CR 2005/15 - Income tax: Colonial Mutual Life Assurance Society Limited - Income Care Policy with Cash Back Option and TTD/TPD Option

Class Ruling

Income tax: Colonial Mutual Life Assurance Society Limited – Income Care Policy with Cash Back Option and TTD/TPD Option

Contents Para

Preamble

*The number, subject heading, **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, the issues are whether the premiums paid under the policy are deductible and proceeds assessable, with particular emphasis given to the 'Cash Back Option', and the 'Total Temporary Disablement Cover Option' (TTD Cover Option) and the 'Total & Permanent Disability Cover Option' (TPD Cover Option).

3. This Ruling offers no opinion on the abovementioned issues as they might relate to benefits received under the 'Reward Cover Benefit' or 'Rehabilitation Benefit'. Additionally, no opinion is offered on the 'Increasing Claim Option', 'Accident Option', 'Super Continuance Option', 'Premium Saver Option', and 'Business Overheads Cover'.

Tax law(s)

4. The tax laws dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 of the ITAA 1997;

- Subdivision 20-A of the ITAA 1997;
- paragraph 118-37(1)(b) of the ITAA 1997; and
- subsection 51(1) of the *Income Tax Assessment Act 1936* (ITAA 1936).

Class of persons

5. The class of persons to which this Ruling applies is those individuals who have taken out the Policy and have elected to have the TPD Cover Option and/or elected to have the Cash Back Option apply.

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 arrangement described in paragraphs 11 to 20.

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

- 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
- this Ruling may be withdrawn or modified.

Date of effect

10. This Ruling applies to the year of income ended 30 June 2005 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 this 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 Greenwoods & Freehills Pty Limited on behalf of Colonial, being the application for Class Ruling dated 2 December 2004;
- Appendix One, being a one page description of the Benefits and Options applicable to the Policy (attached to the abovementioned correspondence dated 2 December 2004); and
- a 22 page copy of the Policy document titled 'Income Care Policy Document (with TTD and TPD options)' (attached to the abovementioned correspondence dated 2 December 2004).

12. Colonial offers a policy named 'Income Care'. The Policy is designed to replace a proportion of a policyholder's income where that person suffers a sickness or injury and cannot work.

13. The Policy offers a number of varied benefits based on whether the policyholder is claiming a benefit for 'Total Disability', 'Partial Disability' or 'Recurrent Disability'. These terms are defined in the Policy document.

14. Benefits under the Policy are calculated on a monthly basis.

15. Colonial has an option to the Policy known as the Cash Back Option, the terms of which are set out in the Policy document. This option is designed so that where no claim is made under the Policy Colonial will, on cessation of the Policy, refund to the policyholder a percentage of premiums 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 Cash Back Option is payable are:

- the continuance of the Policy and the Cash Back option for a period; and
- for no claim to be made on the Policy during the period.

17. Colonial also offers a TPD Cover Option in the Policy, the terms of which are set out in the Policy document. The TPD Cover Option is designed so that if a policyholder becomes totally and permanently disabled, as defined by the Policy, the policyholder receives the TPD Cover benefit in the form of a lump sum payment and the Policy will terminate. The amount payable is set out in the Policy Document, and is the lesser of the following amounts:

1. the amount which is 10 times the Annual Sum (the Annual Sum being 12 times the Monthly Benefit, which is detailed in the policyholder’s schedule); or
2. the amount calculated by:

   (65 – Age at TPD) $\times$ Annual Sum.

   If the calculation is a negative or nil amount, the TPD cover benefit is nil.

18. If the TPD Cover lump sum benefit becomes payable, no other benefits are payable under the Policy, whether in relation to the total and permanent disability suffered or for further sickness and injury suffered by the policyholder.

19. For the TPD Cover Option to be selected, a policyholder must first select the TTD Cover Option. Under the TTD Cover Option, a person who becomes disabled other than totally and permanently disabled, as defined by the Policy, is temporarily disabled. That is, if a person is disabled and not totally and permanently disabled, the person is temporarily disabled, and their disability benefits under the Policy remain payable to the extent that the person does not become totally and permanently disabled. However, if the TPD Cover Option is also selected they will be entitled to a lump sum benefit if they become totally and permanently disabled.

