CR 2002/57 - Income tax: Colonial Mutual Life Assurance Society Limited - Income Care Policy

Class Ruling
Income tax: Colonial Mutual Life Assurance Society Limited – Income Care Policy

Contents Para

Preamble

*The number, subject heading, and the **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains Class Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

2. Broadly, this ruling addresses issues relating to the 'Income Care' policy ('the Policy') offered by Colonial Mutual Life Assurance Society Limited ('Colonial') being a personal disability insurance policy. Specifically these issues are whether the premiums paid under the Policy are deductible and proceeds assessable with particular emphasis given to the 'No Claim Option' that is available under the Policy.

3. This ruling offers no opinion on the abovementioned issues as they might relate to the other options which might be selected under the Policy. These options are known as the 'Increasing Claim Option', 'Accident Option', 'Super Continuance Option', and 'Business Overheads cover'.

Tax law(s)

4. The tax law(s) dealt with in this Ruling are:

- Subsection 25(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- Subsection 51(1) (ITAA 1936);
- Section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');

- Section 8-1 (ITAA 1997);
- Subdivision 20-A (ITAA 1997).

Class of persons

5. The class of persons to which this Ruling applies is those individuals (being self employed or employees) who have taken out the Policy in order to replace a proportion of their own income where that individual suffers a sickness or injury and cannot work.

Qualifications

6. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

7. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is carried out in accordance with the the arrangement described below at paragraphs 11 to 16 in this Ruling.

8. If the arrangement actually carried out is materially different from the arrangement that is described in this ruling:

(a) this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled; and

(b) this Ruling may be withdrawn or modified.

Date of effect

10. This ruling applies to the year of income ended 30 June 2002 and all subsequent years of income. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of

settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 to 22 of Taxation Ruling TR 92/20). Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the Gazette;
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Arrangement

11. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- correspondence from the applicant on behalf of Colonial dated 11 March 2002;
- appendix one being a one page description of the No Claim Option (attached to the abovementioned correspondence dated 11 March 2002);
- appendix two being a 16 page copy of the Policy document titled 'Income Care-Business Overheads Cover' (attached to the abovementioned correspondence dated 11 March 2002); and
- correspondence from the applicant on behalf of Colonial dated 5 June 2002.

12. As part of its insurance business, Colonial offers a policy named 'Income Care'. The Policy is designed to replace a proportion of a policy holder's income where that person suffers a sickness or injury and cannot work.

13. The Policy offers a number of benefits which differ based on whether the policy holder is claiming a benefit for 'Total Disability' or 'Partial Disability'. These terms are defined in the Policy document.

14. All benefits under the Policy are paid on a monthly basis.

15. Colonial has included an additional option to the Policy known as the 'No Claim Option'. This option is designed so that where no claim is made under the Policy, Colonial will on cessation of the Policy, refund to the policy holder a percentage of all premiums (including policy fees and frequency charges) which have been paid

under the Policy and which have not otherwise been refunded. The percentage of premiums which are refunded under this option will be calculated by reference to the number of complete years between the date the option is taken out and the date of cessation of the Policy.

16. Therefore the contingencies on which the No Claim Option is payable are: the continuance of the Policy and the No Claim Option for a period, and for no claim to be made on the Policy during the period.

Ruling

17. Premiums paid under the Income Care part of the Policy (i.e., not including the additional premium payable for the No Claim Option or any other option) are considered to be a deductible loss or outgoing in terms of section 8-1 of the ITAA 1997.

18. Benefits received under the Income Care part of the Policy are considered to be assessable income in terms of section 6-5 of the ITAA 1997.

19. Any premiums refunded under the No Claim Option that equate in any way to a proportion of the premiums actually paid for that option are not considered to be assessable income in terms of section 6-5.

20. Where the No Claim option is selected, additional premiums payable for that option are not considered to be a deductible loss or outgoing in terms of section 8-1.

21. Any premiums refunded under the No Claim Option that relates to premiums for the Income Care part of this Policy for which a deduction has been allowed or is allowable in terms of section 8-1 are considered to be an assessable recoupment in terms of Subdivision 20-A of the ITAA 1997.

Explanations

Deductibility of premiums for personal accident/sickness policies

22. It is well established that premiums paid in respect of personal disability insurance policies which provide for payment of periodic benefits of an income nature during a period of incapacity are deductible to the policy holder.

23. Generally, the question of whether a premium is deductible is answered by reference to whether the benefits when paid would become assessable. In the leading decision of *FC of T v. D.P. Smith*

81 ATC 4114; 11 ATR 538, the High Court was unanimous on this point. In discussing the operation of section 51 of the ITAA 1936, Gibbs, Stephen, Mason and Wilson JJ held that:

> *'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. It is true that the payment of the premium… did not result in the generation of any income in that year, but there is a sufficient connection between the purchase of the cover against the loss of ability to earn and the consequent earning of assessable income to bring the premium within the first limb of sec. 51(1)'.*

24. In his separate judgement, Murphy J simply stated that:

> *'In general, if receipts under such a policy would be treated as income, the premiums should be treated as allowable expenditure, and if the receipts would be treated as capital the premiums should not be allowable expenditure'.*

