For adviser use only

Business Insurance Guide

2020/21

Why business insurance is essential

Many business principals don't hesitate to insure physical assets such as motor vehicles, plant and equipment.

However, they often overlook the importance of insuring themselves (and other key people in the business) for death, disability and illness.

This can be a very risky oversight, as the long term absence or loss of a key person can have a dramatic impact on a business and the principals' interests in that business.

Issues faced by the departing principal

Each of the principals needs to consider that, if something happened to them and they were no longer able to participate in the business:

- whether their personal assets (such as their family home) would remain exposed to the ongoing fortunes of the business
- whether the other principals would be able to find enough cash to buy them out and what price would they be prepared to pay, and
- whether the business would be able to repay amounts owed to them.

Issues faced by the remaining principals

Each principal also needs to consider that, if something happened to one of their fellow principals:

- what the impact would be on business revenue
- whether the business would be able to maintain its commitments to customers, suppliers and employees, in addition to servicing its loans
- who would inherit the departing principal's interest in the business and how much would it cost to buy them out
- whether the departing principal's beneficiaries would want a say in how the business is run (if they cannot or won't be bought out), or would settle for continuing to receive a share of the profits and capital growth without contributing, and
- whether the departing principal (or their legal personal representative) can demand immediate repayment of any amounts owed to them.

The purpose of this guide

This guide has been prepared to help you understand some of the key risks that business principals face and the role that insurance can play in:

- protecting personal and business assets
- offsetting a reduction in business revenue, and
- funding an orderly transfer of business ownership.

The key to good protection advice is to ensure the right amount of cash is paid to the right people at the right time.

Note: The information in this guide is based on our understanding of current legislation and Australian Taxation Office practice as at 1 July 2020. Taxation rates include the Medicare Levy where applicable.

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1

Overview of business insurance

In this section, we outline some of the basic concepts that need to be understood when providing quality advice to business principals.

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Key participants and their roles

There are three participants who play an important role when developing insurance solutions for business principals.

These are summarised in the table below. The value in partnering with other professionals is that it enables each participant to provide advice in their area of expertise.

Participant	Role
Financial adviser	• Identifies the principals' business and personal goals. • Assesses the principals' and the business' financial position, including assets, liabilities, revenue and cashflow. • Assesses and prioritises the principals' business and personal protection needs. • Acts as facilitator between the principals and the other key professionals, including project managing the preparation of any agreements that may be required, as part of the advice process. • Advises the principals on the type, amount and ownership of insurances required to meet their business and personal needs. • Considers the tax implications that apply with each of the different insurance policy ownership options. • Advises the principals on the premium structure and payment options that best suit their business and personal needs. • Co-ordinates the implementation of the insurances by managing the process from application and underwriting to policy implementation. • Provides ongoing advice to the principals as their needs and circumstances change. • Manages any claims that arise due to death, disability or illness of the principals or other key persons.
Solicitor	• Drafts legal agreements that outline the rights, duties and obligations of the principals in relation to their role in the business and each other in both planned and unplanned scenarios. • Identifies any additional estate risks in the business structure. • Ensures the principals' personal estate plans complement any business agreements required. • Determines whether stamp duty will be payable if business interests are sold or transferred.
Accountant	• Generally has established relationships with the business principals and will have a key influence on the advice outcome. • Values the business and each principal's interest in it. • Identifies the business structure and connection between the operating and ownership entities and (with the solicitor) advises on any restructuring of business entities that may be required. • Identifies the debts owed either to third parties or the principals. • Calculates the CGT payable on the disposal or transfer of each principal's interest in the business. • Determines which small business CGT concessions may be available when an interest in the business is sold or transferred. • Provides general taxation advice.

Protection needs of different businesses

The importance of asset (debt), revenue and ownership protection will often depend on whether the business is in the start-up, growth or mature phase.

Understanding the stage in the lifecycle a business is in can assist in dealings with the principals.

New (or start-up) businesses

The primary risk for the principals of a start-up business is typically that, in the event of the loss of a key person, the principals could lose personal assets used to secure business debts or amounts they have contributed to the business as 'start-up capital'.

Because these businesses may have little equity, ownership protection may be of a lower priority when compared to asset (debt) protection. The principals should still, however, address business succession at the time the business is established.

Furthermore, it may not be possible to obtain revenue protection if the revenue patterns have not been established.

Established or developing businesses

While an established business will usually have grown its revenue, it often remains heavily dependent on the skills and intellectual property provided by its key people and their contacts with clients, suppliers or financiers.

The loss of a key person at this stage will therefore significantly hamper the business' ability to continue its growth or even survive. Revenue protection can assist the business in overcoming the loss of a key person by replacing lost revenue and providing the business with the breathing space and funds it requires to recruit and train a suitable replacement.

Mature businesses

Mature businesses will typically be less reliant on key people and have a significantly improved (ie lower) debt-to-equity ratio. The main risk to these businesses will often be a lack of succession planning.

To help ensure an orderly transfer of ownership, the principals should establish:

- a **Business Owners' Agreement** that deals with both planned and unplanned events that cannot be funded by insurance, as well as a range of matters concerning the rights and conduct of the principals in relation to each other, and
- an (ideally) separate **Buy Sell Agreement** where the exit of a principal due to death, total and permanent disablement and (in some cases) critical illness is funded or part-funded by ownership protection insurance.

What structures can be used to operate a business?

There are four main structures that can be used to operate a business, each with its own features and benefits.

Sole traders

A sole trader is a person trading under their own name or a registered business name. When a business is run by a sole trader, the individual:

- is fully liable for any debts or legal actions brought against him or her in relation to the business, and
- income received from the business is generally taxed in the individual's hands at the marginal rates that apply to Australian residents.

Partnerships

A partnership generally arises when two or more parties carry on a business with a view to making a profit and is generally subject to a written Partnership Agreement that sets out:

- how the partnership will operate
- how the provision of capital will be handled
- how the profits will be divided, and
- the decision-making powers and authority vested in each partner.

The partners in a partnership may be individuals or entities (eg a partnership of trusts).

From a legal liability and taxation perspective, there's minimal difference between a sole trader and a partnership of individuals. However, the partners are jointly (wholly) and severally (proportionately) liable for all debts and obligations that arise in the course of the partnership's business.

Partnerships aren't subject to tax. A partnership return is lodged to determine each partner's share in the partnership income, capital gains or losses.

Where the partners in a partnership are individuals, partnership law states that on the death of a partner, the partnership automatically dissolves. However, a Partnership Agreement may include a pre-arranged right to purchase the deceased partner's interest, without which the surviving partners must either liquidate or reorganise.

Companies

A company is a separate legal entity to the principals who own the shares (directly or indirectly). It can raise capital through the issue of shares. The number of shares held by a shareholder determines that shareholder's ownership proportion.

A company may have different classes of shares. For example, 'A class' shares may entitle the relevant shareholder to capital and voting rights, while 'B class' shares may entitle the relevant shareholder to dividends.

The liability of shareholders is usually limited to the value of their shares in the company. However, company directors have a range of responsibilities including those contained in common law and statutes such as the Corporations Act 2001 which, if breached, could render them personally liable.

Income and capital gains derived by the company are taxed at a flat rate of 26%[1], (or 30% where annual aggregated turnover is $50 million or more in 2020/21). Companies are not eligible for the 50% CGT discount. Company profits may be paid out as dividends or retained in the company to, for example, fund future expansion.

There are complex laws about retaining and distributing earnings in a company that are derived from the provision of personal services or personal exertion.

[1] For companies with less than $50m annual aggregated turnover the tax rate will be 25% in 2021/22.

When the profits are distributed to shareholders as a dividend, the shareholders are effectively taxed on the profits at their marginal rate. If the dividend is fully franked, shareholders on a higher tax rate than the applicable company tax rate will pay additional tax after they lodge their tax return and shareholders on a lower rate may be refunded the difference by way of a franking credit.

In addition to the Company Constitution (which governs the relationship between directors and shareholders in accordance with the Corporations Act 2001) there may be a Shareholders' Agreement (which governs the relationship between the shareholders).

The Shareholders' Agreement may contain dispute and deadlock resolution clauses. The agreement may also be tailored for various scenarios such as minority shareholders. For instance, if a majority shareholder wants to sell their shares to a third party, the minority shareholder may be compelled to do likewise. This is often referred to as a 'drag-along' clause.

Trusts

When a business is run through a trust, the trustee (which can be an individual, individuals or a company) legally holds property and income for the benefit of the beneficiaries. The duties, responsibilities, powers, restrictions and discretions the trustee has will be set out in the Trust Deed.

Legal liability rests with the trustee. This liability is limited to the value of the shares if the trustee is a company, or unlimited if the trustee is an individual. However, a trustee acting in good faith will normally be indemnified from the assets of the trust.

The income of a trust is either taxed in the hands of the trustee (if no beneficiary has an entitlement to the income) or distributed to and taxed in the hands of the beneficiaries at least once in the financial year. Where the income is taxed in the hands of the trustee, the highest marginal rate of 47% will generally apply.

The two main types of trusts are:

- **A fixed trust**, where the beneficiaries have fixed entitlements to income and/or capital distributions. These entitlements are often unitised to facilitate the trading of entitlements between beneficiaries (ie unitholders) and between unitholders and prospective investors in the trust. Where this is done, the fixed trust is usually referred to as a unit trust.

  The unitholder is entitled to a fixed distribution of income and/or capital in accordance with the proportion of units the unitholder owns. In addition to the trust deed (governing the relationship between the trustee and beneficiaries), there may be a Unitholders' Agreement (which governs the relationship between the unitholders). This agreement may give, for example, existing unitholders the right to acquire any units that a unitholder wishes to sell before that unitholder could offer them to a third party (this is often referred to as the 'right of first refusal').
- **A discretionary trust**, where the distribution of any capital or income is entirely at the discretion of the trustee. While the trustee has day-to-day control of the trust, ultimate control may be in the hands of an appointer. This is a person, persons or entity that has the power to remove and appoint the trustee.

There are a number of complex rules relating to the taxation of trusts, in particular discretionary trusts. These issues should be referred to a tax professional.

How are structures used to operate and own a business?

It's common for various entities to be involved in a business structure.

Operating entities

These are the entities that carry on the business, employ staff, enter into contracts or agreements to provide goods or services to customers, obtain goods and services from suppliers, take on debt and/or earn revenue.

Operating entities tend to be companies or unit trusts where the shareholders or unitholders have a fixed entitlement to the profits of the business.

The division of the fixed entitlement into homogenous shares (or units) means the outgoing owners can more easily sell their interests to the remaining owners or incoming owners.

Where families operate a business, the operating entity may be a discretionary trust.

Protection entities

To protect assets for legal purposes, valuable business assets are often owned in a separate entity. This can provide a higher degree of protection than would be the case if the assets were owned in the entity operating the business, where there's generally greater exposure to creditors or legal action.

A common type of protection entity is a 'service entity'.

Ownership entities

These are the entities that own the operating entity or other entities. An operating entity with multiple principals may have a variety of ownership arrangements.

For example, the units of a unit trust may be owned by principal A's discretionary trust, principal B's company, principal C's spouse and principal D personally.

Service entities

These entities are common with professional businesses operated by doctors, dentists, solicitors, accountants and architects.

The service entity will enter into a servicing agreement with the operating entity to provide the latter with administrative and non-professional services, and the fees and charges are set out in the agreement.

In this way, income that is initially derived by an operating entity or partnership is paid to the service entity and in turn to the entities that own the service entity. The most common type of service entity is a unit trust, the units of which are typically owned by each of the principals' discretionary trusts.

This arrangement means that a lower overall rate of tax may be paid than if the income were simply paid or distributed from the operating entity to the principals.

Additionally, the service entity will tend to own (and lease to the operating entity) the assets or property used to carry on the business. So there's a greater chance the assets will be protected in the event, for example, that a person brought a successful legal action against the operating entity.

It's important for succession planning that the plan captures each relevant entity and takes into account the entities or persons that own these entities.

Self-managed super funds

A common strategy is for the property on which the business is conducted to be owned by the principals' self-managed super fund (SMSF).

The SMSF charges the business a market rent for use of the property. This can enable the principals to build their retirement savings in a tax-effective manner.

There are, however, important obligations contained in SIS that the trustees must satisfy when a business property is owned by the SMSF. Advice should therefore be sought from a specialist in superannuation before entering into such an arrangement.

Note: Due to the 'sole purpose test' in s62 of the SIS legislation, it's not feasible to operate a business through an SMSF.

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Asset (Debt) Protection

In this section, we explain how insurance can protect assets used to secure business debts if a principal becomes totally and permanently disabled, suffers a critical illness or dies.

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Overview of asset (debt) protection

When advising business principals, it's important to understand which debts need to be protected and the role of insurance.

Which debts need to be protected?

Key situations where it's important to protect debts (and the underlying assets) are where:

- There's a risk the lending institution will recall the loan if a principal departs the business and/or the remaining principals breach one or more of the loan conditions (referred to as covenants). Where the remaining principals cannot meet this demand, the institution may need to sell the personal or business assets held as security, including those of the departing principal.
- There's a risk the business won't be able to repay amounts owing to a departing principal (or their estate/associated entity). Because the terms of these loans are often not documented and are therefore at call, these creditors can demand immediate repayment.

Funding alternatives

There are various funding alternatives that could be used to repay debts if a principal (or another key person) becomes TPD, suffers a critical illness or dies.

For example, the business could sell assets to repay the debts. However, the business may not get fair value for these assets if it's a forced seller. Also, offloading assets such as plant and equipment could adversely impact the business' ability to continue as a viable operation.

