THE STRATEGY series

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Business insurance trusts

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In the world of business succession planning, insurance trusts can be an excellent commercial alternative to the usual forms of structuring buy/sell and key person insurance cover for business owners.

The need

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. Whilst a comprehensive business succession plan would address voluntary and involuntary exits from a business, this article will focus on the use of life insurance as a funding mechanism for buy/sell arrangements and as compensation to the business for any financial loss or cost suffered because an insurable event has occurred with respect to a key person. It benefits all parties – the exiting and continuing proprietors, as well as the business itself – which otherwise would suffer in the absence of a succession plan.

Buy/sell agreements and 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. We will look at life insurance as the funding mechanism, as this is generally the most logical and cost effective funding option for insurable events warranting a mutually agreed exit from a business.

Whilst buy/sell agreements are commercial arrangements, it is important to consider the structure of these arrangements and of the insurance policies underpinning them in order to avoid unnecessary tax implications, particularly as regards to capital gains tax (CGT).

CGT and 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 or terminal illness 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.

The CGT exemption under section 118-300 ITAA97 only applies if the cause of the claim or payment was the death or terminal illness of the life insured. This particular CGT exemption does not apply to the proceeds of Total and Permanent Disability (TPD) and trauma policies.

The only exemption available for TPD and trauma proceeds is the exemption for compensation or damages received for any wrong, injury or illness suffered in your occupation or personally under section 118-37 ITAA97. The definition of injury is not limited to physical injury. It also extends generally to illness or disease (Taxation Ruling TR 95/35). This CGT exemption under Section 118-37 ITAA97 is only available if the person who is beneficially entitled to the insurance proceeds is the injured person, their spouse or a defined relative. The Government recently confirmed that CGT consequences would also be disregarded where a taxpayer receives these insurance proceeds indirectly through a trust (though this has always been the case with properly structured insurance trusts).

Buy/sell insurance and policy ownership

Due to the CGT implications for TPD and trauma insurance policy proceeds, cross-ownership (where each owner has a fractional interest in the life policies of the other owners) has been largely discontinued.

Entity policy ownership, such as unit trusts or companies taking out life insurance policies on the principals, and then either redeeming units or buying back the shares of the outgoing principals, is tax inefficient, in that it results in the remaining owner/s owning all the equity in the business but not getting any cost base for acquiring the interest of the outgoing party. It also has the problem of not satisfying non-death benefit (TPD and trauma) CGT exemptions.

Under self-ownership, where a business owner takes a policy on his or her own life – ideally for the full market value of the business and in conjunction with a buy/sell agreement – the insured or the estate (in the case of death) receives the insurance proceeds tax free and then transfers the equity in the business to the remaining owner/s. This would seem to be a simple and easy alternative to other ownership structures, as all insurance proceeds (term life, TPD and trauma) would be received tax free. However, practitioners in this area have noted that most business owners who take buy/sell insurance cover do not go on to implement a buy/sell agreement, which effectively means the outgoing owner or estate can still ask for payment for its share of equity even though it has received the insurance proceeds.

Another issue with self-ownership is when an interest in a business is held indirectly through a fixed trust or family company, in which case either of these entities should be the vendor in a buy/sell agreement, but which would likely entail adverse CGT consequences on non-death insurance benefits.

In addition, in its minutes of a meeting held November 2010 the ATO's National Tax Liaison Group stated that the Business Succession Arrangements Discussion Paper (Buy-Sell Agreements) – circulated in 2000 and used as a basis of self-ownership of buy/sell cover – was withdrawn several years ago and as such it cannot be regarded as current. It is possible the ATO will prepare and issue a Public Ruling on this matter; however, this is unlikely to occur in the foreseeable future.

That leaves indirect self-ownership of insurance policies through a superannuation fund (known as Super Buy/sell), which has the same issues as direct self-ownership, with the additional overlay of the SIS Act and Regulations, which places numerous restrictions on the payment of insurance benefits and raises other issues, such as the erosion of retirement savings and the possible breach of the sole purpose test. Please note that there is usually a separate CGT obligation with respect to the transfer of equity in the business from the exiting to the continuing business owner/s.

