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5 March 2024

Let's Get Technical: Business insurance trusts

All businesses should consider life risk insurance to fund succession and key person strategies should a principal suffer an insured event impacting the business. Generally, the fewer the principals, the greater the impact of these events and conversely, the greater the number of principals, the more likelihood of an insured event occurring.

A business generally depends on a few people to produce the profits, provide the capital or manage the business. If there is no viable succession plan following the occurrence of an insured event, there may be significant financial hardship for the continuing business principals, as well as for the departing principal and their family members.

Many business owners do not consider business succession and key person planning issues because they rely on their accountant and other advisers to alert them to vulnerabilities of the business. They are potentially at risk and need good advice about business insurance.

The core lump-sum business insurance concepts are:

- Buy/sell purpose cover (asset or equity)
- Key person capital purpose cover, including debt reduction and guarantor protection (liability)
- Key person revenue purpose cover (liability)

For a principal departing the business due to an insured event, it is important to ensure not only that they or their estate receive full value for their business interest and that any personal guarantees they have provided for business loans are extinguished, but also that this amount is sufficient to meet the needs of themselves (if totally and permanently disabled or terminally or critically ill) and those of their family members. Whilst it is vital to initially focus on the business insurance aspect, advisers should at least highlight and discuss any potential impact on a client's personal situation due to insufficient personal risk insurance cover.

Buy/sell purpose cover

Life risk insurance cover purchased in connection with buy/sell agreements (buy/sell purpose cover) facilitates the orderly transfer of equity from the departing business proprietor to the remaining proprietor(s).

The insurance funding for the transfer of the business interest from the departing business proprietor (or their estate) to the continuing proprietors should correspond to the terms of the buy/sell agreement, which ideally should be the value of the proprietor's interest plus any tax liability – such as income tax, CGT, legal fees, stamp duty or GST – connected with the transfer of the business interest. The agreement should provide a mechanism whereby the departing proprietor (individual or owning entity) can easily sell its business interest to the continuing proprietor(s) and the continuing proprietor can easily purchase the departing proprietor's business interest.

An insurance policy's sum insured can provide funding for the business proprietor's interest in the business entity as outlined in the terms of the buy/sell agreement. The life insurance products used in buy/sell purpose cover are term life cover (including terminal illness), total and permanent disability (**TPD**) cover and trauma cover.

Since the introduction of capital gains tax (**CGT**) legislation in 1985, self-ownership has been the structure most often used for buy/sell purpose cover. The main reason is that CGT provisions apply when there is a disposal of a CGT asset. The CGT legislation treats an insurance policy as a CGT asset and the payment of the insurance proceeds as a disposal of the policy (asset). However, the legislation also has CGT exemptions, which are different depending on whether the policy relates to a death benefit (term life and traditional life policies) or a non-death benefit (TPD and trauma policies).

Self-ownership of policies satisfy CGT exemptions for death and terminal illness under section 118-300 of the Income Tax Assessment Act 1997 (Cth) (ITAA97) and CGT exemptions for TPD and trauma under section 118-37 of the same Act. Self-ownership is also a simple way of adding new business owners to a buy/sell agreement and allowing that ownership structure to continue if a business owner decided to leave the business and to retain the policy for personal risk insurance purposes.

One glaring shortfall of self-ownership for buy/sell purposes has been advice (generally by advisers before engaging a legal professional) to arrange self-ownership by a business principal, as standard practice, where the business interest is actually owned by a related third party (the proprietor), such as a company or trust. Most lawyers experienced in this area would insist on the insurance cover being owned by the actual business proprietor, who may or may not be the business principal.

Other structures, such as company ownership, of buy/sell cover have been less popular due to their tax ineffectiveness (CGT applies to TPD and trauma cover if company owned and there is no increase in cost base on the buy back and cancellation of shares).

The above deficiencies in ownership structures have largely been addressed by business insurance trust ownership of buy/sell purpose insurance cover. Whereas with the policy ownership structures identified above, one person or entity is both the legal and beneficial owner of a policy, under an insurance trust (an absolute entitlement trust), the insured person (business principal) is always the beneficial owner, but not the legal owner of the policy (which is the trustee). There is only one policy per insured person – an aggregate of all the relevant covers (buy/sell, key person and personal) – whose mix can be reapportioned due to changes in business requirements.

