Guide to business insurance.

CommInsure

Important information

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About this guide

CommInsure is committed to helping advisers tailor solutions to their clients' business insurance needs. We provide a wide range of training, support services and effective insurance solutions.

This guide to business insurance is designed to give you an overview of the core business insurance concepts. The aim of this guide is to provide you with general tools, advice and information to handle questions from a broad range of clients. However, business insurance is inherently complex and this guide does not replace the need for your client to seek tax and legal advice from experts in this area. The information in this guide on legal, financial, taxation and insurance issues is general in nature and is not intended to constitute legal or financial product advice.

Please contact your CommInsure Business Development Manager if you require contact details for a tax adviser.

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expressly as a guide to advisers. **It is not to be issued or made available to members of the general public.** The examples are for illustrative purposes only. The names and identifying features do not reflect any particular individual.

Business risk insurance strategies
Business risk insurance planning should be part of life for all small and medium sized businesses. The following strategies may be considered:

- key person insurance
- buy-sell agreements
- the impact of capital gains tax (CGT) and the commercial debt forgiveness rules
- debt reduction or guarantor protection insurance, and
- business expenses insurance.

Professional advice
A well prepared business risk insurance plan will consider the legal, taxation and financial impact on the business, therefore, the preparation of it should be a team effort.

We suggest the following professionals should be involved:

Financial Adviser (which is you)	• Matches the product to the need, for example: type of business insurance required, amount of insurance, etc.
Lawyer	• Takes instructions from the client(s). • Drafts an appropriate agreement to minimise the potential for any adverse outcomes, such as CGT, hostile estates, etc. • Ensures that the product solution does not trigger unnecessary CGT.
Accountant	• Values the business. • Calculates the transfer costs, e.g. CGT, stamp duty.

All three may need to work together to determine the best strategy.

The 'question and answer' format in this guide is intended to address the most common issues relating to business insurance. Hints and tips to assist you in understanding business insurance concepts are marked with a '✔'.

Why should business owners consider business insurance?

Every business with two or more owners should consider what might happen to the business if one of the owners dies, becomes totally and permanently disabled, or suffers a terminal or traumatic illness.

A business generally depends on a few people to produce the profits, provide the capital or manage the business. If there is no viable succession plan, there may be significant financial hardship for the surviving business owners, as well as for the surviving family members.

Many business owners do not consider business succession planning issues because they rely on their accountant and other advisers to make them aware of potential risks to the business. They are potentially at risk and need good advice about business insurance. It is up to you to identify their needs and provide them with advice.

The core business insurance concepts are:

- buy-sell insurance (asset or equity)
- debt reduction or guarantor protection insurance (liability), and
- key person insurance (liability).

Business insurance is a specialised area of insurance which involves undertaking a full and detailed interview to determine your client's needs, including the:

- needs of the business
- amount of insurance necessary to satisfy these needs
- cost of the insurance
- prioritisation of the business needs and insurance (having regard to the cost), and
- underwriting requirements necessary for the amount of insurance proposed.

To identify your client's needs, some questions you could ask are:

Buy-sell insurance needs assessment – questions

- Will the remaining business owners enjoy working with the family members (usually the spouse) of a deceased owner?
- Can the deceased owner's family members contribute skilfully to the management of the business or will they hinder the business while still drawing a full share of profits?
- How much will the business pay the deceased owner's estate for his or her business interest, over what period of time and where does the money come from?

Debt reduction/guarantor protection and key person insurance (liability) needs assessment – questions

- Will the bank call in all guaranteed loans if there are concerns about the capacity of the business to remain viable?
- If yes, when will the bank call in a guaranteed loan?
- How will the business repay its loans, if one of the owners dies?

If the business can't repay the loans, will the bank call for immediate repayment and renegotiation of personal guarantees given by all of the business owners?

Once you identify a client's needs, the goal of business insurance is to provide a funding mechanism. The funding can help the business to financially survive a key person crisis. A business that has business insurance in place may also demonstrate to creditors, shareholders and employees the principles of sound financial management and planning.

Capital gains tax – general

The following information is general in nature. Taxation and legal advisers will be able to provide you and your clients with a more detailed explanation of how capital gains tax operates, and how it applies to your client's circumstances.

Working in business insurance requires a working knowledge of CGT.

There can be CGT implications not only for the sale of equity in the business, but for the insurance policies themselves.

For instance, there can be CGT implications for buy-sell insurance, debt reduction/guarantor protection and key person insurance.

What is capital gains tax?
Strictly speaking, there is no such thing as a 'capital gains tax'. Rather, the term is used to describe circumstances under which, if a taxpayer makes a gain on the disposal of an asset, all or part of the gain may be included in the taxpayer's assessable income. The CGT legislation results in the taxpayers paying income tax on their net capital gain – ascertained by offsetting capital losses against specific capital gains as selected by the taxpayers, and by excluding the discount amount from any remaining capital gains that are eligible for the CGT discount (see below) – at their marginal tax rate. The requirement for tax to be paid on the gain is commonly referred to as CGT.

The requirement to calculate a capital gain (or loss) is not only triggered upon the disposal or acquisition of an asset. The legislation sets out specific CGT events which can also trigger this requirement. However, for business insurance, the acquisition and disposal of the insurance and business interests or assets are the most relevant CGT events which may give rise to a CGT liability.

What do the words 'acquisition' and 'disposal' mean for CGT purposes?

Acquisition
For CGT to apply, the underlying asset must have been acquired on or after 20 September 1985. Generally, no CGT applies to the sale or disposal of an asset acquired before that date.

A pre-CGT asset can cease to be a pre-CGT asset if there is a change in the majority ownership of the asset (or interest in the asset), after 20 September 1985.

'Acquisition' includes the purchase, assignment or transfer of an asset.

Disposal
The CGT provisions apply when there is a disposal of a CGT asset. Disposal is any change of ownership, including a sale, transfer or assignment of an asset or an interest in an asset.

Death is not a disposal under the legislation, i.e. an asset owned by a person is not deemed to have been disposed of when that person dies. As a result, the estate/beneficiary of the deceased person has no immediate liability to pay CGT.

However, the estate/beneficiary does acquire the asset. If the asset is subsequently sold by the estate/beneficiary, then CGT may apply.

If the deceased acquired the asset before 20 September 1985, the acquisition value for the estate/beneficiary is the market value of the 'pre-CGT' asset at the date of death. This can mean that effectively there is no CGT if a pre-CGT asset is sold soon after the death and the difference between acquisition value and disposal value is nil.

On the other hand, if the deceased acquired the asset on or after 20 September 1985, the cost base for the 'post-CGT' asset is the deceased's cost base.

Thus, if the asset had increased in value between the date of acquisition and the date of death, the deceased's notional CGT liability will be passed on to the estate/beneficiary, although, it will not become payable until a subsequent sale by the estate/beneficiary.

For business insurance purposes, it is possible to estimate the CGT liability that would be payable upon a sale of the deceased owner's equity under a business succession agreement.

The CGT liability can then be insured, so that the CGT liability is paid out of insurance proceeds and the gross value of the interest in the business is passed onto the estate/beneficiaries.

How do you calculate the taxable capital gain?
The taxable capital gain is determined by deducting the taxpayer's cost base from the proceeds of the disposal.

The cost base includes capital expenditure (not already claimed as a tax deduction) associated with the acquisition, disposal, improvement and maintenance of the asset.

Originally;

- the cost base was indexed for inflation; and
- the taxable capital gain was also averaged over a number of years to determine the CGT payable in the particular financial year.

However, this process has been affected by the following:

1. indexation was frozen as at 30 September 1999
2. there may be a 50% exemption (usually referred to as a 50% CGT discount) for individuals as well as a 33.33% exemption for superannuation funds, and
3. the averaging provisions were abolished from 11.45 am on 21 September 1999.

The timing of disposals, and the length of time the asset is held, determines which CGT calculation method is to be used and, ultimately, the amount of CGT payable:

Date asset is acquired	If asset is held for twelve or more months and disposal is after 30 September 1999	If asset is held for less than twelve months
Prior to 20 September 1985	Any capital gain realised on the disposal of the asset is exempt from CGT.	Any capital gain realised on the disposal of the asset is exempt from CGT.
20 September 1985 to 21 September 1999	Use either discount method or the frozen indexation method.	The full amount of capital gain is assessable.
After 21 September 1999	Discount method only – the frozen indexation method does not apply.	The full amount of capital gain is assessable.

The types of methods which may be used to calculate the taxable capital gain are as follows:

Discount method

This method may allow part of the realised capital gain to be exempt from CGT. Individuals may be able to 'exempt' half of the gain. Superannuation funds may be able to exempt one third of the gain.

If an individual taxpayer only has capital gains that are eligible for the 50% CGT discount, he/she would calculate his/her net capital gain under the discount method as follows:

((consideration on sale of asset – tax cost base of assets) – (current year or carried forward capital losses)) x 50%

The resulting net capital gain is included in the individual's taxable income and is taxed at their marginal tax rate.
Note capital losses must be offset against the amount of the capital gains before applying the 50% discount to those gains. Therefore, the benefit of the 50% discount is lost to the extent that capital losses absorb capital gains which would otherwise be eligible for the discount.

Capital losses not used can be carried forward into a later income year.

Frozen indexation method

Using this method, the taxpayer can elect to index the cost base of the asset acquired before 11.45 am on 21 September 1999. The calculation of the frozen indexed cost base is:

$$\textbf{Cost base} \times \frac{\textbf{CPI for September 1999 quarter}}{\textbf{CPI for quarter in which asset is acquired}}$$

Then the frozen indexed cost base is deducted from the consideration the taxpayer receives for disposal. The net amount is the capital gain.

Generally:

- the higher the capital growth rate of the asset, the more likely that less CGT will be payable, using the discount method, and
- the longer the asset is held post 21 September 1999, the less attractive the frozen indexation method may become in minimising CGT.

Capital gains tax – small business concessions

Small businesses are eligible for CGT concessions if they satisfy the basic conditions for one or more of the Small Business CGT concessions.

Specifically the small business CGT concessions are the:

- 15 year asset exemption (a new relief measure under Subdivision 152-B ITAA97)
- 50% active assets exemption (which replaces the old 50% goodwill exemption, but has tougher tests for establishing the asset value of related entities under Subdivision 152-C ITAA97)
- retirement exemption (a slightly changed extension of the old Retirement Rollover Exemption under Subdivision 152-D ITAA97), and
- small business asset rollover relief under Subdivision 152-E ITAA97.

The concessions apply to CGT events that occur after 11.45 am on 21 September 1999. The last three concessions apply in addition to the 50% general CGT concession. These last three concessions are not mutually exclusive, and provided the pre-requisites for each concession are satisfied, as many as all three may be applied. There are rules as to the order and circumstances under which the concession can be applied. This is discussed below.

Accordingly, a capital gain may be reduced first by 50% by applying the general 50% discount concession. The capital gain can be further reduced by the application of any or all of the active assets exemption, retirement exemption or small business asset rollover relief. If the 15 year asset exemption applies then all of the gain is exempt.

If the 15 year asset exemption is not applicable then the concessions are applied as follows

- firstly, the general 50% discount
- secondly, the 50% active asset reduction, and
- then, in the order the taxpayer chooses, the small business $500,000 retirement exemption and the small business asset replacement rollover.

