IT 2434 - Income tax : split dollar insurance arrangements

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TAXATION RULING NO. IT 2434

INCOME TAX : SPLIT DOLLAR INSURANCE ARRANGEMENTS

F.O.I. EMBARGO: May be released

REF N.O. REF: 86/11420-8 DATE OF EFFECT: Immediate

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

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1206522	SPLIT DOLLAR INSURANCE	25(1) 51(1)

PREAMBLE Advice has been sought from this Office on the income tax consequences attaching to an insurance arrangement commonly known as a "split dollar" arrangement. The principal areas of concern are the extent to which both income tax deductions are allowable for premiums paid and the proceeds are assessable income.

2. A "split dollar" arrangement generally involves either a whole of life policy or an endowment policy, both of which are known as permanent insurances and which comprise two components, viz. a risk and an investment or savings component. The risk insurance component ensures the payment of a sum certain on the death of the insured or on the insured reaching a specified age. The investment component is related to the amount of premiums paid in respect of that component and the earning rate of the premiums as reflected by reversionary bonuses declared by the insurance company.

3. A "split dollar" arrangement is said to arise when two or more parties agree in writing to share the benefits provided by a whole of life or an endowment insurance policy. The parties also agree to share the premiums payable on the policy on the basis of the benefits each obtains under the agreement. In other words, the parties agree to "split" between them the benefits and the premiums payable in connection with the insurance policy involved. The agreement between the parties is necessary to overcome the fact that the Life Insurance Act does not recognise a partial or limited assignment of a life insurance policy.

4. It would appear that "split dollar" arrangements are mainly used by employers and employees. In general, the employer takes out a permanent insurance policy on the life of an employee and the parties then enter into an agreement for the division of any benefits becoming payable under the policy. The employee is usually said to be a "key man" i.e. a person who has important status in the employer's business such as an executive director. Usually the employer is entitled to a fixed amount on death of the life insured prior to a stipulated age and all other benefits emerging from the policy are those of the

employee.

5. The life insurance company issuing the policy indicates the amount of premium applicable to the benefits to be obtained by each party. Apportionment of the premium is generally achieved by the employer paying an amount calculated on the basis of an equivalent term life cover having regard to the age of the employee. A term policy of life insurance is an insurance limited for a specified period the sum insured being payable if the life insured dies within the period but nothing is payable if the insured survives. The remaining portion of the premium is paid by the employee. There is mutual benefit to the parties from the savings in costs through the writing of one insurance policy under a "split dollar" arrangement as against the writing of two separate policies.

6. The taxation implications of an employer effecting an insurance policy on the life of an employee were considered by this Office in Canberra Income Tax Circular Memorandum No. 789 (CM 789). CM 789 states that, generally speaking, insurance premiums paid by an employer on the life of an employee are not allowable as income tax deductions under section 51. On the authority of Taxation Board of Review decisions Case 50, 9 CTBR and Case 64, 10 CTBR (Old Series) the premiums are considered to be outgoings of a capital nature. The decisions proceeded on the basis that the premiums serve to build up a capital asset which may be readily turned into money. Conversely, the proceeds of the policies are of a capital nature and do not form part of the assessable income of the recipient company.

7. CM 789 recognises two exceptions to the general rule, i.e. term policies and accident policies. Premiums paid by an employer on either a term life insurance or accident insurance policy in relation to an employee are allowable as deductions under section 51. Conversely, the proceeds of such policies form part of the assessable income of the employer.

8. Taxation Ruling No. IT 155 (IT 155) entitled "Key Man Insurance - Assessability of Proceeds and Deductibility of Premiums", which is a reproduction of a memorandum from National Office to branch offices of 28 June 1968, deals with the implications for CM 789 of the decision of the High Court of Australia in Carapark Holdings Ltd v F. FCT (1966) 115 CLR 653. In the decision the High Court held that an insurance recovery on the death of an employee under a personal accident policy taken out by the holding company was assessable income of the holding company.

9. IT 155 states that the decision in the Carapark Holdings Ltd case generally supports the comments in CM 789. It goes on to say that a review of the Carapark Holdings Ltd decision and other cases leads 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". Furthermore, it recognizes that the Carapark Holdings Ltd decision required a modification of the views expressed in CM 789 concerning term

policies, i.e. that the proceeds of an accident or term policy were assessable and the premiums deductible only where it could be shown that the purpose of the insurance was to provide against a possible loss of revenue or a possible outgoing of a revenue nature.