The trustee of the business insurance trust (generally the business itself in a trustee capacity) is the legal owner of the policy, held in trust for the beneficiaries (insured persons), who can therefore direct payment of the insurance proceeds to nominated recipients and which, in a buy/sell situation, would be either the related party that owns the business interest (the proprietor) or the insured person themselves or their estate in the case of direct individual ownership. All life risk insurance proceeds are exempt from CGT as this is a form of indirect self-ownership.

Key person capital purpose cover

Traditional buy/sell agreements have been almost exclusively concerned with the sale and purchase of a business interest. Consequently, they often fail to deal with the extinguishment or release of guarantees and securities granted by the insured person or a related party to obtain a loan.

It is increasingly common for agreements to deal both with asset (buy/sell) and liability (debt reduction/guarantor protection and key person) issues. These agreements are usually called business succession agreements. If an absolute entitlement trust structure is used to deal tax effectively with the insurance proceeds, they are generally called business insurance trust agreements.

A key person is someone whose continued association with a business provides that business with a significant and direct economic gain. Economic gain means more than just profits. It can, amongst other things, also include cost savings, capital injections, goodwill, access to credit and access to customers. The loss of a key person generally results in the reduction of the capital value of a business. Insurance proceeds can offset that reduction.

The main components of key person capital purpose cover are:

- External debt reduction/repayment and guarantor protection: ideally, this would result in the full repayment of the loan, which would generally include the lifting of the principals' personal guarantees and release of securities.
- Internal debt repayment: loans owed to a business principal are generally 'at-call', meaning they may need to be repaid immediately to the departing key person (or to the estate). Insurance proceeds can be used to repay such loans, as well as loan accounts owed by a principal to the business where amounts owed to the business owner or director are recorded in the company's financial records as a creditor.
- Goodwill: insurance can compensate the business for any loss of personal goodwill associated with the departure of a business principal.
- Credit standing: some businesses can secure credit lines more easily than others because, for instance, one director has sufficient personal assets to secure the debt. With the loss of that individual, the business may find it more difficult to access or maintain lines of credit and overdraft facilities. Key person insurance proceeds give the business an alternative source of funds.

The traditional ownership structure for key person capital cover (including debt reduction and guarantor protection) has been to hold the cover in the name of the business entity, because it is the debtor that owes the debt to the creditor (financial institution). This is a form of cross-ownership. However, since the introduction of CGT, this method of ownership will result in CGT with respect to TPD or trauma proceeds paid to a company, requiring a gross-up (up to 47 per cent) of the sum insured (aside from sole proprietors, 61% of small businesses in Australia are companies[1]). When TPD or trauma is a rider (or linked) to a term life policy, this generally means that the term life sum insured is also grossed up. This excess of life cover following the death of an insured business principal would mean no CGT liability and therefore no franking credits in relation to the proceeds. If that is the case, and if the proceeds are subsequently distributed to the shareholders as a dividend, there would be income tax payable on the dividend at the marginal rate applicable to shareholders which would not be offset by franking credits.

Self-ownership is the alternative ownership structure recommended by some commentators because it is exempt from CGT on insurance proceeds. In the case of external debt reduction, once the proceeds have been paid to the insured principal or their estate, it is necessary for them to be repaid to the creditor or bank.

What guarantee do the continuing principals have that the proceeds will be used to discharge the loan? It would be necessary to impose a contractual or legal obligation (a 'debt reduction agreement') on the insured principal or the estate to pay the proceeds to the creditor. This constitutes a second-level chose-in-action, whose performance (payment to creditor) will create a disposal for CGT purposes, as opposed to a first-level chose-in-action, which is the payment of the insurance proceeds, exempt from CGT by operation of section 118-300 or section 118-37 of the ITAA97. This second-level chose-in-action would also apply to contractual payments of insurance proceeds to co-principals to repay the debt in order to avoid right-of-contribution issues.

A right of contribution is a concept of equity law. Unless it is contractually excluded from arising, it is created if a debt is repaid by a guarantor or another party other than the debtor business and entitles the guarantor to be reimbursed by the debtor (and any other guarantors) for the payment it has made on their behalf. This then creates a new loan account owing to the insured or the estate at a time when the aim of the parties was to exit the business principal or estate from the business relationship. If this right is released or extinguished, there may be adverse CGT implications.