Capital gains derived in respect of active assets that are

1. 50% exempt pursuant to the active assets exemption
2. applied against the $500,000 retirement exemption, or
3. are able to be deferred under the asset replacement roll-over, all have to be applied against any capital losses of the taxpayer. In contrast to the other small business CGT concessions, the capital gain made under the 15 year exemption does not have to be offset against any capital losses.

The basic conditions[1] that must be met before any of the four concessions can apply are:

1. a CGT event happens in relation to an asset that the taxpayer owns
2. the event would otherwise have led to a capital gain
3. except in respect of Simplified Tax System taxpayers, the maximum net asset value requirements are met (i.e. the net value of assets of the taxpayer and connected entities cannot exceed $6 million[2] and
4. the asset disposed of needs to be an active asset.

If the asset is a share in a company or an interest in a trust, the company or trust must satisfy the controlling individual test and the taxpayer must either be that controlling individual or their spouse provided the spouse has an interest in shares in the company or an entitlement in relation to a trust[3].

Further, specific conditions apply to some of the concessions.

What is the 15 year asset exemption?
The CGT exemption arises where there is a capital gain from disposal of assets by the small business entity, and:

- those assets have been used in the course of carrying on a business for at least half the period of ownership (i.e. an active asset)
- those assets were held by the business entity for at least 15 continuous years, and
- the disposal relates to a business owner or, controlling individual, retiring over the age of 55 years, or becoming permanently incapacitated.

Example
Brad and Jenny (who are not connected) are equal partners in a partnership that buys and develops property. The partnership dates back to 1986 when the land was purchased. They have owned the land continuously since then. The total value of the partnership assets is under $6 million. Both Brad and Jenny are now 65 years old and they both wish to retire. They sell the partnership business in 2001 and realise a capital gain of $200,000. Brad and Jenny are each entitled to the small business 15 year exemption on their portion of the entire capital gain.

1 It was announced on 13 November 2006 that it is the Government's intention to amend the law with effect from 1 July 2007 to allow all small businesses that have an annual turnover of less than $2 million to access the small business CGT concessions. The precise details as to how turnover is to be measured is yet to be released.
2 Note: the Government has proposed to increase this to $6 million from 1 July 2006.
3 Note: The Government has proposed to change from the controlling individual test to a more generous 20% significant individual test from 1 July 2006. To be entitled to the small business CGT concessions, a person has to be a CGT concession stakeholder. An individual will be a CGT concession stakeholder if he or she is a significant individual or a spouse of a significant individual. An individual is a 'significant individual' in a company or trust if he or she has a small business participation percentage (direct or indirect) in the company or trust of at least 20%. For an interest in a company to be counted the shareholder must hold the voting, dividend and capital rights in respect of that interest. In relation to a trust, an interest will only be counted where the beneficiary has either an entitlement to receive [or has actually received] a percentage of the income and capital distributed by the trust.

What is the 50% active assets exemption?
Where a business owner transfers or disposes of their interests as a result of business succession planning trigger events (such as the retirement of a business owner), the owner (or their estate) disposing of the interest may qualify for the 50% active assets exemption.

An asset is an active asset if the taxpayer (or a connected entity) owns it and uses it in carrying on a business (or holds it ready for use in that business). Active assets include intangible assets, such as goodwill or restrictive covenants, connected with the business.

The 50% active assets exemption will be available on assets disposed of or transferred.

What is the retirement exemption?
The retirement exemption is an exemption which allows a taxpayer to choose that capital gains (not exceeding $500,000 in total) arising from the disposal of active assets are exempt. However, the retirement exemption only applies where the taxpayer chooses to utilise the exemption and the proceeds are used to fund retirement.

Note that the exempted capital gains must be paid out as ETPs to controlling individuals (or from 1 July 2006, significant individuals) by the taxpayer or (if an individual) treated as ETPs received by the taxpayer. If the recipient is under age 55 then the ETP must be rolled over into a complying superannuation fund, complying approved deposit fund or retirement savings account.

What is small business asset rollover relief?
The small business replacement asset rollover relief is where an active asset is disposed of, and a capital gain may be effectively deferred if the taxpayer uses the sale proceeds to acquire a replacement active asset to be used in the existing or a new business of the taxpayer. The capital gain is only ignored to the extent that it does not exceed the cost of the replacement asset.

CGT rollover relief can be claimed provided the basic conditions once again are satisfied for small business CGT concession. In addition, replacement assets must be acquired within the period, beginning one year before and ending two years after the disposal of the original small business assets.

Essentially, the rollover relief allows a taxpayer to defer making a capital gain from the original small business assets which have been replaced to the extent that the capital gain does not exceed the cost of the replacement assets. This is ignored until there is a disposal or change in status in the replacement assets, provided the assets acquired also satisfy the active asset test and, if shares in a company or an interest in a trust, the controlling individual (or from 1 July 2006, significant individual) tests.

- ✔ The client's accountant or tax adviser is best qualified to give advice on many issues, which include what constitutes ‘active assets’, entities that are connected with another entity, and ‘small CGT business affiliates’ and to comment on the ‘look through’ rule that relates to controlling individuals.
- ✔ Your role as financial adviser is to use your skills to advise the client on the very important issues of rollovers, Reasonable Benefit Limited (RBL) and retirement planning generally, within the context of business succession planning.

Note The Government has announced that it intends to abolish RBLs from 1 July 2007.

Capital gains tax – insurance policies

Insurance policies are treated as CGT assets for CGT purposes. The payment of the insurance proceeds can therefore constitute a disposal of a CGT asset.

The cost base of an insurance policy usually consists of the aggregate of the premiums paid over the life of the policy. Because they may add up to only a small percentage of the insurance proceeds paid on the claim, there can be a high taxable capital gain.

However, there are certain exemptions for insurance proceeds. Unfortunately, the exemptions do not apply equally to all insured events.

Advisers might be familiar with some of these exemptions in the context of buy-sell agreements. However, it is important to remember that the basis of the exemptions apply equally to other business and personal insurance.

Thus, ownership considerations are also relevant to debt reduction/guarantor protection, key person insurance and personal insurance.

What is the CGT treatment of life insurance policies?
The 'disposal' of a 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 life insurance policy payable on the death of the insured are exempt from CGT under section 118-300 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, but they 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 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, in Tax Determination TD 94/31 states 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".

As an example, a trustee can own a life insurance policy on the life of Brad, under a trust deed that requires the trustee to give the insurance proceeds payable on Brad's death to Jenny. In this example the trustee is the legal owner (original beneficial owner) and Jenny is the beneficiary (holds the beneficial interest). Section 118-300 ITAA97 will exempt the trustee of the trust from CGT, provided it is the original beneficial owner of the policy, (or if it is isn't, if it didn't acquire it's interest for money or other consideration). Irrespective of the difference at law between the legal interest in an asset held by a trustee and the beneficial interest held by certain beneficiaries, the ATO considers that the trustee is typically the original beneficial owner for section 118-300 ITAA97 purposes (as per TD 94/31 – refer above).

The term 'original beneficial owner' means the person who first possesses or has control of the benefit(s) of the policy. He or she may or may not be the legal owner of the policy.

The fact that changes in beneficial ownership can occur after the policy is first taken out (e.g. through a transfer of the policy), does not change the definition. For example, say Brad purchased a life insurance policy on the life of his business partner Jenny. Brad is the original beneficial owner. Jenny later decides to leave the workforce to travel overseas for two years. Brad assigns the policy to Jenny, but Jenny is not the original beneficial owner. Jenny returns to the business and assigns the policy back to Brad. Brad is still the original beneficial owner, even though beneficial ownership has changed over the life of the policy.

An alternative to transferring the ownership of the policy would be to cancel it and issue a new policy. However, care must be taken to ensure that the cancellation and reissue does not result in any business owner becoming unable to obtain cover at the same level, on the same terms, or at all (e.g. if their health has deteriorated).

What is ‘consideration’?
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.

What is the CGT treatment of total & permanent disability (TPD), trauma and terminal illness proceeds?
The exemption for the proceeds of life insurance policies 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 of the life insured.

This particular exemption does not apply to the proceeds of TPD, trauma and terminal policies.

As a terminal illness benefit is paid upon the diagnosis of a terminal condition (rather than upon the death of the life insured), the proceeds of a terminal illness claim may not be exempt from CGT in the same basis as the proceeds of a TPD or trauma policy may not be exempt.

As a result, the proceeds of a normal term life policy might be taxed differently, depending on whether the proceeds were paid upon the death of the life insured or upon the diagnosis of a terminal illness (or TPD and trauma).

The only exemption available for TPD, trauma and terminal illness proceeds is the exemption for ‘compensation or damages received for any wrong, injury or illness suffered in your occupation or personally’ under section 118-37 ITAA97.

The definition of ‘injury’ is not limited to physical injury. The Commissioner accepts that a specified illness in a trauma insurance policy is an ‘injury’ (Taxation Determination TD 95/43), and that the term ‘injury’ extends generally to illness or disease (Taxation Ruling TR 95/35).

This exemption is only available if the person who is beneficially entitled to the insurance proceeds is the ‘injured person’, their spouse or a defined relative.

The concept of an ‘injured person’ is much narrower than the concept of an ‘original beneficial owner’ or subsequent owner for no consideration, which applies to death benefits.

This means that proceeds paid in respect of an illness would be subject to CGT, if (assuming cross-ownership of policies) the uninjured business owner owned a buy-sell policy against the TPD, trauma or terminal illness of the other owner. If the business owned a key person policy with a TPD, trauma or terminal illness 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, trauma and terminal illness policies (and death policies, where this is combined with an illness policy) be owned by (or held under an appropriately drafted trust for) the insured to take advantage of the exemption.

However in certain cases, from a risk management perspective, CommInsure might require the business to own the key person policy.

Buy-sell insurance

A buy-sell agreement involves the business owners entering into a written agreement to plan what they are to do with their respective interests in the business should any one of the owners die, become disabled, suffer a traumatic or terminal illness, resign or retire – just like having a will in place for the business. Essentially, the agreement should provide a mechanism whereby the terminating business owner (or his or her estate) can sell his or her interest in the business to the continuing owners, and whereby the continuing owners can purchase the terminating owner's interest in the business. The agreement generally also recognises the means of funding the buy-sell obligations of the respective owners.

Why is buy-sell insurance needed?
The death, TPD, traumatic or terminal illness, resignation or retirement of an owner can have a dramatic effect on a business. Some of the problems that can occur are:

- the terminating business owner (or, in the case of death, his or her estate) may make demands on the business for it to be wound up, to be paid out for his or her interest in the business, or for the repayment of loan account balances
- in the case of death, the estate may insist on immediate and direct involvement in the control and operation of the business, but may not have the expertise
- in the case of death, the estate of the deceased business owner may be forced by circumstances to sell his or her interest in the business to an outside buyer at fire sale values
- in the case of a traumatic illness (e.g. heart attack), there may be uncertainty over the likelihood of the business owner recovering or ever returning to work. The continuing business owners may end up doing all of the work, but splitting the profits with a non-working owner.

What insurance products can be used?
The choice of insurance solution depends on which trigger events are being provided for.

Death and TPD
Death and TPD can usually be readily insured against, by way of life and TPD insurance in the buy-sell arrangement.

Traumatic and terminal illness Trauma insurance can also be used in a buy-sell arrangement but some complex issues must be considered. These issues are explained further on pages 19 to 22.