20. The premiums paid under the Policy are reduced where only the TTD Cover Option is selected without the TPD Cover Option as no TPD benefits arise. When the TPD Cover Option is selected the premiums under the policy then increase by the same amount they were reduced by under the TTD Cover Option.

Ruling

21. Proceeds received in respect of 'Total Disability', 'Partial Disability' or 'Recurrent Disability', herein referred to as the Income Care terms of the policy, by a policyholder under the Policy, excluding any TPD Cover Option lump sum benefit or Cash Back Option benefit, are assessable to the policyholder as ordinary income pursuant to section 6-5 of the ITAA 1997.

22. Premiums paid in respect of the policy, other than for the TPD Cover Option (but including where only the TTD Cover Option is selected) or Cash Back Option, are a deductible loss or outgoing in terms of section 8-1 of the ITAA 1997.

23. Any lump sum received pursuant to the TPD Cover Option of the policy is not included in the assessable income of the policyholder.

24. Where the TPD Cover Option is selected, additional premiums payable for that option are not a deductible loss or outgoing in terms of section 8-1 of the ITAA 1997.

25. Where the Cash Back Option is selected, additional premiums payable in respect of this option are also not a deductible loss or outgoing in terms of section 8-1 of the ITAA 1997.

26. That portion of any premiums refunded under the Cash Back Option that relates in any way to the premiums paid for that option or the TPD Cover Option is not included in the assessable income of the policyholder.

27. That portion of any premiums refunded under the Cash Back Option which relates to those premiums for which a deduction has been allowed or is allowable in terms of section 8-1 of the ITAA 1997 is an assessable recoupment in terms of Subdivision 20-A of the ITAA 1997.

Explanation

Proceeds received by a policyholder under the Policy (excluding any TPD Cover Option benefit or Cash Back Option benefit)

28. Subsection 6-5(2) of the ITAA 1997 provides that the assessable income of a resident taxpayer includes ordinary income derived directly or indirectly from all sources during the income year.

29. In Taxation Ruling IT 155, the Commissioner of Taxation (the Commissioner) states that proceeds received under the 'accident or term' component of a 'Key Man' insurance policy are assessable. The assessability of the proceeds was based on *Carapark Holdings Ltd v. FC of T* (1967) 115 CLR 653; (1967) 14 ATD 402; (1967) 40 ALJR 506, where the High Court stated at CLR 663; ATD 405; ALJR 509:

> …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.

30. Cases such as *FC of T v. Inkster* (1989) 24 FCR 53; (1989) 20 ATR 1516; 89 ATC 5142; *Tinkler v. FC of T* (1979) 10 ATR 411; 79 ATC 4641; and *Case Y47* (1991) 22 ATR 3422; 91 ATC 433 are further authorities that payments received in substitution for income are assessable.

31. Equally, payments made under the Policy, excluding the TPD Cover Option and Cash Back Option, are in substitution for income and are assessable under subsection 6-5(2) of the ITAA 1997 to the policyholder.

Deductibility of premiums paid by a policyholder in respect of the Policy (excluding the TPD Cover Option and the Cash Back Option)

32. 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* (1981) 147 CLR 578; (1981) 11 ATR 538; 81 ATC 4114 (*D.P. Smith*), the High Court was unanimous on this point. In discussing the operation of subsection 51(1) of the ITAA 1936 (being the equivalent of section 8-1 of the ITAA 1997), Gibbs, Stephen, Mason, and Wilson JJ held at CLR 585; ATR 542; ATC 4117 that:

> 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 in June 1978 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 s 51(1).

33. Murphy J delivered a separate judgment but concurred with the view of the majority of their Honours and stated at CLR 587; ATR 543; ATC 4118:

> 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.

34. *D.P. Smith* was applied by the Taxation Board of Review in *Case T8* 86 ATC 158; (1986) 29 CTBR (NS) *Case 11*, where it was 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) of the ITAA 1936.

35. As any benefits, excluding TPD Cover Option lump sum benefits and Cash Back Option benefits, would be assessable to the policyholder, any premiums paid by the policyholder, to the extent that they do not relate to the TPD Cover Option or the Cash Back Option, are deductible under section 8-1 of the ITAA 1997 as the premiums are incurred in 'gaining or producing' assessable income (being when the benefit, if at all, becomes payable).