Some advocates of self-ownership of key person capital cover describe the payment under a contractual obligation as a 'gift'. This is misleading as the CGT test is whether there is a legal obligation. By definition, a gift is something transferred voluntarily.

Again, insurance trust ownership largely avoids the above-mentioned pitfalls. As mentioned previously, because the insured business principal is the beneficial owner, trust ownership obtains CGT concessions on term life, TPD and trauma benefits. In addition, it can distribute the debt reduction cover to the creditor both securely and tax effectively.

The trustee (generally the business itself in that capacity) controls the distribution of the insurance proceeds to the creditor in accordance with the terms of the business insurance trust agreement. This means that the physical control of the proceeds is in the hands of a custodian that has a contractual and fiduciary duty to comply with the directives of the beneficial owner in the trust agreement.

Repayment of debt to the creditor can be achieved by a payment by the trustee to:

- the creditor directly
- the business or debtor (who then pays the creditor); or
- the continuing proprietors (who then pay the creditor).

There is a commercial advantage in paying the continuing proprietors by using a substitute loan account structure to channel the insurance proceeds from the continuing proprietors to the business and then to the actual creditor. The trust agreement created new loan accounts owing to the continuing proprietors (referred to as 'substitute lenders') for the external debt owing to the creditor. The creation of the new loan accounts in favour of the substitute lenders allows future cash flow of the business to be paid to the substitute lenders as tax-free repayments of principal (rather than as assessable dividends in the case of a company).

If the business owns the debt reduction cover, the payment of insurance proceeds would normally increase the value of the business by the level of cover. Although the payment would be used to repay the creditor, it would also reduce the amount of debt on the balance sheet (also known as a 'statement of financial position) and increase the net asset value of the business. This may impact an existing buy/sell purchase price (by increasing the value of a proprietor's business interest) and lead to disputes after between the departing and continuing proprietors after an insured event took place. Under an insurance trust this does not occur due to the substitute lender strategy. It effectively replaces the external liabilities with identical loan accounts.

An additional advantage is that insurance proceeds are not available to a creditor of the business, while it holds them in its capacity as the policy owner or trustee. And in the unlikely event that the business became insolvent, the parties may direct the business or trustee to transfer the policies to a substitute trustee, if they wish their succession plan to continue.

1. ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2019 to June 2023

The trust structure also avoids right-of-contribution issues and franking credit problems (no excess of term life proceeds) mentioned above.

Key person revenue purpose cover

There is no difference between the tax treatment of key person revenue cover owned by the operating entity or as part of the policy owned by the insurance trust trustee. With the latter, the premium attributable to key person revenue cover is deductible and that part of the insurance proceeds is assessable as income to the business. The advantage of an insurance trust is that the sum insured can be repurposed from one purpose to another (e.g., from key person capital to key person revenue), which is not possible with traditional structures.

Summary

As you can see from the above analysis, business insurance trusts can play a very positive role in business succession and key person planning.

One of the main advantages of this ownership structure is the ability – or flexibility – to reapportion, or to repurpose cover to reflect changing business situations and circumstances. These are usually organic developments associated with growth of the business and/or the repayment of external debt, but also where personal risk protection is included in the mix. Where there is a decrease in a business's external debt, there is a general view that there is an increase in business value. This, however, is not necessarily desirable, given that an increase in value also increases the sum insured for buy/sell purposes and therefore, in most cases, the CGT liability on the sale of the business interest following an insured event.

Where it is justifiable to keep the business valuation constant, any reduced level of cover in relation to debt reduction can be apportioned to either personal risk protection (which is the ultimate goal of buy/sell cover anyway), or – in the absence of key person revenue cover – may be repurposed there, without having necessarily to decrease and increase sums insured in separate policies used with traditional ownership methods. Having one policy per insured person and aggregating all needs in one sum insured provides an easy method of rebalancing the level of cover appropriate to each purpose, bearing in mind this can only be done before an insured event takes place at the directive of the beneficial owners (the insured persons).

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CVE 0403 03/24