Resignation and retirements
Resignation and retirement cannot specifically be insured against and, therefore, cannot be funded with insurance proceeds. However, a permanent policy can help by providing a cash amount that can be used as a 'deposit' against any buy-out obligation at the time of a retirement or resignation. Any balance of the purchase price could be obtained by way of additional savings or borrowings. Alternatively, an arrangement could be documented whereby the remaining owners could repay the balance in instalments over an agreed time. The time agreed by the owners will reflect the ability of the business to fund the buy-out. The buy-out may therefore take up to several years.

Given the potentially long lead-time, a retiring or resigning business owner may wish to retain entitlement to certain dividends, and may only wish to relinquish ownership of their business interest when the final instalment has been made. These are issues which the business owners will need to discuss with a lawyer.

How do you determine the sum insured?

Valuing each owner's share
The sum insured should generally be the value of each business owner's share in the business, usually valued on a yearly basis.

For example, if the business consists of two business owners and is valued at $200,000 (being the sum of stock, debtors and work in progress, for example), the sum insured on the life of each business owner should be $100,000, assuming they are equal partners.

Current Market Value
The sum insured is not as easy to establish each year if the business owners agree that it be the current market value. One alternative to having to determine the market value of the business on a yearly basis would be to base the sums insured upon the current market value of the interests of the business owners at the date of proposing the insurance and index the sum insured to inflation. Another possibility is to index the original market valuation by the anticipated growth rate of the value of the business.

✔ The level of cover should be reviewed annually to ensure that the sums insured always reflect the market value of each owner's business interest. A holistic approach should be taken when assessing the business' insurance requirements.

Given that the Australian Taxation Office (ATO) will likely deem that the disposal of a business interest under a buy-sell agreement occurs at market value, and that the purchaser has paid market value to acquire the disposed business interest, it may be prudent to use market value as the valuation method of choice.

However, the following alternative methods of valuing a business for buy-sell purposes may be considered.

As you can see, if a business does not have a buy-sell agreement in place and a trigger event occurs, the effect on the remaining business principal(s) may be a deterioration in working conditions, their living standards and for the business itself, a decrease in its value, or possible closure. The departing proprietor and their family, and creditors, might fare little better.

Alternative methods of valuing the business

Generally, there are three methods (besides current market value) that may be used to provide an acceptable way to agree on a realistic business value. These are illustrated below.

Agreed formula or valuation formula

- The principals of the business agree to use a particular formula. The formula would reflect either an industry standard, or something that is specifically appropriate to the business in question.
- The formula would generally be determined in consultation with the accountants for the business.
- It is suggested that the principals should, on a regular basis (at least annually), recalculate the business value using the formula and then subjectively determine whether the formula is giving rise to realistic and acceptable figures. This ensures that the market value of each business owner's interest is always recorded and funded.
- A formula for valuing the business should be set out in the written buy-sell agreement.

Example
Capitalised Earnings Method = maintainable earnings x price/earnings multiple appropriate to the industry + fair market value of unnecessary or excess assets.

Agreed dollar value

- The principals of the business agree on the value of the business,
- As a general rule, it is prudent for the business principals in adopting this method of valuation, to also have their accountant review the figure and confirm that it is justifiable on ordinary commercial terms.
- It is suggested that the value be reviewed and updated on a regular basis.

Value to be determined by an independent arbitrator

- The business principals rely on an independent arbitrator (e.g. the business' accountant, or the president from time to time of the Australian Society of Certified Practising Accountants, at the time of the valuation) to be appointed to value the business at an appropriate time.
- The independent arbitrator uses an acceptable market valuation method.
- The name of the arbitrator, or the method by which the arbitrator is to be appointed, is specified in the buy-sell agreement.
- This method may involve extra expense and delays in finalising the buy-out.
- Using this method, it is difficult to determine the necessary level of insurance cover at a given point in time.

✔ After considering all of the alternative methods, the principals might decide that the most effective approach is to use the current market value (or an amount the business owners believe is a fair value for the business) at the time of proposing the insurance, and to review the market value annually to ensure that fluctuations in the value of the business over time are accounted for.

The principals should obtain advice from their accountant and tax advisers as to the most suitable valuation method.

Ownership of buy-sell insurance

Buy-sell insurance policies protect the business owners and their respective estates. As such, the policies are generally owned and paid for by the business owners.

There are three main methods of ownership:

- cross-ownership
- self-ownership, and
- trust ownership.

The section also briefly discusses the use of a superannuation fund trustee, operating entity and group life policies as methods of achieving ownership.

The advantages and disadvantages discussed for each ownership method are general in nature and do not take into account the specific requirements of business owners. Business owners should seek their own accounting, legal and taxation advice for their particular circumstances.

Cross-ownership

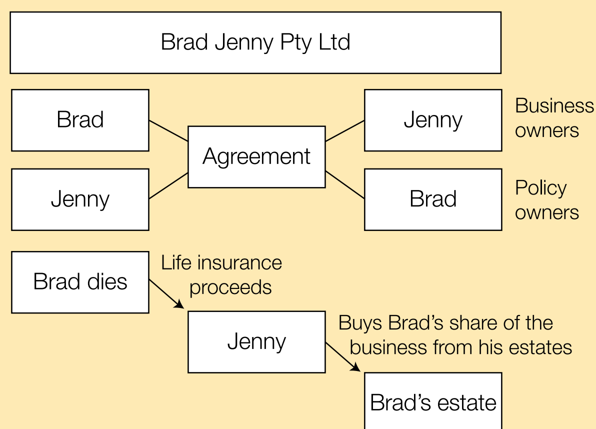
Summary

Each business owner owns an insurance policy on the life of each of the other business owners.

Example

If Brad and Jenny are the business owners, Brad would own a policy on the life of Jenny, and Jenny would own a policy on the life of Brad. If Brad died:

- the proceeds of the policy owned by Jenny on Brad's life become payable to Jenny
- Jenny uses the proceeds to purchase Brad's share of the business from his estate.



This example is for illustrative purposes only.

Cross-ownership was the standard method of ownership before the introduction of CGT.

The insurance proceeds were paid to the purchaser, who then paid them to the estate in exchange for a transfer of the equity.

The business succession agreement in such a scenario was, therefore, substantially the same as a normal sale of business agreement.

Advantages

Since the introduction of CGT, the ATO has approved the cross-ownership of death cover as being exempt from CGT.

Disadvantages

However, because most modern term life policies contain a trauma or terminal illness benefit, cross-ownership of such policies would incur CGT on the payment of the insurance proceeds as the recipient of the insurance proceeds is not the injured party. The same would apply to the cross-ownership of TPD or trauma insurance.

Other disadvantages of cross-ownership include:

- Scalability – the admission of new business owners may involve a change of beneficial ownership of an existing policy and, therefore, a risk that the new partner might be seen to have given consideration for the acquisition of his interest in the policy.

For example, assuming that Chris is to join the business and Brad, Jenny and Chris will be equal partners, Chris may wish to take a 50% interest in the existing policies on the lives of Brad and Jenny. However, for the purposes of section 118-300 ITAA97, Chris will not be an original beneficial owner of either policy, and upon receiving any policy proceeds, Chris has a potential CGT liability (Figure 1). This can be overcome by Chris taking out new policies on Brad and Jenny. Chris will then be the original beneficial owner of these policies (subject to underwriting considerations) (Figure 2). Note, however, that section 118-300 ITAA97 does not apply to TPD.

- Portability of the policy – if the policy was assigned to the insured on his retirement, he would not be the original beneficial owner and there may be a risk that he might be seen to have given consideration for the acquisition of his interest in the policy.

This assignment could result in a CGT liability on the ultimate payment of the proceeds to the insured or his/her estate.

Figure 1: Example

Chris joins the business and Brad (B), Jenny (J) and Chris (C) become joint business owners.

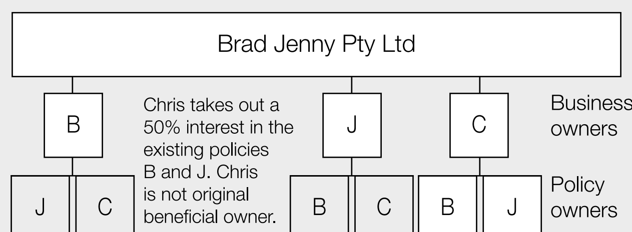


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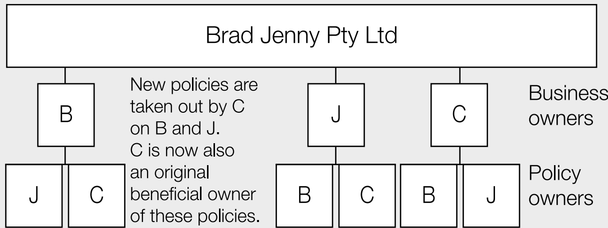
Figure 2: Example
New policies are taken out.



This example is for illustrative purposes only.

Self-ownership

Summary

Each business owner owns their own policy.

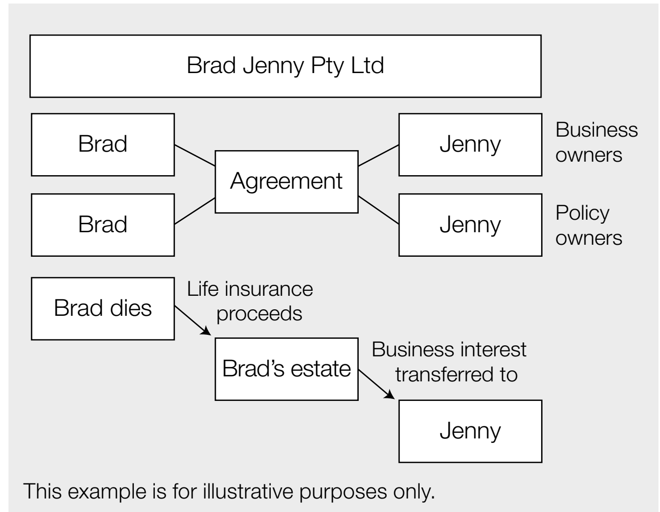
Example

If Brad and Jenny are the business owners, Brad would own a policy on his own life, and Jenny would own a policy on her own life. If Brad died:

- the proceeds of the policy owned by Brad become payable to Brad's estate
- pursuant to the terms of Brad's will or, a legal agreement, Jenny receives the insurance proceeds and uses those funds to enable a transfer of Brad's share of the business from his estate. As Jenny has an entitlement to the insurance proceeds from Brad's estate but also a liability to pay Brad's estate the market value of Brad's interest in the business, the two payments may be offset and merely Brad's interest transferred to Jenny (plus/minus any mismatch between the proceeds and the market value of the interest). Superficially, it may appear that Jenny has paid no or little consideration for the acquisition of Brad's interest in the business, which (if it were true) would be a substantial disadvantage in CGT terms if they subsequently disposed of the interests they acquire.

However, the ATO has accepted that, for CGT purposes, Jenny is deemed to have paid market value for the purchase (section 112-20 ITAA97), and Brad's estate is deemed to have received market value.

It is vital that a written business succession agreement is entered into. Without a written agreement, on the death of a business owner, the estate ends up with both the sum insured and the business interest. The estate may argue that an agreement never existed and it is entitled to sell the business interest for additional cash to the other business owners. However, this issue is common to trust ownership.



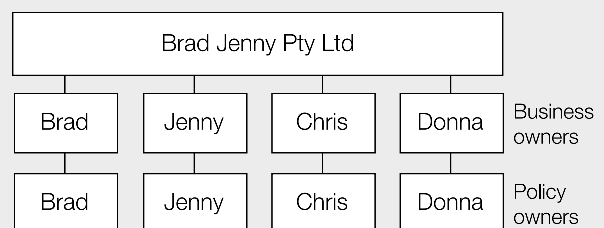
This example is for illustrative purposes only.

