IT 2504 - Income tax : deductibility of interest on borrowed funds - life assurance policies

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This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

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TAXATION RULING NO. IT 2504

INCOME TAX : DEDUCTIBILITY OF INTEREST ON BORROWED FUNDS - LIFE ASSURANCE POLICIES

F.O.I. EMBARGO: May be released

REF N.O. REF: 86/6592-3 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211413	INTEREST	25
	LIFE ASSURANCE POLICIES	26(i)
		26AH
		51(1)
		160AAB
		PART IVA

OTHER RULINGS ON TOPIC IT 155, 208, 2346, 2434

PREAMBLE This Ruling considers the question of whether interest payable on money borrowed to purchase life assurance policies is deductible under subsection 51(1) of the Income Tax Assessment Act (the Act). Section 26AH includes in assessable income certain bonuses received in the first 10 years of a policy. Bonuses are declared only on life assurance policies known as permanent insurances i.e., whole of life policies or endowment policies. Term or temporary life insurance policies do not entitle the holder to bonuses.

2. Bonuses received on a policy of life assurance are not income according to ordinary concepts and therefore do not constitute assessable income under subsection 25(1) of the Act. However, paragraph 26(i) of the Act provides that the assessable income of a taxpayer shall include any amount received as or by way of bonus - other than a reversionary bonus on a policy of life assurance.

3. Subject to certain qualifications, section 26AH provides that where, during the period of 10 years from the date of commencement of risk of a policy of life assurance, a taxpayer receives an amount under the policy as, or by way of, bonus which would not otherwise be included in the assessable income of the taxpayer, the assessable income of the taxpayer shall include the full bonus if it is received in the first eight years, two-thirds of the bonus if received in the ninth year and one-third of the bonus if received in the tenth year.
The effect of section 26AH is that reversionary bonuses received within 10 years from the date of commencement of risk of a policy are either wholly or partially included in assessable income. Where, however, reversionary bonuses are received more than 10 years from the date of commencement of the policy, they do not fall within the operation of section 26AH and are

therefore not included in assessable income.

4. In the case of a unit-linked life assurance policy, the policy holder is not entitled to a bonus but rather to the increase in unit value. As there is no bonus, paragraph 26(i) does not apply. However, subsection 26AH(9) deems the increase in unit value to be a bonus for the purposes of section 26AH. Where a unit-linked life assurance policy is held for more than 10 years and no amount is assessable income under section 26AH, the profit represented by the increase in the value of the units is considered to be of a capital nature and not assessable income according to ordinary concepts. Moreover, where the original beneficial owner makes a profit or loss on the disposal of a life assurance policy or any right under or interest in such a policy, subsections 160ZZI(2) and (3) have the effect that the capital gains provisions do not apply.

RULING

5. Subject to the exceptions in Taxation Rulings Nos. IT 155 (key man insurance) and IT 2434 (split dollar insurance), interest on money borrowed to meet premiums on a life assurance policy is not an allowable income tax deduction under subsection 51(1) of the Act. This is so whether the policy is for a term of more or less than 10 years or, in the case of a policy which has a term of at least 10 years, it is purchased with the intention of being surrendered before the tenth year.

6. Subsection 51(1) requires that expenditure be incurred in gaining or producing assessable income or that it be necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. In FCT v D.P. Smith 81 ATC 4114; 11 ATR 538 the High Court of Australia (particularly Gibbs CJ and Stephen, Mason & Wilson JJ) said at page 4117, 542:

> "The section does not require that the purpose of the expenditure shall be the gaining of the income of that year, so long as it was made in the given year and is incidental and relevant to the operations or activities regularly carried on for the production of income. What is incidental and relevant in the sense mentioned falls to be determined not by reference to the certainty or likelihood of the outgoing resulting in the generation of income but to its nature and character and generally to its connection with the operations which more directly gain or produce the assessable income."

In other words, while it is not necessary that an outgoing actually result in production of assessable income in the year in which it is incurred, there must still be a connection between the expenditure and "the operations which more directly gain or produce the assessable income".