The business may instead be able to raise alternative finance. But the problem with this approach is that lending institutions may be reluctant to loan money to a business that's experiencing financial problems or has just lost a key person.

When it comes to providing an injection of cash, insurance is usually considered the most cost-effective funding solution.

All the principals have a vested interest in ensuring that suitably funded asset protection strategies are implemented. Benefits for the departing principals include:

- releasing any loan guarantee or security they have provided
- ensuring the lending institution won't need to sell any personal or business assets, and/or
- enabling any proprietor loan accounts (see **page 56**) to be repaid.

Benefits for remaining principals are maintaining or improving the cashflow and credit standing of the business and possibly release personal loan guarantees they have provided.

Note: Insurance proceeds could also be used to cover the interest costs (rather than repay the loan principal). However, this would be regarded as having a revenue protection purpose (see **page 20**).

Who can be insured?

When using insurance for asset (debt) protection purposes, the policy will usually be taken out on the life of:

- a principal who has provided a guarantee or security for a loan sourced by the business from a lending institution, or
- a principal who has a proprietor loan account.

Case study

Kerry and Jill are pharmacists who own and operate three pharmacies, collectively valued at $3.2 million. In expanding their business from their original pharmacy, they have borrowed a total $1.8 million from the bank to acquire their second and third pharmacies over the past year.

In addition to the pharmacies, their personal guarantees have been used to secure the loans. This means if either was lost to the business due to death, illness or injury and revenue and loan servicing ability were adversely impacted, personal assets such as their family homes may have to be sold if the bank required immediate loan repayment.

After assessing Kerry and Jill's business risks and goals, their adviser gives them the choice of:

- insuring them for their share of the loans ($900,000 each), or
- insuring each of them for the entire amount of the loans ($1.8 million each).

Their adviser explains the trade-off between affordability (if they take the first approach) and the security of knowing they can both be released from their personal guarantees in the event either of them is lost to the business (if they take the second approach). See **page 19** for an explanation of the two approaches used in determining the sum insured.

Release from the personal guarantee is particularly important if either exits the business due to death or disability and do not want to be exposed to the ongoing fortunes of a business they no longer participate in.

Overview of policy ownership options

When lending money to a business, a lending institution may require the principals to take out insurance on their lives.

This is to ensure sufficient funds become available to repay some (or all) of the debt if a principal becomes TPD, suffers a critical illness or dies.

When a lending institution requires an interest in the policy

Occasionally, the lender will require an interest in the policy (ie they will hold the policy as security for the loan).

Most lenders may, however, be prepared to approve a loan or facility if they are provided with evidence the policy has been established and ongoing evidence the policy remains in force.

This approach is generally preferable, as it gives the principals the flexibility to choose a policy ownership option that suits their circumstances and enables them to use a range of strategies if an insured event occurs.

Note: In some cases, the lender may require outright ownership of the insurance policy, however, this is rare. Additionally, a policy held in super may not be used as security for a loan.

If a lending institution doesn't require an interest in the policy

The policy could be owned by:

- the entity through which the business is run
- an individual (on their own or another person's life), or
- the trustee of a super fund.

With each of the alternatives, the most appropriate ownership option will depend on a number of factors.

These could include, for example:

- who the insured person is and the scenario in which the insurance is required (eg to release a loan guarantee or security or to pay out a proprietor loan account - see **page 56**)
- the relationship between the principals (if there's more than one), and
- the specific business and personal objectives the departing and remaining principals want to achieve if an insured event occurs.

The following pages outline the ownership options commonly used by different business structures and explain the tax implications.

Given the potential complexities involved, the principals should seek legal and taxation advice when selecting which ownership option best suits their situation.

Policy ownership options where business has sourced loan from lending institution

Three policy ownership options are often considered when a business run through a partnership, company or trust has borrowed from a lending institution and the principals have provided a guarantee or security.

These are business ownership, self-ownership and super fund trustee ownership. While each option has distinct pros and cons, business ownership is the most commonly used approach.

Business ownership

The business can own the TPD, Critical Illness and/or Life insurance policy on the lives of its principals. If an insured event occurs, the business can use the money to:

- pay off or significantly reduce its debt
- release any loan guarantee or security provided by the principal, and
- improve the cashflow position and credit standing of the business.

With this option:

- CGT will not be payable on Life insurance proceeds
- CGT will be payable on the portion of any TPD or Critical Illness proceeds that are paid to the business (see **page 53**), except:
  - in partnerships, to the extent that the recipients are partners who are the life insured or a defined relative of the life insured), and
  - for trustees of a trust, where the policy is held for beneficiaries who are the insured or relatives of the insured, and
- the premiums aren't tax deductible.

The business could, however, make a provision for CGT by grossing up the amount of TPD or Critical Illness cover taken out. To find out how this should be done, see **page 54**.

Another issue to consider is that when the business receives the TPD, Critical Illness or Life insurance proceeds, its working capital and net value will increase. While this, in isolation, can be a good result, it can lead to financial outcomes that are less optimal than the other policy ownership options.

For example, if a company sells the asset securing the debt and the principals want to distribute some of the increased value to themselves as a dividend[1], tax will be payable in their hands at the relevant marginal rate less any franking offset available in respect of tax paid by the company.

Alternatively, if the principals want to sell their interest in the business (rather than the assets securing the debt) they could receive a higher price due to the improved net asset position. As a result, a higher CGT liability could arise when their interest is sold.

Note: To ensure the remaining principals use the insurance proceeds for the intended purpose, the principals should have a legally binding agreement that sets out, among other things, the rights and obligations of the relevant parties. This agreement could be included in, or drafted separately to, the Business Owners' Agreement.

Self-ownership

Another approach is for the principals to own the TPD, Critical Illness and/or Life insurance policy on their own lives.

If an insured event occurs, the principal, their nominated beneficiary or the executor of their estate will receive the policy proceeds. This can provide a greater degree of control, as the recipient can stipulate that the loan repayment (or reduction in the loan) is conditional on the release of any loan guarantee or security provided.

Like business policy ownership, CGT will not be payable on Life insurance proceeds. However, unlike business ownership:

- CGT won't be payable on TPD or Critical Illness proceeds, as the money will be received by the life insured (see **page 53**), and
- because the working capital and net value of the business won't increase, certain sub-optimal financial outcomes outlined above can be averted.

Where self-ownership is suitable, the premiums aren't tax deductible if they are paid personally by the insured principals. However, if the business pays the premiums on behalf of principals who are employees for fringe benefits tax (FBT) purposes (see **page 62**):

- the business will have to pay FBT of 47% on 188.68% of the premiums, and
- both the premium and FBT liability will be deductible to the business.

[1] While the company may be able to pay out the money as a partially or fully franked dividend, it will use up franking credits that would otherwise have been available when distributing other proceeds.

As a result, if the principals pay tax at a marginal rate of 47%, the effective premium costs will be the same where they are paid by the business. However, if the principals pay tax at a marginal rate of 39% (or lower) it can be more cost-effective if they pay the premiums themselves.

But despite the potential benefits, self-ownership won't suit all businesses and before a principal selects this option, they should consider the following issues:

1. If the recipient lends the insurance proceeds to the business so the debt can be repaid, they will replace the lending institution as creditor. This outcome may be acceptable in certain situations, such as where a business is run through a company and a husband and wife are the sole directors and shareholders. Where problems are more likely to arise is in businesses where:
   - the principals have more of an arm's length relationship
   - the aim is to exit the insured principals from the business when an insured event occurs (ie not have them or their estate become a creditor), and
   - the remaining principals want the debt to be extinguished so the cashflow and credit standing of the business can be maintained or improved.
2. If the recipient lends the insurance proceeds to the business and then forgives the loan, the commercial debt forgiveness (CDF) laws could apply, which may have adverse tax implications (see **page 59**).
3. If a business is liable for the debt and the recipient uses the insurance proceeds to repay the lending institution directly, the recipient will generally be deemed to have the same rights against the business that the lending institution had previously due to an equity law concept known as the 'doctrine of subrogation'. Furthermore, the ATO's view (in TD 2004/17) is that if these rights are waived or forgiven, the CDF provisions may be applied to the business.
4. If the principals are jointly and severally liable for the debt (eg in partnerships and the recipient uses the insurance proceeds to repay the lending institution directly, the recipient will have the right to seek contribution from the other principals due to an equity law concept known as the 'doctrine of contribution'. If this right is waived or forgiven, it's also likely the CDF provisions may be applied to the business.
5. The principals can establish a documented loan agreement funded by self-owned policies prior to the occurrence of an insured event (see **page 58**). CGT will not apply to the insurance proceeds and the agreement will typically require the departing principal to pay the insurance proceeds over to the continuing principals on the condition that the departing principal's personal guarantee is no longer held by the lending institution. Once the continuing principals receive the insurance proceeds, they would loan the proceeds to the business, so it can repay the lending institution.

In summary, self-ownership will generally only suit businesses where:

- it will be acceptable for the recipient of the insurance proceeds to remain as a creditor to the business (eg a company whose shareholders are spouses)
- the business is operated by a sole trader, or
- there's the capacity to implement a documented loan agreement.

In other circumstances, the business may be better off owning the policy and grossing up the sum insured to make a provision for any CGT on the TPD and/or Critical Illness proceeds that may arise.

Super fund trustee ownership

A third option is for the principals to take out TPD and/or Life insurance in a super fund, where the policy is owned by the super fund trustee.

This option is similar in many respects to self-ownership (see above) and therefore may appeal to single principal businesses and businesses where the principals are spouses. However, unlike self-ownership, super ownership is usually not recommended in other scenarios because documented loan agreements are generally not available for super owned policies.

Policy ownership options where principal has loan account with business

Two policy ownership options may be used when a principal has a loan account with a company, discretionary trust or unit trust.

These are business ownership and cross-ownership. For more information on proprietor loan accounts (and how they may arise), see **page 56**.

Business ownership

The business can own the TPD, Critical Illness and/or Life insurance policy on the life of the principal. If an insured event occurs, the business can use the proceeds to repay the loan account.

With this option, CGT will not be payable on Life insurance proceeds. CGT will, however, be payable on TPD and Critical Illness proceeds, as a business isn't a defined relative of the life insured (see **page 53**), except:

- in partnerships, to the extent that the recipients are partners who are the life insured or a defined relative of the life insured), and
- for trustees of a trust, where the policy is held for beneficiaries who are the insured or relatives of the insured.

The business will therefore need to gross-up the amount of TPD and Critical Illness cover if it wants to ensure enough funds are available to repay the loan account (see **page 54**). Also, the business cannot claim the premiums as a tax deduction.

Cross-ownership

In situations where the principals are defined relatives, a potentially better approach is for each of the principals to own the policies taken out on the lives of the other principals that have loan accounts, except for themselves.

If an insured event occurs, the remaining principals can lend the proceeds to the business, so it will have sufficient cash with which to pay out the loan account of the departing principal.

As a result, the remaining principals will replace the departing principal as creditor.

With this option, like business ownership:

- CGT will not be payable on Life insurance proceeds, and
- the principals cannot claim the premiums as a tax deduction.

However, when compared to business ownership, the key benefit is that CGT won't be payable on TPD and Critical Illness proceeds if the life insured is a defined relative of the policy owners – see **page 53**. As a result, there's no need to gross-up the sum insured.

How do you determine the sum insured?

Two approaches are often used to calculate the sum insured required for asset (debt) protection purposes.

These are the debt cancellation and the proportionate method. With both these approaches, the principals should consider grossing up the sum insured to make a provision for any:

- CGT that may be payable on TPD or Critical Illness proceeds (see **page 54**), and
- lump sum tax that may be payable on death or TPD benefits if the policy is owned by the trustee of a super fund.

It's also important to take into account any underwriting rules that could limit the amount of insurance that can be taken out in certain circumstances (see below).

Finally, once determined, the sum insured should be reviewed at least annually and adjusted accordingly.

Debt cancellation method

The debt cancellation method involves calculating the cost of cancelling the entire debt so that all personal guarantees can be terminated and/or all loan accounts can be repaid to the relevant principal.

The basis of this method is that the business principals are each jointly liable for the debt of the business.

This method may be appropriate where there are only a small number of principals (eg two or three) and each of them plays a crucial and distinct key person role in the business.

In this scenario, the death, disability or illness of one of these principals is likely to have a significant impact on the business' ability to meet its loan commitments.

As a result, there's a high risk that all of the principals could lose (or be forced to sell) any personal or business assets used as loan security.

The debt cancellation method may, however, not be available for businesses with several principals.

This is because the insurer's underwriters may determine that the impact on the business' ability to service its debts will generally be satisfactory if several principals remain in the business.

Proportionate method

With the proportionate method, you need to work out the interest each principal has in a debt and insure that principal for that specific amount.

The basis of this method is that the business principals are severally liable for the debt of the business. You should be aware, however, that the proportions for each principal may not necessarily be aligned with their equity in the business or security they have provided.

For example, one principal may have provided a significantly greater amount of their personal assets as security than the other principal if the latter's assets are already highly encumbered with debt.

Insurers' underwriting approaches

The underwriting approach varies from insurer to insurer when assessing lending institution business debt. It generally depends on the number of principals in the business and the size of the debt.

Insurers will either underwrite on the basis of:

- the proportionate method only, or
- a hybrid of the proportionate and debt cancellation method.

An example of the latter approach that some insurers use for debts up to $10,000,000 where business ownership is equal or close to equal is shown in the table below.

Note: the standard maximum cover limits for TPD and Critical Illness apply.

Number of business principals	% of debt covered
Two	100% of the first $2 million + 75% of the excess
Three	100% of the first $1 million + 75% of the next $1 million + 50% of the excess
Four	100% of the first $1 million + 75% of the next $1 million + 25% of the excess
More than four	% of debt equal to % of business ownership

3

Revenue Protection

In this section, we explain how insurance can offset a reduction in revenue if a principal or other key person becomes totally and permanently disabled, suffers a critical illness or dies.