Advantages

The advantages of self-ownership include:

- Simplicity – each policy is owned by one person, regardless of any changes of ownership of the business
- Portability of the policy – as each insured owns their own policy, if they were to leave the business, they could take their own policy with them. There is no need to assign policies and there is no change in beneficial ownership. Therefore, there is no issue regarding a CGT liability on the proceeds of the policy under section 118-300 ITAA97
- Scalability – new business owners can become party to the agreement more easily than cross-ownership simply by acquiring their own policy (Figure 3). There is no potential CGT problem as a result of the new business owner acquiring an interest in the other policies. This is of major benefit in a business in which there is a high turnover of business owners and
- CGT Exemption – because the policies are self-owned, the recipient of any trauma, TPD or terminal illness proceeds is the insured. The insurance proceeds are, therefore, not subject to CGT.

Figure 3: Example
If Brad and Jenny had two new business partners (Chris and Donna) each would acquire their own insurance policies.



This example is for illustrative purposes only.

Disadvantages

The disadvantages of self-ownership include:

- It is vital that a written legal agreement, to pay insurance proceeds to the continuing business owner, is entered into. Without a written agreement, on the death or injury of a business owner, the estate/insured business owner ends up with both the sum insured and the business interest.
- The business owners are paying premiums to fund their own buy out. However, as with cross-ownership, the business owners can pay into a premium pool to share the premium costs.

Trust ownership

Summary

The cross-ownership and self-ownership models can be housed under the roof of a trust pursuant to which an independent trustee owns the policies on behalf of the other business owners (indirect cross-ownership) or the insured (indirect self-ownership).

Because of the CGT concerns with respect to cross-ownership, it may be more appropriate that the trust be a form of indirect self-ownership.

If Brad and Jenny are the business owners, where there is indirect self-ownership under the terms of the Trust, the Trustee would own a policy on Brad's life, and a policy on Jenny's life. If Brad died:

- the proceeds of the policy owned by Brad become payable to the Trustee
- the Trustee pays the insurance proceeds to Brad's estate or the appropriate vendor
- Jenny does not have to make any other payment in return for a transfer of Brad's share of the business from his estate pursuant to an agreement between Jenny, Brad and the vendor
- Under the CGT rules that operate in respect of non-arm's length transactions, Brad's estate is deemed to have received as consideration for Brad's interest in the business, its market value (hopefully this is equal to the insurance proceeds); and Jenny is deemed to have paid market value to acquire Brad's interest.

Advantages

The advantages of indirect self ownership through a trust include:

- Simplicity – each policy is owned by the trustee, regardless of any changes of ownership of the business.
- Portability of the policy – the trust owns each policy on behalf of the insured. If the insured were to leave the business, the trustee can assign the policy to the insured. However, this may involve a change of 'original beneficial owner' with the possibility of adverse CGT implications in respect of a subsequent death benefit.
- Scalability – new business owners can become party to the agreement more easily than cross-ownership simply by the trustee acquiring a policy on their behalf. There is no potential CGT problem as a result of the new business owner acquiring an interest in the other policies if the trustee is considered the 'original beneficial owner' of the death benefit. This is of major benefit in a business in which there is a high turnover of business owners.
- CGT exemption – if the insured is the appropriate vendor, then policy proceeds from any TPD, trauma or terminal illness benefit go to the insured. The insurance proceeds are, therefore, exempt from CGT.
- Commercial appropriateness – the insurance proceeds must be paid to the appropriate vendor. If somebody other than the insured (e.g. a company, a family trust or another related party) owns the business interest, the trustee must pay the purchase price to them and the CGT exemption is lost for TPD, trauma and terminal illness benefits. However, unlike direct self-ownership, indirect self-ownership through a trust has a third person (the trustee) ensuring that the insurance proceeds are directed to the appropriate person.
- Fiduciary duties – the trustee must comply with its fiduciary duties to the trust beneficiary.
- Comprehensiveness – a multiple purpose trust can allow other cover (such as debt reduction/guarantor protection cover, key person cover and personal cover) to be held on the same policy.
- Tax effectiveness – a multiple purpose trust, if adequately drafted, can avoid the adverse CGT and income tax implications with respect to debt reduction/ guarantor protection cover and key person cover that apply if cross-ownership or self-ownership is used.
- Cost Savings – use of a multiple purpose trust may result in lower policy fees and volume discounts with respect to premiums.
- Flexibility – a multiple purpose trust may allow changes of the mix of cover between the different needs (as a result of future changes) with reduced underwriting or administrative difficulties.

Disadvantages

The possible disadvantages of some (but not all) indirect self ownership trust arrangements include:

- Cost – in some cases, the costs with respect to a trust structure can be higher than a direct self-ownership buy-sell agreement. However, it should be remembered that business insurance trust agreements are often used to deal with debt reduction/guarantor protection, key person and personal cover in a tax-effective manner. Thus, any additional cost might reflect the additional benefits of the trust. (Advisers should nevertheless ensure that the costs are within the range of fees applicable to self-ownership business succession agreements.)

Superannuation fund trustee ownership

Summary

A superannuation fund trustee can be the trustee owning the policies on behalf of the insureds.

- Again, the obligation to pay the vendor entity the insurance proceeds and to transfer the deceased/injured owner's business interest to the remaining business owner should be contained in a formal legal agreement.
- TPD, traumatic illness (for a buy-sell agreement) may be unsuitable to be held through a superannuation fund as conditions of release may not be satisfied upon the occurrence of the insured event.
- There may be Reasonable Benefit Limit ('RBL') issues in relation to the proceeds (which may be used in conjunction with excess benefit pension strategies). Note that the Government has announced its intention to abolish RBLs from 1 July 2007.
- On the death of the life insured, benefits could be paid directly to the deceased's estate and then under the will to the surviving business owners (subject to superannuation law and the trust deed).

Advantages

- The original beneficial owner is not affected by a principal entering or exiting the business.
- Premiums – normally a tax deduction (up to the maximum deductible contributions subject to age based limits) can be obtained for any contributions made to the superannuation fund that are used for the purposes of providing death or disability insurance*.

Disadvantages

- Currently, if a death benefit from superannuation exceeds the RBL, then adverse taxation consequences may apply. If a beneficiary chooses to use an allocated pension to receive the proceeds, this may defer or reduce the taxation depending upon the relationship of the beneficiary to the deceased. Any commutations of the pension will involve particular taxation consequences depending upon the dependency relationship of the deceased and the beneficiary. However, the Government has announced that from 1 July 2007 RBLs no longer apply.
- TPD and terminal illness insurance may not be suitable to be held through a superannuation fund as any such benefits from superannuation funds are taxed as an ETP and are subject to the conditions of release under superannuation legislation which may prevent the release of benefits.
- Trauma insurance, in particular, may not be suitable to be held through a superannuation fund as the insured event will rarely meet a condition of release under superannuation legislation.
- If, following the death of a member inadequate provision has been made for a beneficiary(ies), they may be able to challenge the terms of any death benefit paid by the trustee of the superannuation fund and seek to have the trustee pay more of the insurance proceeds to them.
- Money distributed via a superannuation arrangement may be challenged under family law provisions.

Operating (business) entity ownership

Summary

- Insurance policies can also be held by the operating entity. Accordingly, upon the occurrence of an insured event it is the operating entity who will receive the insurance proceeds.
- On death of life insured – the company buys back the shares from the deceased's estate, then cancels them (or units in a unit trust are redeemed). This may lead to the remaining business principal(s) effectively acquiring more equity but not increasing the CGT cost base for those shares. They may, therefore, be subject to additional tax.

Advantages

- Transfer of ownership – The transfer of ownership is definite. There is no direct entitlement of shareholders or their beneficiaries to the operating entity's assets – the ownership of the company and the policy rests in the shares.
- The original policy owner is not affected by a principal entering or exiting the business.

* Note: The Government intends that age based limits be phased out from 1 July 2007.

Disadvantages

- Taxation – whenever a share buy-back occurs with a private company, the company needs to ensure that no breach of the capital streaming or dividend streaming occurs. These provisions are breached when one shareholder is provided with an advantage or opportunity (i.e. share buy-back) that is not provided to other shareholders. If a breach occurs, adverse taxation consequences may apply to either the shareholder or the operating entity, or both.
- Valuation – it is often difficult to place a value or determine the cost base of the shares if they are not widely held or publicly traded (i.e. private company). This may lead to disputes when any share buy-back occurs, as the share buy-back offer may be less than anticipated by the original shareholder.

Group policies

One alternative (particularly for partnerships) may be is to use a group policy as an indirect self-ownership trust. It could be that each business owner's interest is treated as if it were a separate policy with the business owner in each case being the original beneficial owner of his death benefit. Before a client uses a group policy in this way, independent tax advice should be sought to ensure this is the most appropriate ownership method for the client's situation. Advisers should advise clients that a favourable ruling from the ATO on this structure should be obtained before entering into such an arrangement.

✔ If the trust proceeds do not go to the insured, CGT may be payable with respect to the trauma, TPD and terminal illness proceeds.

Advantages

- If there is automatic acceptance for the group policy, normally everyone within the group scheme is provided with a minimum level of insurance cover without the need for individual medical tests.
- The cost of premium for the riskier lives is normally spread throughout the group thus making the cost of insurance more affordable for everyone, not merely the lives with a lower claim risk.

Disadvantages

- Due to underwriting limits it may not be possible to provide a sufficient level of cover under a group underwriting scheme.
- It should also be noted that most group life policies are normally for a fixed duration (one to three years). After this time these policies are put out for tender and may or may not be renewed by the life insurance companies.
- If the group policy is via a superannuation fund, then any insurance proceeds will have to meet superannuation legislation requirements for the distribution of the funds to beneficiaries.

Business succession agreements (buy-sell agreements or business wills)

A buy-sell agreement involves the business owners entering into a written agreement to plan what they are to do with their respective interests in the business should any one of them die, become disabled, suffer a traumatic or terminal illness, resign or retire – just like having a will in place for the business.

Essentially, the agreement should provide a mechanism for the terminating business owner (or his or her estate) to sell his or her interest in the business to the continuing owners, and for the continuing owners to purchase the terminating owner's interest in the business. The agreement should generally also recognise the means of funding the buy-sell obligations of the respective owners.

Traditional buy-sell agreements have been almost exclusively concerned with the sale of the interest in the business. As a result, they often fail to deal with the extinguishment or release of guarantees or securities granted by the insured or a related party.

It is increasingly common for agreements to deal with both asset (buy-sell) and liability (debt reduction/guarantor protection and key person) issues. These agreements are usually called business succession agreements.

If a trust structure is used to deal tax-effectively with the insurance proceeds, they are often called business insurance trust agreements.

Why is a written business succession agreement important?

If a written business succession agreement is used and triggered according to the terms of the agreement, the business insurance proceeds are generally quickly available, and the following benefits are provided:

- Certainty – about succession plans, i.e. what happens and when.
- Stability – to the business, the continuing business owners, and to employees.
- No need for additional borrowings for the buy out – the continuing business owners can buy-out the terminating business owner's share without having to borrow additional money.
- An agreed sale price – to be paid to the terminating business owner or his or her estate.
- A significant reduction in delay – between the trigger event and receiving the insurance proceeds.
- A sense of security – to financiers, suppliers, staff and customers.
- Preservation of the value of the business.