Lump sum benefits received by a policyholder under the TPD Cover Option

36. The TPD Cover Option provides for a lump sum benefit for total and permanent disability as defined in the Policy document. The benefit is made for injury or illness suffered or sustained and not in substitution for loss of earnings. Accordingly, the benefit under the TPD Cover Option is a capital receipt and not assessable: *FC of T v. Slaven* (1984) 1 FCR 11; (1984) 15 ATR 242; 84 ATC 4077.

37. It should be noted that although a settlement of a personal injury claim normally constitutes a disposal of an asset, paragraph 118-37(1)(b) of the ITAA 1997 disregards payments received as compensation or damages for an injury or illness suffered.

38. Thus, an amount paid under the TPD Cover Option is not brought to tax either as ordinary income or as a capital gain.

Premiums paid by a policyholder relating to the TPD Cover Option

39. As discussed at paragraphs 32 to 35, generally, the question of whether a premium paid is deductible to a policyholder is determined by reference to whether the benefits paid under the policy are assessable income: *D.P. Smith*.

40. As a lump sum benefit paid to the policyholder under the TPD Cover Option is not assessable income (refer paragraphs 36 to 38), the premiums payable in this respect, are not deductible under section 8-1 of the ITAA 1997.

Premiums paid by a policyholder relating to the Cash Back Option

41. The deductibility of premiums is dependant on whether the benefits under the policy, would themselves constitute assessable income to the policyholder. This criterion was established by the High Court in *D.P. Smith* at CLR 586; ATR 542; ATC 4117: refer to paragraph 32.

42. In Class Ruling CR 2002/57, the Commissioner on ruling in respect of a 'No Claim Option' for a policy also offered by Colonial (which has similarities to the Cash Back Option) stated:

> 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.
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> 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...** (emphasis added)

43. Though the terms of the Cash Back Option differ in one aspect only, being the percentage refunded to the policyholder so that refunds apply after three years, an identical outcome is appropriate. That is, additional premiums to fund the Cash Back Option are not deductible.

Assessable recoupment of premiums paid in relation to the Policy other than the TPD Cover Option and the Cash Back Option

44. 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) of the ITAA 1997 defines 'assessable recoupment' 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 income year, under any provision of this Act.

45. ‘Recoupment’ of a loss or outgoing is broadly defined in subsection 20-25(1) of the ITAA 1997 to include any kind of reimbursement, refund, insurance, indemnity or recovery or grant in respect of the loss or outgoing.

46. As such, it is clear from the legislation that the portion of the refunded premium paid under the Cash Back Option which relates to previously deducted premiums paid under the Policy (being premiums paid other than for the TPD Cover Option or the Cash Back Option) by a policyholder are assessable recoupments, and therefore included in the assessable income of the policyholder in the year in which they are recouped.

Assessable recoupment of premiums paid in respect of the TPD Cover Option and the Cash Back Option

47. As noted at paragraphs 44 to 46, Subdivision 20-A of the ITAA 1997 will operate to render a previously deducted premium assessable if it is recouped. However, as has been examined at paragraphs 39 to 43, premiums paid in respect of the TPD Cover Option and the Cash Back Option are not deductible. Accordingly, the requirement in paragraph 20-20(2)(b) of the ITAA 1997 that the amount received as a recoupment must have previously been deductible is not satisfied. Any refunded premiums paid in respect of the TPD Cover Option or the Cash Back Option will not constitute an assessable recoupment and will, therefore, not be assessable income to the policyholder.

Apportionment of deductible and non-deductible amounts

48. In determining whether the bundling of deductible and non-deductible premiums into a single policy will impact upon deductibility overall, the issue of apportionment is an important one.

49. A helpful starting point when dealing with the issue of apportionment is to consider the leading High Court case in *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47; (1949) 8 ATD 431 where it was held at CLR 59; ATD 437:

> It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of the things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other course. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kinds of apportionable items consist of those involving a single outlay or charge which serves both objects... With the latter kind there must be some fair and reasonable assessment of the extent of the relationship of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects. In such a case the result must depend in an even degree upon a finding by the Tribunal of fact.