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Overview of revenue protection

When advising business principals, it's important to understand the sources of revenue that should be protected and the role of insurance.

Sources of revenue that should be protected

The principals should protect sources of revenue that would be adversely impacted if they or a valuable employee were to become totally and permanently disabled, suffer a critical illness or die.

Alternatives to insurance

There are various alternatives that could be used if a person who is directly responsible for generating revenue is lost to the business.

For example, the business could absorb the reduction in revenue into the current year profits. But this would generally reduce the income the principals could receive and may result in the business running at a loss. Significant drops in revenue may also lead to a lending institution recalling credit it has extended to the business, in part or in full, as a deterioration of revenue may cause the business to breach a loan covenant.

Alternatively, the business could accumulate a reserve. However, it could take many years to build up enough funds and, because the money needs to be readily available, it would need to be invested conservatively in liquid assets that typically yield a lower return.

Most businesses generally prefer to put capital to a more efficient use, earning higher returns and generating greater value for stakeholders.

Why use insurance?

When it comes to providing an injection of cash to protect business revenue, insurance is usually considered the most cost-effective funding solution.

In the event of TPD, critical illness or death, the insurance proceeds could be used to offset a reduction in revenue and cover the costs associated with finding and training a suitable replacement.

Note: It's also important to protect the business principals in the event that they suffer an illness or injury that renders them unable to work for a temporary period (see page 26).

Who can be insured?

When using insurance for revenue protection purposes, the policy will usually be taken out on the life of the principals and any key employees of the business.

Examples of key employees include a sales manager, supervisor or technical adviser who may have a significant contribution to the revenue, decision making powers or a unique talent.

As the premiums are generally tax deductible to the business, or less commonly, to sole traders, the ATO has provided guidance in IT 2434[1] on who can be insured for revenue protection purposes.

Implications of IT 2434

The core provision contained in IT 2434 is that to be eligible to claim an expense as a tax deduction when running a business, the expense needs to have been 'incurred in gaining or producing of assessable income'.

IT 2434 confirms that an employee may be accepted as a key person for revenue purposes where the loss of that employee would result in a 'significant' drop in profits being derived by the employer during the continuation of business operations subsequent to that loss.

This would be a situation where there's 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.

A key person isn't seen to exist in a situation where the loss of an employee, such as the owner/manager of a one-person incorporated business, could be expected to result in the termination of the business.

In other words, the ATO doesn't consider that an employee or principal is a key person for revenue purposes if their death or disablement would most likely result in a closure of the business.

[1] IT 2434 deals with 'Split dollar arrangements' where an employee (key person) and employer agree to split policy benefits between them. The aspects of the Ruling dealing with revenue protection are based on an earlier ruling (IT 155), which in turn was based on a High Court judgment Carapark Holdings Ltd v FC of T(1966) 115 CLR 653.

This is because any policy proceeds would most likely be put to capital purposes such as the repayment of debt, wind-up costs or simply taken as a lump sum by the principal or their beneficiaries, rather than be used to continue the business.

The key exceptions are where it's intended the business will be continued by, for example, a family member or be sold to a third party (such as an employee or competitor). In these scenarios, there may be sufficient continuity to satisfy IT 2434.

Finally, it's difficult to generalise what would be considered a significant impact on revenue, given that profit margins can vary between businesses.

Also, measuring the impact a key sales person has on a business' revenue may be simpler than measuring the impact a principal has on relationships with clients, suppliers or other stakeholders.

The cost of replacing principals or employees with complex intellectual property or highly specialised skills or capabilities needs to be factored in, as these costs will adversely impact revenue if these people are lost to the business.

By definition, it's unlikely a business will have numerous key people (for example, ten) as in the event of a loss of one of them, the business should have sufficient remaining key people to either absorb the loss or take on the departed key person's duties.

One could argue that a decline in profit of 20% or more would be sufficient to satisfy IT 2434. This is because in Division 152 of ITAA 1997, 20% and above is seen as a sufficiently 'significant' equity participation to access the small business CGT concessions (see **page 61**).

Who would normally own the insurance policy?

When an insurance policy is taken out for revenue protection purposes, the policy will normally be owned by the operating entity, person or persons (in a partnership) that carries on the business and employs the key person.

Tax implications of revenue protection

When business principals use insurance for revenue protection purposes, it's important to understand the tax implications and keep appropriate records.

IT 155 states that when a TPD, Critical Illness and/or Life insurance policy is used for revenue protection:

- the premiums are tax deductible to the business operating entity, and
- the insurance proceeds will be assessable income to the business.

Furthermore, with regard to CGT:

- Life insurance proceeds will be exempt
- TPD and Critical Illness proceeds will be exempt if received by the life insured or a defined relative of the life insured (see **page 53**), including:
  - in partnerships, to the extent that the recipients are partners who are the life insured or a defined relative of the life insured, and
  - for trustees of a trust, where the policy is held for beneficiaries who are the insured or relatives of the insured, and
- where the CGT exemption doesn't apply to TPD and Critical Illness proceeds, CGT is unlikely to be payable because the capital gain is reduced by the amount included in assessable income[2] (see **page 53** also).

Record keeping requirements

It's important the principals minute the purpose of the revenue protection policy and the method used to determine the sum insured (see **page 25**) on an annual basis, even if there's no change.

If the business fails to do this, the ATO could deem the policy to have a capital (not revenue) purpose. As a result, the ATO could claw back the tax deductions and apply a penalty.

Also, in the event of a claim, if the policy is deemed to have a capital purpose, CGT will be payable on TPD or Critical Illness proceeds rather than the amount being treated as assessable income.

For more information on record keeping in a business insurance context, see **page 63**.

[2] s118-20 ITAA 97

How do you determine the sum insured?

The sum insured should be a best estimate of the financial cost that would be incurred if a key person is lost to the business.

When determining this, regard should be given to factors particular to the business.

Overview of commonly used methods

Two approaches are often used to calculate the sum insured for revenue protection purposes. These are the present value method and the multiples method.

With both these approaches, it's important to take into account any underwriting rules that could limit the amount of insurance that can be taken out in certain circumstances and keep appropriate records (see **page 24**).

Once determined, the sum insured should be reviewed at least annually and adjusted accordingly.

Present value method

This method involves estimating the costs that would be incurred if a key person needed to be replaced.

These would normally include recruitment, relocation and training costs, as well as the salary that would need to be paid up to the point where the new person is of an economic value to the business equivalent to the departed key person.

Multiples method

This method uses a key person factor (or multiple) to assess the impact a key person has on the business' revenue.

For example, in a business with two key people and a small number of employees, each key person may be regarded as having a key person factor of 50%, as they are responsible for 50% of the success of the business.

If, on the other hand, there were a larger number of employees with specialist skills contributing towards the success of the company, the key person factor may be reduced to say 33% or 25%.

There are four basic rules of thumb which can be used as a starting point when using the multiples method.

1. **Revenue:** Sales Revenue x Key Person Factor.
2. **Gross Profit:** 2 to 3 x Gross Profit x Key Person Factor.
3. **Net Profit:** 5 to 8 x Net Profit x Key Person Factor.
4. **Remuneration:** 3 to 10 x Total Remuneration x Key Person Factor.

Where the key person is an employee and not a principal of the business, a multiple of remuneration may be an appropriate method.

Where the key person is a principal, the appropriate rule of thumb will depend on their contribution to the business.

For example, the sales revenue multiple is probably more appropriate if the principal is responsible for sales and a gross profit or net profit multiple may be more suitable if they are a general manager.

Insurers' underwriting requirements

When assessing a revenue protection application, insurers will consider a range of factors, including:

- whether the level of insurance proposed reflects the value of the key person
- that the method used to value the key person is reasonable
- the business structure, turnover, net profit
- the key person's financial interest/share in the business
- the key person's remuneration package
- any other insurance that is in force on the key person, and
- that for an arm's length employee (a key person who does not have a financial interest/share in the business) insurance will usually be restricted to 10 times the remuneration package.

Protecting business revenue in event of temporary disability

It's also important to protect the business principals in the event they suffer an illness or injury that renders them unable to work for a temporary period.

To do this, they should consider purchasing Income Protection and Business Expenses insurance.

Income Protection insurance

If a principal is unable to work due to illness or injury, Income Protection insurance can:

- provide a monthly benefit of up to 75% of their income to replace lost earnings, and
- ensure the business doesn't have to use its own resources to pay a sick or injured principal who isn't contributing to revenue.

Where a principal works for a company or trust, rather than base the sum insured on the principal's actual salary or wage, the insurer's underwriters will generally 'look through' the entity and base the sum insured on the income of the business the principal generates by personal effort.

The policy can be owned (and the premiums paid) by the insured principal(s) or the business. The tax implications for each of these scenarios are outlined on **page 27**.

While self-ownership is relatively straightforward, when assessing whether the business should own the policies, it's important to keep in mind that:

- Underwriting may require the principals own a minimum percentage of the equity (eg 25%). This is to ensure the principal has sufficient influence to require the benefit to be on-paid from the business to them in the event of a claim. Alternatively, the Business Owners' Agreement could stipulate the claim proceeds will be on-paid.
- Where a principal is on a long term Income Protection claim, the business will have to continue as policy owner, even though the principal may have effectively departed the business permanently.
- If the business goes into liquidation, policy payments could cease.

For these reasons, having the principals self-own their policies is often the preferred approach.

Business Expenses insurance

If a small business principal[3] suffers an illness or injury that prevents them from working, the income the business derives from their personal exertion or the provision of their personal services is lost, but fixed expenses and overheads remain the same.

Business Expenses insurance can cover up to 100% of their share of eligible business expenses (see below).

This can enable them to keep their business afloat and ensure that, in the worst case scenario, there's still a business to sell should the need arise.

Typically, Business Expenses insurance will be most appropriate for small professional practices such as accounting and legal firms, medical and dental practices.

Insurers' eligible business expenses will usually include:

- rent or mortgage payments including principal and interest
- property rates and taxes
- equipment or vehicle lease costs
- electricity, heating and water costs
- cleaning and laundry costs
- depreciation on office equipment and premises the business owns
- salaries of employees not generating business income
- costs of accounting services
- fees for membership of professional associations
- business insurance premiums, and
- the net cost of a locum.

The maximum benefit payment period for Business Expenses insurance is usually one year. Some insurers also restrict the number of principals of a small business that can be insured (eg up to six).

Additionally, sole traders with fixed expenses that will continue when they are unable to work may apply.

To find out about the tax implications of Business Expenses insurance, see **page 27**.

3 In this context, small business principal refers to a sole trader, the partners in a small partnership or a person who operates a small business through a company or a trust.

Tax implications of Income Protection and Business Expenses insurance

The tables below summarise the tax implications relating to Income Protection insurance and Business Expenses insurance.

This information is based on our understanding of current legislation and ATO practice as at 1 July 2020.

Income Protection	What upfront tax concessions may be available?	Are the insurance benefits assessable as income?
Where a principal or employee owns the policy and the premiums are paid by that person	The principal or employee can claim the premiums as a tax deduction.	The benefits are assessable to the principal or employee
Where a principal (who may or may not be an employee - see **page 62**) owns the policy and the premiums are paid by their employer	The employer can claim the premiums as a tax deduction. As the premiums are 'otherwise deductible' to the principal or employee (ie the premiums would be deductible to the principal or employee if they paid them personally), the employer isn't liable for FBT.	As above
Where the employer owns the policy on the life of the principal or employee	The employer can claim the premiums as a tax deduction.	The benefits are ultimately assessable to the principal or employee to the extent they are paid to that person.
Where the trustee of a super fund owns the policy on the life of a fund member	The super fund trustee can claim the premiums as a tax deduction. At the fund member level, the principal or the business employing the principal can claim the super contributions funding the premiums as a tax deduction.[4]	When the policy proceeds are paid out they will be assessable to the fund member.

Business Expenses	What upfront tax concessions may be available?	Are the insurance benefits assessable as income?
Where a business owns the policy and the premiums are paid by the business	The business can claim the premiums as a tax deduction.	The benefits are assessable to the business.

4 A cap of $25,000 pa applies to concessional contributions. Additionally, where the principal's adjusted taxable income is above $250,000 pa, an additional 15% tax is payable on concessional contributions. Both the cap and the income threshold apply in 2020/21.

4

Ownership Protection

In this section, we explain how a Buy Sell Agreement funded by insurance can facilitate the orderly transfer of business ownership if a principal becomes totally and permanently disabled, suffers a critical illness or dies.

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Overview of succession planning

When protecting a principal's interest in a business, it's important to understand some key succession planning concepts.

When could a transfer of ownership occur?

There are a number of events that could trigger the need to partially (or completely) transfer the ownership of a business.

These could include:

- planned events that arise on amicable terms (eg when a principal sells their equity to the remaining owners or an incoming owner upon retirement)
- events that aren't amicable (eg when a principal decides to exit the business to establish a competing operation or resigns as a result of a dispute with the other owners)
- unplanned events that can potentially be insured against (eg when a principal is lost to the business due to death, disability or illness), and
- unplanned events that aren't insurable (eg if a principal is convicted of a criminal act or becomes bankrupt).

Why is succession planning important?

Business principals tend to be too preoccupied with the day-to-day running of their business to think about succession planning. However, they will appreciate forward-looking, proactive advice that will ultimately secure them the best return for what is often their major asset.

Comprehensive advice should consider a range of succession possibilities and scenarios. It should also recognise that succession can not only be planned, but unplanned and occur at any time.