How is a business succession agreement set up?

1. The business owners negotiate and agree the trigger events, how the interests in the business will be valued, and the respective buy and sell obligations of the business owners should a trigger event occur.
2. A funding plan is established to provide the cash to achieve the financial obligations of the business owners should any of the trigger events occur.
3. The legal documentation is prepared.

How should the trigger event be drafted?

Mandatory obligations vs. put and call options

There has been much controversy with respect to the drafting of the clause in a business succession agreement that 'triggers' the obligation to buy and sell the equity.

Prior to the introduction of CGT, business succession agreements used mandatory 'must buy/must sell' drafting, under which the parties unconditionally agreed to buy and sell upon the occurrence of the trigger event. Since the introduction of CGT, the date of disposal of such equity for CGT purposes is deemed to be the date of formation of a contract of sale.

Thus, where mandatory obligations appear in a business succession agreement, there is an argument that the date of execution of the business succession agreement itself might constitute the date of disposal for CGT purposes. This would result in a CGT liability at the time of signing the agreement, even though no trigger event had occurred.

The trigger clauses in business succession agreements now generally use mandatory obligations subject to conditions precedent or put and call options to avoid this scenario.

How do mandatory obligations operate?

An improperly drafted 'mandatory obligation' might still result in a deemed disposal of the equity in the business for CGT purposes at the time of execution of the agreement (rather than when the trigger event occurs).

If it is clear that the trigger event is a 'condition precedent' to the 'formation' of the contract of sale (as opposed to a condition precedent to the performance of the contract of sale), then there is no disposal for CGT purposes until the trigger event occurs.

Business succession agreements

However, if the trigger event is only a condition precedent to the 'performance' of the contract, there is an argument that the underlying asset was disposed of at the time the contract was signed.

Care must, therefore, be exercised in the drafting of conditions precedent in business succession agreements, and a legal professional should be consulted in the drafting of such agreements for your clients.

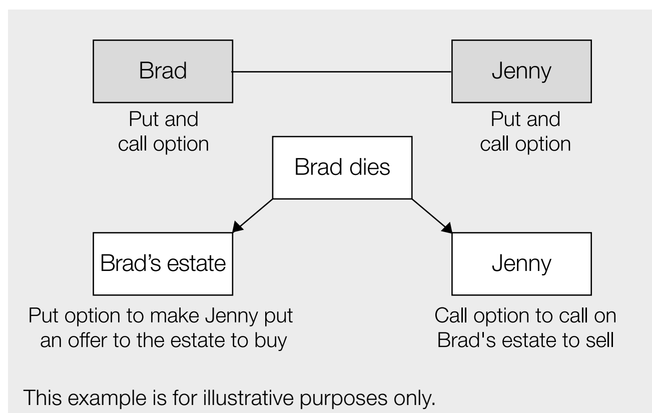
How do put and call options operate?
The alternative to conditions precedent is the use of 'put and call options'.

However, the use of put and call options in the agreement provides the business owners with the same level of comfort as a mandatory agreement because unless all of the relevant business owners do not wish the buy-out to proceed, it will proceed. Both parties must agree not to proceed. If just one party wants the agreement to go ahead, it must.

Put and call options are a combination of two options exercisable by one or other party (i.e. the vendor or the purchaser):

- the 'put option' enables the estate or vendor to require the other business owners to purchase its interest in the business on the occurrence of a trigger event; and
- the 'call option' enables the other business owners to call upon the estate or vendor to sell its interest in the business on the happening of a trigger event.

Both Brad and Jenny have a put and a call option.



This example is for illustrative purposes only.

In such a scenario, we would expect that one party or other is likely to require a sale to occur, so it is highly likely that one of the two options will be exercised and the sale will take place.

However, for taxation purposes the contract of sale is not formed until the option is exercised (regardless of the date of the business succession agreement).

The only disadvantage of a put and call option is that it requires each party to be aware that it has an option and then to exercise it (if appropriate) within the required time. This might not always be possible, e.g. if there is a delay in identifying the executor of the will because of some problem with the will.

Stamp duty implications?
Each State has unique stamp duty legislation. Stamp duty is an issue which needs to be explored in relation to these agreements. Advisers should recommend that clients obtain independent legal advice.

Dealing with traumatic illness in a business succession agreement

Trauma insurance in a business succession agreement provides the funding that enables a buy-out to occur in the event of a business owner suffering the insured event.

However, the traumatic illness might not be sufficient to require the insured to:

- spend a considerable time away from work; or
- sell their business interest immediately.

How do you deal with the trauma proceeds if the insured does not need to sell their business interest?
With trauma insurance, there is some potential for the insured to return to work – in which case there is no need to sell their business interest immediately. In the meantime, what happens to the trauma insurance proceeds?

The ATO requires the insurance proceeds to be paid to the insured, in order for them to satisfy the exemption with respect to compensation or damages for personal injury under section 118-37 ITAA97 and thereby not give rise to a capital gain.

The agreement may therefore deal with the basis upon which the business interest must be sold and the extent to which the insurance proceeds already received by the insured must be credited towards any purchase price that would otherwise be payable upon a future sale.

The conditions precedent or put and call options in the business succession agreement can be postponed until a satisfactory test with respect to the insured's fitness to continue in the business has been satisfied.

For example, the business owners may choose to prevent exercise of the option for six months after the occurrence of the trauma. Alternatively, the remaining owners may choose to look at the impact the particular business owner's trauma has on business turnover to defer the exercise of the option until, say, 20% of turnover has been lost.

Example
Brad and Jenny delay the exercise of the put and call options until six months or a 20% reduction in business turnover upon an insured event. If Brad has a heart attack, Jenny can only exercise the option to buy out Brad, if Brad is not back at work within six months or if the business turnover is reduced by 20% or more. If Brad comes back to work within six months, or if the business turnover is not reduced by 20% or more, the option is not exercisable.

This example is for illustrative purposes only.

In either case, this means that the options do not have to be exercised immediately, giving all business owners some about the procedure for the future, but allowing the insured some time to recover and work out if they can return to the business.

From a tax perpsective, traditionally, trauma proceeds can be dealt with in several ways:

- If self-ownership is utilised for CGT exempt status, the ATO requires the insured to receive the proceeds. The business owners may wish to decrease the purchase price (if any) that would otherwise apply in relation to a sale of the insured's business interest by the amount of the trauma proceeds received by the insured. If this is done, for tax purposes the sale is likely to be deemed to have occurred at market value. The purchaser would get a full market value cost base although he or she paid less. The vendor would be deemed to have received market value although he or she received less, however, the sum of the trauma or terminal illness proceeds and the purchase price paid would equal the market value of the vendor's interest in the business. In the absence of a sale of the business interest, the proceeds will still be compensation or damages for personal injury and will not be subject to CGT.
- If cross-ownership is used, the 'purchasers' might be entitled to keep the proceeds. However, because the policy owner is not the 'injured person', the proceeds would be subject to CGT in the hands of the 'purchasers'.
- Having used self-ownership and obtained an exemption on the payment of the proceeds, it may be possible to declare a trust of the proceeds and distribute them according to the agreement to avoid CGT. The declaration of trust can provide added security and flexibility to the agreement. Advisers may need to obtain a taxation ruling/determination from the ATO (contact the ATO or your taxation adviser for more information).

What are the implications for a subsequent death or TPD?
An example of the possible implications: CommInsure's trauma policy (if not stand alone) requires the value of any life or TPD cover to be reduced by the amount of any trauma benefit paid. The buy-back facility allows the life cover to be reinstated twelve months from the date the trauma claim is accepted.

However, the business succession agreement needs to take into account the implications of two payments upon the occurrence of two successive insured events, both within the twelve month period and outside it.

Commercial Debt Forgiveness (CDF)
Often there are loans, either between the business principals and the business, or between business entities. On the exit of a business principal, it is common to have to tidy up these loan accounts. If this occurs by way of forgiveness of such debts, tax issues can arise.

Why we have CDF rules
CDF rules exist to avoid duplicating possible taxation deductions.

Dealing with traumatic illness in a business succession agreement

Example

The creditor

The business principal lends money to the business to fund the purchase of trading stock. He might be entitled to an income tax deduction or capital loss on forgiveness of the debt; in addition,

The debtor

The company which is relieved of the obligation to repay the debt might not be assessed on any gain from it no longer having a debt in its accounts; plus

It may continue to be entitled to claim tax deductions for the trading stock which is bought with the borrowed funds.

The CDF rules were introduced to subject the debtor, who benefits from the forgiveness, to some unattractive tax consequences.

When does CDF occur?

Broadly, a CDF arises where a commercial debt is forgiven.

A debt is defined as an enforceable obligation to pay another person. A commercial debt is, typically, a debt upon which interest is deductible, or would be deductible if it were payable, (or would have been but for an exception provision).

Broadly, a commercial debt forgiveness can occur if:

- a debt is released, waived or extinguished
- due to the age of the debt, the statute of limitations applies
- an agreement is entered into to reduce the obligation at some time in the future
- there is a debt parking arrangement, or
- a person subscribes for shares to enable the company to repay a debt.

In most cases, the principal of the business will have a written CDF agreement and/or a debt will be written off in the accounts.

Tax treatment

The CDF rules are of particular interest to the debtor, who benefits from the forgiveness.

From a taxation perspective, a business entity can usually claim a tax deduction for accumulated revenue and capital losses and other undeducted expenditure. The CDF rules result in the relevant forgiven amount eroding the debtor's:

- revenue losses
- capital losses
- deductible expenditure (e.g. depreciable plant, intellectual property), and
- the cost base of certain assets,

in that order.

Interaction with the Fringe Benefit Tax (FBT) and income tax rules

If the amount forgiven constitutes a fringe benefit, e.g. a business forgives a debt owing by an employee, the FBT rules, rather than the CDF rules, will apply.

If the forgiveness results in a deemed dividend under other income tax rules, e.g. if a private company forgives a loan owing by a shareholder, it is those (other) income tax rules which will apply.

Exemptions

Generally, CDF rules will not apply to forgiveness in the following circumstances:

- effected under an Act relating to bankruptcy
- effected by a will, or
- which occurs for 'natural love and affection'.

Ownership of the insurance policies – pay the debts

In buy-sell situations, we are used to business principals self insuring for the value of the equity. The exiting business principal or their estate then receives the insurance proceeds, hopefully tax free. They then transfer their equity to the remaining principals for no consideration. You should:

- ensure that the party who has the debt obligation is the recipient of insurance proceeds, so that they can discharge such debts, or
- that they have the capacity to discharge such debts from some other resources.

Debt reduction or guarantor protection insurance

Why is debt reduction or guarantor insurance needed?

Debt reduction or guarantor protection is a form of business insurance that ensures that upon the occurrence of an insured event with respect to a director/guarantor, the business debt guaranteed by that director/guarantor is fully repaid. The proceeds can be used to protect business owners and guarantors from the ramifications of giving a guarantee for a business loan should an event occur which impinges their ability to make good the liability.

When a director signs a guarantee, it generally means the director has secured a loan for the business directly or indirectly using all or some of his or her personal assets.

The guarantee is usually extinguished only when the loan is repaid in full. A lender may be able to call on the guarantee in the event of death, disablement or trauma.

