IT 155 - Key man insurance - assessability of proceeds and deductibility of premiums

TAXATION RULING NO. IT 155

KEY MAN INSURANCE - ASSESSABILITY OF PROCEEDS AND DEDUCTIBILITY OF PREMIUMS

F.O.I. EMBARGO: May be released

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	ASSESSABILITY OF PROCEEDS	51(1)
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PREAMBLE Consideration was given to the taxation aspects of "Key Man" Insurance.

2. Advice was sought as to the tests that would be applied by the taxation administration in determining whether premiums would qualify for deduction under section 51 of the Act and whether insurance proceeds would constitute assessable income. The cause of the enquiry was a view that, as a consequence of the judgment of the High Court in Carapark Holdings Ltd v FC of T, (1966) 115 CLR 653, a new test would have to be substituted for the one normally applied in determining such questions.

FACTS 3. The term "key man" insurance is used in the industry to denote insurance on the life of a director, partner, employer or other "key" person associated with the taxpayer in business. The types of policies involved are whole of life, endowment, term (or temporary) life assurance, sickness and accident insurance.

4. As evidenced by the rulings in paragraphs 4 to 6 of CITCM 789, it has been the practice in relation to insurance policies taken out by employers in respect of their employees to -

(a) treat the premiums as non-deductible under section 51 and the proceeds as non-assessable if a life policy is involved; and

(b) treat the premiums as deductible under section 51 and the proceeds as assessable income if an accident or term policy is involved.

5. In the Carapark Holdings case, it was held that an insurance payment received by the taxpayer as policy holder following the accidental death of a subsidiary company's employee constituted assessable income of the taxpayer. As an

accident policy was involved, the decision itself is not an impediment to the continued application of the established practice but, in reaching its decision, the Court carefully considered the facts in order to determine the purpose for which the taxpayer entered into the insurance contract.

RULING 6. A review of this and other relevant cases led to the conclusion that there is no cause to depart from the practice of treating premiums on life (and endowment) policies as being non-deductible under section 51 and the proceeds as non-assessable. The ruling in paragraph 6 of the Circular Memorandum is qualified to this extent.

7. In deciding whether the proceeds of an accident or term policy are assessable income under section 25 of the Act it would be appropriate to work on the broad proposition, as the High Court did in the Carapark Holdings case, that -

> " ... in general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt which the event insured against has prevented from arising or of any outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by consideration of morality or expediency."

The proposition may also be used as a basis for the determination of claims for the deduction of premiums under section 51.

8. The comments in paragraph 4 to 7 of this ruling relate particularly to insurances taken out by employers in respect of employees but, generally speaking, they may be read as applying also to insurances taken out by companies, in respect of another or by a taxpayer in respect of a person otherwise associated with him in business.

9. Examples of situations in which premiums on accident or term policies would not be deductible under section 51 and the proceeds would not represent income are -

(a) insurance taken out by a company in respect of a director for the purpose of providing, in the event of death by accident, funds for the payment to his estate of a debt owing to the director (see 3 NZ TBRD Case 9);

(b) insurance taken out by one partner in respect of another for the purpose of providing in the event of the other partner's death by accident, funds to buy out his estate's interest in the partnership; and

(c) insurance taken out by a manufacturer in respect of a supplier of components for the purpose of

providing, in the event of the supplier's death by accident, funds to buy the supplier's business.

10. With regard to the type of evidence which would be required to establish the purpose for which an accident or term insurance policy has been effected and kept in force, information about the taxpayer's minutes or book entries would be of some value but should not necessarily be regarded as conclusive. As indicated in the Carapark Holdings case, all the surrounding circumstances may properly be taken into account in seeking to determine the purpose for which a policy was effected. The purpose for which the proceeds are used is relevant not because this governs the issue directly but because it provides some indication of what the purpose of taking out the policy is likely to have been.

11. It could not be conceded that any particular method of declaring the taxpayer's intentions in advance would be conclusive for income tax purposes. Apart from anything else, the taxpayer might change his plans from time to time and renew the same policy from year to year for varying purposes. For example, a company that has received an insurance payment as a consequence of the death of a director may contend that the insurance was taken out for the purpose mentioned in example (a) in paragraph 9 even though no debt was owing to the director when the proceeds were received. This type of situation would call for enquiries to ascertain whether the debt was in existence at the time of the latest renewal. If the debt had been cleared beforehand, evidence such as minutes indicating that the insurance was originally taken out for the purpose stated by the company could be discounted as being irrelevant in the changed circumstances.

12. As a general rule, it will be necessary when the question of allowing deductions for premiums is under consideration to make special efforts to determine the purpose for which the insurance was taken out. For instance, if the taxpayer made a firm declaration of his purposes at the time of paying a particular premium in respect of an accident or term policy and those purposes were such as to make the proceeds of the policy assessable in accordance with the principles explained in the Carapark Holdings case, it would be accepted in the absence of exceptional circumstances that the premiums were allowable as deductions. These are not the only circumstances, however, in which claims may be admitted without seeking further information. There could be odd cases in which it would be appropriate to look for the true purpose before allowing a claim for a deduction (e.g. where a comparatively large premium is claimed and there are grounds for assuming that the taxpayer may be able to establish that any proceeds received would be on capital account) but this exercise could usually be left until such time as a taxpayer has received a payment and claimed that it does not represent assessable income.

13. Life policies are sometimes issued with a term, accident and/or sickness rider. In such cases, the premiums are to be treated as being wholly for life assurance unless they are

readily divisible as being applicable to (a) life assurance and (b) term, accident or sickness benefits. Where a premium is so divisible, the amount applicable to life cover should be treated as non-deductible and the question whether the balance is allowable should be determined according to the purpose for which the term, accident or sickness cover was taken out.

14. As the comments in this ruling concerning the deductibility of premiums deal only with the position under section 51, the possibility that some other provision of the Act might be relevant should not be overlooked when considering claims for deductions. In example (b) in paragraph 9 for instance, the premium would not be deductible under section 51 but would qualify under section 82H if the partners happened to be husband and wife or parent and child. On the other hand, if a premium were paid in circumstances calling for consideration of its deductibility under section 82AAC and the conditions for deduction under that provision were not satisfied, the premium should not be allowed as a deduction under section 51. Even if it could be regarded as deductible on the basis of the proposition mentioned in paragraph 7, section 82AAR would operate in a situation of this type to preclude the allowance of a deduction under section 51.

15. The comments concerning the assessability of insurance proceeds deal only with the question whether, in relation to the application of section 25, amounts received as lump sums constitute receipts of income according to general concepts. The terms of section 26(j) also require consideration, of course, in determining whether insurance proceeds are assessable. Periodical payments under accident insurance policies should be treated as assessable income irrespective of the purpose for which the policy may have been taken out.

COMMISSIONER OF TAXATION