Did you know?

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Capital gains tax – insurance policies

Life insurance policies are treated as capital gains tax (CGT) assets for CGT purposes. The payment of the insurance proceeds can therefore constitute a disposal of a CGT asset. This is not generally a problem for personal risk protection, where the insured is usually also the owner of the life policy, but it may be an issue in business insurance situations.

What is the CGT treatment of term life insurance policies?

The disposal of a term life policy for CGT purposes includes the payment of the insurance proceeds, the transfer or assignment of the policy, and the payment of the cash value of an investment policy. The proceeds of a term life life insurance policy payable on the death or terminal illness of the insured are exempt from CGT under section 118-300 of the Income Tax Assessment Act 1997 (ITAA97), if paid to the original beneficial owner of the policy. They are also exempt if they are paid to someone who was not the original beneficial owner, if the former did not pay any money or give any other consideration for the acquisition of the rights or interest in the policy.

However, CGT is payable if the term life insurance proceeds are paid to:

1. Someone who was not the 'original beneficial owner' **and**
2. That person paid money or gave other consideration for the acquisition of the rights or interest in the policy.

What is an original beneficial owner?

The Commissioner of Taxation, in Tax Determination TD 94/31 stated that:

"… the original beneficial owner is the first person who, at the time the policy is effected, holds the rights or interest, and possesses all the normal incidents of beneficial ownership, for example, who is entitled to the benefits of the policy proceeds and has the power of management and control over the policy, as well as the power to transfer, grant as security, surrender or otherwise dispose of the policy". The determination goes on to state: "Where two or more persons jointly effect a policy of life assurance, each person may be an 'original beneficial owner'. Furthermore, the person holding the rights or any interest in rights under a policy of life assurance may be an individual, a company or a trustee of a trust estate alone or in partnership."

Therefore, the term "original beneficial owner" means the person who first possesses or has control of the benefits of the policy. He or she may not be the legal owner of the policy. Moreover, in an insurance trust, generally the trustee of the trust is the legal owner, whilst the beneficial ownership rests with the life insured, thereby satisfying the exemption under s. 118-300.

What does consideration mean?

If a life insurance policy is transferred to a new beneficial owner for no consideration, the proceeds will still be exempt from CGT in the new beneficial owner's hands. Consideration has a broad meaning. It can be any one of the following:

- an agreement to do something in return for something else
- a payment of money in exchange for an item or a right
- an exchange of life policies, i.e. dual assignment
- the acquisition or disposal of a right
- giving, or receiving the benefits of, promises, or
- an exchange of property.

The new beneficial owner does not give any consideration in respect of the acquisition of the policy simply because he or she assumes responsibility for payment of premiums on that policy in the future.

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What is the CGT treatment of total and permanent disability (TPD) and trauma proceeds?

The CGT exemption under section 118-300 ITAA97, referable to the proceeds of term life insurance policies paid to the original beneficial owner or a subsequent owner who does not provide consideration, only applies if the cause of the claim or payment was the death or terminal illness of the life insured. This particular CGT exemption does not apply to the proceeds of TPD and trauma policies.

As a result, the proceeds from a bundled term life policy might be taxed differently, depending on whether the proceeds were paid upon the death of the life insured or upon meeting the definition of TPD or trauma under the policy.

The only exemption available for TPD and trauma proceeds is the exemption for compensation or damages received for any wrong, injury or illness suffered in one's occupation or personally under section 118-37 ITAA97. The definition of injury is not limited to physical injury. It also extends generally to illness or disease (Taxation Ruling TR 95/35). This CGT exemption under Section 118-37 ITAA97 is only available if the person who is beneficially entitled to the insurance proceeds is the injured person, their spouse or a defined relative. According to section 995-1(1) ITAA97, "relative" of a person means:

(a) the person's spouse (including de facto partner); or
(b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of that person's spouse; or
(c) the spouse of a person referred to in paragraph (b).

Furthermore, based on a 2011-12 Budget announcement, the Government issued a Proposals Paper in June 2012 that it would disregard CGT consequences where taxpayers receive compensation, damages or certain insurance proceeds (i.e. TPD and trauma benefits) indirectly through a trust, ensuring that taxpayers have the same CGT outcome as taxpayers who received such proceeds directly. This was understood previously as being applicable to TPD and trauma benefits paid to the trustee of an absolute entitlement trust (insurance trust) where the beneficiary is the life insured or a relative. However, there had been some doubt as to whether the same exemption would extend to other types of trusts (such as fixed and discretionary trusts).

The concept of an injured person is much narrower than the concept of an original beneficial owner or subsequent owner, which applies to term life insurance policies. This means that proceeds paid in respect of an illness would be subject to CGT, if (assuming cross-ownership of policies) the uninjured and unrelated business owner owned a buy-sell purpose policy against the TPD or trauma of the other owner. If a company owned a key person policy with a TPD or trauma component, the proceeds could be either a capital gain subject to CGT or assessed as ordinary income.

The narrowness of the exemption is the basis for the practice of self-ownership of insurance policies. When appropriate, it may, therefore, be preferable that TPD and trauma cover be owned by (or held under an appropriately drafted insurance trust for) the insured to take advantage of the exemption.

Summary

The payment of life insurance policy proceeds may constitute a disposal of an asset for CGT purposes.

Advisers should be mindful of the potentially different tax treatment of – on the one hand, term life policies – and, on the other, of TPD and trauma policies.

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