People often go into business with each other because they are friends and consequently don't see the need for succession planning. But if, for example, one of the principals in a two-person business dies, the surviving principal will no longer be in business with their friend. Instead, they may have to deal with the friend's spouse, or the executor of their estate.

If it's the spouse, for example, the spouse may seek independent advice regarding the business and whether they should retain the interest they have inherited, or sell it to a third party. They might also have a view on what the interest is worth, try to influence dividend or distribution policy or remarry and seek to have their new spouse placed in the business.

Unfortunately, the best case scenario is the beneficiary becoming a 'silent' partner and participating in the growth and dividends or distributions from the business for no effort.

Without appropriate succession planning, the number of possible scenarios is infinite. However, the issues faced by a business with two or more principals will often be different to those faced by a business with only one principal.

Issues faced by multi-principal businesses

With businesses that have two or more principals, at some stage in the business' life they may develop differing views on:

- how the business should be run
- the actions or performance levels that should force the exit of a principal
- the obligations of principals departing the business and any restraints relevant to protecting the value of the business
- what the business is worth
- what the dividend or distribution policy of the business should be
- whether certain events should trigger a transfer of ownership, and
- who their interests should be transferred to upon their departure.

In a situation where a principal departs, the remaining principals may not have (or be able to arrange) sufficient funding to buy out the departing owner's interest – particularly if the departing principal wants to be paid for their interest quickly. As a result, a situation could arise where the business continues to be partly owned by the departing principal, or a related person or entity over a long period of time.

This outcome is likely to be unsatisfactory for all parties concerned and could destabilise the business and create a range of other problems.

Issues faced by single

principal businesses

Businesses with one principal will need to consider, among other things:

- whether the business will be able to continue as a viable concern (ie to what degree the business depends on the presence of the principal)
- what the value of the business assets are, including client goodwill
- who will take ownership and control of the business if there are no obvious successors such as family members
- how to maximise the sale price if the business is to be sold to a third party
- how they would structure the sale, and
- whether they can arrange succession for unplanned insurable events?

Business succession and Buy Sell Agreements

To minimise disruptions and ensure an orderly transfer of ownership in single or multi-principal businesses, the principals should consider establishing a:

- **Business Owners' Agreement** that deals with planned and unplanned events that can't be funded by insurance[1], as well as a range of matters concerning the rights and conduct of the principals in relation to each other, and
- **Buy Sell Agreement**, where the exit of a principal due to death, total and permanent disablement and (in some cases) critical illness is funded or part-funded by ownership protection insurance.

Ideally, the Buy Sell Agreement should be established separately from the broader Business Owners' Agreement (eg the Partnership, Shareholders' or Unitholders' Agreement). This is because Business Owners' Agreements are often highly customised, can be costly and usually cover a broad range of issues and it can often take a long time for the principals to reach consensus.

As a result, including a Buy Sell Agreement in the broader Business Owners' Agreement can slow down the implementation of the Buy Sell Agreement (which is generally a simple and quick process). This could have an adverse impact on the business (and the principals' interest in the business) if a principal dies or suffers a serious illness or injury prior to the agreement being finalised.

Note: The Business Owners' Agreement or Buy Sell Agreement could also deal with any loan accounts the principals may have with the business (see **page 56**).

1 These Agreements may sometimes deal with temporary absences of the principals by having clauses that require the business to pay sick leave (funded by Income Protection) or to hold Revenue Protection.

Overview of Buy Sell Agreements

A Buy Sell Agreement can help business principals achieve certain succession planning objectives.

What is a Buy Sell Agreement?

A Buy Sell Agreement (or Deed) is a legal contract established by two or more parties that can facilitate an orderly and equitable transfer of ownership if a principal is lost to the business due to death, disability or illness.

What are the benefits?

A suitably structured and adequately funded agreement can:

- enable the remaining principals or another person or entity to acquire the departing principal's interest in the business, and
- ensure the departing principal (or their estate/dependants) receive adequate financial compensation.

What are the key components?

Buy Sell Agreements usually contain two components.

The first, which is known as a 'transfer agreement', outlines the trigger events that will result in a transfer of ownership. Most Buy Sell Agreements include death and total and permanent disability as a trigger event. It's also possible to include critical illness, however, some specific issues need to be considered (see **page 48**).

The transfer agreement should also outline how the business will be valued and the interest owned by (or associated with) each principal.

The second component, which is known as a 'funding agreement', outlines how the money will be raised to finance the ownership transfer and who will receive it.

Why fund a Buy Sell Agreement with insurance?

There are a number of ways the money could be raised to fund a Buy Sell Agreement. For example, with a business that has two or more principals, the remaining principals could borrow money, sell personal or business assets or find a replacement.

But, as the table on the opposite page outlines, the problem with each of these alternatives is that they may not be feasible (or viable) following the departure of a key person. To ensure enough capital is available in the event of death or serious disability, insurance is usually considered the most cost-effective and efficient funding solution.

Alternatives available to the remaining principals

Alternatives to insurance	Issues that may arise
Borrow money	Many lending institutions may be reluctant to provide credit to the remaining owners when a business has just lost the services of one of its principals and for a purpose that is not related to the expansion of the business.
Sell personal assets	This may not be possible if these assets have already been used to secure loans. Also, the remaining owners may not get the price they want if they are forced sellers.
Sell business assets	Stripping the business of valuable assets at such a critical time may make matters worse if these assets are required to generate business revenue.
Find a replacement	This may be difficult or even not possible. At best, this could take a while and, in the meantime, problems may arise if the departing principal or their estate/dependants need the proceeds.
Vendor finance	Paying the departing principal in instalments over an agreed period (usually with an agreed additional interest charge) can place a strain on the cashflow of the remaining principals. Additionally, the departing principal remains exposed to the fortunes of a business in which they no longer have an interest. However, vendor finance will often be the most viable alternative where insurance for a principal is not available (see **page 46**).

Which business structures can establish a Buy Sell Agreement?

Buy Sell Agreements have an important role to play with businesses that are run through a partnership, multi-shareholder company, unit trust or joint venture. On **pages 36–43**, we outline the policy ownership options commonly used by these business structures.

Buy Sell Agreements can also sometimes be used by businesses with a single principal where they enter into an agreement with another similar business ('Horizontal Buy Sell') or another business in their supply chain ('Vertical Buy Sell'). An example of the former is two sole principal accountancy businesses entering into an agreement with each other and an example of the latter is an importer and wholesaler entering into an agreement with each other.

A Buy Sell Agreement cannot, however, be used by businesses that are run through a discretionary trust, as the beneficiaries don't have a present entitlement to the assets or business equity of the trust. As a result, they don't have an interest in the business to buy or sell.

This shouldn't be confused with the scenario where two or more discretionary trusts (or a discretionary trust and other persons or entities) own an interest in a common operating entity (eg a company). In these cases, the trustees of the discretionary trusts can enter into a Buy Sell Agreement with each other to buy and sell the shares or units of the operating entity.

To find out more about succession planning and discretionary trusts, see **page 49**.

Overview of Buy Sell Agreements (continued)

How can a Buy Sell Agreement be established?

Mandatory agreements

With mandatory (or must buy/must sell) agreements, the parties involved unconditionally agree to buy and sell the business interest if certain trigger events occur.

A commonly held view regarding these types of agreements is that the business interests will be deemed to have been disposed of for CGT purposes when the Buy Sell Agreement is established.

As a result, CGT could be payable when the agreement is signed, even though no trigger event has occurred at that time. However, there is a counter-argument that the execution of such agreements to transfer business interests in the event of death, for example, won't constitute a CGT event as there's no certainty as to which party will be buying and which will be selling.

That is, it's impossible to know whether one or more of the principals will die while participating in the business and, if so, be sure which one will die.

However, to be absolutely certain that CGT won't apply when the agreement is executed, condition precedent agreements and/or put and call options are commonly used.

Condition precedent agreements

If the agreement makes it clear the trigger events are a condition precedent to the formation of the contract of sale, then there's no disposal for CGT purposes until a trigger event such as the payment of an insurance claim occurs[2].

Put and call options

With this approach, if a trigger event occurs:

- the remaining principals can exercise the call option (ie their right to buy) so the departing principal must sell their interest in the business, and/or
- the departing principal can exercise the put option (ie their right to sell), so the remaining principals or an associated person or entity must buy the interest in the business.

Put and call options can provide the same level of reassurance as a mandatory agreement. This is because the agreement will proceed if at least one of the parties decides to exercise their option.

However, this approach also provides a degree of flexibility. For example, a business principal could have a family member working in the business. If the other principals agree to allow the principal's son or daughter to simply inherit their equity, then no option need be exercised.

Additionally, where critical illness is a succession event in the Buy Sell Agreement, the remaining principals' call option may have a waiting period (for example, six months) during which time they cannot exercise their option.

This gives all of the principals time to assess whether the principal who has suffered the critical illness can (or will) return to the business. There's the further flexibility that, when the waiting period is over, the remaining principals don't have to exercise their call option to buy the departed principal's equity if they feel it's worthwhile waiting longer to see if the departed principal can return to the business (see **page 48**).

Finally, a contract for sale doesn't arise and, therefore, CGT won't be payable until an option is exercised. So, notwithstanding the counter-argument that CGT is not payable on the execution of mandatory agreements (see above), there's no risk that CGT will be payable when the agreement is entered into[3].

[2] ATO ID 2004/668
[3] ATO ID 2003/1190

What's in a Buy Sell Agreement?

Buy Sell Agreements vary from legal firm to legal firm, as each are based on a particular legal precedent.

An Agreement will usually begin by setting out the parties to the Agreement, including the:

- operating entity or entities
- owners of the operating entities – often these will be corporate trustees of the discretionary trusts, and
- principals.

There will often be a Background section which explains what the Agreement is about (sometimes called 'Recitals') for the principals' clarification and tells them why they are signing the Agreement.

This is usually followed by definitions of words and terms used in the Agreement.

The body of the Agreement will set out or contain:

- how the put and call options work
- the taking out and maintenance of insurance policies and who proceeds are paid to
- triggering events
- valuation or purchase price of equity
- default clauses, where a party does not perform their obligations in the Agreement, and
- mediation or dispute resolution over clauses in the Agreement.

Towards the back of the Agreement, there will generally be:

- schedules, which contain specific details about the insurance policies and option notices, and
- an attestation clause, where the various parties sign the Agreement.

Who can be insured?

When using insurance for ownership protection purposes, the policy will always be taken out on the life of the principals, which could generally be any person with a direct or indirect interest in the business.

Policy ownership options for multi-principal businesses

Four policy ownership options are commonly used by partnerships, multi-shareholder companies and unit trusts.

These are cross-ownership, self-ownership, trustee of discretionary trust ownership and super fund trustee ownership. Each of these options is outlined below, along with the tax implications when insurance is used for ownership protection purposes.

Given the potential complexities involved, the principals should seek legal and taxation advice when selecting which ownership option best suits their situation.

Note: At this point, we don't consider company ownership (see **page 55**) because of some specific issues associated with this option. We also don't cover the CGT implications when the business interest is sold or transferred (see **page 47**). For information on the succession planning issues applicable to discretionary trusts, see **page 49**.

Cross-ownership

With cross-ownership, each principal usually owns the policies taken out on the lives of all the principals except for themselves. If a principal then exits the business due to death, TPD or critical illness:

- the insurance proceeds are paid to the remaining principals
- the remaining principals pay the money to the estate/dependants, the departing principal or an associated entity
- the recipient accepts the insurance proceeds as full (or part) consideration for the interest in the business, and
- the interest in the business is transferred to the remaining principals or their associated entities.

With this option, CGT could be payable on Life insurance proceeds if the recipient isn't the original policy owner and they acquired the interest for consideration.

This may occur, for example, when:

- a new principal joins the business
- the existing policies are assigned to include the new principal (who wouldn't be an original policy owner), and
- the new principal acquires their interest in these policies for consideration (see **page 52**).

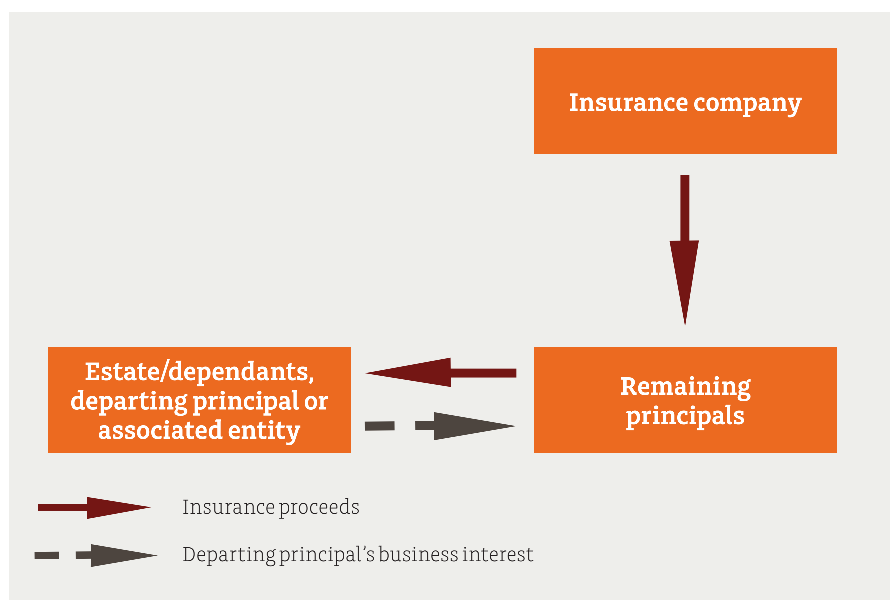
While this adverse CGT outcome could be avoided if the cross-owned policies are renewed each time a principal joins or leaves the business, administration problems can arise if:

- there are several principals and ownership changes frequently, and/or
- the insurer won't issue a replacement policy without up-to-date health evidence where the current policies are from an old, closed series.