10. Paragraph 13 of IT 155 deals with the situation where life policies are issued with a term, accident and/or sickness rider. It is stated that premiums in these cases are to be treated as 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. It is claimed that the approach in paragraph 13 of IT 155 should be adopted in relation to premiums payable under "split dollar" arrangements as the benefits and premiums are capable of being divided by means of a separate legally enforceable contract.

11. This Office advised some years ago that, provided the "split dollar" arrangement resulted in no greater taxation advantage than if two parties separately arranged their insurance needs, each party would be treated as having paid premiums in respect of the particular insurance policy. In so far as the employer was concerned this meant that whether an income tax deduction was allowable for the employer's share of the premium would be determined in accordance with long standing practices applying to "key man" insurance. That, in turn, depended upon the type of policy taken out and the reasons for it.

12. Since the earlier advice a number of variations to the initial "split dollar" concept are known to have developed or are proposed. They include:-

(i) the splitting of the life insurance policy between the employer company and a superannuation fund of which the company is the trustee;

(ii) borrowings against the cash-in value of the life insurance policy which, in some cases, have been used to pay the premiums becoming due on the policy;

(iii) the writing of policies under "split dollar" arrangements in situations which this Office does not accept as "key man" insurance;

(iv) the use of "unbundled" policies for "split dollar" type arrangements rather than the use of the conventional "bundled" whole of life or endowment policies where the term of the "unbundled" contract exceeds the term for which the risk is intended to be covered. An "unbundled" policy is a policy that is drawn in such a way that each component, e.g. the investment component or the risk component, is clearly identified as a separate part of the policy. The premium split

relevant to each component may be ascertained readily from the terms of the policy. A conventional whole of life or endowment policy is drawn in such a way that the existence of the two components is not emphasised;

(v) arrangements involving the use of separate risk and investment type policies which are brought together with the intention of achieving greater taxation benefits than those available through "split dollar" arrangements using "bundled" policies. The policies must be taken out together. Premiums payable in respect of the policies involved are not consistent with the benefits provided by comparable policies taken out independently of each other, e.g. the premium payable by an employer for term life cover under these arrangements exceeds the premium that would normally be payable on an independent policy.

13. A further matter for specific consideration is the manner of splitting the insurance premiums between the parties. A split based on level term insurance rates provides for a consistent amount of the total premium to be regarded as applicable to the term insurance component over the period of the split agreement. A split based on yearly renewable term insurance provides for a much lesser amount to be regarded as applicable to the term insurance component in the earlier years with the amounts increasing each year to the extent that, in the latter years of the split agreement, the yearly renewable premiums greatly exceed the amount determined on a level term basis. This matter takes on particular significance because, in marketing a number of the "split dollar" arrangements, it is apparent that heavy reliance is placed on a significant portion of the total premiums being allowable as income tax deductions. The high percentage of premium claimed to be deductible is not always related to comparable policies marketed by the same company. Furthermore, a number of split arrangements have been marketed on the basis of the benefits obtainable were the policy to be surrendered after the end of the 10 year period laid down in section 26AH of the Income Tax Assessment Act.

14. It is proposed to maintain the approach originally adopted to "split dollar" arrangements, i.e. the agreement between the parties for the splitting of benefits and premiums will continue to be recognized. For income tax purposes this means that premiums payable will be allowable as income tax deductions to the extent that the amounts can be said to represent losses and outgoings incurred in gaining or producing assessable income. Whether this is so can only be determined in the light of the facts of each case. Examples of relevant matters to be considered are discussed in IT 155 (paragraphs 9-12).

15. Now that the income tax law does not provide any general concession, either by way of rebate or deduction, for life assurance premiums an employee will not be entitled to any income tax deduction for his share of the premium. In essence, the payment of the premium by an employee is an investment of the moneys to produce a capital sum.

16. For "split dollar" arrangements entered into on or after 1 July 1987 the amount to be allowed as an income tax deduction to an employer in respect of premiums paid under a qualifying "split dollar" arrangement, i.e. one where the benefits to be obtained by the employer would constitute assessable income, is to be calculated on the basis of a yearly renewable premium for an equivalent term life cover offered by the company issuing the policy subject to a maximum amount to be calculated by the formula:-

R x SI/1000

where: -

R = the yearly renewable premium rate for the life insured at his/her age specified in the Appendix to this Ruling. The rates have been supplied by the Life Insurance Federation of Australia as fair across the board rates.

SI = the sum insured under the policy in respect of the revenue purpose.

17. Any premium in excess of the amount for equivalent term life cover or the calculated amount under the formula will be treated as being attributable to a capital purpose and not allowed as an income tax deduction.