7. The High Court's test is not satisfied in the present circumstances. While there is a connection between the interest and the life assurance policy, the expenditure on premiums does not necessarily gain or produce income. Neither is the expenditure incidental and relevant to any operations or activities regularly carried on by a taxpayer for the production

of income. Bonuses on a life assurance policy do not constitute income according to ordinary concepts. They constitute assessable income only to the extent indicated at paragraphs 2 to 4 above. Moreover, amounts received under life assurance policies are not included in the assessable income of a taxpayer by section 26AH if they are received as a result of the death of, or an accident, illness or other disability suffered by the person on whose life the policy was effected (paragraph 26AH(7)(a)). In addition, there is no assessable income if an amount is received as a result of the forfeiture, surrender or other termination of the whole or a part of a policy in circumstances arising out of serious financial difficulties of the taxpayer, unless the policy was effected, purchased or taken on assignment with a view to it being forfeited, surrendered or otherwise terminated, or to it maturing, within 10 years (paragraph 26AH(7)(c)).

8. In the case of a policy for a term of 10 years or more, no liability to taxation arises if the policy holder fails to exercise his or her right to early surrender or forfeiture and therefore allows the policy to run its full term. In those circumstances it could not be accepted that the taxpayer's declaration of intention at the time of taking out the policy would be conclusive for income tax purposes. Such a declaration would not be binding on the taxpayer who might change plans from time to time.

9. In any case, the subjective intention or purpose of the taxpayer is not sufficient to satisfy the test of deductibility; it is to the objectively ascertained essential character of the expenditure that one must look: Lunney v F.C. of T, Hayley v F.C. of T (1958) 100 CLR 478; Ure v F.C. of T 81 ATC 4100; 11 ATR 484. The inclusion in a loan agreement of a condition that partial encashment of the relevant assurance policy may be used to meet all or part of the interest liability arising under the loan does not alter this proposition.

10. Any connection between the payment of the interest and the possibility of gaining assessable income by way of bonus on the life assurance policy is too remote. In the words of the High Court in Ronpibon Tin N.L. and Tongkah Compound N.L. v FCT (1949) 78 CLR 47, at page 57 when considering subsection 51(1), "to come within the initial part of the subsection it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income".

11. Further, if deductibility of interest is to be determined by looking to "the objects or advantages which the application and use of the borrowed moneys were intended to gain" (Ure supra), the objects or advantages intended to be gained where loan monies are used to pay premiums is, prima facie, the purchase of a life assurance policy. This is not a use for the purpose of producing assessable income - see paragraphs 7 to 10 above.

12. There is an additional reason which militates against the

allowance of a deduction for interest expenses in these cases. In discussing deductibility of interest in Ure v FCT 81 ATC 4100; 11 ATR 484 Brennan J said at page 4104, 488:

> "An outgoing of interest may be incidental and relevant to the gaining of assessable income where the borrowed money is laid out for the purpose of gaining that income (F.C. of T. v. Munro (1926) 38 CLR 153 at pp.170, 171, 197; Texas Co. (Australasia) Ltd. v. FCT (1940) 63 CLR 382 at p.468). The laying out of the borrowed money for the purpose of gaining assessable income furnishes the required connection between the interest paid upon it by the taxpayer and the income derived by him from its use."

Brennan J added that he was not equating 'purpose' with a 'subjective motive' but rather purpose was to be judged objectively having regard to "what the taxpayer in the circumstances of the case is ascertained to have done in using and arranging for the use of the borrowed moneys". For instance, interest on loan funds used for a purpose of a private nature, such as for the purchase of the borrower's home, is not an allowable income tax deduction. The situation of interest on loans to pay premiums on a life assurance policy is analogous.

13. While the term "life assurance policy" is not defined in the Income Tax Assessment Act, it is defined in section 4 of the Life Insurance Act 1945 as "a policy insuring payment of money on death (not being death by accident or specified sickness only) or on the happening of any contingency dependent on the termination or continuance of human life". That definition reflects the common law meaning of life assurance policy: Gould v Curtis [1913] 3 KB 84, NMLA v F.C. of T (1959) 102 CLR 29. A life assurance policy effected by the policy holder on his or her life for the payment of a sum to the policy holder or a nominated beneficiary constitutes an arrangement of a private nature. Accordingly, any expenditure related to it whether by way of interest, management charges or premiums, is an outgoing of a private nature and thus is not an allowable income tax deduction under subsection 51(1).

