Technical Insurance Guide

For advisers

AC&L

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About this Technical Insurance Guide

Most financial plans these days cover retirement planning, wealth creation, tax planning, debt and cash flow management. However, many good financial planning strategies, which focus on wealth creation, can be thrown into complete disarray by events such as death, total and permanent disability, illness or injury, if these events are not planned for. The use of insurance is therefore a vital part of the financial planning process.

This fourth edition of the Technical Insurance Guide has been prepared by the AXA Technical Services team. It has been developed as a reference guide to assist advisers with developing the risk management component of a statement of advice. It has been designed to provide advisers with a technical guide on the issues and the tax implications associated with the use of insurance policies in the financial planning process.

The guide provides up-to-date practical assistance when creating the insurance component of a statement of advice. In particular, it covers the tax implications of owning insurance policies under various ownership structures.

The guide covers a variety of insurance topics such as:

- insurance policies owned for personal protection reasons
- insurance policies owned by an employee, where the premium is paid by an employer as part of a salary packaging arrangement
- superannuation ownership of insurance policies
- insurance-only superannuation products
- insurance policies taken out by a business to protect itself against the loss of a key person, and
- insurance policies taken out by business owners under a business succession planning arrangement.

This revised edition of the Technical Insurance Guide has been updated to incorporate the changes under the Government's Simplified Superannuation system, which came into effect from 1 July 2007.

Furthermore, several sections of this guide have been extended to include:

- the new terminal illness condition of release
- the possible issues associated with self-owned debt reduction insurance policies, and
- a detailed look at the advantages and disadvantages of owning insurance policies for business succession planning purposes under various ownership structures.

We hope that this guide will be a valuable resource that will assist you in providing quality advice to your clients in relation to insurance.

This topic examines the tax implications of various types of insurance policies that are owned by an individual and have been taken out for personal protection reasons. It also looks at the tax implications of insurance policies owned by an employee, where the premium is paid by an employer as part of a salary packaging arrangement.

A personal insurance policy is a product that will pay a financial benefit as either a single lump sum or as a regular series of income payments over a pre-determined period if an insured event happens to an individual who has been nominated as the life insured under the policy.

The amount and type of financial benefit, along with the criteria that must be met by the life insured for a benefit to become payable, is detailed in the insurance policy document, which is a legally enforceable contract between the life insurance company providing the insurance cover and the policy owner.

Generally, personal insurance policies will only remain in force while the policy owner continues to pay insurance premiums to the life insurance company.

Any benefit which is payable as a result of an insured event happening to the life insured is paid by the life insurance company to:

- any beneficiaries nominated in the insurance policy schedule (death benefits only), or
- the owner of the life insurance policy, or
- the policy owner's estate,

as specified in the life insurance policy's schedule.

It is extremely important that before recommending the cover provided by a particular life insurance company to a client, that the client understands the criteria that must be met before a benefit becomes payable, as the criteria can vary significantly between life insurance companies.

Personal insurance – paid for by the individual

The most common types of personal insurance policies held by individuals are:

- life insurance
- total and permanent disability (TPD) insurance
- trauma insurance, and
- income protection insurance.

For the purpose of this topic, it is assumed that these policies are owned by an individual for personal protection reasons outside of superannuation, eg a husband taking out an ordinary life insurance policy to protect his wife and children, in the event of his death, against having to meet mortgage repayments and to compensate for the loss of his income.

Initially, we will look at the tax implications of personal insurance policies where the premium is paid for by the individual.

Life insurance – paid for by the individual

Where a life insurance policy is taken out for personal protection reasons and the premiums are paid for by an individual, as opposed to being paid by an employer, the taxation implications are as follows:

- the premium will not be tax deductible
- the premium will not be subject to fringe benefits tax (FBT)
- the proceeds will not be subject to income tax, and
- the proceeds will usually not be subject to capital gains tax (CGT) unless they were received by someone, other than the original beneficial owner of the life insurance policy, who acquired it for money or other consideration.

According to subsection 118-300(1) of the Income Tax Assessment Act (ITAA) 1997, if a CGT event happens to a life insurance policy or an annuity instrument, a capital gain or loss made from it by:

- the original beneficial owner of the policy or instrument
- an entity that acquired the interest in the policy or instrument for no consideration, or
- the trustee of a complying superannuation entity for the tax year in which the CGT event happened,

is ignored for CGT purposes.

The term 'original beneficial owner' is defined in Tax Determination TD 94/31 as:

An original beneficial owner of any of the rights, or any interest in any of the rights, under a policy of life assurance is the first person who:

(i) at the time the policy is effected, holds such rights, or any interest in such rights, and

(ii) possesses all the normal incidents of beneficial ownership (for example, 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).

Therefore, unless the recipient of the life insurance policy proceeds is not the original beneficial owner of the policy and the recipient acquired the interest in the policy for money or other consideration, life insurance policy proceeds will not be subject to CGT.

According to Tax Determination TD 94/34, consideration in this context refers to actual consideration and does not include a premium paid under the policy.

In Taxation Determination TD 2007/4, the ATO confirmed that the term 'life insurance policy', for the purpose of receiving the CGT exemption in subsection 118-300(1) of the ITAA 1997, includes a life insurance policy that provides for the payment of a terminal illness benefit.

A terminal illness benefit is a pre-payment of a death benefit, which is generally payable upon the diagnosis of an illness that is expected to result in the death of the insured within 12 months, regardless of any treatment that they may receive.

For example, the AXA/AC&L Life Insurance Plan provides a full payment of the life insurance sum insured, if the terminal illness benefit clause can be satisfied.

Therefore the CGT exemption in subsection 118-300(1) of the ITAA 1997 can be utilised on the pre-payment of a death benefit under a terminal illness benefit clause, even though the life insured has not yet died.

Case study

In July 1991, Adrian took out an endowment insurance policy with AXA/AC&L. He is the original beneficial owner of the rights under the policy.

In December 1994, Adrian assigned his rights under the policy to Brian for $10,000. Adrian is taken to have disposed of his rights under the policy.

He is not subject to CGT because he is the original beneficial owner of the policy.

However, Adrian will have the bonus proceeds included in his assessable income under section 26AH of the Income Tax Assessment Act (ITAA) 1936, as he has surrendered an endowment insurance policy within 10 years of its commencement.

Brian retains the policy until July 2007 when he decides to surrender the policy. Assuming that the 125 per cent rule has not been breached, no bonuses will need to be included in Brian's assessable income under section 26AH of the ITAA 1936 as the policy has been held for more than ten years.

However, the disposal will be subject to CGT at this time as Brian is not the original beneficial owner of the policy and acquired the rights to the policy for consideration.

The same principles apply to temporary/risk only life insurance policies, such as term life insurance policies, except that no amount would be assessable under section 26AH of the ITAA 1936, as they do not pay bonuses.

TPD and trauma insurance – paid for by the individual

Where a TPD or trauma insurance policy is taken out for personal protection reasons and the premium is paid for by an individual, as opposed to being paid by an employer, the taxation implications are as follows:

- the premium will not be tax deductible
- the premium will not be subject to FBT
- the proceeds will not be subject to income tax, and
- the proceeds will be subject to CGT unless they are paid to either the life insured or a defined relative of the life insured.

The CGT exemption under subsection 118-300(1) of the ITAA 1997 only applies to life insurance policies and not disability policies such as TPD or trauma insurance.

However, paragraph 118-37(1)(b) of the ITAA 1997 disregards a capital gain or capital loss upon the receipt of compensation for any injury or illness to the person insured or a relative.

Subsection 995-1(1) of the ITAA 1997 defines a relative of a person as:

(a) the person's spouse, 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).

Income protection insurance – paid for by the individual

Where an income protection insurance policy is taken out for personal protection reasons and the premium is paid by an individual, as opposed to being paid by an employer, the taxation implications are as follows:

- the premium will be tax deductible
- the premium will not be subject to FBT
- the proceeds will be subject to income tax, and
- the proceeds will not be subject to CGT.

Income protection insurance premiums are tax deductible for both self-employed people and employees.

Income protection insurance policy proceeds are assessable. While a client is fit and healthy and receiving a salary, the salary forms part of their assessable income. If the client is unable to work as a result of illness or injury, and is receiving a benefit from an income protection insurance policy, the benefit is taking the place of their salary and therefore the benefit from the income protection insurance policy also needs to be included in their assessable income.

Clients who are on long-term income protection insurance policy claims are sometimes offered a lump sum by the insurer as a settlement for rights to future claim payments under their policy.

If the client accepts the lump sum offer from the insurer the lump sum will need to be included in the client's assessable income. In effect, the lump sum is paid in replacement for an income stream under an income protection insurance contract. The income stream is replacing a salary that the client cannot earn, because he is unable to work as a result of illness or injury.

The fact that the client will be receiving a lump sum instead of an income stream will not change the fact that the proceeds are being paid to the client in place of his income and therefore the lump sum still needs to be included in the client's assessable income.

This view was supported in Sommer v. FCT, as recently as 2002. The judge in this case made the following statement, which supports the conclusion reached in the previous paragraph:

> *In all cases a lump sum paid in satisfaction of a right to income will always be income.*

Income protection insurance policy proceeds are assessable even if the policy owner decides not to claim a tax deduction for the premiums.

Personal insurance – paid for by an employer

Employees can sometimes enter into salary packaging arrangements with their employer, where they ask their employer to pay the premiums on personal insurance policies on their behalf from pre-tax salary. Depending on the type of personal insurance policy being paid for by the employer there may be FBT implications with these types of salary packaging arrangements.

In the analysis below we will assume that the employer pays the premium on the insurance policy, but that the policy is owned by the employee and that the policy is outside of superannuation.

The situation where an employer both pays the premium and also owns the insurance policy under a key person insurance arrangement will be covered in a later topic in this guide.

Life insurance – paid for by an employer

Where a life insurance policy, which is owned by an employee, is taken out for personal protection reasons and the premium is paid by an employer, as opposed to being paid by the employee, the taxation implications are as follows:

- the premium will be tax deductible to the employer
- the premium will be subject to FBT. The FBT is paid by the employer, but will also be able to be claimed as a tax deduction by the employer. However, the employer will usually deduct the cost from the employee's salary package
- the proceeds will not be subject to income tax, and
- the proceeds will usually not be subject to CGT unless they were received by someone, other than the original beneficial owner of the life insurance policy, who acquired it for money or other consideration.

TPD and trauma insurance – paid for by an employer

Where a TPD or trauma insurance policy, which is owned by an employee, is taken out for personal protection reasons and the premiums are paid by an employer, as opposed to being paid by the employee, the taxation implications are as follows:

- the premium will be tax deductible to the employer
- the premium will be subject to FBT. The FBT is paid by the employer, but will also be able to be claimed as a tax deduction by the employer. However, the employer will usually deduct the cost from the employee's salary package
- the proceeds will not be subject to income tax, and
- the proceeds will be subject to CGT unless they are paid to either the life insured or a defined relative of the life insured.

Income protection insurance – paid for by an employer

Where an income protection insurance policy, which is owned by an employee, is taken out for personal protection reasons and the premiums are paid by an employer, as opposed to being paid by the employee, the taxation implications are as follows:

- the premium will be tax deductible to the employer
- the premium will not be subject to FBT
- the proceeds received by the employee will be subject to income tax, and
- the proceeds will not be subject to CGT.

Where income protection insurance policy premiums are paid by an employer for an employee's policy, the premiums are not subject to FBT as the expense is otherwise deductible to the employee. This is sometimes referred to as the 'otherwise deductible' rule.

References

http://law.ato.gov.au/atolaw/print.htm?DocID=TXD%2FTD9431%2FNAT%2FATO%2F00001&PiT=99991231235958&Life=20061129000001-99991231235959

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http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal%5fct/2002/1205.html?query=%7e+sommer

This topic looks at both the advantages and the disadvantages of owning life insurance through a superannuation fund. It also examines the tax implications of owning life insurance through a superannuation fund under the Simplified Superannuation system, which came into effect from 1 July 2007.

A significant number of superannuation funds provide not only retirement benefits, but also insurance cover. The most common type of insurance cover provided to members of superannuation funds is life insurance.

If a member has taken out life insurance through their superannuation fund and the member subsequently dies:

- the insurance proceeds are paid by the insurer to the trustees of the superannuation fund, and
- as death is a condition of release, the trustees of the superannuation fund can then pay the proceeds of the life insurance policy, along with the member's account balance, to the beneficiaries or the legal personal representative of the member.

Advantages of owning life insurance through superannuation

There are a number of reasons why consideration should be given to taking out life insurance through a superannuation fund including:

- if the member is entitled to make deductible superannuation contributions, these contributions can be used to pay the insurance premiums. This means that the member is effectively claiming a tax deduction for the cost of his or her insurance premiums
- if an employee uses a salary sacrifice arrangement to have additional superannuation contributions made by an employer, these contributions can be used to pay the insurance premiums. This means, in effect, that the insurance premiums are paid for out of pre-tax salary rather than after-tax salary
- less impact on an individual's day to day cashflow if the premiums are deducted from their superannuation savings
- if taken out through a public offer superannuation fund, the insurance premiums are generally at cheaper group rates, and
- superannuation funds can claim a deduction under section 295-465 of the ITAA 1997 for insurance premiums used to provide superannuation death benefits for their members.

