IT 2460 - Income tax : disability insurance - deductibility of premiums

TAXATION RULING NO. IT 2460

INCOME TAX : DISABILITY INSURANCE - DEDUCTIBILITY OF PREMIUMS

FOI EMBARGO: May be released

REF N.O. REF : 87/1712-5 DATE OF EFFECT: Immediate

B.O. REF :

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT REFS:
I 1010342	DISABILITY INSURANCE INSURANCE PREMIUMS	51(1) 260

OTHER RULINGS ON TOPIC IT 208, 2370.

PREAMBLE Taxation Ruling IT 208 dealt with the decision of the High Court in FCT v D.P Smith 81 ATC 4114; 11 ATR 538. The ruling stated that the decision should be applied in all cases where taxpayers have paid premiums in respect of personal disability insurance policies which provide for the payment of periodic benefits of an income nature during a period of incapacity.

2. Following that decision some taxpayers have entered into artificial arrangements seeking to qualify for similar deductions.

FACTS 3. In Case P 57, 82 ATC 263; 25 CTBR(NS) Case 121 the taxpayer paid a premium for disability insurance to P Pty Ltd, the trustee of his family trust. The taxpayer was also a director of the trustee company. The disability cover provided by the agreement was twenty times the taxpayer's usual income. P Pty Ltd had no assets from which it could pay the insurance if required. Taxation Board of Review No.3 unanimously found that the arrangement was a sham. Thus the taxpayer was not entitled to a deduction for the amount of the premium.

4. In Case P 68 82 ATC 324; 25 CTBR(NS) Case 132 the taxpayer paid a premium for disability insurance to his spouse. The amount of the premium was calculated to reduce the taxpayer's assessable income to nil. The taxpayer did not have sufficient funds to pay the premium. A cheque was made out in favour of the spouse who immediately made out a counter-cheque lending the amount to the taxpayer. The spouse did not have sufficient assets to satisfy the insurance liability. Taxation Board of Review No.3 unanimously found that the transaction was a sham, denying a deduction to the taxpayer.

5. In a decision of the Administrative Appeals Tribunal handed down on 9 April 1987, the Tribunal (Senior Member, Mr P.M. Roach) held that a deduction was not allowable for a premium paid for disability insurance. AAT Reference NT 85/16682. The facts were similar to those in Case P 68; Case 132. In this case the taxpayer and her spouse sought to insure each other. The

taxpayer's husband was also her employer and his income was substantially greater than her income. The amount of the premiums was identical. After the end of the financial year it was decided to reduce the taxpayer's premium to reflect her lower level of income. Neither the taxpayer nor the spouse could have satisfactorily met the insurance liability and they did not consider what would happen if they were both injured.

6. The taxpayer did not disclose in her return that she had received a premium from her husband. She claimed a deduction for the reduced amount of the premium which was disallowed. The Tribunal found that the agreement was not a sham. The taxpayer and her husband had acted honestly, if somewhat naively, intending to create legally enforceable obligations to insure each other.

7. Nevertheless the deduction for the premium paid was not allowable as section 260 of the Income Tax Assessment Act applied to avoid the arrangement. Both the purpose and the effect of the transaction was to avoid paying income tax and the manner of implementing the arrangement in not declaring the premium received pointed to the intention to avoid paying tax.

8. In reaching its conclusion the Tribunal said that, subject to section 260, it would have allowed a deduction for the full amount of the premium as the decision to reduce the premium was not taken before the end of the financial year. Although not in issue before the Tribunal it also found that, subject to section 260, the premium received by the taxpayer from her husband was assessable income. On this view the transactions were self-cancelling and no tax saving was achieved.

RULING

9. Deductions for disability insurance premiums will not be allowed under sub-section 51(1) where parties to the arrangement do not intend to enter legally enforceable obligations nor where the arrangement constitutes a scheme to reduce income tax in terms of Part IVA of the Act. Factors which may indicate either or both of these situations include:-

(i) where the insurer and insured are in a non-arms length relationship;

(ii) where the insurer is not in the business of providing insurance;

(iii) where the amount of premium paid is excessive;

(iv) where the insurer does not have the assets to satisfy the insurance liability;

(v) where the premium is paid by book entry only;

(vi) where the amount of benefits provided greatly exceeds the taxpayer's usual income.

This list is not intended to be exhaustive.

10. Deductions for disability insurance premiums will, of course, continue to be allowed in the circumstances outlined in IT 208 and IT 2370 where there is a legitimate insurance agreement and the policy provides for the payment of periodic benefits of an income nature during the period of disability.

COMMISSIONER OF TAXATION
21 January 1988