Did you know?

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Buy/sell insurance

There are almost two million small businesses in Australia, employing over three million people. Buy/sell insurance supported by a legal agreement can protect the owners of these businesses and their respective estates from the impact of death, disability and critical illness.

Life insurance can be chosen as the funding medium for an owner leaving a business due to death, total and permanent disability (TPD) or critical illness. If that is the case, it is vital for business owners to enter into a written buy/sell agreement so they can set out their respective obligations regarding the transfer of the equity of the business. Plus, the choice of insurance solution for buy/sell purposes depends on the trigger events being covered.

Death (as well as terminal illness) and TPD are clearly events that would warrant the departure of an owner from a business. Trauma insurance may also be used in a buy/sell agreement, but some complex issues must be considered. With a trauma event, there is some potential for the insured to return to work, in which case there is no immediate need to transfer his or her business interest to the continuing owner/s. The buy/sell agreement would need to address the criteria upon which the business interest must be sold and the extent to which trauma proceeds would be credited towards the future sale of the business if the insured does return to work.

Modern buy/sell agreements commonly use 'put and call options', where if just one party wants the transfer of business equity to go ahead, it must proceed. These options avoid the possibility that the date of execution of a buy/sell agreement itself might constitute the date of disposal for capital gains tax (CGT) purposes, thereby triggering full CGT and stamp duty liabilities as at the date of signing the agreement. In the case of a trauma event, these options can be postponed until a satisfactory test about the insured's fitness to continue in the business has been satisfied. For instance, the owners may elect to postpone the exercise of the option for six or 12 months after the occurrence of the trauma event or until business turnover has decreased by a certain percentage.

Level of cover

The sum insured should generally be the value of each owner's share of the business, updated at least on an annual basis. If the business consists of two owners with an equal share of a business valued at $1 million, the sum insured on the life of each business owner should be $500,000. The insurance trigger events should be death and TPD and possibly trauma.

Valuation

Given that the Australian Taxation Office will most likely deem that the disposal of a business interest under a buy/sell agreement occurs at market value, it may be prudent to use current market value as the preferred valuation method. This value would need to be updated on a regular basis (i.e. at least annually). An alternative valuation method would be to base the sums insured on the current market value of the business and either index them to inflation or by the anticipated growth rate of the business. Another alternative would be for the business principals to use a particular formula, reflecting either an industry standard or a method appropriate to that specific business. In this case, it would be prudent for the owners to recalculate the value using the formula, and then subjectively determine whether the outcome is realistic and acceptable. It is worthwhile having the business' accountant review the valuation and confirm that it is justifiable on ordinary commercial terms, which – depending on the sums insured – may also be   an underwriting requirement.

Small business CGT concessions

Small businesses are eligible for CGT concessions if they satisfy the basic conditions for one or more of the relevant concessions, which in some cases may reduce any capital gain to zero. Advisers should seek the advice of their client's accountant to establish if the client or the potential beneficiaries of their estate qualifies. If businesses do not qualify for these concessions, most insurers allow this CGT liability to be included in the buy/sell cover sum insured, at least for term life and TPD. Alternatively, the CGT liability may be insured through personal risk cover.

Policy ownership and taxation issues

Certain ownership structures have tax implications depending on products chosen for buy/sell insurance cover. In any case, it is important for business owners to seek advice that is appropriate to their individual situation and objectives. Regardless of the circumstances, the implementation of a buy/sell agreement is vital. The most common options are as follows:

Self ownership

Each business owner owns his or her policy and there is no CGT liability on the payment of life, TPD or trauma policy proceeds. The market value substitution rule, in section 116.30(1) and (2) of the Income Tax Assessment Act 1997 (ITAA97), deems the market value of the business to have been the price of the interest received by the outgoing owner (or estate) and acquired by the continuing owners, regardless of whether the continuing owners paid less than market value for the interest and the buy/sell agreement was not an arms-length transaction. The other advantages of self-ownership are simplicity and portability (if owners leave the business, for instance, they can take their own policy with them).

Cross ownership

Each business owner owns an insurance policy on the life of each of the other owners. Insurance proceeds are paid to the purchaser (continuing owner/s), who then pays them to the estate or outgoing owner in return for the transfer of the equity in the business. The proceeds of term life and terminal illness cover are exempt from CGT if there is no change in original beneficial ownership (s 118-300 ITAA97). If the proceeds are paid as a TPD or trauma benefit, they are CGT exempt only if paid to the life insured's spouse or a defined relative (s 118-37 ITAA97).

Trust ownership

An independent trustee of an insurance trust (also known as a bare trust) owns the policies on behalf of the insured (indirect self-ownership). Advantages of trust ownership include those for self ownership, as well as cost savings due to fewer policy fees and volume premium discounts, and comprehensiveness (a multiple-purpose trust can allow other life insurance covers – such as debt reduction, key person and personal risk cover – to be held through the same policy).

Superannuation fund trustee ownership

A super fund trustee can own the policies on behalf of the insured. The obligation to pay the insurance proceeds to outgoing owner or estate (or the beneficiary of the business share) and to transfer the outgoing owner's business interest should be contained in a buy/sell agreement. It may be unsuitable to hold TPD (particularly own occupation TPD) and trauma cover through a super fund as the trustee may not be able to release the proceeds to the member or the estate unless a condition of release is met.

Given the above factors, either direct or indirect self-ownership would be the most effective ownership structure.

Summary

Buy/sell insurance provides vital protection for small business owners against the impact of death, disability and critical illness. Advisers should be mindful of the important areas of buy/sell cover, including the choice of risk products, the level of cover, business valuations, policy ownership structures and their tax implications.