18. Where the "split dollar" arrangement is in respect of an "unbundled" policy of the type mentioned at paragraph 12(iv) above the same considerations will apply i.e. premiums paid by employers will be allowed as an income tax deduction to the extent set out in the preceding two paragraphs. Premiums paid in connection with arrangements of the type mentioned at paragraph 12(v) will be similarly treated.

19. Since the advice referred to in paragraph 11 some degree of uncertainty has arisen as to the acceptable means of splitting the premium for income tax purposes. This Office will not seek to apply, retrospectively or prospectively, the basis of income tax deduction specified in paragraph 16 to "split dollar" arrangements entered into prior to 1 July 1987 where the amount of premium paid by an employer for term life cover was based on the level term rate offered by the issuing company at the time the policy was taken out for comparable separate and unrelated term insurance policies.

20. The income tax consequences attaching to "split dollar" arrangements other than those between an employer and employee will generally depend upon the same considerations expressed above. In the situation where a trustee of a superannuation fund is a party to a "split dollar" arrangement it will be a matter of determining whether the superannuation fund trust deed authorises the investment of trust funds in this manner and whether, in all the circumstances, the superannuation funds can be said to be solely maintained for the provision of

superannuation benefits for employees and/or their dependants as is required by sections 23F and 23FB.

21. In some situations the employer may pay to the trustee of the superannuation fund the trustee's portion of the premium payable under the "split dollar" arrangement. In this event the employer's payment would be subject to the normal reasonable benefit guidelines applicable to contributions to superannuation funds.

22. The "split dollar" concept has developed from a need for "key man" insurance. The acceptance of the concept and the deductibility of premium payments as provided by IT 155 is relevant only where the employee involved is a "key man". It is evident that a number of "split dollar" arrangements have been entered into in situations where this Office would not accept the employee as a "key man". A common situation involves the incorporated "one man" business.

23. When determining whether an employee is a "key man" in this context this Office has consistently adopted the view that an employee may be accepted as a "key man" where the loss of that employee would result in a significant loss of profits being derived by the employer during the continuation of business operations subsequent to that loss. This would be a situation where there is a continuing business and the resulting loss of profits is a matter that would be expected to be overcome as another employee or a new employee is trained to replace the expertise lost with the former employee. A "key man" is not seen to exist in a situation where the loss of an employee, such as the owner/manager of a "one man" incorporated business, could be expected to result in the termination of the business. A similar approach is to be adopted in relation to "split dollar" arrangements.

24. Another matter related to "split dollar" insurance arrangements is the extent to which interest on moneys borrowed against the policies is allowable as an income tax deduction. When a loan is sought by the owner of a permanent insurance policy of the type used in "split dollar" arrangements, i.e. whole of life or endowment policies, an insurance company is required by the Life Insurance Act to provide the loan, within certain limits, against the security of the cash-in value of the policy.

25. Whether an income tax deduction for interest paid on moneys borrowed in these circumstances is allowable will depend upon the normal considerations that apply in this situation, i.e. it will depend upon whether the moneys are borrowed for the purpose of producing assessable income.

COMMISSIONER OF TAXATION
16 July 1987

TABLE

APPENDIX

TABLE OF YEARLY RENEWABLE PREMIUM RATES

AGE	MALES	FEMALES
20	2.75	2.68
21	2.72	2.63
22	2.56	2.47
23	2.33	2.26
24	2.12	2.08
25	1.95	1.93
26	1.89	1.88
27	1.87	1.85
28	1.85	1.84
29	1.86	1.85
30	1.87	1.86
31	1.90	1.86
32	1.94	1.86
33	1.99	1.87
34	2.04	1.91
35	2.12	1.94
36	2.20	2.00
37	2.30	2.05
38	2.42	2.12
39	2.55	2.21
40	2.70	2.31
41	2.90	2.43
42	3.12	2.56
43	3.38	2.72
44	3.67	2.91
45	4.01	3.13
46	4.39	3.40
47	4.83	3.69
48	5.33	4.02
49	5.89	4.41
50	6.52	4.84
51	7.22	5.34
52	8.00	5.90
53	8.86	6.53
54	9.84	7.22
55	10.90	8.01
56	12.08	8.87
57	13.39	9.84
58	14.84	10.91
59	16.44	12.08
60	18.20	13.39
61	20.17	14.84
62	22.32	16.43
63	24.69	18.19
64	27.30	20.15

65	30.10	22.39
66	33.64	24.96
67	37.04	27.60
68	40.72	30.44
69	44.75	33.53