Disadvantages of owning life insurance through superannuation

It is important to also point out that there are some disadvantages of owning life insurance through a superannuation fund including:

- a member may only nominate a person who is a dependant under the Superannuation Industry (Supervision) (SIS) Act 1993 to be the intended recipient of their life insurance proceeds
- if life insurance proceeds are paid to a non-dependant under the ITAA 1997 and include a taxable component, the proceeds will be subject to tax, and
- if the premiums are paid via superannuation this will reduce the member's retirement savings.

Estate planning implications

From an estate planning perspective, a member is unable to include directions in his or her will in relation to the distribution of superannuation benefits (both account balance and insurance proceeds) by a superannuation fund trustee.

Instead, a member may have the option of nominating a beneficiary. In order for the trustees of the superannuation fund to accept the member's nomination of beneficiary, the member must nominate either their legal personal representative or a beneficiary who meets the definition of dependant in the SIS Act.

Dependant under the SIS Act

A dependant for the purpose of receiving a benefit from a superannuation fund is limited to:

- the spouse of the member
- any child of the member, and
- any person who is financially dependent on the member or who has an interdependency relationship with the member.

'Spouse' is defined to include an individual, who although not legally married to the person, lives with the person on a genuine domestic basis as the husband or wife of the person.

Therefore, a de facto partner would fall within this definition, whereas a same sex partner or a former spouse would not fall within this definition.

It may be possible for a same sex partner to be considered to be a dependant of a member if they are deemed to be in an interdependency relationship with the member or if the partner is financially dependent on the member.

A child is defined to include an adopted child, a step child or an ex-nuptial child of the person.

Two persons (whether or not related by family) are considered to have an interdependency relationship if:

- they have a close personal relationship, and
- they live together, and
- one or each of them provides the other with financial support, and
- one or each of them provides the other with domestic support and personal care.

However, where two persons (whether or not related by family) have a close personal relationship and the reason that they do not satisfy the other requirements is that either or both of them suffer from a physical, intellectual or psychiatric disability, they are deemed to have an interdependency relationship.

In addition to the above, the definition of dependant for the purpose of receiving a benefit from a superannuation fund includes anyone who is financially dependent upon the member.

To be financially dependent on the member, a person must generally have relied upon financial support from the member in order to maintain their usual standard of living just prior to the member's death. For example, financial dependency would not usually be satisfied purely because a member paid for the private school tuition of a grandchild.

A member can also nominate his or her legal personal representative (ie the executor or administrator of the member's estate) as the recipient of their superannuation benefits on death.

Restrictions imposed by the trust deed

A superannuation fund is a trust which is governed not only by legislation, but also by rules outlined in the fund's trust deed.

Although a trustee is generally able to apply their discretion in relation to a matter, provided that this discretion is within the confines of legislation and common law, including trust law, this discretion may be further restricted by rules contained within the trust deed of the superannuation fund.

For example, a trust deed may state that a death benefit can only be paid to the member's legal personal representative. Therefore, although the law allows a death benefit to be paid to the member's spouse, in this case the member's spouse would be unable to receive the proceeds from the death benefit unless he or she was the beneficiary of the proceeds under the member's will.

It is therefore very important that, prior to insuring a client for death via a superannuation fund, you are aware of any restrictions imposed on the payment of a death benefit by the rules contained in the trust deed of the superannuation fund.

Types of nominations

There are two types of nominations that can be offered by superannuation funds:

(i) non-binding nominations – the trustee will take into account the member's nomination however, it is not bound to pay the superannuation proceeds to the nominated beneficiary. Under these types of nominations the trustee has ultimate discretion as to who will receive the superannuation benefits, and

(ii) binding nominations – the trustee is bound to pay the superannuation benefits to the nominated beneficiaries, provided that certain conditions have been met.

Non-binding nominations

If trustee discretion does exist, the trustee must consider all matters which it believes to be reasonable before using their discretion to select the beneficiaries who will receive a member's superannuation death benefit.

Reasonable matters which may be considered by a trustee under a non-binding nomination could include, but are not limited to:

- any indication of intent provided by the member, including a death benefit nomination which is not binding
- the extent to which a beneficiary was financially dependent on the member at the date of their death, and
- the extent to which a potential beneficiary may receive proceeds from the deceased member's estate.

Binding nominations

A nomination made by a member is only binding on the trustees of a superannuation fund if it satisfies all of the following conditions:

- the notice/nomination must be in writing
- the beneficiary(s) nominated must be either dependants or the legal personal representative of the member at the time of the member's death
- the nomination is clear as to the proportion payable to each beneficiary
- the notice must be signed and dated by the member in the presence of two witnesses being persons:
  - each of whom has turned 18, and
  - neither of whom is a person mentioned in the notice
- the notice must contain a declaration signed and dated by the witnesses stating that the notice was signed by the member in their presence, and
- the nomination must have been signed, confirmed or updated within the previous three years (or a shorter period if specified in the trust deed). The time limit is taken from the last time that the nomination was signed, confirmed or updated.

In order for a superannuation fund to offer binding nominations it must have the provision for such nominations within its trust deed.

If the conditions for a binding nomination are not met, then any nomination will be treated as on-binding. It is therefore important to ensure that any nomination meets the conditions described above, including updating or re-confirming the nomination at least every three years (or a shorter period if specified in the trust deed).

There are a number of reasons why a binding death benefit nomination, which was previously valid, may be invalid at the date of the member's death. The most common reasons are:

- the nomination had not been signed, confirmed or updated in the three years prior to the member's death
- not all of the people named as a beneficiary on the nomination form were dependants of the deceased member just prior to the member's death (eg a named person was divorced from the member at the time of the member's death), and
- one or more people named as a beneficiary on the nomination form died prior to the member's death.

Lump sum death benefits

On the death of a member, their total superannuation benefits (account balance and life insurance proceeds) will be paid out to either the deceased member's legal personal representative or to a beneficiary as a:

- lump sum
- pension, or
- combination of lump sum and pension.

Lump sum benefits paid from a superannuation fund as a result of death are referred to as lump sum death benefits.

The tax treatment of a lump sum death benefit depends on whether it is paid to a dependant or to a non-dependant.

It is important to note that the definition of dependant for tax purposes is similar, but not the same as the definition of dependant under the SIS Act. The key differences relate to the definitions of 'spouse' (includes former spouse) and 'child' (must be under 18 years of age), as described in the following section.

Dependant for tax purposes

A dependant for the purpose of receiving tax concessions on benefits received from a superannuation fund includes:

- any spouse or former spouse of the member
- any child, aged less than 18 years, of the member, and
- any person who is financially dependant on the member or who has an interdependency relationship with the member.

The rules relating to interdependency relationships for tax purposes are the same as those described above for SIS Act purposes.

The definition of dependant for the purpose of receiving tax concessions on benefits received from a superannuation fund also includes anyone who is financially dependent on the member at the time of the member's death.

Tax treatment of lump sum death benefits

Any benefits paid from a superannuation fund, whether as a lump sum or income stream payment, will consist of two components:

- a tax-free component, and
- a taxable component.

The taxable component may be split into two elements – the taxed element and the untaxed element.

The tax treatment of a lump sum death benefit will depend on whether or not the recipient is a dependant for tax purposes or a non-dependant.

The following tax rates apply when a lump sum death benefit is paid on or after 1 July 2007, following the death of a member of a superannuation fund.

Age of deceased at date of death	Tax-free component	Taxable component*		
		Dependant	Non-dependant	
Any age	Tax free	Tax free	Taxed element	16.5%
			Untaxed element	31.5%

* Rates shown include Medicare levy, where relevant. Tax rates shown are maximum rates. Where a person would be subject to a lower rate of tax than the maximum specified, the lower rate applies.

Where the proceeds of a lump sum death benefit are to be paid to a dependant for tax purposes all of the proceeds (regardless of the amount) will be tax free.

Where a lump sum death benefit is paid to an estate and the estate pays the proceeds to a dependant, the same tax treatment as described above will be applied.

If the proceeds of a lump sum death benefit are to be paid to a non-dependant, the tax-free component will be tax free. However, the taxable component will be subject to tax at up to either 16.5 per cent or 31.5 per cent (including the Medicare levy) depending on whether the taxable component is a taxed element or an untaxed element.

Where a lump sum death benefit is paid to an estate and the estate pays the proceeds to a non-dependant, the same tax treatment as described above will be applied. Payment of any tax liability is the responsibility of the executor of the estate.

Special rules apply when calculating the components of a lump sum death benefit that includes life insurance proceeds. Essentially, these special rules revolve around apportioning the taxable component between a taxed and an untaxed element.

This topic looks at the special rules that apply when calculating the tax components of a lump sum death benefit that includes life insurance proceeds. Essentially, these special rules revolve around apportioning the taxable component between a taxed element and an untaxed element.

In the event of a member's death, the member's account balance and life insurance proceeds will be paid to the beneficiaries or the legal personal representative of the member.

The life insurance amount is not treated as a separate component of the lump sum death benefit. It is added to any existing account balance and the combined total is used to calculate the tax components of the benefit.

Taxable component – taxed or untaxed element

Section 307-290 of the ITAA 1997 provides a formula which is used to determine the extent to which the taxable component of a lump sum death benefit consists of taxed and untaxed elements. In relation to lump sum benefits paid from a taxed superannuation fund after the death of a member, the taxed element is the amount calculated under subsection 307-290(2) of the ITAA 1997.

If the trustees of the superannuation fund paying the lump sum death benefit were never entitled to claim a deduction (under section 295-465 of the ITAA 1997 in respect of premiums paid for death or disability cover, or under section 295-470 of the ITAA 1997 in respect of the future service element of a death or disability benefit), then the whole of the taxable component will be a taxed element.

If a tax deduction was allowable under either section 295-465 or section 295-470, then the taxable component will be made up of a combination of taxed and untaxed elements.

Where the trustees were able to claim a tax deduction, the taxable component will be calculated as follows:

Step 1 – Determine the tax-free component

Determine the tax-free component of the lump sum death benefit.

Step 2 – Calculate the taxable component – taxed element

Step 2 is made up of two steps.

Firstly, work out the amount under the following formula, which is found in subsection 307-290(3) of the ITAA 1997:

$$\text{Amount of superannuation lump sum} \times \frac{\text{Service days}}{\text{Service days} + \text{Days to retirement}}$$

where:

Item	Explanation
Service days	is the number of days in the service period for the lump sum
Days to retirement	is the number of days from the day on which the deceased died to the deceased's last retirement day

Subsection 995-1(1) of the ITAA 1997 defines the last retirement day to mean:

(a) if an individual's employment or office would have terminated when he or she reached a particular age or completed a particular period of service – the day he or she would reach the age or complete the period of service (as the case may be), or

(b) in any other case – the day on which the individual would turn 65.

In the absence of any ascertainable date, such as under the terms of employment or an award, the last retirement day is when the client turns 65 years old.

Secondly, deduct from the result arrived at by the formula any tax-free component from step one.

The result will be the taxable component – taxed element of the lump sum death benefit, unless the result of the formula is less than zero. If the result is less than zero, the amount of the taxable component – taxed element will be nil.

Step 3 – Calculate the taxable component – untaxed element

The untaxed element of the taxable component will equal the total lump sum death benefit, less the amounts of the tax-free component determined in step one and the taxable component – taxed element calculated in step two.

Case study

Phillip (date of birth 12 February 1955) started work with XYZ Pty Ltd on 2 January 1980. Unfortunately he died on 25 September 2007, while still an employee of XYZ Pty Ltd.

At the date of his death the total of his accumulated superannuation balance and the insurance proceeds received by the trustee as a result of his death totalled $800,000. Of this amount he has a tax-free component of $350,000.

Step 1 – Determine the tax-free component

Phillip's tax-free component is $350,000.

Step 2 – Calculate the taxable component – taxed element

Firstly, calculate the amount under the following formula, which is found in subsection 307-290(3) of the ITAA 1997:

$$\text{Amount of superannuation lump sum} \times \frac{\text{Service days}}{\text{Service days + Days to retirement}}$$

$$= \$800{,}000 \times \frac{10{,}128}{14{,}652}$$

= $552,989

Item	Explanation	Days/ amount
Amount of superannuation lump sum		$800,000
Service days	is the number of days in the service period for the lump sum (2/1/1980 to 24/9/2007)	10,128 days
Days to retirement	is the number of days from the day on which the deceased died to the deceased's last retirement day (25/9/2007 to 12/2/2020)	4,524 days

As no alternative last retirement day has been nominated for Phillip under the terms of his employment or an award, then his last retirement day is taken to be when he turns 65.

Secondly, from the result arrived at by the formula, deduct the tax-free component from step one.

= $552,989 – 350,000

= $202,989

Therefore, the taxable component – taxed element is $202,989.

Step 3 – Calculate the taxable component – untaxed element

The untaxed element of the taxable component will equal the total lump sum death benefit, less the amounts of the tax-free component determined in step one and the taxable component – taxed element calculated in step two.

