Did you know?

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Who should own an income protection policy?

Although it is possible for a non-super income protection to be owned by a third party or jointly (rather than owned by the life insured), why would a client do this?

Fred and Wilma are a married couple. Wilma decides to take income protection on herself, but is advised to make Fred the policy owner for tax-deductibility purposes as he is on a higher marginal tax rate. Is this OK?

Income protection benefits are designed to replace the insured's income. Section 8-1 ITAA 1997 allows a deduction for all losses and outgoings to the extent to which they are incurred in gaining or producing assessable income except where the outgoings are of a capital, private or domestic nature. This interpretation was also confirmed in CR 2002/57. However, there needs to be a sufficient connection between the purchase of income protection cover and the consequent earning of assessable income.

In Fred and Wilma's example above, there is clearly no link between the insured's income and the policy owner's proposed tax deduction. None of the premium would be tax deductible. Any monthly benefit due to a claim would be assessable to Wilma at her marginal tax rate. A premium would not be deductible to a family trust, for that matter, unless it was a trading trust and the insured was an employee. Income Protection policy proceeds are assessable even if the policy owner cannot or decides not to claim a tax deduction for the premiums (s6-5 ITAA 1997).

Fred and Wilma are lives insured and joint policy owners in the same income protection policy. They claim tax deductions in relation to their respective premiums (based on 75% of each person's gross income). In this case, the ATO **may** allow their respective tax deductions, and the disability benefits would be assessable to the disabled policy owner. If there is a future marriage breakdown, however, both policy owners would have to agree to any policy amendments. Yes, the spouses would save a policy fee, but self-ownership would be preferable.

Fred's boss, Mr Slate, owns the Slate Rock and Gravel Company. Fred takes out an income protection policy where he is both life insured and policy owner. Because Mr Slate considers Fred to be an outstanding employee, he decides to pay Fred's income protection premiums. The taxation implications are as follows:

- the premium will be tax deductible to the Slate Rock and Gravel Company;
- the premium will not be subject to Fringe Benefits Tax (FBT) because the premiums would be otherwise deductible to Fred (sometimes referred to as the "otherwise deductible rule")
- the claim proceeds received by Fred will be subject to income tax; and
- the proceeds will not be subject to capital gains tax.

Premiums are also deductible to an employer and not subject to FBT where the income protection is used as a key person policy and the benefit is a form of income replacement to the business. However, CommInsure guidelines state that if the particular business entity is either a company or family trust, all lives insured must have a controlling interest, such that they can ensure that the proceeds of the policy will ultimately be paid to them.

Business Overheads Cover (BOC)

As the proceeds of business expenses insurance are used for a revenue purpose, the premiums will generally be tax deductible and the proceeds assessable. The proceeds will not be assessable as a capital gain nor will they be subject to CGT.

Fred and Barney have a partnership and run a successful quarry business. They are looking at taking out income protection for themselves. Their adviser, Penny, recommends they also take Business Overheads Cover to pay for fixed operating expenses. Penny is able to set up one policy for the two of them incorporating both the BOC and an Income Care Plus monthly benefit. How can this be done, bearing in mind the normal deductibility and assessability issues with joint ownership of income protection policies?

If each of the partners is a life insured (as master policy) and contributes to the premiums, multiple ownership does not restrict individual deductibility because:

- If benefits are payable to each partner on some formula basis, this clearly demonstrates the required nexus with income; and
- If benefits are paid solely to the disabled party, each contributing partner has an equal expectation that should they be injured, then the IP payments will be made to themselves. So the master policy is just a convenient bundling of a series of individual policies without adverse tax consequences.

The above examples illustrate the tips and traps associated with temporary disability income protection policy ownership. It seems clear that in most cases self-ownership of personal income protection policies is the best structure.

Income Protection (Income Care/Plus) Personal Ownership

	Life Insured	Policy Owner(s)	Premium Deductibility	Benefit Assessability
1	Self	Self	Paid by individual for personal protection – Yes (s8-1 ITAA 1997) – except for premium relating to Cash Back option (CR 2002/57) and Permanent Disablement Cover (PDC) option (CR 2005/15)	Yes (s6-5 ITAA 1997) – except for benefit relating to Cash Back option (CR 2002/57) and PDC option (CR 2005/15) or Crisis Benefit (ATO ID 2004/942)
2	Self	Self	Paid by employer – Yes, premium deductible to employer (s8-1 ITAA 1997). FBT is paid by employer for premium relating to Cash Back and PDC option (CR 2005/15)	Benefit is assessable to employee – except benefit relating to Cash Back option (CR 2002/57) and PDC option (CR 2005/15)
3	Wife	Husband	Paid by husband - No	Yes (s6-5 ITAA 1997) – as above
4	Husband & Wife	Husband & Wife	Possibly, in proportion to their respective premiums	Yes, to the relevant policy owner – as above

Summary

There are adverse tax consequences if a person who is not the life insured tries to claim income protection premiums as a deduction.

Income protection policies should be self-owned unless there is an appropriate business structure and employer-employee relationship.

Important information

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