Insurance trusts

In the above examples of policy ownership, the one person or entity will be both the legal owner and the beneficial owner of a term life, TPD or trauma policy. Under an insurance trust (a special purpose trust created specifically for holding life insurance for business and, if required, personal purposes), legal (nominal) and beneficial ownership is split between the trustee of the insurance trust (legal owner) and the insured (beneficial owner). Because the insured is the beneficial owner of the policy under the "roof" of the insurance trust, trust ownership obtains a CGT exemption for both death and non-death (TPD and trauma) benefits. As we are talking about a trust, this requires a trustee and a trust deed or agreement. An insurance trust agreement is designed to achieve four major objectives:

- It avoids CGT with respect to both death and non-death benefits
- It can distribute the insurance proceeds to a range of recipients, with favourable commercial outcomes
- It can aggregate various business and personal purpose insurance cover into one policy for each life insured, thus achieving cost savings
- If the insured's needs change, it may be sufficient to alter the proportion of the level of cover in the agreement (rather than changing each policy held with the insurer)

The trustee has legal ownership of the life policies (only one policy per life insured is required). On satisfying the definition upon the occurrence of an insurable event (death, Total and Permanent Disability, or trauma), the insurer pays the proceeds to the trustee. As the beneficial owner of each policy, the life insured is entitled to direct the trustee (legal owner) as to the distribution of the insurance proceeds on behalf of the life insured. Examples of this would be:

- Pay the buy/sell purchase price to the appropriate vendor (including company or trust)
- Pay any debt reduction cover to the appropriate creditor (possibly via the continuing proprietor/s)
- Pay any other key person cover to the business (or continuing proprietor/s)
- Pay any personal protection cover to the insured, the insured's estate, a nominated recipient or a Self Managed Super Fund

Who is the trustee?

Whilst it is possible to use an institutional trustee, this involves additional and ever-increasing cost and the added complexity of involving an external party.

If the business is a company, it will normally be the trustee and policy owner. If the business structure consists of a number of companies or other entities (such as trusts), one of the companies will normally be the trustee and policy owner.

If the business consists of a unit trust, the trustee of the unit trust will normally be the trustee and policy owner. The trustee will hold the policies on the terms of the business insurance trust agreement (not the terms of the unit trust).

If the business consists of a discretionary (or family) trust, the trustee of the discretionary trust will normally be the trustee and policy owner. The trustee will hold the policies on the terms of the business insurance trust agreement (not the terms of the discretionary trust).

If the business is a partnership, the partnership can possibly be the trustee and policy owner (note, however, that not all insurers will allow a partnership to own a life insurance policy.) If the business structure includes a unit trust (e.g. a service trust), the trustee of the unit trust will normally be the trustee and policy owner.

It is expected the trustee will have a pre-existing bank account, into which insurance proceeds can be deposited, and then distribute them at time of claim.

Under the insurance trust structure, the business does not hold the policy or the insurance proceeds for its own benefit. Therefore, insurance proceeds are not available to creditors of the business while it holds them in its capacity as policy owner or trustee. In the unlikely event that the business became insolvent, the parties may direct the existing trustee to transfer the policies to a substitute trustee, if they wish their succession plan to continue. If the parties wish to terminate their business relationship altogether, they may direct the trustee to transfer the policies to the relevant lives Insured.

Once the lives Insured own their own policies, they could change the sums insured to meet their new needs. In each case, there are no adverse CGT implications with respect to the transfer, because the insured is and continues to be the original beneficial owner of his or her own policy.

Who pays the premiums?

As there is only one premium per policy, the payment of premiums should be apportioned between components depending on the responsibility of the various parties. Therefore, the business should not be responsible for the payment of the whole premium, particularly if there is an element of personal cover.

It is generally recommended that the business pay for premiums attributable to the liability needs of the different lives insured. For instance, the business would pay for insurance premiums covering:

- Key person capital, i.e. bank debt, lease and other liabilities; loan accounts; reduced goodwill or new working capital (premium non-deductible)
- Key person revenue (premium deductible, benefit assessable), and
- Stamp duty, legal and accounting fees (premium non-deductible)

The business owners (lives insured) would pay insurance premiums covering their:

- Buy/sell obligations, i.e. pre-agreed sale price of equity (premium non-deductible)
- CGT on the pre-agreed sale price, if applicable (premium non-deductible), and
- Personal insurances

The business owners could either pay for their proportionate share of the total premiums referable to all owners' sale price of equity in the business or for just their own share of the sale price. To illustrate:

John and Mary have a 60% and 40% share respectively in their company, valued at $1 million. John is much older than Mary and therefore his premium for buy/sell cover is much higher than hers. John's premium is $14,000 (for $600,000 equity) and Mary's is $6,000 (for $400,000 equity). Total premium are $20,000. John and Mary have two options:

- John can pay his $14,000 premium and Mary can pay her $6,000 premium, or
- John and Mary can pool the premium, and each pay their proportionate share. In this case, John would pay $12,000 (60% of $20,000) and Mary would pay $8,000 (40% of $20,000)

Fringe Benefits Tax (FBT)

The potential application of FBT must be considered in relation to buy/sell insurance premiums. If a business pays an expense, such as a life insurance premium, on behalf of an employee, there is likelihood that the payment would be subject to FBT. This would clearly be the case if a company pays a life insurance premium for personal risk protection on behalf of an employee. But what about payment of premiums for buy/sell cover?