CGT will also be payable on the portion of any TPD or Critical Illness proceeds that are paid to the principals who aren't a defined relative of the life insured (see **page 53**).

This outcome is common in businesses that are run through partnerships, multi-shareholder companies and unit trusts where the principals aren't family members.

Where CGT will be payable in the event of an insurance claim, the principals could gross-up the sum insured to make sure enough money becomes available to fund the ownership transfer. To find out how this should be done, see **page 54**.



If the premiums are paid personally by the principals, a tax deduction cannot be claimed. Conversely, if the company or trustee pays the premiums on behalf of principals who are employees for Fringe Benefits Tax (FBT) purposes (see **page 62**):

- the company or trustee will have to pay FBT of 47% on 188.68% of the premiums, and
- both the premium and FBT liability will be deductible to the company or trustee.

As a result, if the principals pay tax at a marginal rate of 47%, the effective premium costs will be the same where they are paid by the company or the trustee.

However, if the principals pay tax at a marginal rate of 39% (or lower) it can be more cost-effective if they pay the premiums themselves, which could be arranged as an after-tax adjustment to the principals' salary or adjustment to their loan account.

But regardless of who actually makes the payments, the premiums paid on cross-owned policies can be more equitable than the other ownership options.

Consider, for example, a situation where:

- there are two principals who each own 50% of a company
- one of the principals is older and/or in poorer health than the other principal
- each principal cross-owns an insurance policy on the other principal's life, and
- the premiums are paid by the principals.

In this scenario, while the younger and/or healthier principal will pay higher premiums than if they owned the policy on their life, it can be argued this is reasonable given it's more likely the older and/or less healthy principal will depart the business due to an insured event.

As a result, there's a greater chance the younger principal will benefit from the Buy Sell Agreement by taking 100% control of the business.

Similar equity benefits can also arise when the ownership split isn't equal. In other words, it's reasonable a principal who has a smaller share in the business (and would be required to pay a premium relating to their fellow principal's bigger share of the business) should pay the higher premium because they stand to gain a greater increase in the share of the business if the other principal departs due to an insured event.

Another benefit of cross-ownership is that it's the simplest approach from a cashflow perspective. This is because, in the event of a claim, the insurance proceeds will flow directly to the remaining principals so they can acquire the departing principal's interests.

This means that if the principals' respective discretionary trusts own their business interests, for example, the remaining principals will receive the policy proceeds on the life of a departing principal and can then buy the departing principal's interest from the latter's discretionary trust.

Approached this way, the entity selling the business interest (ie the discretionary trust) receives the sale proceeds and this can benefit discretionary trusts that:

- have incurred a CGT liability when disposing of the business interest, or
- have loan accounts, particularly to certain beneficiaries such as adult children and other relatives who don't control the trust, or corporate beneficiaries.

If a company's loan account isn't repaid, it could be deemed (and taxed as) an unfranked dividend in accordance with Division 7A of ITAA 1936, as outlined in TR 2010/3.

Finally, if the insured principal leaves the business in hostile circumstances and the remaining principals won't assign the policy to the departing principal, that principal may face problems when applying for new insurance.

Policy ownership options for multi-principal businesses (continued)

Self-ownership

Another approach is for each of the principals to own a policy on their own life. If a principal then exits the business due to death, TPD or critical illness, the common approach is that:

- the insurance proceeds are paid to the estate/dependants or the departing principal
- the recipient accepts the insurance proceeds as full (or part) consideration for the interest in the business[4], and
- the departing principal's interest in the business is transferred to the remaining principals or their associated entities.

With this option, the principals can bring (or take) their policy with them when they join (or leave) the business.

There's no need to assign the existing policies and there's no change in policy ownership.

As a result, CGT will not be payable on Life insurance proceeds and there's no need to renew the existing policies (which will appeal to multi-principal businesses where ownership changes frequently).

Also, CGT won't be payable on TPD or Critical Illness proceeds, as the money will be received by the life insured (see **page 53**).

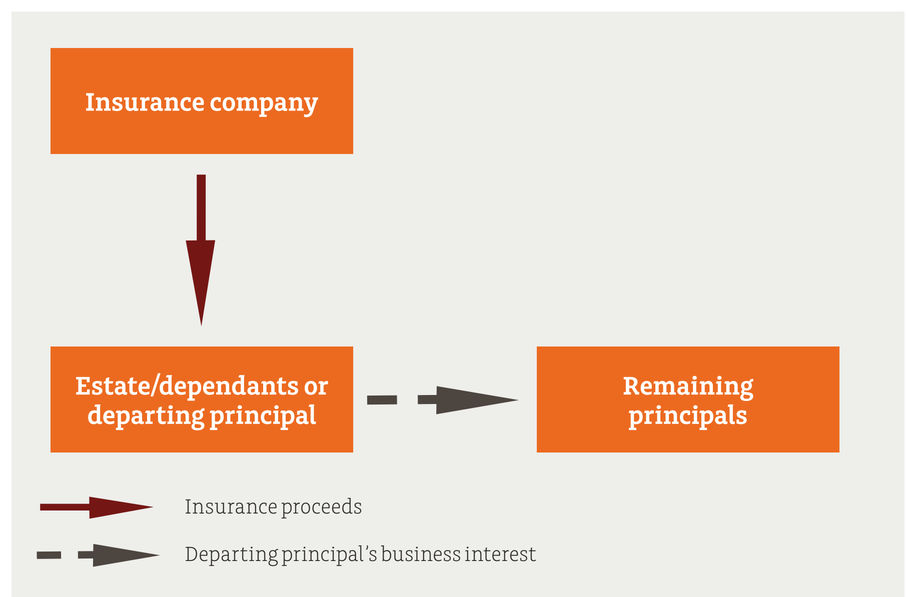
Self-ownership can therefore be a more tax-effective option than cross-ownership where CGT could be payable on Life, TPD and Critical Illness proceeds.

A downside is that the premium payments may not be as equitable in situations where there's a significant difference in:

- the respective interests owned by each of the principals, or
- the age and/or health of each of the principals.

However, it's important to be aware that if a principal is paying a higher premium due to age or health, having a Buy Sell Agreement funded by insurance is strongly in their interest as they are more likely to experience a succession event under the agreement than their fellow principals.

A valid counter-argument (where the principals have similar equity proportions) is that the principal paying the lower premium is more likely to benefit than the principal who is a higher insurance risk.



[4] Many Buy Sell Agreements will require the remaining principals to pay some notional consideration. Additionally, if the insurance proceeds are below the agreed value, the remaining principals may have to pay the balance, usually under vendor finance terms set out in an Agreement (see **page 46**). These amounts would typically be paid to the vendor of the business interest, for example, the discretionary trust.

To overcome any disagreement that may impede the completion of the Buy Sell Agreement, the premiums can be:

- paid by the business, so the costs are effectively pooled (noting the business will be liable for FBT – see below), or
- equalised by upwardly adjusting the remuneration of principals paying a higher premium and downwardly adjusting the remuneration of the principals paying a lower premium, or
- upwardly adjusting all principals' remuneration packages to reflect the cost of their respective premiums.

Notwithstanding the above options, another way of funding the premiums is for each payment to be treated as part repayment of any loan account owed to a partner, shareholder or trust beneficiary (see **page 56**).

Like cross-ownership, if the premiums are paid personally by the principals, a tax deduction cannot be claimed.

Alternatively, if the company or trustee pays the premiums on behalf of principals who are employees for fringe benefits tax (FBT) purposes (see **page 62**):

- the company or trustee will have to pay FBT of 47% on 188.68% of the premiums, and
- both the premium and FBT liability will be deductible to the company or trustee.

As a result, if the principals pay tax at a marginal rate of 47%, the effective premium costs will be the same where they are paid by the company or the trustee.

However, if the principals pay tax at a marginal rate of 39% (or lower) it can be more cost-effective if they pay the premiums themselves, which could be arranged as an after-tax adjustment to the principals' salary or adjustment to their loan account.

Finally, self-ownership may create certain issues where the business interest being disposed of is held in another entity such as a discretionary trust. This is because, in the event of a claim, the insurance proceeds will flow directly to the departing principals or their beneficiaries rather than the discretionary trust.

This can be disadvantageous for discretionary trusts that have:

- incurred a CGT liability when disposing of the business interest
- loan accounts to certain beneficiaries who don't control the trust (such as adult children and other relatives)
- loan accounts to corporate beneficiaries which, if not repaid in accordance with Division 7A of ITAA 1936, could be taxed as an unfranked dividend (as outlined in TR 2010/3), or
- beneficiaries other than those who are nominated to receive the insurance proceeds.

In these circumstances, legal or tax advice should be sought either at the time of preparing the Buy Sell Agreement or in the event of a claim.

For example, where a claim has occurred in relation to a self-owned policy under this scenario, the appropriate advice may be for the claim recipient to place some or all of the insurance proceeds in the discretionary trust (which typically the recipient will now effectively control) so that the trustee can repay any loans owing to beneficiaries and any CGT payable on the disposal of the business interest.

Policy ownership options for multi-principal businesses (continued)

Trustee of discretionary trust ownership

An alternative approach to self-ownership, that may be preferable where a principal holds their interest in the business via their discretionary (or family) trust, is for the trustee of the trust to own the policy on the life of the principal.

All the points relating to self-ownership outlined on pages 38 to 39 apply, except that the proceeds will be paid into the discretionary trust (rather than to the departing principal, their legal personal representative or beneficiaries) and the disadvantageous points mentioned can be alleviated.

Furthermore:

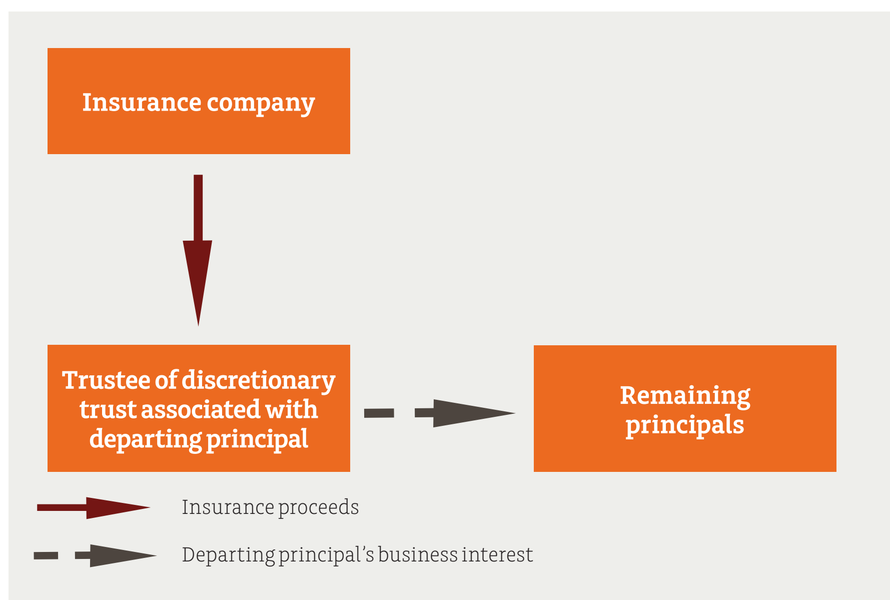
- the proceeds can continue to be held in trust for the beneficiaries, which may provide greater flexibility for the timing and direction of future distributions
- this approach may provide greater protection than if the proceeds were personally received by the principal where greater exposure to creditors or legal action may be faced
- on death, proceeds will not form part of the deceased principal's estate, which could be favourable where family provision or maintenance challenges are likely
- the proceeds will be available to pay any CGT liability incurred by the trustee on disposing of its business interests (such as shares or units in the business) as a result of the Buy Sell Agreement, and
- the proceeds will be available to repay any unpaid present entitlements (including proprietor loan accounts, see **page 56**) owed by the trustee to a beneficiary.

As with self-ownership, the proceeds will usually be exempt from CGT, both in the hands of the trustee and when on-distributed to a beneficiary, given the exemption available on life and terminal illness proceeds (see **page 52**) and the exemption available on TPD and Critical Illness proceeds (see **page 53**).

In relation to the latter exemption, personal beneficiaries of a family trust are invariably related to each other as well as the insured beneficiary, as a trustee of a family trust will generally make a Family Trust Election (FTE) to access certain tax concessions. An FTE means that all beneficiaries, as members of a family group, are related to a 'test individual' (such as the insured principal in this context).

However, one difference to self-ownership, may be in relation to corporate beneficiaries who are part of the family group for FTE purposes. Companies are not relatives of the insured, as required for the CGT exemption to be available on TPD or Critical Illness proceeds received by distribution.

Where it may be desirable to distribute the proceeds to a corporate beneficiary, consideration should be given to grossing up the sum insured, to make a provision for any CGT on the TPD and/or Critical Illness proceeds that may arise (see **page 54**).