50. In *Commissioner of Taxation v. Firth* (2002) 120 FCR 450; (2002) 50 ATR 1; 2002 ATC 4346 the issue of apportionment was revisited. The Court, in applying the principle in Ronpibon stated at FCR 457; ATR 7; ATC 4351:

> The question, what the expenditure which the taxpayer sought to deduct in Ronpibon was for, was clearly answered in that case. For example, one item was directors fees paid for the services provided by the directors. That question having been answered, the statutory question which required apportionment in Ronpibon was the extent to which the expenditure sought to be claimed as a deduction related to assessable income. That apportionment was required to be made on the basis of what was a fair and reasonable apportionment of the sum claimed so as to determine the extent of the outgoing so far as it related to that part of the taxpayer's business which was directed at the gaining of assessable income (which was deductible) and the extent of the outgoing so far as it related to that part of the taxpayer's business which was directed at gaining exempt income (or none at all, where the business had, in effect, ceased). In the present case the Commissioner wishes to apportion at the earliest stage, namely at the stage of identifying what the expenditure was for in a case where the parties had not contracted for separate advantages but for a single, undissectable advantage. No doubt where parties to an agreement do contract for severable advantages and for separate considerations an apportionment will be possible with the result that a deduction will only be available for that consideration or that part of the consideration that relates to an advantage of a revenue nature which fulfils the criteria for deductibility under section 8-1. But whether the contract is severable or indivisible and thus whether an apportionment is required or not will depend upon the terms of the contract and the nature of the advantage to be gained under it.

51. In the present circumstances, the TPD Cover Option is an additional component of the Policy contracted under separate and severable terms, and is paid for under separate consideration (that is, as an additional component of the premium paid under the Policy). Any benefits paid under the option are calculated separately and are severable from the advantages claimed for under the non-TPD Cover Option component of the Policy. Likewise, the Cash Back Option is an additional component of the Policy contracted under separate and severable terms and is paid for under separate consideration. Benefits received (being a percentage refund of premiums) are calculated separately from the Income Care terms of the Policy.

52. Therefore, as the Policy offers:

- an assessable benefit in the form of periodic payments of an income nature during a period of incapacity;
- an assessable benefit in the form of refunded premiums paid under the Cash Back Option of the Policy which relates to deductible premiums paid under the Policy;

- a non-assessable benefit in the form of a lump sum payment upon the policyholder electing to exercise the TPD Cover Option; and
- a non-assessable benefit in the form of any refunded premiums paid under the Cash Back Option which relate to premiums paid for the TPD Cover Option or the Cash Back Option,

an apportionment is to be made to allow premiums paid in respect of the assessable benefits paid under the policy to be deductible whereas premiums paid in respect of the non-assessable benefits are to be non-deductible.

Detailed contents list

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

Commissioner of Taxation
30 March 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

CR 2001/1; CR 2002/57; TR 92/1; TR 92/20; TR 97/16; IT 155

Subject references:

- accident & disability insurance
- assessable income
- expenses
- income protection insurance

Legislative references:

- Copyright Act 1968
- TAA 1953 Pt IVAAA
- ITAA 1936 51(1)
- ITAA 1997 6-5
- ITAA 1997 6-5(2)
- ITAA 1997 8-1
- ITAA 1997 Subdiv 20-A
- ITAA 1997 20-20(2)
- ITAA 1997 20-20(2)(b)
- ITAA 1997 20-25(1)
- ITAA 1997 118-37(1)(b)

Case references:

- Carapark Holdings Ltd v. FC of T (1967) 115 CLR 653; (1967) 14 ATD 402; (1967) 40 ALJR 506
- Case T8 86 ATC 158; (1986) 29 CTBR (NS) Case 11
- Case Y47 (1991) 22 ATR 3422; 91 ATC 433
- Commissioner of Taxation v. Firth (2002) 120 FCR 450; (2002) 50 ATR 1; 2002 ATC 4346
- FC of T v. D.P. Smith (1981) 147 CLR 578; (1981) 11 ATR 538; 81 ATC 4114
- FC of T v. Inkster (1989) 24 FCR 53; (1989) 20 ATR 1516; 89 ATC 5142
- FC of T v. Slaven (1984) 1 FCR 11; (1984) 15 ATR 242; 84 ATC 4077
- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47; (1949) 8 ATD 431
- Tinkler v. FC of T (1979) 10 ATR 411; 79 ATC 4641

ATO references
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