= $800,000 – 350,000 – 202,989

= $247,011

Therefore, the taxable component – untaxed element is $247,011.

Therefore, the tax components of the lump sum death benefit payable upon Phillip's death are:

Tax component	Amount ($)
Tax-free component	350,000
Taxable component – taxed element	202,989
Taxable component – untaxed element	247,011
Total lump sum death benefit	800,000

The tax payable on the lump sum death benefit would then depend on whether the benefit is paid to dependants or non-dependants.

The components of a lump sum death benefit, including the taxed and untaxed elements of the taxable component, are calculated by the superannuation fund.

It is important that financial advisers are aware that a taxable component – untaxed element may arise where life insurance is taken out through a superannuation fund and that there are different tax implications if it is paid to a dependant compared to a non-dependant.

Where TPD insurance is owned through a taxed superannuation fund and it is paid out to a member by the trustees of the superannuation fund, the whole of the taxable component will be a taxed element, ie the rules described above only apply to the life insurance component.

Case study (continued)

Returning to the case of Phillip, if the proceeds of his lump sum death benefit are paid to a dependant they will not be subject to tax.

If the lump sum death benefit is paid to Phillip's estate and the estate pays the proceeds to beneficiaries who are dependants, the same tax treatment as described above will be applied.

However, if the proceeds of Phillip's lump sum death benefit are paid to a non-dependant the tax payable would be:

Component	Tax
Tax-free component	$0
Taxable component – taxed element	$33,493 ($202,989 x 16.5 per cent)
Taxable component – untaxed element	$77,808 ($247,011 x 31.5 per cent)
Total tax payable on lump sum death benefit	$111,301

If the lump sum death benefit is paid to Phillip's estate and the estate pays the proceeds to a non-dependant, the same tax treatment as described above will be applied. Importantly, in this situation, payment of any tax liability is the responsibility of the executor of the estate.

A taxable component – untaxed element will not exist if the death benefit is paid as a death benefit income stream.

This topic examines the issues and tax implications associated with owning TPD insurance through a superannuation fund under the Simplified Superannuation system, which came into effect from 1 July 2007.

A significant number of superannuation funds provide not only retirement benefits, but also insurance cover. The most common type of insurance cover offered is life insurance. Often, the amount of life insurance offered by a superannuation fund is mirrored by a similar amount of TPD insurance.

If a member has taken out TPD insurance through his or her superannuation fund and subsequently becomes totally and permanently disabled, the amount of the payment and the taxation treatment will depend on three definitions:

(i) if the member can satisfy the definition of TPD in the insurance policy, the insurance proceeds are paid by the insurer to the trustees of the superannuation fund

(ii) if the member satisfies the definition of permanent incapacity, or another condition of release, which is contained in the SIS legislation, then the trustees of the superannuation fund can pay the proceeds of the insurance policy and any account balance to the member, and

(iii) a lump sum payment to the member from the superannuation fund will be treated as a lump sum superannuation benefit and will be taxed accordingly. However, if the definition of disability superannuation benefit in subsection 995-1(1) of the ITAA 1997 can be met, the disability superannuation benefit may include an increased tax-free component.

TPD – insurance policy definition

For a member of a superannuation fund to receive the proceeds of a TPD insurance policy, the first step is satisfying the insurer's definition of TPD.

If the member cannot satisfy this first definition, the insurer will not accept the member's claim and will not pay the insured amount to the trustees of the superannuation fund.

However, if the insurer agrees that the member meets the definition of TPD under the insurance policy, it will pay the proceeds of the policy to the trustees of the superannuation fund.

Essentially, there are two main TPD definitions:

(i) own occupation, and

(ii) any occupation.

'Own occupation' TPD definitions cover the insured if he or she is incapacitated to the extent that he or she is unable to work again in their own occupation. This definition is not available to all job categories. It is generally only available to white collar workers. For example, most insurers will not offer an 'own occupation' TPD definition to a labourer.

'Any occupation' TPD definitions cover the insured if he or she is incapacitated to the extent that he or she will never return to work in any occupation for which he or she is suited by education, training or experience.

Purely from the perspective of choosing a definition under which the member is more likely to be able to submit a successful TPD claim, an 'own occupation' definition is preferred.

However, in order for the member to be able to access the proceeds of a TPD insurance policy that has been paid by the insurer to the trustees of a superannuation fund, the member will have to satisfy an 'any occupation' definition of TPD. This is discussed further in the next section.

For TPD insurance policies owned by superannuation funds, consideration should be given to using an 'any occupation' definition of TPD.

Permanent incapacity – satisfying a condition of release

In order for the trustees of the superannuation fund to be able to pay the proceeds of the insurance policy, along with the member's account balance, to the member, they must satisfy the definition of permanent incapacity, or one of the other conditions of release, in the SIS legislation.

Under SIS subregulation 6.01(2), 'permanent incapacity', in relation to a member, means:

> Ill-health (whether physical or mental), where the trustee is reasonably satisfied that the member is unlikely, because of the ill-health, to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

If a member satisfies this definition, they meet a condition of release and the trustees can pay the balance of the member's account (both investment

and insurance proceeds) to the member, regardless of the member's age.

The above definition of permanent incapacity applies from 1 July 2007 and has changed slightly from the previous definition. There is no longer a requirement that the member must have ceased a gainful employment arrangement to satisfy the definition of permanent incapacity.

The implication of this change is that it is possible for a non-working spouse/homemaker to take out TPD insurance through a superannuation fund and be able to meet the new permanent incapacity definition in SIS subregulation 6.01(2).

However, the definition of permanent incapacity under the SIS Regulations is still an 'any occupation' definition of TPD. As discussed in the preceding section, it is unadvisable to take out a TPD insurance policy with an 'own occupation' definition of TPD through a superannuation fund.

This is because, even if the insurer agrees to pay the claim to the trustees of the superannuation fund, the trustees may not be able to pay the proceeds to the member if the member is unable to satisfy the 'any occupation' permanent incapacity definition.

If the insurer pays a TPD claim to the trustees of the superannuation fund on behalf of the member, but the member is unable to satisfy the definition of permanent incapacity under the SIS legislation, the insurance proceeds will be retained in the member's account until the member satisfies another condition of release such as:

- retirement at or after preservation age
- reaching age 65
- severe financial hardship
- compassionate grounds, as determined by the Australian Prudential Regulation Authority (APRA)
- terminal medical condition, or
- death.

Case study 1

A superannuation fund trustee takes out a TPD insurance policy with an 'own occupation' definition of TPD for a member, David, who is 50 years old and works as a surgeon. This policy is designed to pay a benefit to the trustee of the superannuation fund if the member meets the 'own occupation' definition contained in the policy document.

In this scenario, the 'own occupation' clause contained in the insurance policy states that a benefit will be payable by the insurer should the insured be unable to perform the duties of his or her regular occupation (or occupations, if more than one) at the time of the disability.

Therefore, under this definition, if David hurt his hand so that it was likely that he would not be able to perform surgery in the future, the insurer would be able to pay a benefit to the trustee of the superannuation fund.

However, as David has previously worked as a lecturer at a medical college and the injury does not prevent him from being employed in the future as a lecturer, the trustee may not be able to pay a benefit to him as the permanent incapacity condition of release, or any other condition of release, has not been met.

It is important to note that trustees are often required to make a subjective decision as to whether a member meets the definition of permanent incapacity, ie the trustee must be 'reasonably satisfied'.

Where a client receives proceeds from a personal injury or lump sum workers compensation payment and intends to contribute those proceeds to a superannuation fund in order to commence a pension to fund their living requirements, it is prudent that, prior to the contribution being made, you get agreement from the trustees that they are reasonably satisfied that the client is permanently incapacitated.

Without this agreement, the client may inadvertently have locked their proceeds in a superannuation fund without the ability to access the funds until another condition of release is met.

Disability superannuation benefits – concessional tax treatment

Assuming that the member satisfies the insurance policy definition of TPD and the permanent incapacity definition under the SIS legislation, the trustees will be able to pay the member's retirement benefits and insurance proceeds to the member. This payment will be taxed as a lump sum superannuation benefit.

A benefit paid from a superannuation fund will be made up of two components:

- the tax-free component, and
- the taxable component.

However, if the member can satisfy a third definition, the definition of disability superannuation benefit in subsection 995-1(1) of the ITAA 1997, the benefit paid by the superannuation fund may include an increased tax-free component.

The tax-free component:

- is tax free on withdrawal, and
- retains its status if rolled over to another superannuation fund, although any growth earned on this component in accumulation phase is allocated to the taxable component.

The following table outlines how the components of a disability superannuation benefit, paid from a taxed superannuation fund as a lump sum, will be taxed in the 2007/08 tax year.

Age at withdrawal	Tax-free component	Taxable component – taxed element*	
Below preservation age	Tax free	Total amount	21.5%
Preservation age to age 59	Tax free	First $140,000	0%
		Excess	16.5%
60 and above	Tax free	Tax free	

* Rates shown include Medicare levy, where relevant. Tax rates shown are maximum rates. Where a person would be subject to a lower rate of tax than the maximum specified, the lower rate applies.

Subsection 995-1(1) defines a disability superannuation benefit to mean a superannuation benefit if:

(a) the benefit is paid to a person because he or she suffers from ill-health (whether physical or mental), and

(b) two legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

Like the permanent incapacity definition in the SIS legislation, this definition is also an 'any occupation' definition of TPD. The main difference between the ITAA definition and the SIS Act definition is that the former requires the member to provide medical evidence of the disability from two medical practitioners to the trustees.

The increased tax-free component is calculated as follows:

$$\text{Amount of benefit} \times \frac{\text{Days to retirement}}{\text{Service days} + \text{Days to retirement}}$$

where:

Item	Explanation
Days to retirement	is the number of days from the day on which the person stopped being capable of being gainfully employed to his or her last retirement day
Service days	is the number of days in the service period for the lump sum

Subsection 995-1(1) defines the last retirement day to mean:

(a) if an individual's employment or office would have terminated when he or she reached a particular age or completed a particular period of service – the day he or she would reach the age or complete the period of service (as the case may be), or

(b) in any other case – the day on which he or she would turn 65.

In the absence of any ascertainable date, such as under the terms of employment or an award, the last retirement day is when the client turns 65 years old.

From 1 July 2007, both employed and self-employed individuals can take advantage of the increased tax-free component associated with a disability superannuation benefit. Prior to 1 July 2007, the concessionally taxed post-June 1994 invalidity component was not available to self-employed people.

Case study 2

Bob (date of birth 24 July 1965) works as a forklift driver for Safety Pty Ltd. He started working for Safety Pty Ltd on 15 March 1992. He has a superannuation fund with an account balance of $125,000, which is made up of the following components:

Tax-free component	$35,000
Taxable component	$90,000
Total	**$125,000**

In addition to his retirement benefits, Bob also has $470,000 of life and TPD insurance through his superannuation fund.

As a result of a workplace accident on 24 July 2007, Bob loses the use of both of his legs. The accident will require him to be wheelchair-bound for the rest of his life and unable to ever work as a forklift driver/storeman, which are the only types of jobs that Bob is reasonably qualified for by reason of his education, training or experience.

The insurer agrees that he satisfies the TPD definition in their insurance policy and they pay the proceeds to the trustees of Bob's superannuation fund.

The trustees of the superannuation fund agree that Bob meets the definition of permanent incapacity in SIS subregulation 6.01(2) because he is in their opinion, 'unlikely, because of the ill health, to engage in gainful employment for which he is reasonably qualified for by education, training or experience'.

This being the case, the trustees can pay the proceeds of Bob's account (investment and insurance proceeds) to him as he satisfies a condition of release, ie on the grounds of permanent incapacity.

At this stage, his lump sum superannuation benefit is made up of the following components:

Tax-free component	$35,000
Taxable component	$560,000
Total	**$595,000**

Bob will receive the tax-free component tax free, but will have to pay up to 21.5 per cent tax on the taxable component, as he is under preservation age. The amount of tax payable on the taxable component reduces his net benefit by $120,400 ($560,000 x 21.5 per cent).

However, Bob is able to produce evidence from two medical practitioners that his disability is likely to result in him being unable to ever be gainfully employed in a capacity for which he is reasonably qualified for because of education, training or experience.

As the definition of disability superannuation benefit in subsection 995-1(1) of the ITAA 1997 is satisfied, Bob's superannuation benefits will include an additional amount of tax-free component, which is calculated as follows:

$$\text{Amount of benefit} \times \frac{\text{Days to retirement}}{\text{Service days + Days to retirement}}$$

$$= \$595{,}000 \times \frac{8{,}402}{14{,}011}$$

$$= \$356{,}805$$

Item	Explanation	Days/ amount
Amount of benefit		$595,000
Days to retirement	the number of days from the day on which the person stopped being capable of being gainfully employed to his or her last retirement day (24/7/2007 to 24/7/2030)	8,402 days
Service days	the number of days in the service period for the lump sum (15/3/1992 to 23/7/2007)	5,609 days

As no alternative last retirement day has been nominated for Bob under the terms of his employment or an award, then his last retirement day is taken to be when he turns 65.