- ✔ One purpose of debt reduction or guarantor protection cover is to protect the guarantor and their estate. The availability of proceeds ensures that funds are available to extinguish the guarantee, releasing the guarantor and the estate from the lender's security over the family's personal assets.
- ✔ The second purpose is to benefit the business and the remaining business owners – if the debt is wholly or partly repaid, the financial burden on the business is reduced and other guarantors could be released from the bank's security over their assets.

How much debt reduction or guarantor protection cover is needed?

It is necessary to determine how much of the business debt should be repaid in order to release the personal guarantee and any other personal securities. A holistic approach should be adopted, considering the overall insurance requirements and funding needs of the business and the owners.

The amount of debt reduction or guarantor protection cover required depends on the type of guarantee signed. Most bank loan or overdraft guarantees are 'joint and several'. This means that every guarantor is 100% liable for the loan, regardless of their share of the business and regardless of the individual assets each guarantor might have used as security.

In such cases, where the guarantor generates the majority of the business's income the client may want to obtain death cover for the full value of the debt. When the proceeds are received, the guaranteed debts are repaid in full. In the absence of a total repayment, the personal assets or estates of every guarantor could remain vulnerable until the debt is repaid in full. However, if the guarantor does not generate the majority of the business's income it may be sufficient for your client if the cover provided for the guarantee is equivalent to their share of ownership of the business.

You should also consider whether it is appropriate to recommend that the business owners include TPD, traumatic or terminal illness cover.

The decision depends on the specific needs and situation of the guarantors and of the business. The level of debt reduction/guarantor protection needed should be assessed taking into consideration the total insurance funding requirements for the business and its owners.

Who owns the policy and pays the premiums?

The introduction of CGT and the different treatment of death cover (on the one hand) and TPD, traumatic illness and terminal illness cover (on the other hand) have complicated the ownership of debt reduction or guarantor protection cover.

Who can be a policy owner?

Cross-ownership

The traditional method of owning debt reduction or guarantor protection cover has been to hold it in the name of the business entity, because it is the debtor that owes the debt to the creditor or bank. This is a form of cross-ownership.

However, since the introduction of CGT, this method of ownership will result in CGT with respect to TPD, trauma or terminal illness proceeds paid to the entity.

This method of ownership will not, however, result in CGT with respect to death proceeds paid to the entity.

However, there may be adverse tax implications with respect to subsequent dealings with the proceeds by the business.

The repayment of the debt by the business results in an increase in the working capital and net value of the business.

If the business is a company and the shareholders wish to distribute some of the increased value to themselves as a dividend (e.g. so that they may reduce their personal debt), the franking level of the dividend will depend on the franking account status of the company. Refer to page 16 for more information on operating entity ownership.

There is likely to be income tax payable with respect to the dividend at the marginal rate applicable to the shareholders offset against these franking credits. In other words, it is possible to get death proceeds into a company tax-free, but it is usually not possible to get them out tax-free.

Self-ownership

One alternative is for the insured to own the debt reduction or guarantor protection cover.

This method of ownership will avoid CGT with respect to the proceeds paid in the case of death, TPD, traumatic illness and terminal illness.

However, once the proceeds have been paid to the insured or their estate, it is necessary for them to be repaid to the creditor or bank.

It is necessary to consider the CGT, income tax and commercial implications with respect to this transaction. There should be a debt reduction agreement that requires the proceeds to be paid to the creditor or bank in reduction of the debt owed by the business to the creditor or bank.

However, such an agreement might have CGT implications in its own right.

If the insured or estate repays the debt, it may have a 'right of contribution'* (unless the right to contribution was contractually excluded from arising) against the debtor business and the other guarantors, pursuant to which it is entitled to be reimbursed for the amount it has just repaid. If this right is released or extinguished, there are adverse CGT implications.

Without a contractual agreement to exclude rights of contribution from arising, if the right of contribution is exercised against the debtor, it will create a new loan account owing to the insured or the estate at a time when the aim of the parties was to exit the insured or the estate from the business relationship.

In the future, income and capital of the company will need to be paid to the insured or the estate by way of repayment of the loan account.

Thus, the insurance proceeds would have improved the financial position of the insured or the estate (rather than the business). Instead of the business being indebted to an external creditor, it will now have a new loan account or internal creditor to repay.

Trust ownership

If a bare trust is structured as an indirect form of self-ownership, it can assist in avoiding CGT with respect to the proceeds paid in the case of death, TPD, traumatic illness and terminal illness, if the insured directs the trustee to pay the proceeds to the creditor on behalf of the debtor business.

It may be possible to structure the business insurance trust agreement so that there are no adverse CGT or income tax implications with respect to the rights of contribution or subsequent payment of dividends. Advisers may need to obtain a taxation ruling/determination from the ATO (contact the ATO or your taxation adviser for more information).

Summary

There are a number of other methods to set up the policy ownership.

The disadvantages discussed below are general in nature and do not take into account the specific requirements of business owners. Business owners should seek their own accounting, legal and taxation advice for their particular circumstances.

Operating entity owns the policy and pays the premiums

This method of ownership is equivalent to key person capital purpose insurance for debt cancellation (refer page 22). The justification for this method is that the business is taking responsibility for its debt and is also taking responsibility for the people who have enabled it to secure the debt.

Disadvantages

Certain disadvantages to consider:

- Application to other creditors – if the business becomes insolvent, then the proceeds for debt would be pooled with the other business assets. All of the creditors (not necessarily the guarantors) may have a right to the proceeds. The result could be that the guaranteed debt which was intended to be repaid might not be repaid, and the creditor could still call on the guarantor/s (or the relevant estate/s) to repay the guaranteed debt under the guarantees.
- CGT – if the policy pursuant to which the TPD, trauma or terminal illness proceeds are paid is owned by the business, the cover would be cross-owned and the proceeds would be subject to CGT.
- No franking credit – if the business is the original beneficial owner of the policy pursuant to which the death proceeds are paid to the business, there would be no CGT liability and therefore no franking credits would arise in relation to the receipt of the proceeds. Hence, if the proceeds were subsequently distributed to the shareholders as a dividend, there is unlikely to be any franking credit attached to the dividend. As a result, there would be income tax payable with respect to the dividend at the marginal rate applicable to the shareholders which would not be offset by franking credits.

Guarantor owns the policy and pays the premiums

This method of ownership requires the insured to own the policy and agree to repay the debt on behalf of the debtor business.

Debt reduction agreement

If all business owners/guarantors have taken out debt reduction/guarantor protection, a written agreement should be in place setting out the respective parties' obligations. Alternatively, an individual guarantor could also take out debt reduction/guarantor protection individually and on his own behalf.

In the case of trauma, TPD or terminal illness proceeds, the proceeds will be exempt from CGT, if the injured person within the meaning of section 118-37 ITAA97 beneficially owns them.

* The 'right of contribution' is a concept of equity law. However, if the parties have signed joint guarantees or loan agreements, it is possible that a recoupment of the insured's contribution to repaying the debt might also be contractually enforceable. If such an equitable or contractual right is released, there may be a disposal of an asset for CGT purposes but a capital gain is unlikely to arise as the cost base of the right (i.e. the amount paid to extinguish the loan) is unlikely to be less than the market value of the right.

To enable the guarantor to make the premium payments, the business could pay a 'guarantee fee' to the guarantors as compensation for giving the guarantee and risking their personal assets. The fee must be set at arm's length and should be valued regularly by a bank manager or finance broker. The fee is deductible to the business, but assessable to the guarantors.

Disadvantages

- To protect all parties, a simple written agreement may be entered into that says that any claim proceeds will be used to repay the debt. However, such an agreement might have CGT implications of its own if the agreement is not acted upon as this would constitute the disposal of a right.
- Right of Contribution – If the insured or estate repays the debt, unless excluded by contract, it may have a right of contribution against the debtor business and the other guarantors, pursuant to which it can be reimbursed for the amount it has just repaid. If this right is released or extinguished, there are adverse CGT implications.
- New Loan Account – If the right of contribution is exercised against the debtor, it will create a new loan account owing to the insured or the estate at a time when the aim of the parties was to exit the insured or the estate from the business relationship.

Trustee owns the policy and business pays the premiums

This method of ownership involves the trustee owning the cover on behalf of the insured. As a result, the proceeds are exempt from CGT. However, should the insured direct the trustee to pay them to the creditor on behalf of the debtor business, it may be possible to structure the arrangement so that there are no adverse CGT or income tax implications with respect to the rights of contribution or subsequent payment of dividends. Advisers should insist on obtaining a positive opinion from the ATO.

Disadvantages

The possible disadvantages of some (but not all) trust arrangements include:

- Cost – In some cases, the costs with respect to a trust structure can be higher than a self-ownership debt reduction agreement. However, it should be remembered that business insurance trust agreements are often used to deal with buy-sell, debt reduction/guarantor protection, key person and personal cover both tax effectively and securely. Thus, any additional cost might reflect the additional benefits of the trust. Advisers should nevertheless ensure that the actual costs are within the range of fees applicable to self-ownership business succession agreements.

Business expenses insurance

How much cover?

Three things should be considered when calculating the amount of insurance required for business expenses. These are:

1. How many business owners/partners are in the business?
2. How much revenue does each owner/partner generate for the business?
3. Does the business have any income producing employees?

Note: Business expenses insurance is an indemnity policy, there has to be a genuine fall in revenue, due to the business principal's or key employee's illness or injury, before a claim will be covered.

Policy ownership

The ownership of business expenses insurance depends on the structure of the specific business.

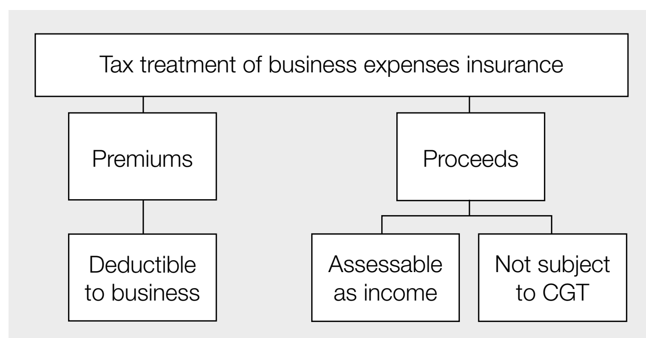
The following table may be used as a simple guide:

Insured	Suggested policy owner
Sole trader	Self
Partner	Joint owners or partnership
Principal of a single director company	Self or company (but probably company)
Employee or director	Company or trustee of a unit trust which will continue after the death, disability or critical illness of the insured of a company or trustee of a unit trust

The examples above are not exhaustive.

Tax treatment

The following chart shows the general tax implications of business expenses insurance.



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.

The above chart and explanation reflects our interpretation of the legislation and ATO releases at the date of this document. Advisers should seek their own legal advice.

Key person insurance

Why is key person insurance needed?

All businesses should consider the use of insurance to compensate the business for any financial loss or cost suffered because an insurable event has occurred with respect to a key person.

Most businesses take out insurance cover for assets that do not actively make them profits – their plant, equipment, vehicles and buildings. But it is the human asset that, through initiative, drive, skill, specialist knowledge and ingenuity which, can actively generate profit from this business.

Who is a key person?

A 'key person' is someone whose continued association with a business provides that business with a significant and direct economic gain. Economic gain means more than just profits. It can, amongst other things, also include cost savings, capital injections, goodwill, access to credit and access to customers. A common example of a key person is an employee who is directly responsible for bringing in sales or who holds the key technical expertise on which a business relies.