The ATO has not published any relevant rulings or determinations in respect of this issue. , Accordingly, it would be prudent for businesses to obtain specific advice on this issue from its taxation agents or accountants. In the absence of this advice, we may assume FBT would apply.

The standard wording in a business insurance trust agreement specifies that:

- The business will physically pay buy/sell insurance premiums to the insurer; and
- The business may recover the premium from the business owners (and their related parties) by way of reimbursement

Once the appropriate share is determined, each owner would pay the required amount to the business. Alternatively, if there are credit loan accounts owing to the owners by the business, the premium could be offset against these loan accounts. Payment of insurance premiums via superannuation concessional contributions from the business is not subject to FBT.

Are the premiums deductible?

The deductibility of premiums will depend on the purpose of the insurance cover. Is the purpose revenue or capital? If the purpose of the cover is revenue – to compensate the business for loss of revenue or profits, or to fund the costs of a replacement employee and associated costs – the premium will be deductible to the business. This is normally called key person revenue cover. The insurance proceeds will be assessable according to normal income tax principles. However, when the business uses the proceeds to pay for salary and other costs, it will receive a deduction for the financial expenditure in the year it was spent. If the insurance proceeds are assessable, they will not also be subject to CGT. There will be no CGT on insurance proceeds held by a properly constructed business insurance trust as all CGT exemptions will be satisfied due to the beneficial ownership of the cover resting with each life insured.

Case study

Frank, Jane, Brad and Wanda are unrelated directors of a successful advertising agency, Advert Pty Ltd. Their respective family trusts each own 25 per cent of the company, which is valued at $2.8 million. The company has an $800,000 bank loan and each shareholder has injected $100,000 of their own capital into the business. The directors all wish to obtain full insurance cover for their business and personal needs (we will assume they require the same personal cover, and are taking trauma cover for personal protection only). Their requirements can be summarised as follows:

Purpose of cover		**Sum insured**
Assets (Buy/sell)	**Agreed equity sale price**	**$400,000**
	CGT on equity sale price	**$100,000**
	Stamp duty, legal, accounting	**$30,000**
Liabilities (Key person)	**Bank loan**	**$800,000**
	Loan account	**$100,000**
	Reduced goodwill	**$150,000**
	Key person revenue	**$400,000**
Personal	**Home loans, living expenses**	**$700,000**
Total cover		**$2,680,000**

The usual policy ownership recommendation (not using a business insurance trust) for the above would be as follows:

Purpose of cover	Sum Insured	Policy owner
Buy/sell cover	$530,000	Individual/self
Key person capital	$1,500,000*	Company
Key person revenue	$400,000	Company
Personal Cover	$700,000	Individual/self
Total cover	$3,130,000	

* Grossed up for CGT on TPD (and term life if bundled cover)

The above recommendation would require four policies (one for buy/sell, one for key person revenue, one for key person capital, and one personal protection policy). As company-owned TPD would be subject to CGT, the key person capital sum insured would need to be grossed up from $1,050,000 to $1,500,000. The total cost of the cover for business owner Brad, who is 42 years old[1], would be as follows:

Purpose	Term life	TPD	Trauma	Premium
Buy/sell	$530,000	$530,000	N/A	$1,124
Key person capital	$1,500,000	$1,500,000	N/A	$2,811
Key person revenue	$400,000	$400,000	N/A	$961
Personal	$700,000	$700,000	$700,000	$3,656
Total	**$3,130,000**	**$3,130,000**	**$700,000**	**$8,552**

In contrast, the required insurances owned by a business insurance trust would require only one policy per life insured, would not require a gross up of key person capital premiums, and would take advantage of volume discounts. Using the parameters for the above life insured, the total premium would be $7,019, a saving of $1,533.