Therefore, after taking into account his increased tax free-component, Bob's disability superannuation benefit is made up of the following components:

Tax-free component	$391,805
Taxable component	$203,195
Total	**$595,000**

Bob will receive the tax-free component tax free, but will have to pay up to 21.5 per cent tax on the taxable component, as he is under preservation age. The amount of tax payable on the taxable component now reduces his net benefit by only $43,687 ($203,195 x 21.5 per cent).

Therefore, the increased tax-free component associated with a disability superannuation benefit will save Bob $76,713 in tax.

An interesting observation about the formula that is used to calculate the tax-free component of a disability superannuation benefit is that the further the client is from their last retirement day, when they are forced to terminate their employment as a result of disability, the higher their tax-free component will be.

This topic looks at the ability of terminally ill members of superannuation funds to access their superannuation benefits under a new condition of release and the tax treatment of benefits paid due to terminal illness.

Many life insurance policies, both within superannuation and outside of superannuation, allow for a death benefit to be pre-paid as a terminal illness benefit where the insured is diagnosed with an illness that is expected to result in their death within 12 months, regardless of any treatment that they may receive.

If a member has taken out life insurance through a superannuation fund and is subsequently diagnosed as being terminally ill, the amount of the payment and the taxation treatment will depend on three definitions:

(i) if the member can satisfy the definition of terminal illness in the insurance policy, the life insurance proceeds under the terminal illness benefit clause are paid by the insurer to the trustees of the superannuation fund

(ii) if the member satisfies the definition of terminal medical condition, or another condition of release, which is contained in the SIS legislation, then the trustees of the superannuation fund can pay the proceeds of the insurance policy and any account balance to the member, and

(iii) a lump sum payment made to a member from a superannuation fund will be treated as a lump sum superannuation benefit and will be taxed accordingly. However, if the definition of terminal medical condition in the Income Tax Assessment Regulations (ITAR) 1997 can be met, the lump sum superannuation benefit will be tax free in the hands of the member.

Terminal illness – insurance policy definition

For a member of a superannuation fund to receive the proceeds of a life insurance policy prior to their death, the first step is satisfying the insurer's definition of terminal illness.

If the member cannot satisfy this first definition, the insurer will not accept the member's claim and will not pay the insured amount to the trustees of the superannuation fund.

However, if the insurer agrees that the member meets the definition of terminal illness under the insurance policy, the amount payable under the terminal illness benefit clause can be paid to the trustees of the superannuation fund.

Terminal medical condition – satisfying a condition of release

In order for the trustees of the superannuation fund to be able to pay the proceeds of the insurance policy, along with the member's account balance, to the member, he or she must satisfy the definition of terminal medical condition, or one of the other conditions of release, in the SIS legislation.

Under SIS regulation 6.01A a terminal medical condition exists under the following circumstances:

(a) two registered medical practitioners have certified, jointly or separately, that the person suffers from an illness, or has incurred an injury, that is likely to result in the death of the person within a period (the certification period) that ends not more than 12 months after the date of the certification

(b) at least one of the registered medical practitioners is a specialist practicing in an area related to the illness or injury suffered by the person, and

(c) for each of the certificates, the certification period has not ended.

Please note that a terminally ill member can also use this new condition of release to access their accumulated superannuation benefits even where there is no life insurance benefit, ie there is no requirement for a life insurance policy benefit to have been pre-paid to the member under a terminal illness benefit clause in order to use this condition of release.

Terminal medical condition – concessional tax treatment

It is proposed that a lump sum superannuation benefit paid to a member with a terminal medical condition, from either a taxed or untaxed source, will be non-assessable non-exempt income, ie it will be tax free in the hands of the member.

This change is contained in the Tax Laws Amendment (2008 Measures No.1) Bill 2008, which once passed, will apply to payments made on or after 1 July 2007.

At the time of writing, the changes to make lump sum benefits paid from a superannuation fund to a terminally ill member tax free have yet to be passed.

However, as an interim measure, an instrument has been created under the Taxation Administration Act 1953 which removes the requirement for superannuation funds to withhold tax from lump sum superannuation benefit payments made to a member who is terminally ill.

This instrument, at the time of writing, was due to cease on 1 July 2008.

A definition of terminal medical condition will be introduced into the ITAR 1997 once the above bill is passed.

Advice issues

While the introduction of the new SIS condition of release and the proposed change to make lump sum benefits paid from a superannuation fund to a terminally ill member tax free are very positive changes, advisers need to be aware of a couple of advice issues.

Firstly, if a terminally ill member uses the terminal medical condition of release to access their superannuation benefits, his or her beneficiaries may miss out on receiving a future anti-detriment death benefit. An anti-detriment death benefit can only be paid to a spouse, a former spouse or any child of the deceased, in conjunction with a lump sum death benefit.

Secondly, some terminal illness benefit clauses in insurance policies cap the amount of life insurance that can be paid out under such a clause.

Therefore, if a member decides to use the terminal medical condition of release to withdraw their total superannuation benefits from the fund, the insurance policy will no longer be in force and their beneficiaries may miss out on the remaining sum insured, once the member dies.

This potential issue is illustrated by the following case study.

Case study

Tania, who is 46 years old, has been diagnosed with leukaemia and is told that she has less than 12 months to live.

She has a superannuation fund with a current account balance of $60,000. Tania's superannuation fund also provides her with an additional life insurance benefit of $2 million.

Furthermore, the life insurance policy that is owned by the trustees of Tania's superannuation fund contains a clause that allows for a terminal illness benefit, of up to $1 million, to be paid in the event of a member becoming diagnosed with a terminal illness.

The insurer agrees that Tania satisfies the terminal illness definition in their insurance policy and they pay the $1 million proceeds to the trustees of her superannuation fund.

After receiving the required medical evidence, the trustees of Tania's superannuation fund agree that she meets the definition of terminal medical condition in SIS regulation 6.01A and allow her to access her full account balance of $1,060,000.

If she meets the definition of terminal medical condition, which will be included in the ITAR 1997, the payment to her from the superannuation fund will be tax free.

However, if she withdraws all of her entitlements from the superannuation fund she will no longer be a member of the fund and therefore on her death her beneficiaries will not be entitled to the additional $1 million of life insurance proceeds.

When faced with this type of situation advisers may need to advise terminally ill members like Tania not to fully close their superannuation account, ie don't withdraw their total entitlement from the superannuation fund, so that once they die the additional sum insured, which in this case is $1 million, can be paid to their beneficiaries.

Care should also be taken that the funds remaining in the superannuation account are adequate enough to meet future premium payments.

This topic examines superannuation products, such as the AXA/AC&L Life Insurance Superannuation Plan, which only provide life and TPD insurance. It also looks at the advantages and disadvantages of using these products compared to using insurance policies owned outside of superannuation.

Most public offer superannuation funds provide their members with the ability to save for their retirement, and as a rider benefit, allow part of their superannuation contributions to be used to pay for life and TPD insurance, and in some cases salary continuance insurance. These products are predominantly retirement savings vehicles that offer insurance as an additional benefit.

However, there are several superannuation products on the market, such as the AXA/AC&L Life Insurance Superannuation Plan, that are insurance-only products. Typically, these products offer members the ability to use the full amount of their superannuation contributions to these products to acquire life and TPD insurance. As the name suggests, insurance-only superannuation products do not offer the member any retirement savings element.

Structure

The key to understanding these products is to recognise that payments to these products are superannuation contributions, even though the contributions are fully used to pay for insurance premiums, ie they look like insurance premiums.

Therefore, only someone who is eligible to make or receive a superannuation contribution is eligible to take out insurance through an insurance-only superannuation product.

In theory, an insurance-only superannuation product can receive two types of superannuation contributions:

- concessional contributions which include employer contributions (eg Superannuation Guarantee and salary sacrifice contributions) and personal deductible superannuation contributions (eg unsupported member or self-employed contributions), and
- non-concessional contributions which include personal contributions for which no tax deduction has been claimed and spouse superannuation contributions.

In practice, the type of contributions that can be made to an insurance-only superannuation product is governed by the superannuation fund's trust deed. Therefore, when using one of these types of contributions it is important to check with the superannuation fund to determine whether the fund can accept that type of superannuation contribution.

Contributions tax

Generally, if a member receives a Superannuation Guarantee or a salary sacrifice superannuation contribution that is within the member's concessional contributions cap, the contribution will incur 15 per cent contributions tax.

Similarly, if a self-employed person, an unsupported member or a substantially self-employed member makes a deductible superannuation contribution that is within their concessional contributions cap, the contribution would also incur 15 per cent contributions tax.

However, if a member makes or receives any of the above superannuation contributions to an insurance-only superannuation product, the contribution will not incur the 15 per cent contributions tax. The reason for this can be best illustrated by the following case study.

Case study 1

Litsa, who is 40 years old, is a self-employed doctor who decides that she needs to take out life and TPD insurance for herself. She decides to purchase $500,000 of life and TPD insurance through the AXA/AC&L Life Insurance Superannuation Plan.

She makes a $5,000 superannuation contribution to pay for the cover and is able to claim a deduction of $5,000 for her superannuation contribution. She wants to know whether the 15 per cent contributions tax will be deducted from her contribution.

The $5,000 contribution to the AXA/AC&L Life Insurance Superannuation Plan will count towards Litsa's concessional contributions cap of $50,000. It is assumed that this is the only concessional contribution that she will be making or receiving for this tax year.

Litsa's deductible contribution of $5,000 will need to be included in the AXA/AC&L Life Insurance Superannuation Plan's assessable income.

Trustees of superannuation funds can claim a deduction under section 295-465 of the ITAA 1997 for so much of any insurance premiums paid that are attributable to the provision of superannuation death benefits and disability superannuation benefits for their members.

Therefore, as Litsa's deductible superannuation contribution is used by the trustees to acquire death and disability benefits for her, the $5,000 can be claimed as a deduction by the fund.

If we look at the impact of this transaction in isolation on the tax position of the AXA/AC&L Life Insurance Superannuation Plan, we can see why no contributions tax needs to be deducted by the fund from Litsa's contribution.

AXA/AC&L Life Insurance Superannuation Plan tax position	
Assessable income	
Concessional/taxable contributions	$5,000
Less: allowable deductions	
Premium for death and disability insurance	$5,000
Taxable income	$0

Advantages of using insurance-only superannuation products

Generally, where a life or TPD insurance policy is taken out for personal protection reasons outside of superannuation and the premiums are paid for by an individual, the premium will not be tax deductible.

However, by using an insurance-only superannuation product to acquire the insurance, it may be possible for the payer of the premium/superannuation contribution to qualify for one or a combination of the following:

- a tax deduction
- a tax offset, and/or
- a Government co-contribution.

The following case study illustrates how an insurance-only superannuation product can be used to make insurance premiums, which would otherwise offer the payer no tax relief, more tax effective.

Case study 2

John and Mary are both 46 years old and have four children, all of whom are of primary school age. John has a high income-earning job, while Mary is kept busy being a full-time mum and does not work. They are both Australian tax residents.

John realises that if Mary died or became totally and permanently disabled this would have a major financial impact on him. John would have to take time off work or hire someone to look after the children. Therefore, he wants to take out life and TPD insurance on Mary's life.

If he takes this cover out under a non-superannuation policy the premiums will not be tax deductible. He queries whether there is a more tax effective manner in which to structure the insurance.

Personal deductible superannuation contribution

As Mary is only 46 years old she is eligible to make a personal superannuation contribution on behalf of herself, notwithstanding that she is not employed. Furthermore, as she is a non-working spouse she is an unsupported member.

Therefore, Mary can make a superannuation contribution to an insurance-only superannuation product and as an unsupported member can claim the contribution as a deduction under section 290-150 of the ITAA 1997. This amount will count towards her concessional contributions cap.

However, it is only worthwhile for Mary to claim a deduction if she has other assessable income against which she can utilise the deduction.

If Mary has no other income she may be better off having John make a spouse superannuation contribution on her behalf.

Spouse superannuation contribution

As an alternative, John can make a superannuation contribution on behalf of Mary into an insurance-only superannuation product and qualify for a spouse superannuation contribution tax offset.

John may be entitled to a spouse contribution tax offset of 18 per cent of the lesser of:

- $3,000 reduced by $1 for every $1 of the amount by which Mary's assessable income plus reportable fringe benefits exceeds $10,800, or
- the total of the eligible spouse contributions made by John in that tax year.

The maximum spouse contribution tax offset available for John is $540 where Mary's assessable income and reportable fringe benefits are less than $10,800 and the amount of the spouse contribution is $3,000 or more.

John would be eligible for at least a partial spouse contribution tax offset as long as Mary's assessable income plus reportable fringe benefits are less than $13,800.

Personal non-concessional contribution

Let's suppose that instead of being a non-working spouse Mary was employed part-time and that she earned at least 10 per cent of her total income for the year from this part-time work.

If Mary makes a personal non-concessional contribution to an insurance-only superannuation product she may become eligible for a Government co-contribution. This contribution will count towards her non-concessional contributions cap.

