Did you know?

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30 March 2012

Buy/sell insurance cover

According to a 2008 survey, while 37 per cent of business owners have heard of buy/sell insurance cover, only nine per cent actually have it.[1]

Life insurance can provide a funding mechanism for business owners should a fellow owner depart the business due to death (and terminal illness), total and permanent disability (TPD) or traumatic illness. In these cases, it is vital for business owners to enter into a written buy/sell agreement, setting out their respective obligations with regard to the transfer of the business equity. The choice of insurance solution for buy/sell purposes depends on the trigger events being covered.

Death (and 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 treatment of trauma proceeds, if the insured does return to work.

Modern buy/sell agreements commonly use put and call options, whereby 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 of 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 a yearly 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 ATO 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, 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 CGT concessions for small business, which in some cases may reduce any capital gain to zero. Advisers should seek the advice of their clients' accountants to establish if the clients or the potential beneficiaries of their estates qualify.

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[1] Ross Cameron Research: *The Australian Small Business Market for Financial Services, July 2008*

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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

Before the introduction of CGT in 1985, cross ownership was the standard structure for holding insurances (see below). Since then, self ownership has been the most common structure, with each business owner owning his or her policy and there being 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 issue with self ownership is the situation where individuals do not own business assets in their own name, but use third parties, such as a spouse, a company or a family trust. This means that the actual vendor in a buy/sell agreement (i.e. company or trust) does not receive the insurance proceeds, but is expected to sell its equity in the business on the occurrence of an insurance event, which presents a number of problems.

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

The trustee of an insurance trust (also known as a bare trust) owns the policies on behalf of the insured (indirect self-ownership). In other words, legal ownership rests with the trustee, whilst beneficial ownership rests with the lives insured (thus satisfying all CGT exemptions on insurance proceeds). Apart from the advantages of self-ownership, insurance trust ownership also provides 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 one policy for each insured).

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.

Entity ownership

A company or trust owns the policies and receives the proceeds. The company buys back the outgoing owner’s shares, then cancels them, or units in a unit trust are redeemed. However, there is no CGT exemption on TPD or trauma proceeds, and the cancellation of shares or redemption of units may lead to the remaining owners acquiring more equity, but not increasing their cost base for those shares or units.

On the basis of the above factors, policy ownership by an insurance trust seems the more logical option.

Summary

Buy/sell insurance cover provides vital protection for small business owners against the impact on their businesses of death, disability and traumatic 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.
For a more detailed overview of the technical aspects of business insurance, head to the CommInsure Adviser Site for your copy of our Business Insurance Guide.