The owners of the business will usually be key people. While the following list is not exhaustive, a key person could also include a:

- Managing director – whose expertise, ingenuity and ability enable the business to run smoothly, operate within budget and establish a strong market presence.
- Sales manager – whose unique contacts or business methods give the business a competitive edge.
- Financial controller – who has set up a budgeting and reporting system that has saved the business money, and will continue to do so as the system develops.
- Computer programmer – who has been contracted to write a software program that the business can on-sell and who the business may later contract to maintain.
- Specialist engineer – whose knowledge enables the business to win contracts.
- Famous actor – who is expected to be a big drawcard for a new movie or theatre production.
- Working director – who does the work of two employees, but only draws a moderate salary, so that more money can go back into the business.
- Silent partner – whose strong reputation with financiers allows the business to access more, or better financing.

What cover does key person insurance provide?

Key person insurance can compensate the business for the loss of two different qualities:

- business profitability (revenue purpose), and
- the capital value of the business (capital purpose).

Key person insurance proceeds can replace the lost profit or capital value that the key person would have generated. The funds can be used to stabilise the business until a suitable replacement person is found and who is capable of being trained to have the same key skills.

Reduction of business profitability (revenue purpose)

Losing a key person can cause revenues to go down, and business costs to increase. Key person insurance proceeds can be used to:

- replace the revenue the key person would have generated, or
- pay the extra costs the business incurs in finding a suitable replacement.

In either case, the profitability of the business can be maintained, and the business stabilised, when key person proceeds are available.

Some other areas of business profitability that can be affected are:

- Sales/revenue – the loss of a key person directly responsible for sales can result in a fall in sales until a replacement is found and the replacement person starts to generate similar sales results.
- Recruiting costs – the costs incurred by a business to locate, attract and recruit a suitable replacement can be considerable and will lower business profit.
- Training costs – the replacement key person may require expensive specialist training.
- Destabilisation – a key person is an integral member of the business. The loss of a key person can also indirectly affect business revenue. Short-term internal reorganisation can cause remaining staff to take on extra duties. The extra pressure put on those people may prevent them from performing to their usual standard. In addition, the remaining staff may feel insecure about their future and the future of the business. Other businesses with which the business deals may also have the same misgivings. This type of destabilisation can have a profoundly negative effect on business revenue.

What to ask

The aim is to determine:

- the loss of profit and/or
- the cost of replacing the key person.

One way to value the loss of the key person to the business is to multiply their remuneration (salary, bonus, commission and super) by 4 to cover the costs of recruitment and training of a good candidate in a short period of time. Also as a guide, ask the business owner how much of the business revenue was contributed by the key person? 50%, 20%, etc? Or, ask the business owner what effect the loss of that key person would have on the profit/revenue of the business, and how long would it be before a replacement can be found and trained to produce the same results? Ask the business owners– how they would replace the key person? What role did the key person play? What position would need to be filled? What is the annual salary cost of the replacement?

Reduction in the capital value of the business (capital purpose)

Losing a key person can also adversely affect the capital value of the business. Key person insurance proceeds can be used to maintain the capital value and stabilise the business.

The capital value of a business can be reduced by the loss of the key person having an impact on:

- Goodwill – goodwill is what brings clients to the business. A key person may have specialised knowledge, unique skills, high quality business contacts or even a reputation for excellence. The loss of that person can adversely affect this goodwill factor.
- Credit standing – some businesses can secure credit lines more easily than others because, for instance, one director has sufficient personal assets to secure the debt. With the loss of that director, the business may find it more difficult to access or maintain lines of credit and overdraft facilities. Key person insurance proceeds give the business an alternative source of funds.
- Loan accounts – the loss of a key person who has loaned money to the business may mean that the loan must be repaid to the key person (or their estate) immediately.
- Other debts – if the business is destabilised and defaults on a loan, the financier could call in one or more of the loans made to the business.
- Capital purpose key person insurance aims to ensure that the business can repay debts on the loss of the key person, easing the financial burden of the business at a crucial point in time. This will give the remaining business owners some breathing space to stabilise and maintain the capital value of the business.

What to ask

Ask the business owner – how much of the current capital value and yearly capital appreciation is attributable to the key person? 50%, 20%, etc?

Would the capital value of the business suffer without the key person? Even with a replacement staff member funded by key person insurance?

The capital value of the business is often determined by profitability and/or might include a goodwill component.

If the profitability or goodwill would be reduced by 50%, 20%, etc. upon the loss of the key person, this will be one measure of the capital loss suffered by the business.

Debt reduction/guarantor protection insurance is another form of capital insurance which could be considered at the same time.

What insurance products can be used?

Death, TPD, traumatic illness and terminal illness

The sudden death, TPD, traumatic illness or terminal illness of a key person will have the most impact on the business if there has been no planning for the loss. Life insurance, TPD, terminal illness and trauma insurance cover can help protect a business should such events occur.

Permanent policies

To allow for retirement and resignation, a policy that builds up a cash value could be used to offset the effects of retirement and resignation in part or full, when they happen.

✔ The type of policy used can impact on the taxation treatment of the premiums and proceeds.

What is the tax treatment of a key person insurance proceeds?

It is important to consider both the income tax and the CGT treatment of key person insurance.

The income tax treatment of key person premiums and proceeds depends on the type of policy used and its purpose.

Income Tax Ruling IT155 is the governing ATO ruling for key person insurance.

IT155 applies some basic rules that depend on whether ‘temporary’ (i.e. term) life insurance or ‘permanent’ (i.e. whole of life or cash value) policies are used.

If term insurance is used, then the tax treatment depends on whether the purpose of the insurance is for ‘revenue’ or ‘capital’. Revenue purpose insurance premiums are tax deductible to the business and the claim proceeds are assessable. Capital purpose insurance premiums are not tax deductible to the business and the claim proceeds are not assessable if the benefit is a death benefit and the recipient was the ‘original beneficial owner’ of that benefit or did not pay consideration to acquire it.

The view of the ATO is that, if whole of life (permanent) insurance is used (which is not a ‘split dollar’ arrangement – see below), the premiums paid by the business are not tax deductible and the insurance proceeds are not taxable in the hands of the policy owner regardless of the purpose for which the policy was written. However, it may be arguable that it is the purpose for which the policy was taken out/renewed that governs the tax treatment of the premiums and proceeds.

You should seek specialist taxation advice for your clients in respect of these issues.

The taxation treatment depends on whether the key person policy is for a capital or revenue purpose.

It is necessary to establish two different issues:

- the intent when the policy was taken out, and any change in intent during the life of the policy and
- the purpose for which the proceeds are actually used.

How is the purpose established?

IT155 states that:

> "… 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".

When the policy is first taken out, the purpose of the insurance should be recorded through minutes or book entries.

If the business succession agreement deals with debt reduction/guarantor protection and key person needs, it can be an appropriate record of the purpose for tax purposes.

In the case of a sole trader, the purpose can be recorded by a file note or in a letter to the insurance company.

What do 'revenue purpose' and 'capital purpose' mean?

IT155 requires that, in deciding the tax treatment of a term key person insurance policy, the purpose of taking out the insurance, and the intended application of the proceeds, must first be determined.

Revenue purpose insurance is key person insurance taken out to protect the business from a fall in revenue or increased costs and includes any protection against an adverse event affecting the revenue or profit and loss account.

Capital purpose insurance is protection against an adverse event affecting the balance sheet and/or unrecorded assets or values of assets e.g. self generated goodwill.

Examples of revenue purpose	
✔	Costs to locate, recruit and train a full-time replacement.
✔	Cost of a temporary replacement until a full-time replacement can be recruited.
✔	Compensation for falls in revenue/sales/profit.
✔	Compensation for bad debts resulting from the loss of a key person.

Examples of capital purpose	
✔	Repaying the estate of a deceased key person for loans made by the deceased key person to the business.
✔	Repaying other debts called in because of the loss of the key person.
✔	Replacing the value of goodwill lost because the key person is no longer there.
✔	Replacing lines of credit guaranteed by the key person.

The purpose must still apply at the time of the claim. If there has been a change in the purpose or the insurance proceeds are used for a different purpose at the time of the claim, it may affect the deductibility of past premiums and the assessability of the insurance proceeds.

The proceeds of a policy minuted for capital purposes (and for which the premiums have not been deducted) might still be assessable at the time of claim, if the proceeds are used for revenue purposes.

It is important that there be new records of the purpose each year when the policy is renewed, because the need or amount might have changed over the 12 month period.

✔ Draft minutes for revenue and capital purposes along with file notes for a sole trader are on pages 28 to 31.

What is the tax treatment for sole traders?

Sole traders and one-person incorporated businesses cannot normally insure themselves as a key person for key person revenue purposes and get a tax deduction for the premiums. Income tax ruling IT2434 defines a 'key person' and states that the business must suffer a loss of profits during the continuation of business. If the business would automatically cease when the person was lost, then the business could not continue or suffer a loss of profits after the occurrence of the insured event.

However, if the business was to be continued by a family member or it was intended to be sold to a nominated third party (e.g. an employee) under a business succession agreement, there might be sufficient continuity to satisfy IT2434.

Even if the sole trader could not obtain deductible key person revenue insurance, he or she could obtain personal insurance to deal with the increased needs of his/her family resulting from the occurrence of the insured event.

✔ Sole traders or one-person incorporated businesses that have employees working for them may be able to insure those employees as key persons.

What is the income tax treatment of whole of life or permanent policies?
A whole of life or permanent policy is a policy that consists of two components:

- a risk component and
- an investment or savings component.

A 'split dollar' arrangement exists where two or more parties agree to split the benefit of the two components of the whole of life or permanent policy. It is common for an employer to own the risk component and the employee to own the investment component. The arrangements usually split the premium between the employer and the employee according to the ownership of each component. In some cases, the risk component owned by the employer might be intended for a revenue purpose.

CommInsure does not offer whole of life policies, including 'split dollar' arrangements.

However, as some business owners may have existing whole of life policies, it is useful to be aware of the tax treatment of these types of products.

IT155 effectively requires two conditions to be satisfied before any part of the premium can be deductible:

- the cost of the risk component must be divisible from the investment component; and
- the purpose of procuring the risk component must be for a revenue purpose. The ATO takes the view that if the premium is not divisible, there can be no deduction for any part of the premium (regardless of the purpose of the insurance proceeds).

The premium with respect to the investment component is, in the opinion of the ATO, not deductible, because it is of a capital nature.

What is the income tax treatment of 'split purpose' whole of life or permanent policies?

Under a 'split dollar' arrangement, the risk and investment components of a whole of life policy are split between two different parties.

Under a 'split purpose' arrangement, one party (e.g. the employer) owns both components of the one policy, but attempts to split the premium between a deductible purpose and a non-deductible purpose.

Because there is only one owner, the ATO's view is that there is no legal split of the benefits or the premiums. Therefore, it will not allow a deduction for the premium for the risk component (regardless of the purpose of the insurance proceeds).

What is the CGT treatment of key person insurance proceeds?
The purpose of the key person insurance policy will determine its income tax treatment.

It is also necessary to determine the CGT treatment of the proceeds.

If the policy is for a revenue purpose and is subject to income tax, the proceeds cannot also be subject to CGT. However, if the policy is for a capital purpose and is not subject to income tax under IT155, it is possible that the proceeds might be subject to CGT.

The CGT treatment of debt reduction/guarantor protection and buy-sell insurance proceeds and policy ownership discussed previously is just as applicable to key person cover.

TPD, trauma and terminal illness proceeds owned by and paid to the business will normally be subject to CGT.

