of the concept on which the basic example is based. The example and explanation are provided merely to illustrate the concept. Some arrangements also involve aspects such as employee remuneration or split dollar arrangements.

33. As is usual in the presentation material used to market arrangements, the example and explanation represents a summary of the situation over a 10 year period. They include a loan of more than the premium required, the excess funds being used for interest payments with tax savings accounting for the balance.

EXAMPLE OF A BASIC ARRANGEMENT:**EXISTING SITUATION:**

Business expenses	\$1,000,000	
Tax savings	<u>390,000</u>	
NET OUTLAY		<u>\$610,000</u>

LIFE INSURANCE POLICY INTRODUCED:

<u>OUTGOINGS:</u>	\$	\$
Premiums on life insurance policy	1,000,000	
Business expenses	1,000,000	
Interest	550,000	
Loan repayments	<u>1,335,500</u>	
		3,885,500
<u>RECEIPTS:</u>		
Loans	1,335,500	
Claimed tax savings	604,500	
Life insurance policy	<u>1,600,000</u>	
		<u>3,540,000</u>
NET OUTLAY		<u>\$345,500</u>

DIFFERENCE IN NET OUTLAYS**\$ 264,500**

TR 92/D29**EXPLANATION OF CASH FLOW EFFECTS OF
EXAMPLE ARRANGEMENT****Cash flow positions:**

	<u>TAXPAYER</u>	<u>LIFE INSURER</u>
	\$	\$
Premiums	- 1,000,000	+ 1,000,000
Loans	+ 1,335,500	- 1,335,500
Interest	- 550,000	+ 550,000
Loan repayments	- 1,335,500	+ 1,335,500
Surrender payment	+ 1,600,000	- 1,600,000
	<hr/>	<hr/>
	+ 50,000	- 50,000

Other cash flow effects:

Commissions paid.....	- 50,000
Admin expenses.....	- 20,000
Income tax.....	- 100,000
Other income.....	+ 100,000
	<hr/>	<hr/>
NET RESULTS:	+ \$50,000	- \$120,000

Add tax savings arising
from interest deductions
(\$550,000 x 39%)

+ \$214,500

**TOTAL BENEFIT
TO TAXPAYER**

+ \$264,500

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- interest
- life insurance

legislative references

- ITAA 51(1)
- ITAA Part IVA

case references

- Ure v FC of T 11 ATR 484
81 ATC 4100
- FC of T v Ilbery 12 ATR 563
81 ATC 4661
- FC of T v Myer (1987) 18 ATR 693
87 ATC 4363
- Fletcher & Ors v FC of T (1991) 22 ATR 613
91 ATC 4950