Did you know?

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CGT exemption for insurance policies held by trusts

In the 2012-13 Federal Budget, the Government announced it will make minor extensions to the CGT exemptions for certain compensation payments or damages payments received under life insurance policies via trust structures.

The draft legislation on this measure is not yet available. However, the ATO has published the following summary:

- This measure will disregard CGT consequences where a taxpayer receives compensation, damages or certain insurance proceeds ***indirectly through a trust***.
- This will ensure that the taxpayer has the ***same CGT outcome*** as a taxpayer who receives such proceeds directly.
- It will also ensure that ***insurance policies owned by super funds*** that were treated as being CGT exempt prior to the 2011-12 Budget changes to compensation payments and insurance policies continue to be CGT exempt.

The type of trust is not relevant to the exemption. Thus, it is likely that it will apply to insurance policies owned by absolute entitlement trusts (insurance trusts), fixed trusts and discretionary trusts.

CGT treatment of non-death benefits

Section 118-300 of the Income Tax Assessment Act 1997 (ITAA97) contains a CGT exemption for insurance proceeds payable under a life insurance policy. However, this section only applies to death and terminal illness benefits.

The section of the Act applicable to non-death insurance benefits – total and permanent disability (TPD) and trauma cover – is section 118-37, which contains a CGT exemption for “compensation or damages you [the taxpayer] receive for any wrong, injury or illness you or your relative suffers personally”.

As defined by section 995-1(1) of ITAA97 a “relative” of a person means:
(a) the person's spouse (including de facto partner); or
(b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of that person's spouse; or
(c) the spouse of a person referred to in paragraph (b).

In Technical Cell Determination CGT 14 (TD 14), the ATO determined that the equivalent exemption in the original legislation would extend to a trustee for the taxpayer. This is the basis upon which TPD and trauma benefits paid to the trustee of an absolute entitlement trust (insurance trust) where the beneficiary is the life insured or a relative will be exempt from CGT. However, there has been some doubt as to whether the same exemption would extend to other types of trusts (such as fixed trusts and discretionary trusts).

Identity of beneficiary

The tax exemption will depend on the identity of the person (the beneficiary) who receives or is deemed to have received the insurance proceeds when they are distributed by the trustee. If the recipient is the life insured or a “relative”, the insurance proceeds will be exempt. If the recipient is the trustee of another discretionary trust, it is likely that the exemption will flow through to the beneficiaries of the second trust. However, it would not be available to a company beneficiary (such as a “bucket company”), because the company cannot be a “relative” of the insured.

Implications for insurance policies owned by family (discretionary) trusts

If the trustee of a family trust owns a TPD or trauma policy (for personal or business purposes), any insurance proceeds distributed to an appropriate family member would be exempt from CGT.

The exemption would apply to family insurance policies used for:

- Buy/sell arrangements between family members; and
- Debt reduction (key person capital) cover with respect to debts of the family trust and/or the family members.

Example:

John Smith is the appointer and, along with his wife and two children, is a beneficiary of the Smith Family Trust. The Smith Family Trust owns 50 per cent of the shares in ABC Pty Ltd, of which John is a director. John has a non-super CommInsure term life and TPD policy on his life, owned by the trustee of the Smith Family Trust, for $500,000, which is half the value of the business. John suffers an illness and qualifies for a TPD benefit, which is paid to the trustee. The trustee can then distribute the $500,000, free of CGT, to any of the beneficiaries.

Implications for TPD or trauma policies owned by fixed or unit trusts

If the trustee of a fixed or unit trust owned a TPD or trauma policy, the exemption would depend on the identity of the beneficiary who received the insurance proceeds. If a family used a fixed or unit trust to own a business or property, then the exemption would be available to appropriate family members.

However, fixed or unit trusts are often used by unrelated parties to own a business or property. In the case of a unit trust, the units are generally owned by the trustee of each life insured's family trust. If the trust owned a business or property on behalf of unrelated lives insured, the exemption would only be available to beneficiaries or recipients associated with the life insured.

Debt reduction (key person capital) cover owned by a fixed or unit trust

If two unrelated lives insured (e.g. Sam and Mary) jointly owned a business or property through a fixed or unit trust in equal proportions, any debt reduction cover owned by the trust would be:

- exempt in the hands of the beneficiaries or recipients associated with the life insured; and
- subject to CGT in the hands of the beneficiaries or recipients associated with the other life insured.

In this case, if Sam became totally and permanently disabled:

- the insurance proceeds distributed to Sam or his relatives (50 per cent) would be exempt; and
- the insurance proceeds distributed to Mary or her relatives (50 per cent) would be subject to CGT.

In contrast, an insurance trust for the benefit of the life insured Sam would obtain an exemption for 100 per cent of the insurance proceeds in this situation.

Buy/sell cover owned by a fixed or unit trust

For the same reasons, if the trustee owned buy/sell cover in this example, the insurance proceeds distributed to Mary or her relatives would be subject to CGT. An exemption for 100 per cent of the insurance proceeds would be available only if the cover was owned by:

- the life insured or a relative; or
- an insurance trust for the benefit of the life insured.

Summary

Most family insurance cover is currently owned by the life insured. This Budget measure creates an opportunity to hold this cover in the name of a family trust or an insurance trust. In the case of unrelated parties, it would be preferable to use:

- self-ownership or an insurance trust for buy/sell cover; and
- an insurance trust for debt reduction (key person capital) cover.