Ownership of key person capital cover by a trust in relation to which the insured is beneficially entitled can avoid CGT in the case of TPD, trauma and terminal illness proceeds.

Who owns the policy and pays the premiums?
Since it is the business that is being protected and that will receive the proceeds of the policy, the entity* usually owns the policy and pays the premiums.

An alternative is for the business owners or shareholders to take out the policy, so that they can compensate themselves for any loss of value.

Ownership of key person capital cover by the shareholders or a trust in relation to which the insured is beneficially entitled can avoid the adverse income tax implications of getting insurance proceeds into a company tax-free (such adverse implications could result from there being no franking credits to attach to a subsequent distribution of the insurance proceeds as a company dividend).

However, ownership by the shareholders will still result in CGT with respect to TPD, trauma and terminal illness proceeds.

Key person insurance
The following draft minutes and files notes are templates only and should be tailored to each particular client's circumstances and requirements.

* Entity depends upon the business structure – it may mean company, partnership, individual or trust.

Draft minutes for key person insurance (capital purpose)

Minutes of meeting of [directors/partners] of ____ (the Business)

ACN/ABN (if applicable) ____

Held at ______________________________ **on the** _________________ **day of 20** _______

Present ____

____

____

Chairperson ____

Key person insurance (capital purpose)

The Chairperson informed the meeting that discussions are concluded for the procurement of key person insurance for the Business with respect to ____ (the key person).

The purpose of the cover is to, e.g.

- maintain the capital value of the Business
- repay a debt owing by the Business to ____

(the creditor): ____ upon the occurrence of the following insured events with respect to the key person:

- ☐ death
- ☐ total and permanent disablement
- ☐ traumatic or terminal illness.

The proposed policy is policy number ____________ to be issued by The Colonial Mutual Life Assurance Society Limited (CommInsure) for the sum insured of $ __________________ to be paid upon (e.g. the occurrence of any of the insured events) for the premium of (e.g. $XX inclusive of all taxes and duties for the year).

Having considered the information obtained through the course of the (company/partnership's) investigations into the procurement of the insurance, the (directors/partners) (e.g. unanimously) resolve to purchase the proposed key person insurance with respect to the key person.

It was noted that because the policy is for a capital purpose:

- the premiums paid in respect of the policy will not be tax deductible
- the tax treatment of the insurance proceeds will be as follows:
  - for life insurance, it will not be subject to income tax or capital gains tax
  - for trauma insurance, it will be subject to CGT
  - for TPD insurance, it will be subject to CGT.

It was noted that a similar minute is necessary at the time of any future renewal or change in either the purpose of taking out the policy, or the intended application of the proceeds.

Closure: There being no further business, the meeting was declared closed.

Confirmed as a true and correct record by:

____ (Chairperson) on ______ /______ /______ (insert date).

File note for key person insurance (capital purpose) – sole trader

Re: purpose of policy no. ______________________________

Date: ______________________________

This note is a record of the purpose for the purchase of policy no. ______________________________

issued by The Colonial Mutual Life Assurance Society Limited (CommInsure) for the sum insured of $ ______________

to be paid upon (e.g. the occurrence of any of the insured events) with respect to______________ (the key person)

by ____________________ (my Business) for the premium of (e.g. $XX inclusive of all taxes and duties for the year).

The above policy was purchased to: (e.g.)

- ☐ maintain the capital value of my Business
- ☐ repay a debt owing by my Business to ______________________________ (the creditor)

upon the occurrence of the following insured events with respect to the key person:

- ☐ death
- ☐ total and permanent disablement
- ☐ traumatic or terminal illness.

Because the policy is for a capital purpose:

- the premiums paid in respect of the policy will not be tax deductible
- the tax treatment of the insurance proceeds will be as follows:
  - – for life insurance, it will not be subject to income tax or capital gains tax
  - – for trauma insurance, it will be subject to CGT
  - – for TPD insurance, it will be subject to CGT.

I note that a similar file note is necessary at the time of any future renewal or change in either the purpose of taking out the policy, or the intended application of the proceeds.

Signature of sole trader: ______________________________

Draft minutes for key person insurance (revenue purpose)

Minutes of meeting of [directors/partners] of ______________________________ (the Business)

ACN/ABN (if applicable) ______________________________

Held at ____________________ **on the** ____________ **day of 200**___

Present ______________________________

____

____

Chairperson ______________________________

Key person insurance (revenue purpose)

The Chairperson informed the meeting that discussions are now concluded for the procurement of key person insurance for the Business with respect to ______________________________ (the key person).

The purpose of the cover is to (e.g. assist the Business meet its continuing expenses and other outgoing revenue commitments, to meet costs incurred in recruiting and training a replacement for the key person or recoup lost revenue):

- ☐ death
- ☐ total and permanent disablement
- ☐ traumatic or terminal illness.

The proposed policy is policy number ____________ to be issued by The Colonial Mutual Life Assurance Society Limited (CommInsure) for the sum insured of $ ______________________________ to be paid upon (e.g. the occurrence of any of the insured events) for the premium of (e.g. $XX inclusive of all taxes and duties for the year).

Having considered the information obtained through the course of the (company/partnership's) investigations into the procurement of the insurance, the (directors/partners) (e.g. unanimously) resolve to purchase the proposed key person insurance with respect to the key person.

It was noted that because the policy is for a revenue purpose:

- the premiums paid in respect of the policy will be tax deductible, and
- the proceeds of the policy will be subject to income tax.

It was noted that a similar minute is necessary at the time of any future renewal or change in either the purpose of taking out the policy or the intended application of the proceeds.

Closure: There being no further business, the meeting was declared closed.

Confirmed as a true and correct record by:

______________________________ (Chairperson) on ______ /______ /______ (insert date).

File note for key person insurance (revenue purpose) – sole trader

Re: purpose of policy no. ______________________________

Date: ______________________________

This note is a record of the purpose for the purchase of policy no. ______________________________

______________________________ issued by The Colonial Mutual Life Assurance Society Limited

(CommInsure) for the sum insured of $ ______________ to be paid upon (e.g. the occurrence of any of the

insured events) with respect to ______________________________

(the key person) by ______________________________

(my Business) for the premium of (e.g. $XX inclusive of all taxes and duties for the year).

The above policy was purchased to (e.g. assist my Business meet its continuing expenses and other outgoing revenue commitments, to meet costs incurred in recruiting and training a replacement for the key person or recoup lost revenue):

______________________________ upon the occurrence of the following insured events with respect to the key person:

☐ death
☐ total and permanent disablement
☐ traumatic or terminal illness.

Because the policy is for a revenue purpose:

- the premiums paid in respect of the policy will be tax deductible; and
- the proceeds of the policy will be subject to income tax.

I note that a similar file note is necessary at the time of any future renewal or change in either the purpose of taking out the policy, or the intended application of the proceeds.

Signature of sole trader: ______________________________

Worksheets

When giving advice with respect to business insurance, it is important to identify:

- the equity in the Business that needs to be sold upon the occurrence of an insured event with respect to the insured, and
- the needs of the Business and the insured.

The following worksheets are a general guide to identifying these issues:

- an equity analysis worksheet, and
- a risk analysis worksheet.

The purpose of these worksheets is to help advisers identify the key needs of a business and assist in the process of collecting the information needed to prepare a legal agreement. The information you collect (whether by using the guidelines or otherwise) can then assist you to form the basis of your recommendation with respect to the type of insurance required, ownership structure and sum insured. Versions of the worksheets (which includes a worksheet with notes and sample information) are set out on the following pages. You can use these notes to structure your discussion. It is important to note, however, these worksheets are only suggested methods of collecting information and are general guidelines. They are not intended to be an exhaustive listing of factors to consider or strict procedures to be followed. You will need to consider the circumstances and requirements of your particular clients in structuring your own information gathering processes.

To follow are:

- Equity analysis worksheet.
- How to complete the risk analysis worksheet (sample with notes).
- Risk analysis worksheet (blank).

Equity analysis worksheet

Name of proprietor/insured	Insured's name			
Type of equity (name and ABN of each partnership, company unit trust, other business entity)	What do you own?	What do you own?	What do you own?	What do you own?
Amount/quantity of equity (percentage of partnership, or number of shares or units)	How much do you own?	How much do you own?	How much do you own?	How much do you own?
Value/purchase price of equity	What is it worth?	What is it worth?	What is it worth?	What is it worth?
Name of owner/vendor of equity (insured or related party)	Who owns it?	Who owns it?	Who owns it?	Who owns it?

How to complete the risk analysis worksheet

Guide to how much insurance is enough (sample only)

Purpose	Notes	Recipients
Assets +		
Purchase price of equity	All owners are asset rich, cash poor. Purchaser can't afford to pay purchase price. Insurance funds 100% of price. No need to negotiate or borrow. Price = 100% of value.	Vendors
CGT on purchase price	CGT on sale price of equity (not insurance proceeds). Varies between nil and 40% of price/value. Average = 25%. Personal cover earmarked for tax liability.	Vendors
Stamp duty, legal & accounting fees	Stamp duty and transactional costs payable by purchasers including costs associated with shares and other property.	Business
Liabilities +		
Bank debt, lease & other liabilities	Need to extinguish personal guarantees and securities for business debt when exit. Exit liability side of ledger, as well as asset side. Can be 100% of debt, if bank/creditor regards life insured as absolute key person. Otherwise, normally proportionate amount of debt. Debt reduction cover can be reapportioned to purchase price, as debt reduces.	Creditor
Loan account	Need to repay debt owing by business to insured (or vice versa).	Creditor
Key person (income)	Compensates for temporary, once-off loss of income, say, for three to six months. Alternatively, compensates for increased expenses of replacement staff, e.g., for twelve months. Premium deductible, proceeds taxable for this component.	Business
Key person (capital) (reduced goodwill or working capital)	In contrast, compensates for permanent loss of income stream, continuing profitability, goodwill, loss of capital value of business or equity in business. Will the business be worth less without insured?	Continuing proprietors
Personal		
Personal (home loan, equity loan, living expenses)	Analyse personal needs, having regard to funds from purchase price of equity and CGT coming through to estate (if insured is vendor).	Life insured, self managed super fund
Trustee's fee (see fee policy)	As a guide, a normal trustee's fee is a maximum of $10,000.	Trustee
= Total		
Total	Total of above amounts are held by trustee and distributed tax-effectively and securely to intended recipients.	

Risk analysis worksheet

Purpose	Amount			Notes	Recipients
	Death	TPD	Trauma		
Assets +					
Purchase price of equity					Vendors
CGT on purchase price					Vendors
Stamp duty, legal & accounting fees					Business
Liabilities +					
Bank debt, lease & other liabilities					Creditor
Loan account					Creditor
Key person (income)					Business
Personal					
Key person (capital) (reduced goodwill or working capital)					Continuing proprietors
Personal (home loan, equity loan, living expenses)					Life insured, – self managed – super fund
Trustee's fee (see fee policy)					Trustee
= Total					
Total					

Contact details

Adviser Assist – general enquiries
1800 671 040

Cover Assist – underwriting queries
1800 257 328

Claims Assist
1800 221 516

Adviser Technical help desk (including Adviser site)
1800 240 405

Customer Assist
13 10 56

Website
comminsure.com.au

Adviser website
adviser.comminsure.com.au

Adviser Technical hotline
1800 761 067

1800 671 040
Adviser Assist
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Manager, Customer Relations, CommInsure Life Insurance, PO Box 320, Silverwater NSW 2128.

CommInsure

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