A Government co-contribution will be payable if:

- the person made a personal non-concessional contribution to a complying superannuation fund or retirement savings account (RSA) during the tax year
- an income tax return has been lodged for the tax year
- the person's total income (assessable income and reportable fringe benefits less eligible business deductions) is less than $58,980 for the 2007/08 tax year
- the person does not hold an eligible temporary resident visa at any time during the tax year
- the person is less than 71 years old at the end of the tax year, and
- 10 per cent or more of the person's total assessable income and reportable fringe benefits for the year is attributable to eligible employment, carrying on a business or a combination of both.

Please note while a non-concessional contribution to an insurance-only superannuation product may qualify Mary for a Government co-contribution (subject to her meeting all of the eligibility conditions above) the actual Government co-contribution cannot be paid to an insurance-only superannuation product.

Therefore, if Mary qualifies for a Government co-contribution she will have to nominate another complying superannuation fund to accept the Government co-contribution.

Combination of contributions

It may be possible for Mary and John to make a combination of superannuation contribution types to an insurance-only superannuation product.

For example, if Mary's assessable income and reportable fringe benefits are less than $13,800 and at least 10 per cent of her assessable income and reportable fringe benefits came from eligible employment it may be possible:

- for her to make a personal non-concessional contribution of $1,000, so that she can qualify for a Government co-contribution of $1,500, and
- for the remainder of the contribution to be made by John as a spouse superannuation contribution, so that he becomes eligible for a spouse contribution tax offset.

It is important to check with the superannuation fund to see whether it is possible to make a combination of superannuation contribution types to an insurance-only superannuation product.

Disadvantages of owning insurance through superannuation

To date we have focused on the advantages of owning life and TPD insurance through a superannuation fund. In particular, we have focused on the tax effectiveness of using an insurance-only superannuation product compared to using a life and TPD insurance policy outside of superannuation, where the premiums are generally not deductible.

For balance, it is important to point out that there are some disadvantages of owning life and TPD insurance through a superannuation fund including:

- if life insurance proceeds are paid to a non-dependant and include a taxable component, the proceeds will be subject to tax at up to either 16.5 per cent or 31.5 per cent, depending on whether the taxable component is a taxed element or an untaxed element
- if TPD insurance proceeds are paid to the trustees of a superannuation fund, the member must satisfy the definition of permanent incapacity in subregulation 6.01(2) of the SIS Regulations, or another condition of release, before they can receive the proceeds, and
- TPD insurance proceeds are taxed as a lump sum superannuation benefit, although if the definition of disability superannuation benefit can be satisfied then the lump sum superannuation benefit will include a higher tax-free component.

In comparison, where life insurance is owned outside of superannuation and the policy is taken out for personal protection reasons:

- the proceeds can be paid to anyone that the policy owner wants the proceeds to go to, ie the beneficiary does not need to be a dependant
- the proceeds will not be subject to income tax, and
- the proceeds will usually not be subject to CGT unless they were received by someone, other than the original beneficial owner, who acquired it for money or other consideration.

Similarly, where TPD insurance is owned outside of superannuation and the policy is taken out for personal protection reasons:

- the proceeds will not be subject to income tax, and
- the proceeds will not be subject to CGT where they are paid to either the life insured or a defined relative of the life insured.

Conclusion

Financial advisers need to give consideration to both the advantages and disadvantages of owning life and TPD insurance through a superannuation fund and compare this with owning life and TPD insurance policies outside of superannuation, prior to recommending insurance-only superannuation products to their clients.

Generally speaking, superannuation contributions/ premium payments to insurance-only superannuation products may be more tax effective for some clients, but there is more chance that there may be tax to pay in the event of a claim being paid under an insurance-only superannuation product when compared with an insurance policy that is owned outside of superannuation.

This topic examines the tax implications and the other issues associated with owning salary continuance insurance through a superannuation fund. It also looks at the implications of a tax determination issued by the Australian Taxation Office (ATO) on the tax deductibility of salary continuance insurance premiums.

Many superannuation funds offer their members life and/or TPD insurance. However, some superannuation funds also offer their members salary continuance insurance.

Salary continuance insurance is a term that is generally used to describe income protection insurance held within a superannuation fund. It is also sometimes referred to as total and temporary disablement (TTD) insurance.

Salary continuance insurance benefits

Salary continuance insurance benefits are insured benefits payable in the event of the temporary disablement of a superannuation fund member.

Salary continuance insurance benefits are designed to be paid to a superannuation fund member during a prolonged absence from employment, because of temporary disability, to compensate the member for the loss of salary/income.

Salary continuance insurance benefits are not normally payable to compensate the member for the loss of salary due to relatively minor illnesses. This is because as a matter of practice, most salary continuance insurance benefits are paid after a waiting/qualifying period, which is commonly a month or three months.

Members can use their sick leave entitlements to replace their salary in the event of illness/injury that causes them to be absent from work for short periods.

Neither the SIS Act or the SIS Regulations contain any formula or other guidance as to how the benefit provided under a salary continuance insurance arrangement is to be calculated. Theoretically, the benefit payable under a salary continuance insurance arrangement can be equal to 100 per cent of a member's pre-disability earnings.

However, insurers are not comfortable with providing members with a benefit equal to 100 per cent of their pre-disability earnings, as there is no incentive for the disabled member to return to work.

As a result of this most salary continuance insurance arrangements dictate that the benefit provided may only be up to a maximum of 75 per cent of pre-disability earnings.

The level of benefits provided will vary between funds. Some may stipulate a set percentage of salary as the benefit, while others may work on a formula basis. There will also be variations between funds in regard to specific exclusions, for example, incapacity due to intentional self-injury, existing medical conditions, war and other specified items.

Temporary incapacity

As is the case with any benefit payable from a superannuation fund, in order for the benefit to be paid the member must have met a condition of release.

Temporary incapacity is defined in subregulation 6.01(2) of the SIS Regulations as:

> In relation to a member who has ceased to be gainfully employed (including a member who has ceased temporarily to receive any gain or reward under a continuing arrangement for the member to be gainfully employed), means ill-health (whether physical or mental) that caused the member to cease to be gainfully employed, but does not constitute permanent incapacity.

The payment of temporary incapacity benefits is subject to the following restrictions:

- the purpose of the payment is to continue (in whole or part) the gain or reward which the member received before the temporary incapacity
- the period of benefit payments must not exceed the period of incapacity from full employment of the kind engaged in immediately before the member became ill (including the level of weekly hours)
- the benefit must be paid at least monthly, and
- cannot be paid out of member or mandated employer financed minimum benefits.

Generally, a person on fully paid leave, such as on sick leave, will not be eligible to receive temporary incapacity benefits.

Furthermore, according to APRA Superannuation Circular No. I.C.2, temporary incapacity benefits may be paid where a member makes a partial return to gainful employment whilst incapacitated, provided that the member's remuneration plus the temporary incapacity benefits, do not exceed their remuneration at the time that they became ill or injured.

Tax deductibility of salary continuance insurance premiums

Trustees of complying superannuation funds can claim a deduction under section 295-465 of the ITAA 1997 for so much of any insurance premiums paid that are attributable to the provision of any benefits for their members that are outlined in section 295-460 of the ITAA 1997.

Section 295-460 of the ITAA 1997 lists the following benefits:

(a) a superannuation death benefit

(b) a disability superannuation benefit

(c) a benefit consisting of an amount payable to a person under an income stream because of the person's temporary inability to engage in gainful employment, that is payable for no longer than:

- (i) two years, or
- (ii) if an approval under section 62 of the SIS Act 1993 is in force for benefits of that kind and that approval specifies a longer maximum period – that longer period, or
- (iii) if there is no such approval in force – a longer period allowed by the Commissioner.

Tax Determination TD 98/27

In Tax Determination TD 98/27 (which has now been replaced) the ATO confirmed that under section 279 of the ITAA 1936 (the predecessor to section 295-465 of the ITAA 1997) complying superannuation funds could only obtain a tax deduction for the premiums paid on policies that provide income payments for periods of temporary disability no longer than two years.

Salary continuance insurance benefit payment periods of greater than two years were able to be provided, but the deduction to the trustees of the superannuation fund was limited to the proportion of the premium that related to a two-year benefit payment period.

However, TD 98/27 has been withdrawn and replaced by Tax Determination TD 2007/3.

Tax Determination TD 2007/3

In TD 2007/3, released in March 2007, the ATO overturned its previous view that the trustee of a complying superannuation fund could only claim a tax deduction for the premiums paid on policies that provide income payments for periods of temporary disability no longer than two years.

In TD 2007/3 the ATO referred to an 'Approval of Provision of Benefits' issued on 1 July 1997 by the Insurance and Superannuation Commission (ISC), which reflects the provisions of the SIS Act and its regulations that permit temporary disability benefits to be paid for a period not exceeding the period of incapacity.

Accordingly, the 'Approval of Provision of Benefits' constitutes an approval of a longer benefit payment period (a period not exceeding the period of incapacity), as contemplated by subparagraph (c) (ii) of the definition of death or disability benefits in sub-section 267(1) of the ITAA 1936 (the predecessor to section 295-460 of the ITAA 1997).

Therefore, the ATO confirms that a deduction is now available to a complying superannuation fund under section 295-465 of the ITAA 1997 for salary continuance insurance premiums that provide benefit periods for temporary disability that exceed two years.

Furthermore, the conclusions in TD 2007/3 apply both before and after the date that this determination was issued. Therefore, it is possible for superannuation funds to amend past years tax returns to claim a deduction for salary continuance insurance premiums, where the benefit periods were in excess of two years.

In deciding whether to amend past year tax returns, trustees of superannuation funds need to compare the benefit of any tax savings associated with the ATO's new interpretation against both the time and costs (eg accounting fees) associated with amending a past year's tax return.

Taxation of salary continuance insurance benefits

Salary continuance insurance benefit payments are intended to be direct compensation to the member for salary lost because of illness or injury. The payments are therefore regarded as normal income for the same reasons that the proceeds of an income protection insurance policy, held outside of superannuation, would need to be included in the recipient's assessable income. This is the case regardless of whether or not the member is 60 years old or older.

Furthermore, salary continuance insurance benefits paid to a member from a superannuation fund are not eligible for the 15 per cent offset, regardless of the member's age.

If a member makes a successful claim for a payment under a salary continuance insurance policy owned by a superannuation fund, the gross salary continuance insurance benefit is paid by the insurer to the trustees of the superannuation fund.

The superannuation fund will not have to include the proceeds it receives from the insurer in its assessable income. The superannuation fund will then pass the proceeds on to the incapacitated member (assuming the definition of temporary incapacity can be satisfied) in the form of an income stream.

As the proceeds were not included in the superannuation fund's assessable income, the payment of the salary continuance insurance benefits to the member cannot be claimed as a deduction by the superannuation fund.

On receipt of the benefits by the member, the income payments are then included in the member's assessable income and are subject to Pay As You Go (PAYG) tax, which should be deducted by the superannuation fund.

Alternatively, where salary continuance insurance arrangements are held through an employer sponsored superannuation fund, the trustees will often pay the gross salary continuance insurance benefit to the employer. Under these sorts of arrangements the employer effectively acts as an agent for the trustees of the superannuation fund.

On receipt of these proceeds the employer will need to include this amount in its assessable income. The employer will then pass the proceeds on to the incapacitated member/employee and would normally be entitled to claim a tax deduction for this payment, thus offsetting the amount included in its assessable income.

The income payments are then included in the assessable income of the member/employee and are subject to PAYG tax, which should be deducted by the employer.

Strategy implications

Following the release of TD 2007/3, which allows the trustees of a superannuation fund to claim a tax deduction on salary continuance insurance premiums regardless of the benefit period chosen, advisers who have clients needing salary continuance/income protection insurance must decide whether to put this type of cover in or outside of superannuation.

The advantages of owning salary continuance insurance through a superannuation fund include:

- less impact on an individual's day to day cash flow if the premiums are deducted from their superannuation savings, and
- if taken out through a public offer superannuation fund, the insurance premiums may be at cheaper group rates, however group insurance policies can tend to be a bit more restrictive then individual insurance policies, ie they may have less features.

The disadvantages of owning salary continuance insurance through a superannuation fund include:

- in addition to the disability definition in the insurance policy, the temporary incapacity definition in subregulation 6.01(2) of the SIS Regulations also needs to be satisfied, and
- if the premiums are deducted from the superannuation fund this will reduce the individual's retirement savings.

Furthermore, once extended benefit periods are offered by more superannuation funds, the strategy where a salary continuance insurance policy is taken out with a two-year benefit period through a superannuation fund, in conjunction with a second income protection insurance policy outside of superannuation, with a two-year waiting period and a benefit period of up to age 65, will no longer be necessary. This should reduce the complexity of providing advice in this area to clients.

The final point that advisers wishing to transfer personally owned income protection insurance policies to a superannuation fund need to be aware of is the restriction in sub section 66(1) of the SIS Act which prohibits a superannuation fund from acquiring a life insurance policy from a member of a superannuation fund or a relative of a member. However, as a workaround it may be possible to have the policy re-issued.

From a practical point of view, clients wishing to cancel and re-issue an income protection insurance policy will need to arrange with the insurer that the transfer to the new insurance policy is agreed to without any need for re-underwriting the risk.