25. This decision was applied by the Taxation Board of Review in *Case T8* 86 ATC 158, where the board held that as the income payable under illness and disability policies would have been assessable when paid, the premiums were deductible pursuant to subsection 51(1). The Commissioner of Taxation ('the Commissioner') in Income Tax Ruling IT 2370 stated (at para 6) that:

> *'once it is established that the benefits payable under the policies would be assessable in Australia, the decision to allow the premiums as deductions under subsection 51(1) is seen to accord with the direction contained in paragraph 8 of Taxation Ruling IT 208. Deductions should be allowed for premiums in respect of personal disability policies providing for payment of periodic benefits of an income nature where those benefits would be assessable in Australia'.*

26. Since the Policy offered by Colonial provides for payment of periodic benefits of an income nature during a period of incapacity (assessable under section 6-5 of the ITAA 1997), the Policy can be regarded as a personal disability insurance policy, the premiums of which are deductible to the policy holder in terms of section 8-1.

Apportionment/ No Claim Option

27. Section 8-1 of the ITAA 1997 provides however that losses and outgoings are deductible to the extent to which they are incurred in earning assessable income or carrying on a business for that purpose.

28. Similarly, losses and outgoings are not deductible to the extent they are capital or private in nature, or are incurred in relation to earning exempt income. Accordingly the section allows for apportionment between the deductible and non-deductible components of a loss or outgoing. The appropriate method of apportionment will depend on the facts of each case. However, the method adopted in any particular case must be both 'fair and reasonable' in all the circumstances: *Ronpibon Tin NL v FCT* 78 CLR 47; 4 AITR 236. Income Tax Ruling IT 155 supports this view.

29. In the present case the No Claim option is an additional component of the Policy which is not compulsory, which is contracted under separate and severable terms, which is paid for under separate consideration (that is, an additional premium), and any benefits paid under the option are calculated separately and are severable from the advantages claimed for sickness and accident under the Income Care part of the Policy.

30. A refund of additional premiums payable under the No Claim Option would be a single lump sum payment in respect of successful fulfilment of two contingencies, being that the Policy remain on foot and that no claim be made on that Policy at the point where the No Claim Option refund premium is paid. The payment is not periodical, is not received on successful fulfilment of a contingency which relates to the production of assessable income, and is in no way paid to fill the place of any lost earnings or revenue receipts.

31. On this basis, a refund of the additional premiums paid under the No Claim Option would not be received by an individual on revenue account and, based on the once off non-periodical nature of the payment, would be regarded as a non assessable capital receipt. Accordingly, based on the aforementioned analysis, as any refund of additional premiums paid under the No Claim Option is not assessable, the payment of the additional premium in respect of the No Claim Option is correspondingly not deductible to the taxpayer. That is, an apportionment of the total premium paid in any year must be made as no deduction is allowable for the amount of the additional premium paid to fund the No Claim Option.

Assessable Recoupment

32. Subdivision 20-A of the ITAA 1997 operates to include in the assessable income of a taxpayer amounts received as recoupment for

certain previously deducted losses or outgoings. For this subdivision to operate there must be an 'assessable recoupment'. Subsection 20-20(2) states as follows:

> '*An amount you have received as recoupment of a loss or outgoing is an assessable recoupment if:*
>
> *(a) you received the amount by way of insurance or indemnity; and*
>
> *(b) you can deduct an amount for the loss or outgoing for the current year, or you have deducted or can deduct an amount for it for an earlier year, under any provision of this Act'.*

33. 'Recoupment' of a loss or outgoing is broadly defined in section 20-25 to include any kind of recoupment, reimbursement, refund, insurance, indemnity or recovery, however described or a grant in respect of the loss or outgoing.

34. As such, it is clear that the proportion of any premiums refunded under the No Claim Option that relates to premiums for the Income Care part of the Policy for which a deduction has been allowed or is allowable are assessable recoupments, and therefore included in assessable income. That is, under the terms of the Policy a policy holder could potentially receive a refund of premiums that is over and above the total amount they have paid for the No Claim Option. As this excess relates to premiums for the Income Care part of the Policy for which a deduction has been allowed or is allowable, the amount received by the policy holder is an assessable recoupment.

Detailed contents list

35. Below is a detailed contents list for this Class Ruling:

Commissioner of Taxation
28 August 2002

Previous draft:
Not previously released in draft form

Related Rulings/Determinations:
CR 2001/1; TR 92/1; TR 92/20; TR 97/16; IT 155; ;IT 208; IT 2370

Subject references:
- accident & disability insurance expenses
- assessable income
- income protection insurance

Legislative references:
- ITAA 1936 25(1)
- ITAA 1936 51
- ITAA 1936 51(1)
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Subdiv 20-A
- ITAA 1997 20-20(2)
- ITAA 1997 20-25
- TAA 1953 Pt IVAAA
- Copyright Act 1968

Case references:
- FC of T v. D.P. Smith 81 ATC 4114; 11 ATR 538
- Case T8 86 ATC 158
- Ronpibon Tin NL v. FCT 78 CLR 47; 4 AITR 236

ATO References
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