Super fund trustee ownership

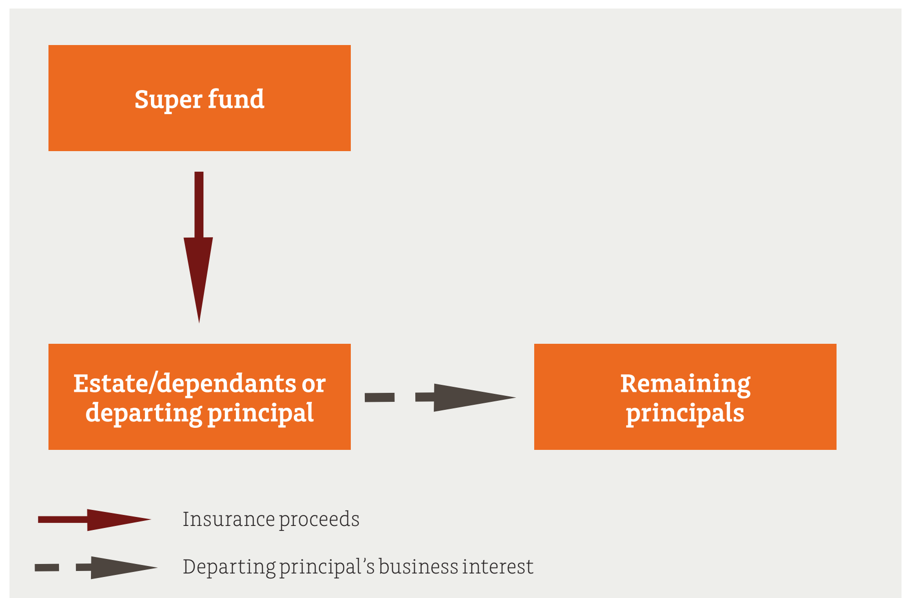
A fourth option is for the principals to take out TPD[5] and/or Life insurance in a super fund, where the policy is owned by the super fund trustee.

In the event of death or TPD, the common approach is that:

- the insurance proceeds are paid from the super fund to the estate, directly to a dependant for superannuation purposes or to the disabled principal
- the recipient accepts the insurance proceeds as full (or part) consideration for the interest in the business[6], and
- the departing principal's interest in the business is transferred to the remaining principals.

This option is similar in many respects to self-ownership (see **page 38**), given that:

- CGT will not be payable on Life insurance proceeds
- CGT won't be payable on TPD proceeds (see **page 53**), and
- there's no need to renew any existing policies.



[5] From 1 July 2014, only TPD policies with an 'Any occupation' definition may be taken out in super. 'Own occupation' policies taken out in super prior to this may remain in place.

[6] Many Buy Sell Agreements will require the remaining principals to pay some notional consideration to the departing principal. Additionally, if the insurance proceeds are below the agreed value, the remaining principals may have to be pay the balance, usually under vendor finance terms set out in an Agreement.

Policy ownership options for multi-principal businesses (continued)

A key difference is that if the insured principal is an employee of the business and they arrange to make salary sacrifice contributions into their super fund, the premiums can be funded with pre-tax dollars[7] and no FBT will be payable by the company or trustee of the unit trust.

Alternatively, both employee principals and self-employed principals may be able to claim their personal super contributions as a tax deduction.

As a result, it will generally cost less on an after-tax basis to insure in super than the other ownership options. This will usually also be the case if the sum insured is grossed-up to make a provision for any lump sum tax that's payable when a TPD benefit is received by a departing principal under age 60 or a death benefit is paid to a non-dependant for tax purposes.

However, you should keep in mind that if the principal has taken out sufficient personal insurances to meet certain needs (such as eliminating the mortgage on the family home) there's no need to withdraw the proceeds from a super-owned ownership protection policy as a lump sum in all scenarios.

For example, it may be possible for:

- a spouse (or other eligible beneficiary) to receive the death benefit as a pension
- a departing principal to use the TPD benefit to commence a pension, or
- a departing principal to keep the TPD benefit in the accumulation phase of super.

With each of these scenarios:

- the investment earnings and/or income payments will be concessionally taxed when compared to investing the proceeds from a cross-owned or self-owned policy outside the superannuation system, and
- the recipient could qualify for (or increase their entitlement to) social security benefits.

Since 1 July 2017, in relation to death benefit pensions and TPD pensions, the Transfer Balance Cap (TBC) must be considered. The TBC limits the amounts a person can transfer into a retirement phase income stream to $1.6 million (periodically indexed).

When insuring in super, you need to remember that salary sacrifice, personal deductible (and certain other) super contributions will count towards the insured principal's concessional contribution cap and penalties could arise if the cap is exceeded (see **page 60**).

Another matter to consider is that super ownership may create certain issues where the business interest being disposed of is held in another entity such as a discretionary trust.

This is because, in the event of a claim, the insurance proceeds will flow directly to the departing principal's super fund (and from there will either remain in the fund or be paid to them, their beneficiaries or their estate) rather than the discretionary trust.

[7] This is because the super fund can claim the insurance premiums as a tax deduction. As a result, 15% contributions tax is generally not payable on salary sacrifice (and other concessional) super contributions when made to fund the insurance premiums.

As with self-ownership, this can be disadvantageous for discretionary trusts for the same reasons as outlined on **page 39**.

In these circumstances, legal or tax advice should be sought either at the time of preparing the Buy Sell Agreement or in the event of a claim.

For example, where a claim has occurred in relation to a super-owned policy under this scenario, the appropriate advice may be for the claim recipient to place some or all of the insurance proceeds in the discretionary trust (which typically the recipient will now effectively control) so that the trustee can repay any loans owing to beneficiaries and any CGT payable on disposal of the business interest.

In respect of companies, the disposal of a business interest for no consideration may be deemed (and taxed as) an unfranked dividend in accordance with Division 7A of ITAA 1936.

Finally, trustees of self-managed super funds should be aware of ATO ID 2015/10. In relation to the fund in this ID, the ATO considers the trustee has breached the sole purpose test and provided financial assistance to a relative and thus breached the SIS legislation.

However, the ATO later cautioned that "deciding if the trustee has complied with the sole purpose test requires an examination of all the facts and circumstances associated with the maintenance of the SMSF. Generally, the presence of a Buy-Sell Agreement on its own will not result in a breach of the sole purpose test".[8]

Given that trustees of APRA funds are at arm's length from their members, these issues are unlikely to apply to these funds.

8 See **'Life insurance and buy-sell agreements'** at ato.gov.au

How do you determine the sum insured?

When determining the sum insured, you need to obtain a business valuation and determine each principal's interest in the business.

Overview of commonly used valuation methods

Three approaches commonly used to determine the business value are the formula, independent valuation and agreed dollar value methods.

With each of these approaches, the calculations are generally provided (or approved) by the principals' accountant or other suitably qualified professional and the agreed valuation method (or value) should be included in the Buy Sell Agreement.

In all cases, the principals should consider grossing up the sum insured to make a provision for any:

- CGT payable on Life, TPD or Critical Illness proceeds (see **page 54**), and
- lump sum tax payable on death or TPD benefits if the policy is held in super.

The valuation should also be reviewed at least annually and the sum insured adjusted accordingly.

Formula method

With this method, the business is valued by applying a multiple to, for example, earnings before interest and tax, revenue or net profit that reflects an industry standard or is tailored to suit the business' needs. While the valuation can be updated simply by inserting the latest earnings or other figure into the formula, it may be necessary to amend the formula as the business moves through different life cycle stages, or due to changes in industry conditions and profitability.

Independent valuation method

With this approach, the business is valued by an independent valuer. In some cases, it may be prudent (or necessary) to obtain two independent valuations and take an average. This method is only viable if the valuations are conducted when the agreement is put in place. If the valuations are only done at succession time, the sum insured may be incorrect.

Agreed dollar value method

With this approach, the principals agree on a dollar value, which may be fixed or indexed. For larger sums insured, the agreed amount should be verified by a professional valuer.

The main issue with this method is that the valuation is generally only done at inception (and on periodic review), and if the value at succession time differs from the most recently agreed value, the latter value (which could be the originally agreed value) prevails.

By contrast, with the formula method, a valuation is generally also obtained at succession time.

Dealing with funding shortfalls

Whatever method is used, the sum insured can differ from the business value at succession time.

One way to minimise this risk is to ensure the valuation (and resulting sum insured) is updated frequently. It's also common to include a 'shortfall provision' when establishing the Buy Sell Agreement.

Such a provision will usually outline how any funding gap will be addressed. This is often done by raising vendor finance (see **page 46**), in which case the Buy Sell Agreement will usually specify the agreed term, interest rate and payment frequency.

A shortfall provision can help ensure the departing principal receives full value for their business interest. The downside is they may be forced to receive the amount above the insured benefit over an extended period, during which they are exposed to the ongoing fortunes of the business.

Conversely, the remaining principals may effectively end up with a debt that needs to be funded from business cashflow. However, if the vendor finance arrangement is agreed (and documented) in advance, the remaining principals have peace of mind the business will not be encumbered with a debt it cannot service. Also, the remaining principals will have a greater stake in the business, which may assist in funding the shortfall.

Should the sum insured be grossed-up for CGT on sale proceeds?

There's a common misconception that the sum insured should be grossed-up to allow for the estimated CGT that may be payable on the sale of the business interest (as distinct from the CGT that may be payable on the life insurance proceeds).

Some of the reasons why this practice should generally not be adopted include:

- The sum insured (net of any CGT or lump sum tax that may apply on insurance proceeds) should reflect the acquisition/sale price of the business, otherwise the vendor will receive a greater amount than if they sold their interest. For example, if a third party was acquiring the business interest, the acquirer wouldn't gross-up the purchase price to cover the vendor's CGT.
- Some principals (or their associated ownership entities) may have different CGT liabilities to others when disposing their respective business interests. This could be because some principals are eligible for CGT concessions while others aren't, or because some principals own their interest directly and others indirectly (eg via a company, which would not be eligible for the 50% discount that may otherwise be available if the business interest was owned for over 12 months or the 50% 'active asset' discount that may otherwise be available under the small business CGT concessions).
- If the insurance proceeds were grossed-up for the CGT incurred by the vendor on sale of the business interest, the vendor is effectively receiving more (or deemed to receive more) for the business interest. This could lead to the vendor incurring a greater CGT bill and, therefore, if the logic is followed, warranting a further gross-up of the insurance. In theory, the gross-up process could therefore require endless iterations.

The vendor may be eligible for the small business CGT concessions (see **page 61**) when the CGT estimate is made (and sum insured recommended), but at a later stage become ineligible for the concessions. Alternatively, the vendor may be eligible for certain concessions and upon attaining a particular age (eg 55) be eligible for different concessions.

If the proceeds net of CGT from the sale of a business interest are insufficient for a departing principal's personal purposes, they should consider arranging additional personal insurance.

Uninsurable and under-insured principals

It's not always possible to insure principals (or offer them standard terms) due to age or health issues.

Where this is the case, other options that should be considered during the succession planning process include:

- fixed term insurance
- exclusions for certain risks, or
- using any existing insurance that a principal may have.

Additionally, there may be times when the principals are under-insured due to an increase in the value of the business since the last review was conducted.

Under-insurance may be compounded where one or more of the participants in the business succession planning process hasn't been diligent.

For all these reasons, it's common to include 'shortfall' provisions in Buy Sell Agreements that outline alternative funding methods to insurance.

Vendor finance

The most common alternative is often referred to as vendor finance. Such an arrangement stipulates an agreed period over which the remaining principals in a business must repay the departing principal or their estate or associated entity.

The relevant clause in the agreement will usually include details regarding the periodic repayments and may specify an interest rate. This is because the business interest is generally transferred at the time of succession.

As a result, the departing principal or their beneficiaries are effectively out of pocket for the proceeds they would normally have received in a timelier manner, had the transfer been entirely insurance funded.

A vendor finance clause gives the remaining principals sufficient breathing space to obtain finance or fund the transfer using alternative methods such as selling personal or business assets.

Importantly, the clause gives the remaining principals control over the entire business at the time the succession is triggered by the Buy Sell Agreement. Access to a greater proportion of the profits of the business may also assist in financing the vendor finance payments.

It's important the implementation of a Buy Sell Agreement not rely on the principals being insurable. In other words, the key objective of a Buy Sell Agreement should be to facilitate an orderly transfer of ownership, regardless of how it's funded.

CGT implications when business ownership is transferred

When an interest in the business is transferred to the remaining principals, you need to consider the CGT implications.

A capital gain or loss may arise for the departing principal if an interest in the business was acquired by the departing principal on, or after, the introduction of CGT on 20 September 1985.

It may, however, be possible to reduce or eliminate CGT by claiming:

- the general 50% concession, which is available to individuals and beneficiaries of trusts when an asset has been held for 12 months or more, and/or
- the small business CGT concessions, which may be available when disposing of business interests and business assets (see **page 61**).

After ownership is transferred, the remaining principals will have more than one cost base for CGT purposes.

For example, where there are two people who own 50% of a business, the remaining principal will retain the original CGT cost base for their original 50% of the business and the market value cost base for the 50% transferred from the departing principal.

Market value substitution rule

When an interest in a business is transferred from one party to another (including as the result of a Buy Sell Agreement) at less than or greater than market value, tax law will deem that the disposal and acquisition occurred at the market value. This is known as the market value substitution rule and is contained in s116-30 (disposal) and s112-20 (acquisition) of ITAA 1997.

Critical Illness and Buy Sell Agreements

A number of issues need to be considered before including critical illness as a trigger event.

In the event of death or TPD, the transfer of the relevant business interest is a relatively simple matter if there's a well-drafted Buy Sell Agreement.

However, the transfer is potentially less straightforward if critical illness is included as a trigger event.

This is due to the number of potential scenarios that could occur when a principal suffers a critical illness. For example, the affected principal may:

- have to (or want to) cease working in the business, which is straightforward as the policy proceeds can be used to fund the ownership transfer
- return to work and perform their duties satisfactorily until another succession event occurs, such as a third party sale or retirement
- return to work and suffer another critical illness, or
- return to work and be unable to perform their duties satisfactorily.

One way to cater for these uncertainties is to use put and call options in the Buy Sell Agreement. In the event of a critical illness, the affected principal can exercise the put option so that the remaining principals buy their interest in the business.