An insurer is not bound to do this without re-underwriting the risk, however for commercial reasons most insurers will agree to such a transfer if the income protection insurance policy under the superannuation fund will remain with them and the sum insured does not increase. In some cases insurers will agree to such a transfer with only limited re-underwriting.

As a new policy will be purchased, new terms and conditions and premium rates may apply.

It is also important to point out that if you recommend a cancel and re-issue of an income protection insurance policy, or of any type of life insurance policy, it is important to ensure that the new policy is in force, prior to cancelling the existing policy.

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Key person insurance

Technical Insurance Guide

This topic looks at who is a key person and the tax implications of a business owning insurance policies to protect itself against the loss of a key person as a result of the key person dying, becoming disabled or suffering a specified medical condition.

Most businesses have one or more individuals whose continued association with the business, as a result of their investment, experience, technical expertise or connections, provide the business with a significant and direct economic gain. Such individuals can be identified as key persons.

Their loss from a business could result in a significant impact on revenue, profit or other financial aspects of a business eg goodwill, ability to repay debt and other expenses or access to credit, business contacts and customers.

Key person insurance is essentially life, TPD or trauma insurance policies taken out by a business on the life of a key person.

Where this insurance is taken out and a key person either dies or is unable to perform their duties due to an insurable event (disablement or a specified medical condition), the business can use the insurance proceeds to replace lost revenue, repay debt, cover additional expense items or inject required capital into the business.

This ensures that the business is supported financially until a replacement is found or other staff are trained to fulfil a particular role. Hence, key person insurance helps protect the financial stability of a business and reduces business risk.

It is important to understand the distinction between key person insurance and insurance policies used for business succession planning.

Key person insurance is about protecting the ongoing viability of the business. Conversely, business succession planning is about protecting the owner's (and indirectly his or her family's) personal investment in the business.

Who is a key person?

A key person is any person whose continued association with the business provides the business with a significant economic gain.

The term economic gain used in this context can mean any of the following:

- increased sales and revenue
- cost savings
- increased profit
- increased goodwill
- ability to access finance, and
- ability to access or retain customers.

Key persons can include employees, owners of the business, managing directors, even suppliers – generally those persons whose loss would have a significant impact on the financial viability of the business.

Common examples of an employee who may be a key person include:

- a chief executive officer
- a sales representative who has many contacts and has forged successful relationships with the business's larger customers, and
- a technical person who has a specialist skill that the business relies on to either attract customers or to ensure that its manufacturing process can continue to operate.

A key person does not even have to be an employee of the business. For example, an external supplier of a key component/part in the business's own manufacturing process can be a key person of the manufacturing business, even if the supplier is not employed by the manufacturing business.

Similarly, a non-working shareholder, ie a silent partner, who puts up his personal assets as security for the loans of the business may also be considered to be a key person if the business relies on these guarantees to obtain loans.

Who is a key person for tax purposes?

The identification of a key person is also important from a taxation perspective. The Australian Taxation Office (ATO) defines a key person in Tax Ruling IT 2434:

> An employee may be accepted as a key man where the loss of that employee would result in a significant loss of profits being derived by the employer during the continuation of business operations subsequent to that loss. This would be a situation where there is a continuing business and the resulting loss of profits is a matter that would be expected to be overcome as another employee, or a new employee, is trained to replace the expertise lost with the former employee.

However, IT 2434 also explains that a key man for taxation purposes is not seen to exist in a situation where the loss of an employee, such as the owner/manager of a one man incorporated business, could be expected to result in the termination of the business.

Capital or revenue purpose

Key person insurance can be taken out to cover the business against losses of a:

- capital nature, and/or
- revenue nature.

In an accounting context, where key person insurance is taken out for capital purposes it is attempting to protect the balance sheet of the business ie assets, liabilities and shareholders' equity.

Conversely, where key person insurance is taken out for a revenue purpose it is attempting to protect the profit and loss statement of the business.

Capital purpose

Capital purpose reasons for taking out key person insurance may include:

- repaying debt that may be called in by the lenders as a result of the key person's death, disablement or major illness
- protecting the ongoing credit rating of the business
- repaying loans that have been made to the business by the key person
- repaying debt that has been guaranteed by the key person, and
- protecting the goodwill and capital structure of the business.

Revenue purpose

Revenue purpose reasons for taking out key person insurance may include:

- covering the replacement of lost sales revenue or profits as a result of the death, disablement or major illness of a key person
- covering the added expenses of recruitment costs and the costs of finding a temporary replacement for the key person, and
- enabling the business to make an attractive remuneration offer to prospective replacements for the key person.

Substantiation of purpose

Keeping records relating to the purpose for which an insurance policy is taken out is a very important step for a business.

Tax Ruling IT 155 states that:

> With regard to the type of evidence which would be required to establish the purpose for which an accident or term insurance policy has been effected and kept in force, information about the taxpayer's minutes or book entries would be of some value, but should not necessarily be regarded as conclusive.
>
> As indicated in the Carapark Holdings case, 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.

It is also important to realise that a business's circumstances may change. According to IT 155:

> The taxpayer might change his plans from time to time and renew the same policy from year to year for varying purposes.

This may occur where a company takes out key person insurance for the purpose of repaying a debt to a director's estate on the director's death. At the time of taking out the life insurance policy it would appear that the purpose of the cover was capital purpose.

However, a number of years later, when the insurance policy proceeds are received on the death of the director, the business no longer owes the director any money, as the loan to the director has already been repaid in full.

Tax Ruling IT 155 commentary indicates that:

> This type of situation would call for enquiries to ascertain whether the debt was in existence at the time of the latest renewal. If the debt had been cleared beforehand, evidence such as minutes indicating that the insurance was originally taken out for the purpose stated by the company could be discounted as being irrelevant in the changed circumstances.

Therefore, it is advisable to record in the formal documents of the business, such as a company's minutes or other formal notes, that a decision was made in relation to the purpose for which the cover was obtained and the rationale behind this decision. However, this in itself cannot be relied on as evidence and the ATO may want to consider all the circumstances surrounding the insurance in assessing whether any claimed deductions are valid.

Income tax treatment of insurance premiums and proceeds

The taxation treatment of both the insurance policy premiums and any benefits paid will be determined by whether the benefit is considered to be for capital or revenue purposes. To a large extent this will be determined by how it is likely that the benefit will be used.

The tax implications of key person insurance are also discussed in Tax Ruling IT 155. In this ruling the ATO quotes from a judgement of the High Court in Carapark Holdings Ltd v FCT 1966 as to whether the proceeds of an accident or term policy are assessable under section 25(1) of the ITAA 1936:

> In general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt which the event insured against has prevented from arising or of any outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by consideration of morality or expediency.

The ruling goes on to say that the above proposition may also be used as a basis for the determination of claims for the deduction of premiums under section 51(1) of the ITAA 1936, which has been rewritten as section 8-1 of the ITAA 1997.

Broadly speaking, for risk only policies for death, TPD and trauma insurance, where the policy is taken out for:

- capital purposes, the insurance premiums will not be tax deductible under section 8-1 of the ITAA 1997 and any proceeds will not be assessable as income
- revenue purposes, the insurance premiums will be tax deductible under section 8-1 of the ITAA 1997 and any proceeds will be assessable as income.

In addition to the income tax implications of receiving the proceeds of an insurance policy taken out on the life of a key person, there may also be CGT implications.

Capital gains tax

According to subsection 118-300(1) of the ITAA 1997, if a CGT event happens to a life insurance policy or an annuity instrument, a capital gain or loss made from it by:

- the original beneficial owner of the policy or instrument, or
- an entity that acquired the interest in the policy or instrument for no consideration, or
- the trustee of a complying superannuation entity for the tax year in which the CGT event happened,

is ignored for CGT purposes.

The term original beneficial owner is defined in Tax Determination TD 94/31 as:

An original beneficial owner of any of the rights, or any interest in any of the rights, under a policy of life assurance is the first person who:

(i) at the time the policy is effected, holds such rights, or any interest in such rights, and

(ii) possesses all the normal incidents of beneficial ownership (for example, 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).

Therefore, unless the recipient of the life insurance policy is not the original beneficial owner of the policy and the recipient acquired the interest in the policy for money or other consideration, life insurance policy proceeds will not be subject to CGT.

According to Tax Determination TD 94/34 consideration in this context refers to actual consideration and does not include a premium paid under the policy.

In Tax Determination TD 2007/4, the ATO confirmed that the term 'life insurance policy', for the purpose of receiving the CGT exemption in subsection 118-300(1) of the ITAA 1997, includes a life insurance policy that provides for the payment of a terminal illness benefit.

A terminal illness benefit is a pre-payment of a death benefit which is generally payable upon the diagnosis of an illness which will result in the death of the insured within 12 months, regardless of any treatment that they may receive.

Therefore, the CGT exemption in subsection 118-300(1) of the ITAA 1997 can be utilised on the pre-payment of a death benefit under a terminal illness benefit clause, even though the life insured has not yet died.

It is important to note that the CGT exemption under subsection 118-300(1) of the ITAA 1997 only applies to life insurance policies and not disability policies such as TPD or trauma insurance.

However, paragraph 118-37(1)(b) of the ITAA 1997 disregards a capital gain or capital loss upon the receipt of compensation for any injury or illness to the person insured or a relative, as defined in subsection 995-1(1) of the ITAA 1997.

Subsection 995-1(1) of the ITAA 1997 defines a relative of a person as:

(a) the person's spouse, 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).

If a business has received the proceeds of a key person life, TPD or trauma insurance policy that was taken out for revenue purposes the proceeds would be assessed as income under the general income provisions.

Under these circumstances, even where the proceeds do not fall under any of the CGT exemptions mentioned above, the capital gain would not need to be included in the assessable income of the business a second time. This is because under section 118-20 of the ITAA 1997 the same income cannot be taxed under two sections of the ITAA.

However, where a business received the proceeds of a key person life, TPD or trauma insurance policy that was taken out for capital purposes and the amount was not assessed as income under the general income provisions, the proceeds may still be subject to CGT if the exemptions mentioned above cannot be satisfied.

Ownership of insurance policies

As the purpose of key person insurance is to ensure the ongoing viability of a business, insurance policies taken out to protect the business against the death, disablement or major illness of a key person should be owned by the business.

Premiums on these insurance policies should also be paid by the business. It is particularly important where the key person insurance policies are taken out for revenue purposes, and the premiums can be claimed as a deduction under section 8-1 of the ITAA 1997, that the entity claiming the deduction actually incurs the expenditure.

One disadvantage of the business owning TPD and trauma insurance for capital purposes is that businesses often trade as either companies or trusts and therefore there may be CGT payable on any TPD or trauma insurance proceeds received.

Case study

Tony and Barry run a company called ABC Pty Ltd together. Tony has provided personal guarantees for ABC Pty Ltd's loans.

ABC Pty Ltd has taken out a life and TPD insurance policy on Tony's life so that if he died or became permanently disabled the business would be able to repay the debt guaranteed by him. ABC Pty Ltd owns the insurance policy and pays the premiums, which are not claimed as a tax deduction.

A year later Tony has an accident that leaves him permanently disabled and ABC Pty Ltd receives the proceeds of the TPD insurance policy.

From the facts that have been disclosed it appears that the TPD insurance policy was taken out for capital purposes. Therefore, it would not be assessable as income.

However, as the proceeds were received by someone (ABC Pty Ltd) other than the life insured or a defined relative of the life insured, the proceeds of the TPD insurance policy will be subject to CGT at the company tax rate of 30 per cent.

Alternative ownership structures for debt reduction insurance

Strictly speaking, capital purpose key person insurance policies which are established to pay off a debt owed by a business in the event of the death, disablement or major illness of a key person who is a guarantor for the loan, are sometimes referred to as debt reduction or guarantor protection insurance.

As has already been illustrated in the case study, if a company receives the proceeds from a TPD or trauma insurance policy there will be CGT to pay.

As a result of this some advisers recommend that, where insurance policies are used to protect the business against the death, disablement or major illness of a guarantor, any insurance policies taken out should be owned by either the:

- guarantor, or
- an insurance trust, where the guarantor is absolutely entitled to the proceeds from the insurance policy.

Under this type of arrangement, a legal document called a debt reduction agreement needs to ensure that there is a legal obligation for the guarantor or their estate to pay the insurance proceeds to the lender, so that the proceeds can be used to extinguish the business debt that has been guaranteed. To a large extent the success of this strategy hinges on the strength of the agreement.

An advantage of this approach is that if any TPD or trauma insurance proceeds are received by the life insured or a specially drafted insurance trust then the exemption in paragraph 118-37(1)(b) of the ITAA 1997 can be used and no CGT will be payable.

However, care must be taken with this type of arrangement as it might give rise to a right of contribution by the insured/guarantor or their estate, unless this right is specifically excluded in the agreement.

A right of contribution usually gives rise to a loan account being established by the business in favour of the insured or their estate. This loan subsequently needs to be repaid to the insured or their estate by the business.

The net effect for the business is that it still has a debt, which instead of having to be repaid to the lender now needs to be repaid to the insured or their estate. This defeats the purpose of taking out the insurance policy in the first place.

There is even a school of thought that this type of strategy gives rise to a CGT event.