14. The question of whether the private nature of expenditure overrides deductibility even though it might be said to have been incurred in deriving assessable income was discussed by K.W. Ryan in Manual of the Law of Income Tax In Australia, 5th Edition, Law Book Company, 1980, p. 133 as follows:

> "Losses and outgoings to the extent to which they are of a private or domestic nature are not allowable deductions, even though they satisfy the primary requirement of s.51(1) in that they were incurred in earning the assessable income. Of course, if they do not satisfy that requirement a fortiori they are not deductible. Thus, for example, expenditure by a professional man on doctors bills to keep him fit to carry on his profession is not deductible by virtue of s. 51(1), (Norman v Golder [1945] 1 All E.R. 352) nor are payments by a territorial officer to batmen or for mess expenses (Lomax v. Newton [1953] 1 W.L.R. 1128; [1953]

2 All E.R. 801). In these two instances, the expenditure would be disallowed both because it was of a private nature and because it was not incurred in the course of earning the assessable income."

Likewise, interest on loan funds used to pay premiums on a policy of life assurance is not deductible because it is expenditure of a private nature and it is not incurred in the course of earning assessable income - see paragraphs 7 to 10 and 13 above.

15. Even where the arrangement is such that a taxpayer is to definitely receive bonuses before 10 years (e.g., a short-term non-renewable policy of 1 to 9 years), it is considered that the essential nature and character of the expenditure on premiums - and interest - is still of a private nature.

16. The private nature of expenditure on policies of permanent insurance may be contrasted with the costs of a policy acquired by an employer on the life of a key employee where the policy is effected for income producing purposes. Such arrangements are known as 'key employee' and 'split dollar' insurances and are dealt with in Taxation Rulings Nos. IT 155 and 2434 respectively. Deductions for premiums paid are allowed in accordance with those Rulings on the basis that they are made to obtain term or temporary insurance. Any proceeds received in consequence of the premiums paid under these arrangements are assessable under subsection 25(1). Interest on money borrowed to pay premiums is deductible to the same extent that premiums are deductible - see paragraph 25, Taxation Ruling No. IT 2434.

17. In addition to the usual situation of an independent borrowing to invest in a life insurance policy, which is covered in the previous paragraphs, and without in any way limiting what has been said there, special consideration needs to be given to certain arrangements involving single premium life insurance policies of a kind commonly referred to as "insurance bonds" that have been marketed with the apparent object of securing taxation benefits from the use of loan moneys. Some of the more common features of the arrangements are:

- a loan is taken out for an amount equal to the whole or a large part of the value of the life assurance policy acquired;
- the policy is used as security against the loan;
- the loan is taken out for a period equivalent to the term of the policy (which in most cases does not exceed 8 years);
- the policy may be used to pay out the loan at any time at the discretion of the lender or the borrower; and
- partial surrender of the policy may be used to meet part or all of the interest payments to the lender.

The incidence of high level borrowings in these arrangements is a predetermined, integral and related part of the transactions. Significant taxation benefits are claimed to be available from the deduction of the interest payments and the entitlement to section 160AAB rebates in respect of bonuses included in assessable income under section 26AH. For example, an individual on the top marginal tax rate is claimed to be able to deduct the interest and thereby obtain a tax saving of 49 cents in the dollar whereas the bonuses are claimed to be assessable at the rate of 20 cents in the dollar because section 160AAB gives a 29 cents in the dollar rebate (up to the year ended 30 June 1989). The arrangements being marketed generally place heavy emphasis on these taxation benefits which, it is claimed, can be obtained often without any, or minimal, cash outlays by the policy holder over the term of the policy. Interest paid under these arrangements is not accepted as being deductible. In addition to the reasons set out in relation to the straightforward cases where independent borrowings are made to invest in life assurance policies, this latter category of case also raises a question as to whether Part IVA applies.

COMMISSIONER OF TAXATION
3 November 1988