By contrast, if the call option has a waiting period that prevents the remaining principals from exercising this option until a particular time period has elapsed (eg six months after the critical illness has occurred) the affected principal will have some time to recover and consider whether they can or will return to work in the business or not.

Importantly, no party actually has to exercise an option should, for example, the remaining principals decide to give the affected principal a longer period of time to recover or decide whether they want to return to the business prior to the expiration of the call option waiting period.

If the affected principal does return to the business and can perform their duties satisfactorily within the agreed timeframe, the ownership transfer won't go ahead and the critical illness proceeds could be:

- treated as deemed consideration for a future succession trigger event, such as retirement or another illness
- lent back to the business in order to, for example, lower the business overdraft so that assets used to secure the loans can be released by the lender, or
- placed in trust for the affected principal until such time as the affected principal's equity is transferred or disposed.

Given this, the most appropriate solution to cover all potential scenarios may be to include provisions in the Buy Sell Agreement for a trust to be established where all the principals would act as a trustee. Where this is done, the principals would agree on:

- what would be an appropriate waiting period before the call option could be exercised by the remaining principals, and
- what constitutes a satisfactory performance of duties should an affected principal return to the business.

If the business (or principal's equity) is ultimately sold, the proceeds can be released from the trust and treated as a windfall for the affected principal or divided amongst the remaining principals.

Succession planning for discretionary trusts

If a business is run by a discretionary trust, a Buy Sell Agreement isn't appropriate because no beneficiary has an entitlement to buy and sell.

Day-to-day control of a discretionary trust rests in the hands of the trustee. However, ultimate control of the trust is in the hands of the persons (or directors of a company) named in the trust deed that have the power to appoint or remove the trustee.

Succession can be catered for by ensuring the trust deed names the successor appointer/trustee.

An important point to remember in relation to discretionary trusts is to identify unpaid present entitlements. A departing principal or their beneficiaries (via a deceased principal's executor) can generally call for these entitlements to be repaid (refer to case study on **page 56**).

5

Other Essential Facts

In this section, we explain some other important concepts you may need to be aware of when recommending protection solutions for your business clients.

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CGT and insurance policies

Here we outline the CGT rules when a payment is made from an insurance policy in the event of death, terminal illness, TPD and critical illness.

This information is based on our understanding of current legislation and ATO practice as at 1 July 2020.

Life and Terminal Illness insurance

Under s118-300(1) of ITAA 1997, proceeds received from a Life insurance policy in the event of death are exempt from CGT if received by:

- the original policy owner, or
- a person who isn't the original policy owner, so long as the recipient didn't pay money or provide any other consideration (see below) when acquiring the interest in the policy.

With regard to terminal illness, TD 2007/4 confirms that 'essentially, a Terminal Illness benefit is a pre-payment of a death benefit and in determining whether it's covered by (the relevant) items in s118-300(1) it's irrelevant that it's paid before death rather than after death'.

s118-300(1) Item 5 of ITAA 1997 also provides the trustee of a complying super fund with an explicit exemption from CGT when insurance proceeds are received by the fund in the event of the death or terminal illness of a member.

In the context of business insurance, this collectively means that CGT will usually not be payable (and in the case of superannuation trustee ownership, it will definitely not be payable) on the proceeds received from a Life or Terminal Illness insurance policy.

The main exception is where:

- a Life insurance policy is cross-owned for ownership protection purposes
- the existing policies are assigned to include a new principal (who wouldn't be an original policy owner), and
- the new principal acquires their interest in these policies for consideration.

In this context, the ATO has expressed a wide view of the meaning of the word 'consideration'. They have expressed in TD 94/34 that while consideration can be monetary, or otherwise, it doesn't include premiums paid on the policy.

However, in TR95/3, the ATO states that it considers 'mutual promises' (such as those business principals undertake in Buy Sell and Business Owner Agreements) to be consideration. This is particularly true if the agreement includes many promises and commitments beyond insurance-funded succession events.

Furthermore, where a principal leaves a business where cross-insurance is used and the remaining principals agree to assign the policy to the departing principal, the latter won't be the original owner of that policy.

Consideration in this context may be an agreement to a restraint, such as contacting clients of the business or not establishing a competing business within a certain geographical radius.

While this adverse CGT outcome could be avoided if the cross-owned policies are renewed each time a principal joins or leaves the business, administration problems can arise if there are several principals and ownership changes frequently.

Also, some insurance providers may not reissue a policy without additional health evidence, particularly where the original policy is an old one.

TPD and Critical Illness insurance

s118-37(1) of ITAA 1997 states that the proceeds received from a TPD or Critical Illness policy are exempt from CGT if paid to the life insured or a defined relative of the life insured.

This exemption extends to trusts where all of the beneficiaries are related (as is typically the case with discretionary trusts).

A relative of a person as defined by s995-1 of ITAA 97 is:

a. the person's spouse, or

b. the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of that person, or of that person's spouse, or

c. the spouse of a person referred to in paragraph b.

S118-300(1) Item 7 of ITAA 1997 also provides the trustee of a complying super fund with an explicit exemption from CGT when insurance proceeds are received by the fund in the event of TPD or critical illness of a member.

Implications for asset (debt) and ownership protection

When the insurance is used for asset (debt) and ownership protection, this exemption means CGT won't be payable on TPD or Critical Illness proceeds if the policy is self-owned, owned by a defined relative or a trustee of a trust where the policy is held for the insured or relatives of the insured.

However, if a company owns an asset (debt) protection policy on the life of a director or shareholder, any proceeds will be subject to CGT, as the company isn't a relative of the director or shareholder.

Implications for revenue protection

The s118-37(1)(b) exemption generally won't apply when TPD or Critical Illness insurance is used for revenue protection purposes. However, because the proceeds are assessable to the partnership, company or trustee of a trust, it's unlikely that CGT will be payable in these circumstances.

This is because the anti-overlap provisions in s118-20 of ITAA 1997 state that the capital gain will be reduced to the extent that an amount is also included as assessable income under another provision of the ITAA 1997.

50% CGT discount

When CGT is likely to be payable on the proceeds from the insurance policy, the ATO's view (as stated in the NTLG Losses and CGT Subcommittee minutes on 7 June 2006) is that the 50% CGT discount is unlikely to be available.

This is because, for CGT purposes, the acquisition and disposal dates are unlikely to be more than 12 months apart, as the ATO considers that:

- The CGT asset is acquired when the triggering event occurs that gives the policy owner a right to the policy proceeds. This may occur, for example, on the date the illness or injury occurs, or the date the claim is accepted by the insurance company.
- In accordance with CGT event C2, which deals with intangible assets such as rights and obligations, the policy (and therefore the CGT asset) is considered to be disposed of when the right to the policy proceeds ceases. This usually occurs when the claim is paid.

The ATO's view is not beyond dispute.

Cost base

Where CGT is payable, the ATO's view (as stated in the NTLG Losses and CGT Sub-committee minutes on 7 June 2006) expressed in relation to Critical Illness policies is that the premiums paid don't form part of the cost base.

This ATO opinion is also not beyond dispute and would be clearly incorrect if applied to whole of life or endowment insurance. Additionally, it appears to contradict the view expressed by the ATO in PR 2010/18 in relation to the CGT consequences for a beneficiary of an insurance trust deed where it's stated that 'the cost base or reduced cost base of the rights under the insurance policy to which the beneficiary is absolutely entitled includes the insurance premiums'.

In any event, where CGT is payable in relation to an insurance policy, it will apply to all (or most) of the proceeds received.

Grossing up the sum insured for CGT

The following approaches could be used when grossing up the sum insured in scenarios where CGT will be payable on the proceeds from a business insurance policy.

This information is based on our understanding of current legislation and ATO practice as at 1 July 2020.

Where CGT is payable by a company

The sum insured should be grossed up by 143% to take into account CGT being payable by the policy owner at the flat rate of 30%.

Gross-up factor
= (1 / [1 – 30%])
= 143%

Alternatively, the sum insured should be grossed up by 135% where the company tax rate is 26% (see **page 8**).

Gross-up factor
= (1/ [1 – 26%])
= 135%

For these companies, this gross-up factor will drop to 133% from 1 July 2021 as a result of the tax rate dropping to 25%.

Where CGT is payable by an individual, a trustee or a beneficiary of a trust

The sum insured should be grossed up by 189% to take into account the possibility that CGT will be payable at the highest marginal tax rate of 47%.

While CGT may actually be payable by the recipient at a lower rate, it's prudent to assume the highest marginal rate will apply. This is because it can be difficult to predict what the individual's taxable income will be at the time, if an insured event occurs.

Also, because the insurance payment is likely to be large, it could easily bump the individual's taxable income above the threshold at which the highest marginal rate applies.

Gross-up factor
= (1 / [1 – 47%])
= 189%

Note: If the TPD or Critical Illness cover was an extension of the Life cover and the insured person was to die instead, because CGT is generally not payable in this situation, the policy owner would receive additional funds that it could put to another use. If allowed by the Life insurance provider, the policy owner could choose a TPD or Critical Illness extension with a sum insured that's greater than the amount of death cover. Alternatively, the additional TPD or Critical Illness cover could be arranged as a stand-alone policy. Where both TPD and Critical Illness extensions are required, the TPD cover could be arranged as a definition of the Critical Illness extension.

Company ownership of ownership protection policies

Some companies own TPD, Critical Illness and/or Life insurance policies on the lives of the principals for ownership protection purposes.

If an insured event occurs, the company can use the proceeds to acquire and cancel a departing principal's shares via an off-market share buy-back.

This option can be relatively attractive from a premium payment perspective. While premiums are not deductible, they are effectively funded from monies that have only been taxed at 26% or 30% (see **page 8**). Furthermore, FBT is not payable.

However, it's important to consider the implications on claim under both the tax laws and the Corporations Act 2001 in relation to off-market share buy backs.

From a taxation perspective, CGT will not be payable on Life insurance proceeds. CGT will, however, be payable on TPD and Critical Illness proceeds, as a company isn't a defined relative of the life insured (see **page 53**).

The company will therefore need to gross-up the amount of TPD and Critical Illness cover (see **page 54**). However, even after grossing up the cover for CGT, further amounts will be lost in tax.

This is because the distribution of the policy proceeds from the company to the departing principal (or the beneficiaries of their estate) will be generally treated as a dividend or deemed dividend (rather than capital) to the extent the amount exceeds the amount debited against the company's share capital account.

As mentioned on **page 57**, many companies are funded by debt rather than share subscription, so there is only a notional amount in the company's share capital account.

Because the departing principal's shares have been acquired by the buy-back (which will include the deemed payment of a dividend), the amount of capital gain the principal otherwise would have included in their assessable income is reduced by the dividend received due to the anti-overlap provisions in s118-20 of ITAA 1997.

Given the departing principal hasn't made a capital gain on disposal of the shares, they aren't entitled to the 50% discount (that would otherwise apply if they or their trust has held the shares for over 12 months) or the small business CGT concessions (see **page 61**).

The ATO has also indicated (in TR 2010/4) that 'the dividend doesn't form part of the cost base of the shares in the hands of the purchaser even though it's included as capital proceeds of the vendor'. This may mean a greater CGT liability when the remaining principals eventually dispose of their shareholding.

Finally, the directors must adhere to the procedure for share buy-backs as set out in the Corporations Act 2001. This law also stipulates that the buy- back must not materially prejudice the company's ability to pay its creditors.

In summary, given the tax and Corporations Law issues raised above, company ownership of insurance policies used for ownership protection purposes is usually not a recommended option.

Proprietor loan accounts

Proprietor loan accounts (PLAs) arise when a business entity owes money to the principals and are common in both trusts and companies, but typically for different reasons.

Proprietor loan accounts and trusts

Before explaining the role that PLAs can play in a trust, it's important to understand that various sources of income that are derived by a trust (including profits and capital gains) are either:

- taxed in the hands of the trustee if no beneficiary has an entitlement to the income, or
- distributed to (or applied for the benefit of) and taxed in the hands of the beneficiaries.

When the income is taxed in the hands of the trustee, the highest marginal tax rate of 47% will generally apply. This punitive taxation treatment provides a strong incentive for the trustee to distribute income to the beneficiaries on an annual or more frequent basis.

This is particularly the case with discretionary trusts, as the entitlements can be determined differently from year to year, depending on the beneficiaries' circumstances. However, there's also often a strong desire for the principals to retain the income to fund operations or expand the business.

As a result, a common practice is for the trustee to retain the cash in the trust and make the distributions to the beneficiaries 'on paper'.

Where this is done, the distributions are still taxed in the hands of the beneficiaries. In some cases, the trustee will also distribute an amount in cash to help the beneficiaries meet their tax liability.

But because the beneficiaries have not received the cash they are entitled to, they become creditors of the trust and a PLA is created on the trust's balance sheet.

These loans (which are often referred to as 'unpaid present entitlements') can accrue over the years to be a significant amount.

As a result, they can create significant estate planning and business succession issues when a principal departs the business, as the following case study highlights.

Note: PLAs to corporate beneficiaries which, if not repaid in accordance with Division 7A of the ITAA 1936, could be taxed as an unfranked dividend (as outlined in TR 2010/3).

Case study

Andrew is the principal of a business worth $3 million that he carries on with his two sons, Paul and Richard, using a discretionary trust.

While all three are trustees, Andrew is the sole appointer.

Andrew has recently remarried (to Sonia) several years after his first wife (Samantha) passed away and wishes to get his estate planning affairs in order.

Andrew has a strong desire for his sons to inherit the business and understands that the assets of the business won't form part of his estate on his death.

Accordingly, he gets legal advice to ensure the trust deed will enable Paul and Richard to become the appointers of the trust on his death and, therefore, control the business from that point on.