It is important that your clients seek professional tax advice on these matters prior to entering into an arrangement whereby they take out insurance policies for debt reduction purposes under a self ownership or insurance trust ownership structure, as described in this section.

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This topic is the first of two that will cover business succession planning. This topic provides a broad overview of business succession planning and also examines the tax implications of receiving proceeds from insurance policies that are owned as part of a business succession planning arrangement.

There are a number of reasons why a business owner may leave a business. Some reasons, such as retirement, may be a planned event which the other business owners can prepare for, often years in advance.

Other events, such as death or a disagreement between owners, may happen unexpectedly. This may cause a business owner to want to, or have to, give up their ownership interest.

Benefits of business succession planning

Business succession planning plays an important role in ensuring that both the business and its owners are protected in the event of the departure of an owner, whether due to a voluntary or involuntary event.

From the perspective of the departing owner or their estate, a good business succession plan provides a greater level of certainty, whereby the departing owner or their estate knows how much they will receive and that these proceeds are available due to the funding arrangement that has been entered into.

From the perspective of the remaining business owners, a good business succession plan:

- provides a greater level of control over who will replace the departing owner
- already addresses the issue of where the funding used to buy out the departing owner will be sourced from
- may prevent the introduction to the business of a third party or a family member of the departing owner who is either unsuitable for the business or who cannot work cohesively with the remaining owners
- reduces the feeling that there is some sort of moral obligation to look after a deceased owner's spouse and family, as this has already been done via the business succession plan, and
- offers greater peace of mind for everyone involved in the business including customers, financiers, suppliers and employees.

Business succession agreements

A business succession agreement is a contract between individuals and/or entities, all of whom have an interest in a business, that details:

- under what circumstances an ownership interest will be sold to the other owners, ie what are the trigger events
- how the shares and other interests that are being disposed of will be allocated amongst the remaining owners
- how the value of the business will be determined, and
- how the consideration payable to the departing owner will be funded.

There are many reasons why a business owner may leave a business including (but not limited to) the following:

- death
- TPD
- suffering a major illness, such as a heart attack or stroke
- retirement
- dismissal
- disagreement
- incarceration, and
- resignation.

A good business succession plan should cover all of these succession or trigger events.

There are two principal types of agreements that form the basis of a complete business succession plan:

(i) buy/sell agreement, and

(ii) equity or shareholder agreement.

A buy/sell agreement can be used to cover the situation where an owner dies, becomes totally and permanently disabled or suffers a major illness and is forced to leave a business. These succession or trigger events are commonly referred to as the insurable events.

Buy/sell agreements are usually (but not always) funded through the use of insurance policies.

Conversely, an equity or shareholder agreement is used to cover situations such as where an owner retires, is dismissed, resigns, goes to jail or is in dispute with the other owners of the business.

There are numerous other succession events that an equity or shareholder agreement should also cover. These succession events are commonly referred to as

the uninsurable events. In these situations, another method of funding the transfer of ownership must be found, as insurance policies are not appropriate for these types of exit situations.

In any case involving business succession planning, a legal practitioner should be used to prepare the business succession agreement.

Valuing a business

One of the most important elements in a business succession agreement is establishing a methodology for valuing the business on which all of the business owners agree.

There are many ways of valuing a business including:

- current market value – in theory this is probably the best valuation method, however in practice it will mean that the business will regularly need to be revalued for the purposes of the agreement, the sum insured on any insurance policies and the funding mechanism. There are also some practical difficulties with determining an accurate market value for a business that is not listed on a stock exchange
- formula method – an agreed upon formula, that is suitable for the industry in which the business operates, is included in the business succession agreement to value the business and the individual interests of the business owners
- fixed dollar value – the business owners simply agree on a certain dollar value as being representative of their respective interests in the business. If this method is chosen it should also allow for annual indexation of the fixed dollar value and set a date at which this dollar figure needs to be reviewed, and
- independent valuation – relies on an independent professional, such as an accountant or other professional who values businesses, to assess the value of the business.

In relation to valuing a business, the financial adviser will need to work in conjunction with the client's accountant to establish a method for valuing the business and ultimately the individual interests of the business owners.

Also, regardless of which of the valuation methods is used, it is important that the method used to value the business is reviewed at least annually to ensure that it continues to provide a fair and reasonable value for the individual business owners.

Funding business succession agreements

Unfortunately, not many businesses or business owners can be sure that they will have the financial ability to finance the purchase of a departing owner's interest (particularly if the departure of the owner is unexpected) without putting a large strain on either their own or the business's financial resources.

Therefore, it is vital that a business succession plan also has in place a mechanism to ensure that any funding required to compensate the departing owner will be available if and when required.

Many business owners will use insurance policies to fund the transfer of ownership of a business from a departing business owner to the remaining business owner(s).

However, it needs to be recognised that insurance policies will only cover situations where the departing business owner has left the business as a result of death, TPD or suffering a major illness. Furthermore, insurance policies can only be used where the business owners are insurable.

If the departing owner has left the business through resignation, dismissal, disagreement, incarceration or retirement, alternative methods of funding for these events need to be examined as part of the business succession planning process.

Alternative methods of funding a business succession planning arrangement include:

- self funding – where the business uses its own funds/capital to buy out the business owner who has departed. This method is probably the cheapest type of funding, however many businesses do not have access to the capital required for self funding
- vendor finance terms – where the remaining owners pay out the departing owner in instalments over a number of years, using either the business's funds or their own funds. The terms of the vendor finance arrangement are agreed upon by all parties and are set out in the agreement, and
- finance – where either the business or the remaining owners borrow in order to buy out the business owner who has departed. The problem with this type of arrangement is that many lenders may be reluctant to lend to a business that has lost an owner who was a key person in the success of the business. Furthermore,

the business or the remaining owners will be burdened with the additional cost of having to meet the loan repayments.

Tax implications

The tax implications of business succession planning arrangements will be split into three parts:

(i) deductibility of premiums on insurance policies that are owned as part of a business succession planning arrangement

(ii) receiving the proceeds of various insurance policies that are owned as part of a business succession planning arrangement, and

(iii) transfer of business ownership.

The remainder of this topic will look at the deductibility of insurance policy premiums and the tax implications of receiving insurance policy proceeds under the various ownership structures used to own insurance policies that are used as a funding mechanism for a business succession planning arrangement.

The tax implications of the transfer of business ownership under a business succession planning arrangement will be covered in the next topic titled 'Business succession planning – part two.'

Tax deductibility of business succession planning insurance premiums

The premiums payable for the insurance policies that are used to fund the business succession planning arrangement are generally not tax deductible, as they are not necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

The exception to this is where life and TPD insurance policies, used to fund the business succession planning arrangement, are owned by a superannuation fund, whereby a deduction may be able to be claimed by the superannuation fund. This will be discussed in more detail later in this topic.

Who pays the insurance premiums?

Essentially, there are three parties who can pay the insurance premiums on insurance policies used to fund a business succession planning arrangement:

(i) the owners

(ii) the business, or

(iii) a superannuation fund.

Where the owners decide to pay the insurance premiums personally, any of the methods described in the next section of apportioning the cost of the premiums between owners may be appropriate.

Where it is decided for cash flow purposes that the insurance premiums on insurance policies used to fund a business succession planning arrangement are to be paid by the business, it is important to remember that there may be FBT implications or Division 7A of the ITAA 1936 implications of such arrangements.

For example, if a policy is owned by an individual under a self ownership arrangement and the business/employer pays the premiums in relation to that policy, this will be treated as an expense payment fringe benefit and will give rise to an FBT liability.

It is suggested that where the insurance premiums are paid by a business, that is trading as a company, this payment should be accounted for as a dividend.

Please note that under the SIS Act, a superannuation fund can only pay a premium on an insurance policy that is owned by the fund.

Apportioning insurance premiums between business owners

Where the insurance premiums are paid for by the owners, there are a number of ways that this can be done, as in almost every business succession planning case there will be disparities between the cost of insurance premiums on each owner's life because of differences in age, gender, smoking status, health and pastimes.

Alternative ways of paying the insurance premiums include:

- self funding – where each owner pays the premiums on the insurance policy that relates to their life
- pooling – where the total cost of all insurance premiums is divided equally between all of the owners, and
- cross pooling – where the premiums on the life insured's policy are paid by all of the owners, other than the life insured.

Often the owners will be able to discuss these options and decide on which approach is most equitable.

Tax implications of various ownership structures

The most common types of insurance policies used as part of a business succession planning arrangement are:

- life insurance
- TPD insurance, and
- trauma insurance.

The CGT implications on receipt of the proceeds of any of these insurance policies depend on the type of insurance policy (life insurance policies are treated differently to TPD and trauma insurance policies) and the owner of the policy.

Tax implications of receiving proceeds of life insurance policies

According to subsection 118-300(1) of the ITAA 1997, if a CGT event happens to a life insurance policy or an annuity instrument, a capital gain or loss made from it by:

- the original beneficial owner of the policy or instrument, or
- an entity that acquired the interest in the policy or instrument for no consideration, or
- the trustee of a complying superannuation entity for the tax year in which the CGT event happened,

is ignored for CGT purposes.

The term original beneficial owner is defined in Tax Determination TD 94/31 as:

An original beneficial owner of any of the rights, or any interest in any of the rights, under a policy of life assurance is the first person who:

(i) at the time the policy is effected, holds such rights, or any interest in such rights, and

(ii) possesses all the normal incidents of beneficial ownership (for example, 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).

Therefore, unless the recipient of the life insurance policy is not the original beneficial owner of the policy and the recipient acquired the interest in the policy for money or other consideration, life insurance policy proceeds taken out under a business succession planning arrangement will not be subject to CGT.

According to Tax Determination TD 94/34, consideration in this context refers to actual consideration and does not include a premium paid under the policy.

In Tax Determination TD 2007/4, the ATO confirmed that the term 'life insurance policy', for the purpose of receiving the CGT exemption in subsection 118-300(1) of the ITAA 1997, includes a life insurance policy that provides for the payment of a terminal illness benefit.

A terminal illness benefit is a pre-payment of a death benefit which is generally payable upon the diagnosis of an illness which will result in the death of the insured within 12 months, regardless of any treatment that they may receive.

Therefore, the CGT exemption in subsection 118-300(1) of the ITAA 1997 can be utilised on the pre-payment of a death benefit under a terminal illness benefit clause, even though the life insured has not yet died.

Tax implications of receiving proceeds of TPD and trauma insurance policies

It is important to note that the CGT exemption under subsection 118-300(1) of the ITAA 1997 only applies to life insurance policies and not accident or disability policies such as TPD or trauma insurance policies.

However, paragraph 118-37(1)(b) of the ITAA 1997 disregards a capital gain or capital loss upon the receipt of compensation for any injury or illness to the person insured or a relative (as defined).

Subsection 995-1(1) of the ITAA 1997 defines a relative of a person as:

(a) the person's spouse, 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).

Therefore, it is important to recognise that if the proceeds of a TPD or trauma insurance policy are paid to someone other than the life insured or a defined relative, the proceeds will be subject to CGT. In determining the sum insured for these clients, you may need to gross up the sum insured to take into account the CGT payable.

The following table summarises the tax implications of receiving the proceeds of a TPD or trauma insurance policy under the various ownership structures that are commonly used under a business succession planning arrangement.

Ownership	Tax implications – TPD and trauma insurance policies
Self ownership	No CGT
Cross ownership	CGT payable except if recipient is a defined relative of the life insured
Company ownership	CGT payable
Trust ownership	CGT payable unless the beneficiary is absolutely entitled to the proceeds from the trust and the beneficiary is the life insured or a defined relative of the life insured
Superannuation fund ownership	Taxed as a lump sum superannuation benefit, which may include an increased tax-free component

The ATO treatment of the proceeds of a TPD or trauma insurance policy, where these policies are owned by a trust, is not entirely clear.

The general view of the industry, based on correspondence released by the ATO, is that where the proceeds of a TPD or trauma insurance policy are paid to an insurance trust, the proceeds are subject to CGT unless the beneficiary of the insurance trust is:

- absolutely entitled to the proceeds from the insurance policy, and
- the beneficiary is the life insured or a relative (as defined above) of the life insured.

In light of the above, it is probably most appropriate if the insurance trust is a bare trust. An insurance trust will be a bare trust where the only duty of the trustees of the insurance trust is to pass on the proceeds of the insurance policy to the beneficiary. If the trustees of the insurance trust perform any other duties then the ATO may not view the trust as a bare trust.

As the ATO has yet to provide any determinations or rulings specifically on the tax treatment of the receipt of TPD and trauma insurance policies by insurance trusts, it is important that your clients seek professional tax and legal advice on these matters prior to entering into the insurance trust ownership structure.

Ownership of insurance policies

There are five ownership structures for insurance policies that are used for a business succession planning arrangement:

(i) self ownership – where the life insured owns their own policy

(ii) cross ownership – where the policy on the life of one owner is owned by the other owners

(iii) operating entity ownership – where the policy is owned by the business

(iv) insurance trust ownership – where a specially drafted trust is set up to own the insurance policies, and

(v) superannuation fund ownership – where the insurance policies are owned through a superannuation fund.