Purpose	Term life	TPD	Trauma	Premium
Buy/sell	$530,000	$530,000	N/A	N/A
Key person capital	$1,050,000	$1,050,000	N/A	N/A
Key person revenue	$400,000	$400,000	N/A	N/A
Personal	$700,000	$700,000	$700,000	N/A
Total	**$2,680,000**	**$2,680,000**	**$700,000**	**$7,019**

Let's look at what could happen at claim time:

Assume Brad, from the above example, suffers a TPD event, generating a successful claim. Under the usual policy structure, the insurer would pay to Advert Pty Ltd $1,500,000 key person capital and $400,000 key person revenue proceeds. After deducting 30 per cent ($450,000) to cover CGT, Advert Pty Ltd would discharge the bank loan ($800,000), pay out the loan account owing to Brad ($100,000) and retain $150,000 for lost goodwill. It would use the $400,000 to replace lost revenue and to fund a replacement key person. Brad's family trust would receive $530,000 of TPD benefit in lieu of the purchase price for its equity in the

[1] Based on CommInsure stepped annual premium rates for a 42 year-old male non-smoker, resident in NSW, with TPD own occupation, Trauma Plus and Business Safe Cover Option. Quotation current as of 5 October 2012.

business, to cover the CGT liability on the sale of the equity, and to cover legal and accounting costs and stamp duty. Brad would receive a TPD benefit of $700,000 as personal cover. As his policies are with CommInsure, he could buy back his reduced term life cover 12 months after claim payment date (as can his family trust). The company owned policies could be transferred into Brad's personal name; however, there is a chance that the transfer would be for consideration and would have CGT consequences.

Under the insurance trust structure, the entire $2,680,000 TPD benefit would be paid to the trustee of the insurance trust. The trustee would then distribute the proceeds in a secure manner to the appropriate recipients. Note that the trustee will control distribution of the insurance proceeds in accordance with the terms of the trust agreement, so the physical control of those proceeds is in the hands of a custodian that has a contractual and fiduciary obligation to comply with the directions of the beneficial owner in the trust agreement. The trustee has no discretion in distributing the proceeds but is instructed to allocate the proceeds via the business insurance trust agreement. The key person revenue proceeds ($400,000) would be paid to the company. Brad's family trust would receive the buy/sell and associated proceeds (covering CGT and other costs), and Brad would receive his personal insurance benefit as well as payment for the loan account owing to him. The term life cover reduced as a result of the TPD payout can then be transferred to Brad (via Memorandum of Transfer, providing Brad with legal, as well as beneficial ownership). He will be able to buy back $2,680,000 of life cover 12 months after the claim payment date.

As for the key person capital cover, the repayment of the business debt to the bank can be achieved by a payment to the trustee to one of the following:

- The bank directly
- The business or debtor, or
- The continuing proprietors

If the third option is chosen, the $800,000 owing to the bank can be credited to the continuing owners, who now own 100 per cent of the business between them. The proprietors then lend the insurance proceeds to the company, which can then repay the bank debt. (This would be a paper entry only, as the proceeds would physically be repaid to the financial institution.) In effect, this creates new loan accounts owing to the continuing owners in substitution for the external bank debt as well the reduced goodwill amount. This means that the remaining owners – Frank, Jane and Wanda – will have created a loan account of $266,666 each in their favour. The existence of these loan accounts allows the future cash flow of the company to be paid to the continuing owners as tax-free repayments of principal.

The end result of this process is that the exiting business owner's equity will be transferred to the continuing business owners and external debt and internal debt will have been repaid, releasing personal guarantees and discharging the company's loan obligations to the exiting owner. The company will have additional funds to cover lost profits and to recruit a replacement key person. From the exiting owner's perspective, Brad will have been released from personal guarantees, and will have sufficient cash for out-of-pocket medical expenses and achieve his and his family's financial objectives. The financial impact of total and permanent disability on both the business and on Brad personally will have been minimised.

Legal costs

Contrary to the general perception, the fees for setting up a complete succession plan (including a business insurance trust and the drafting of a buy/sell agreement) generally fall within the $3,000-$5,000 range, which is the usual range for a buy/sell agreement by itself.

Summary

Business succession planning using business insurance is an important consideration for business owners.

Whilst business succession arrangements are commercially driven, it is important to ensure that the structure of these arrangements avoids unnecessary tax consequences.

The use of business insurance trusts has a number of commercial advantages over conventional structures, including potentially substantial cost savings, and avoids CGT liability with respect to both death and non death insurance benefits.

Advisers should consider insurance trusts in discussions with their business succession clients.