Andrew decides to look after Sonia in his Will by arranging for his solicitor to make her executor and sole beneficiary. As a result, Sonia will receive his personal assets (which include his home and are worth $2 million) in the event of his death.

Five years later, Andrew dies and, during probate, the accountant who is looking after the tax administration of the estate discovers the trust had owed Andrew $1.5 million in accrued unpaid present entitlements at death[1].

This amount owing is an asset of Andrew's estate. Furthermore, the loan has no documented terms and is effectively at call.

Because Sonia is the sole beneficiary of Andrew's estate, she demands that the loan be paid to her, and Paul and Richard have to sell the business to meet the repayment.

This outcome could, however, have been avoided if insurance was used to provide sufficient funds to pay out the loan account (see **page 18**).

Alternatively, the loan could have been forgiven in Samantha's Will. As mentioned on page 67, the commercial debt forgiveness provisions will not apply where a loan is forgiven in the creditor's Will.

Proprietor loan accounts and companies

Companies can also retain income (including profits and capital gains) or distribute them to shareholders as a dividend. But, unlike trusts, regardless of which of these options the company selects, from the company's perspective the income will be taxed at the same rate, which is a flat 26%[2], or 30% where annual aggregated turnover is $50 million or more in 2020/21.

As a result:

- there's no tax disincentive to retaining earnings in the company (assuming the principal isn't on a lower marginal tax rate than the company tax rate), and
- if the company wants to use some of the income to fund operations or expand the business, there's no need to make on paper dividend payments to shareholders (which would create a shareholder loan account).

Where shareholder (or director) loan accounts primarily tend to arise is when the principals lend 'start-up capital' or expansion capital to the company using their own funds.

While the principals could instead use their start-up capital to subscribe for shares in the company, this option tends to be less common in small to medium sized businesses than loaning the capital.

This is because if the share subscription method is used, any payments made back to the directors would usually be in the form of a taxable dividend, whereas the repayment of a loan to the principals would generally be tax-free.

Additionally, if they are a creditor of the business, they stand more of a chance to get some of their investment returned in an involuntary liquidation scenario than if they subscribed for shares.

1 The reason the loan account was extremely large was that:

- for many years, Andrew distributed most of the business profits to his first wife (Samantha) as she didn't work and was on a low marginal tax rate, and
- when Samantha passed away, because he was the sole beneficiary of her estate, he inherited the loan account.

2 For companies with less than $50m annual aggregated turnover the tax rate is 25% in 2021/22.

Documented loan agreements and asset (debt) protection

The directors of a company or trustees of a discretionary trust or unit trust will often have provided a guarantee or security for a loan sourced from a lending institution.

Where this is the case, if the insurance policy used to protect these debts is self-owned, the proceeds will be received by the life insured (in the event of TPD and critical illness) or the beneficiaries of the insured's estate (in the event of death).

If the recipient of the insurance proceeds lends the money to the business so the debt can be repaid, the recipient will replace the lending institution as creditor.

If the recipient subsequently forgives the loan they make to the business, the commercial debt forgiveness (CDF) laws could apply. These laws, which are outlined on **page 59**, subject the business to some adverse tax implications but don't necessarily apply in the event of death if the loan is forgiven by the deceased principal's Will.

The same outcomes can also occur if the recipient uses the money to repay the lending institution directly. This is because the recipient has the right to be repaid the money or effectively stands in the shoes of the original creditor (the lending institution).

In TD 2004/17 (concerning the scenario where a guarantor repays a debtor's debt), the ATO ruled that unless 'the guarantor is subrogated to the rights formerly held by the creditor in relation to the debt so that the debt is now enforceable by the guarantor' the commercial debt forgiveness laws may apply to the business.

One way to ensure the recipient doesn't become the creditor and the CDF laws don't apply is for the directors/trustee to establish a legally binding documented loan agreement prior to the occurrence of an insured event.

Such an agreement could specify that:

- each of the directors/trust beneficiaries will self-own their insurance policies
- if an insured event occurs, the recipient of the insurance proceeds will be obliged to pay the money to the remaining directors/ trust beneficiaries on the condition the remaining directors/beneficiaries arrange with the lending institution for the departing director's/ beneficiary's personal guarantee to be released, and
- the remaining directors/beneficiaries will reduce or repay the debt with the lending institution and take over as the creditors of the business.

Commercial debt forgiveness laws

The commercial debt forgiveness (CDF) laws may adversely impact businesses run through an entity when a debt is forgiven by a creditor, such as a director or trust beneficiary.

Why were the laws introduced?

The CDF laws, which are contained in Division 245 of ITAA 1997, were introduced in 1996 to remove an anomaly in our tax system whereby:

- the forgiven amount could be treated as a capital loss or allowable tax deduction for the creditor, and
- the debtor (ie the entity) was able to continue, for example, to claim tax deductions relating to the assets or stock purchased with the loan proceeds.

In other words, prior to the introduction of the CDF laws, the tax implications for creditors had no corresponding tax implications for debtors.

When is a debt considered to be forgiven?

A debt is considered to be forgiven if 'the debtor's obligation to pay the debt is released or waived or otherwise extinguished'[3].

When could the laws apply to asset (debt) protection?

The CDF laws could apply where a company director or trust beneficiary has provided a guarantee or security for a loan sourced from a lending institution if:

- they receive proceeds from a self-owned or super owned insurance policy
- they lend the money to the entity so it can repay the debt, or they repay the money directly to the lending institution, and
- they subsequently forgive the amount they are owed by the entity.

The CDF laws could also apply if a company director or trust beneficiary forgives a proprietor loan account (eg as a result of receiving proceeds from a self-owned or super owned insurance policy).

What impact do the laws have?

Assuming the relevant provisions apply, the CDF laws subject the entity (ie the party that benefits from the forgiveness) to the following adverse tax consequences[4]:

- first, the net forgiven amount reduces the debtor's revenue losses in the income years before the forgiveness income year
- then any balance remaining of the net forgiven amount is applied to reduce the deductible net capital losses of the debtor in respect of the income years before the forgiveness income year
- then any balance remaining of the net forgiven amount is applied to reduce certain deductible expenditures of the debtor in respect of the income year in which the forgiveness occurred or of a subsequent income year, and
- then any balance remaining of the net forgiven amount is applied to reduce the cost base of the debtor's assets at the beginning of the forgiveness income year.

The aim of these laws is to claw back the net forgiven amount from the entity.

If a balance of the net forgiven amount still remains at this point, it's disregarded, except in the case of partnerships, where any remaining balance is applied to the income or loss distributed in the relevant year to the partners[5].

These potentially adverse CDF laws may apply to the debtor unless an exemption applies. The main exemptions[6] likely to apply are if the debtor becomes bankrupt or the creditor forgives the loan in their Will.

3 s245-35 of ITAA 1997.

4 s245-95 of ITAA 1997.

5 s245-215 of ITAA 1997.

6 s245-40 of ITAA 1997.

Super concessional contribution cap

When making contributions to fund insurance in super, it's important to take into account the concessional contribution cap.

Failure to do this could result in unintended tax consequences.

The concessional contribution (CC) cap is a cap that applies to certain super contributions that include, but aren't limited to:

- all contributions from an employer (including salary sacrifice), and
- personal contributions claimed as a tax deduction.

In 2020/21, the CC cap is $25,000.

If the cap is exceeded, excess contributions will be effectively taxed at the contributor's personal marginal rate of tax, plus an interest charge on tax due. The contributor will then have the choice of retaining the excess CCs in super or having up to 85% of the excess CCs released from super.

Note: Because Life and TPD insurance premiums are deductible to the super fund trustee, 15% contributions tax is generally not payable on concessional contributions that are made to fund the insurance premiums in a super fund.

Small business CGT concessions

Small business principals may have a number of CGT concessions available to them when selling their interests in the business.

Some can also take advantage of more than one CGT concession.

To qualify for the concessions, a number of basic conditions need to be met, as well as some conditions that are specific to each of the concessions.

Note: The rules relating to the small business CGT concessions are complex and have been outlined below in summary form only.

Basic eligibility conditions

To meet the basic eligibility conditions:

- The business must have a turnover of $2 million or less, or the net value of the principal's existing CGT assets (subject to certain exclusions) must not exceed $6 million [the Net Asset Value (NAV) test].

  If the principals have connected or affiliated entities, then the annual turnover or net value of the CGT assets of those entities must be aggregated.

  In practice, the NAV test will tend to be the predominant test, except in the case of businesses such as farms where the asset value may be high and turnover low.

  When determining whether the net value of the entire entity (or associated entities) or just a principal's share is counted, a 40% threshold is generally applied. If a departing principal and/or their affiliates have the right to receive 40% or more of the distribution of either income or capital (or net income for partnerships), the net value of the connected entity will count towards the test.

  Assets for personal use and enjoyment (including superannuation) are excluded.

- The assets disposed of must be active assets. These are tangible and intangible assets used, or held ready for use, in the course of carrying on a business (eg land, buildings and goodwill).

  Shares in Australian resident companies and interests in Australian resident trusts are active assets where at least 80% of the assets owned by these entities are active assets.

- If the asset is a share in a widely held company or an interest in a trust, there must be a 'significant individual' who is entitled to at least 20% of (as relevant) voting rights, distributed income and capital from the entity.

The concessions can also be accessed by the legal personal representative or beneficiary of a deceased small business principal, provided the deceased would have been able to access them just before they died. A time limit of two years from the principal's date of death generally applies.

In addition to the small business concessions, the 50% CGT discount is available to individuals and beneficiaries of trusts (excluding corporate beneficiaries) on all assets held for more than 12 months.

This exemption is generally utilised before any other concession is claimed except for the 15 year exemption.

Concessions and specific eligibility conditions

The concessions that may be available (and the specific eligibility conditions that apply to these concessions) include the:

- **15 year CGT exemption** – This is a 100% CGT exemption available to small business principals on the disposal of active assets held for 15 years or more. The assets must have been disposed of for the purpose of retirement and the small business principal must be at least 55 years of age or permanently incapacitated.
- **50% CGT active assets exemption** – This is a 50% exemption available to small business principals on the disposal of active assets.
- **CGT retirement exemption** – This is available to small business principals up to a maximum lifetime limit of $500,000. If the small business principal is less than 55 years of age, they must invest the exempt amount in a super fund. However, if the small business principal is 55 or over, they can take the proceeds as cash, invest in super or purchase a pension.

Lifetime CGT cap

Business principals and family members (typically the spouse of a principal) that are eligible for the 15 year CGT concession or the CGT retirement concession can make non-concessional contributions (NCCs) in addition to the standard NCC cap (which is $100,000 in 2020/21).

Where the 15 year CGT concession is used, a lifetime cap of $1,565m (in 2020/21) is available. Both the exempt gain and other proceeds (such as the cost base) can be contributed.

Where the CGT retirement exemption is used, up to $500,000 (not indexed) of the exempt gain proceeds can be contributed. This amount is counted as part of the lifetime cap.

Who may be an employee for FBT purposes

Principals who operate their business through a company or trust are often employees for Fringe Benefit Tax (FBT) purposes.

This will generally be the case where the business pays them:

- salary or wages
- Superannuation Guarantee contributions, or employer concessional contributions generally, and/or
- reportable fringe benefits.

In these situations, if the business pays premiums on policies owned by the principals for asset and ownership protection purposes:

- the business will have to pay FBT of 47% on 188.68% of the premiums, and
- both the premium and FBT liability will be deductible to the business.

This grossed-up cost will either be:

- charged back to the relevant principal's salary package, or
- paid for by the business (by pooling the premium costs for principals concerned).

An example of principals who aren't employees for FBT purposes are company shareholders who are remunerated entirely by dividends. In this situation, the payment of a premium for a shareholder's policy may be a deemed dividend under s109C(3) of ITAA 1936.

Records principals should keep

Different tax implications can arise when using insurance for asset (debt) and revenue purposes.

It's important that the principals document:

- the purpose for the insurance
- the life insured
- the insurance provider, product and policy number
- the types and amounts of insurance, and
- the basis for determining the sum insured.

Appropriate records should be kept, including minutes. Yearly reviews should also be conducted, with new minutes recording that a review took place and the outcome of any review. The minutes should detail any changes made. They should also reiterate the cover and purpose, even if this hasn't changed.

These requirements are particularly important for revenue protection policies. This is because if annual minutes aren't recorded, the ATO could deem the policy to have a capital (not revenue) purpose. As a result, the ATO could claw back the tax deductions and apply a penalty.

Furthermore, in the event of a claim, if the policy is deemed to have a capital purpose, CGT will be payable on TPD or Critical Illness proceeds rather than the amount being treated as assessable income.

It's also important to note that the insurance needs (and sums insured) can change over time and, in the event of a claim, the ATO will generally consider all the surrounding circumstances, including:

- the minutes
- the use to which the proceeds are actually put, and
- advance declarations of the intended purposes contained in any other relevant correspondence (such as letters, emails and file notes).

Finally, retaining comprehensive records can provide some protection for the principals in the event of a dispute, and during the critical period between when the insurance is taken out and the relevant agreements are finalised.

If the matter ends up in the courts, this may be the only evidence available to establish the intent of the principals.

Commonly used abbreviations

ATO – Australian Taxation Office

ID – Interpretative Decision

IT – Income Tax Ruling

ITAA – Income Tax Assessment Act (1936 or 1997)

NTLG – National Tax Liaison Group

PR – Product Ruling

SIS – Superannuation (Industry) Supervision Act, 1993 and Superannuation (Industry) Supervision Regulations, 1994.

TD – Tax Determination

TR – Taxation Ruling

TPD – Total and Permanent Disability

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