We will briefly examine the advantages and disadvantages of all of these ownership structures below.

Self ownership

The advantages of self ownership of insurance policies for business succession planning purposes are as follows:

- it is the simplest ownership structure from an administrative perspective
- if an owner leaves the business they can retain the insurance policy for personal protection reasons
- if each owner pays the premiums on the insurance policy that relates to their own life, there is an incentive for each owner to ensure that premium payments are met, as the insurance proceeds will essentially be their respective sale proceeds
- there will be no CGT payable on receipt of proceeds from self-owned TPD and trauma insurance policies, and
- if new business owners are accepted into the business they can simply take out their own insurance policies and existing policies do not need to be altered.

The only real disadvantage of the self ownership structure is the perception that the business owners are effectively funding their own sale proceeds.

Cross ownership

Traditionally many business succession planning arrangements were funded by cross-owned insurance policies.

However, this ownership structure has become less popular for a number of reasons including:

- unless the other owners are relatives as defined in subsection 995-1(1) of the ITAA 1997, there will be CGT payable on any TPD or trauma insurance proceeds received, and
- if new business owners are accepted into the business, the ownership interests in existing insurance policies will need to be changed.

Operating entity ownership

The advantages of operating entity ownership are:

- if new business owners are accepted into the business, existing insurance policies do not need to be changed, and
- cash flow benefits for the business's owners, as the insurance premiums will generally be paid by the business.

The disadvantages of the operating entity ownership structure include:

- operating entities are often companies or trusts and therefore there may be CGT payable on any TPD or trauma insurance proceeds received
- if there is a buyback of shares from the deceased owner's estate, the remaining owners will effectively acquire more equity without increasing their cost base for CGT purposes, and
- there may be adverse tax implications if the operating entity pays the proceeds to a deceased owner's beneficiaries as a death benefit termination payment.

Insurance trust ownership

An insurance trust is a trust that is specifically set up to hold various types of business insurance policies.

The advantages of insurance trust ownership are:

- if new business owners are accepted into the business then the trustee simply needs to take out a new insurance policy on the life of the new owner and existing insurance policies do not need to be changed
- it is relatively easy to administer
- it can be set up for multiple business insurance needs, ie for business succession planning, key person insurance and guarantor protection purposes, and
- if a beneficiary of the trust is either the life insured or a relative as defined under subsection 995-1(1) of the ITAA 1997, and that beneficiary is absolutely entitled to the proceeds of a TPD or trauma insurance policy, then no CGT will be payable.

The disadvantages of insurance trust ownership are:

- the legal costs associated with establishing and maintaining the insurance trust, and
- if the trust deed is not written correctly and absolute entitlement cannot be proven then CGT will be payable on any TPD or trauma insurance proceeds received by the insurance trust.

Superannuation fund ownership

The main benefit of the superannuation fund ownership structure is that if the premiums are paid by a superannuation fund, the fund will be able to claim the premiums as a deduction under section 295-465 of the ITAA 1997, whereas insurance premiums used to fund a business succession plan outside of superannuation are not tax deductible.

Under section 295-465 of the ITAA 1997, only premiums for life and TPD insurance policies will be deductible for the trustee of the superannuation fund. Trauma insurance policy premiums would not to be deductible for the trustee.

Another advantage of owning life insurance through a superannuation fund is if life insurance proceeds are to be paid to a tax dependant, or to a member who is terminally ill, the proceeds will be paid out tax free.

Furthermore, with the abolition of reasonable benefit limits from 1 July 2007, the amount of life insurance that can be paid out tax free to a tax dependant is unlimited.

However, there are a number of pitfalls of superannuation fund ownership of insurance policies including:

- if life insurance proceeds are paid to a non-dependant and include a taxable component, the proceeds will be subject to tax at up to either 16.5 per cent or 31.5 per cent
- if TPD insurance proceeds are paid to the trustee of a superannuation fund, the member must satisfy the definition of permanent incapacity in SIS subregulation 6.01(2), or another condition of release, before they can receive the proceeds

- TPD insurance proceeds are taxed as a lump sum superannuation benefit, although if the definition of disability superannuation benefit can be satisfied then the lump sum superannuation benefit may include an increased tax-free component
- in the event of a successful trauma insurance claim, the insurer will pay the sum insured to the trustee of the superannuation fund. In turn, the trustee will pay the proceeds to the member only if he or she can satisfy the definition of permanent incapacity, which is that the member will be, 'unlikely to engage in gainful employment for which the member is reasonably qualified for by education, training or experience'. It may often be the case that the illness being claimed for under the trauma insurance policy (eg heart attack) will not enable the member to satisfy the permanent incapacity definition or any other condition of release, and
- contributions made to the superannuation fund, which are subsequently used to pay the insurance premiums, will be counted towards superannuation contribution caps.

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http://law.ato.gov.au/atolaw/print.htm?DocID=TXD%2FTD9431%2FNAT%2FATO%2F00001&PiT=99991231235958&Life=20061129000001-99991231235959

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This topic is the second of two topics that cover business succession planning. It examines the tax implications of the transfer of business ownership under business succession planning arrangements as well as the role of accountants and solicitors in the business succession planning process.

The previous topic titled 'Business succession planning – part one' covered the tax implications on receipt of proceeds from the various types of insurance policies that are commonly used to fund buy/sell agreements.

It is important to recognise that once the terms of a buy/sell agreement are triggered and the ownership of the business changes hands, ie where the shares in a private company or units in a unit trust are transferred from the departing/deceased business owner to the remaining business owner(s), this transfer of shares or units may be a CGT event.

This is in addition to the possible CGT event on receipt of any insurance proceeds, as discussed in the earlier topic titled, 'Business succession planning – part one.'

However, the departing owner of shares in a private company or units in a unit trust will only be subject to CGT if the value of those shares or units exceeds the cost base and the shares or units were acquired on or after 20 September 1985.

Where CGT does apply on the transfer of business ownership it may be possible to utilise the small business CGT concessions to either fully eliminate, defer or reduce the amount of assessable capital gain, if the eligibility conditions for these concessions can be met.

Please note an estate or a beneficiary generally has up to two years (or longer, if granted an extension by the ATO) after the death of the business owner to utilise the small business CGT concessions, provided that the deceased was eligible for the concessions prior to their death.

Types of buy/sell agreements

There are two types of buy/sell agreements that are available to business owners:

(i) a mandatory agreement, or

(ii) a put/call option agreement.

The timing of the CGT event on the transfer of the shares or units under a buy/sell agreement will depend on whether the buy/sell agreement is a mandatory agreement or a put/call option agreement. The actual wording in the agreement may also affect the timing of the CGT event.

Mandatory agreement

Under a mandatory agreement, the terms of the buy/sell agreement are put into force immediately once a succession event occurs. There are both practical issues and possible adverse tax implications associated with mandatory agreements.

From a practical perspective, if suffering a major illness (such as a heart attack) is a succession/trigger event, the terms of the mandatory buy/sell agreement are triggered immediately on one of the owners suffering the heart attack. Theoretically, the transfer of the business ownership is mandatory.

These days many people return to work within three to six months of suffering a heart attack and are able to return to either all or most of the duties that they were performing prior to suffering their heart attack. A mandatory agreement therefore may lock the heart attack sufferer and the other owners into a transfer of ownership that they don't really need or want.

To recognise this issue, some mandatory agreements include clauses that a trigger event involving a major illness only occurs for the purposes of the buy/sell agreement if the owner suffering the illness or injury cannot return to full duties within a certain time period, such as six or twelve months from the date of being diagnosed with the illness.

From a tax perspective, the ATO may take the date that the mandatory agreement was entered into as the date that a disposal of the ownership of the business occurred.

Subsection 104-10(3) of the ITAA 1997 provides that CGT event A1 happens when a contract is entered into to sell an asset, or if no contract exists, when a change of ownership actually occurs.

That is, once you sign the mandatory buy/sell agreement the CGT event may occur immediately on the signing of the buy/sell agreement, even though the event that triggers the terms of the buy/sell agreement eg death, TPD or resignation might not occur for a number of years.

Whether or not the ATO takes the date that the buy/sell agreement was entered into as the date that a disposal of the ownership of the business occurred depends on the wording/terms in the buy/sell agreement.

The ATO has issued an interpretative decision that deals with the question of whether a buy/sell agreement, entered into for the purposes of paragraph 104-10(3)(a) of the ITAA 1997, is fulfilled before a condition precedent, in this particular case being on the death of one of the owners, actually occurs.

ATO Interpretative Decision ID 2004/668 states:

> If a contract is subject to a condition, an issue arises whether the condition is a condition precedent to its formation or whether it is a condition precedent to performance of the contract. In the first case, the contract does not come into existence until the condition is met. In the second case, the condition does not prevent the creation of the contract – non-fulfilment of the condition merely entitles a party to terminate the contract.
>
> In this case, the language used to describe the condition evidenced the parties' intention not to be bound by it from the date it was signed. That is, it was a condition precedent to the formation of the agreement. Accordingly, no agreement will be entered into for the purposes of CGT event A1 until the death of a party to the contract.

Put/call option agreement

An option allows one owner to require another owner to buy or sell their equity in the business, by exercising the option within a defined period, following the occurrence of a succession event.

A put option allows the outgoing owner or their estate to require the remaining owner(s) to buy the equity in the event of a trigger event. A call option allows a remaining owner(s) to call on the outgoing owner or their estate to sell the equity in the event of a trigger event.

Practically, with a put/call option agreement, all business owners own put and call options. In the event of a trigger event occurring if at least one owner decides to exercise their option, the terms of the buy/sell agreement will come into force. The only way that the terms of the buy/sell agreement will not come into force is if all option holders decide not to exercise their options.

The conventional view is that a buy/sell agreement, being a contract, triggers a change in ownership at the time the contract was entered into. This is certainly the case with a mandatory buy/sell agreement that has no conditions precedent to its formation attached to it, as described above.

However, buy/sell agreements using put and call options differ in that they simply create an option under which the owners can choose whether or not they wish to buy/sell the equity of the outgoing owner.

The ATO has also issued an interpretative decision that deals with the question of whether CGT event D2 happens when options are granted under a business succession agreement, where the options will only be legally enforceable on the death or disablement of one of the shareholders.

Section 104-40 of the ITAA 1997 states that CGT event D2 occurs when an option is granted, renewed or extended.

ATO Interpretative Decision ID 2003/1190 states that:

> Under the buy/sell agreement, put and call options are granted to the parties to the agreement. When these are exercised they will create a legally binding contract to buy and sell shares.
>
> However, the granting of the options may not occur at the time of entering into the agreement if there is a specified condition in the agreement that is yet to occur. In this case it was necessary for the death or disability of a major shareholder to occur before the remaining major shareholders obtained legally enforceable options.
>
> The buy/sell agreement is a contract with a condition precedent and cannot proceed until that condition is fulfilled. It is necessary to distinguish between a condition precedent to the performance of the contract and a condition precedent to the formation of the contract as this determines the timing of the D2 event and the subsequent transfer of the shares.

Therefore, where there is a put/call option under a well drafted buy/sell agreement, which has condition precedents attached to it, the date of acquisition/disposal for CGT purposes is deemed to be the date that the condition precedent to the grant (eg death, TPD or suffering a major illness etc) occurs.

Put/call option agreements tend to provide the parties to the agreement with more flexibility when compared to a mandatory agreement. The parties to the agreement have the option of triggering the terms of the buy/sell agreement, rather than being forced to meet the terms of the buy/sell agreement. This may be useful where trauma insurance illnesses are included in these agreements as a succession event.

Role of the solicitor

If financial advisers are providing business succession planning advice to their clients it is important that they recognise that they will need to involve a solicitor in the process of drafting up the business succession agreement.

It is preferable to select a solicitor that specialises in business succession planning as the:

- success of a business succession plan to a large extent hinges on the strength of the agreement, and
- CGT implications will also depend on the wording in the agreement (refer to ATO ID 2004/668 and ATO ID 2003/1190).

A business succession agreement should:

- clearly identify and define the succession events eg death, TPD, resignation etc
- identify the type of agreement, ie mandatory agreement versus put/call option agreement
- under a put/call option agreement, outline what to do if a succession event occurs
- determine the valuation method to be used to value the interests in the business that need to be transferred at the time of the succession event
- identify the terms of the transfer
- if insurance policies are used, include details of the policies (including policy numbers) and how the proceeds should be used, and
- if other modes of funding are used, include details of how these proceeds should be allocated.

Role of the accountant

Many business people have a close relationship with their accountant. Therefore, it is often necessary for financial advisers who are involved in business succession planning to also involve the client's accountant in the advice process.

The accountant can be used to assist the financial adviser with the taxation implications of business succession planning, which can be very complex, and to assist the business owners to arrive at a value for their equity in the business. The valuation of the business will be required to assess the amount of funding required under the business succession plan and to determine the sums insured under any insurance policies.

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For more details on any of the above information and the implications for your clients, please contact the AXA Technical Services team on 1800 644 644 or email axatechservices@axa.com.au.

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Member of the Global AXA Group
Registered Office: 750 Collins Street Docklands Victoria 3008

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