FOR ADVISER USE ONLY

3 December 2024

Let's Get Technical: Sole traders and key person revenue cover

While all businesses should consider life risk insurance – where applicable – to compensate for lost revenue or profits following the sudden loss of a key person due to an insurable event and to provide funding for the extra costs a business would have in finding a suitable replacement, not all business structures are created equal when it comes to key person revenue purpose cover.

As of June 2024, there were 803,687 sole traders (also known as sole proprietors) in Australia, comprising 30.2 percent of all private sector business structures. This was the second most common business structure after companies, which came in at 43.3 per cent and include one-person companies. Another telling statistic is the number of non-employing businesses: 1,666,837 or 62.5 per cent of all businesses, which the Australian Bureau of Statistics defines as sole proprietorship and partnerships without employees[1].

We don't exactly know how many one-person companies there are, but it is worth noting that they may be treated similarly to sole traders when it comes to key person revenue cover if their business does not continue following their death or total and permanent disablement.

One benefit of taking out key person revenue cover is that the insurance premiums may be tax deductible. With respect to general deductions, section 8-1 of the Income Tax Assessment Act 1997 (Cth)) (ITAA 1997) taxpayers can deduct from their assessable income any loss or outgoing to the extent that it is incurred in gaining or producing assessable income, or it is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

Tax rulings IT155 and IT2434 have been the main ATO rulings regarding key person insurance for many years. For tax deductibility purposes, these rulings can be summarised as follows:

1. The policy must be a term insurance policy (IT155, paragraph 4)
2. The policy must be owned by the trading entity on the life or disability of a key person, e.g., by an employer on the life of a key employee (IT155 paragraphs 3 and 4)
3. The purpose in effecting and maintaining the policy is to offset the loss of revenue that the key person would have generated and/or to pay any costs incurred to replace that key person (IT155 paragraph 7)
4. The employee must be a 'key person', i.e., the loss of that employee would result in a significant loss of profits being derived by the employer (IT2434 paragraph 23)
5. Revenue purpose premiums can only be deductible if there is a continuation of business operations after the loss of the key person (IT2434 paragraph 23)

If the above five requirements are met and incorporated in a business's minutes or file notes, a tax deduction may be available under section 8-1 of ITAA 1997.

1 ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2020 to June 2024

Point 5 above means that where a sole proprietor or director/shareholder of a one-person company insures themselves as a key person, the premiums cannot be tax deductible if their death or disablement would most likely result in the termination of the business.

This rules out deductibility of term life and total and permanent disability (**TPD**) policies, but not necessarily trauma cover, which has a high likelihood of return to work given the two major causes of claim, cancer and circulatory (cardiovascular) conditions account for 83 per cent of trauma claims[2].

However, if the business were to be continued by a family member or intended to be sold to a nominated third party (e.g., an employee) under a business succession agreement, there may be sufficient business continuity required for key person revenue insurance deductibility.

Sole proprietors or sole directors can of course insure a key employee for key person revenue cover. Taxation Ruling IT 2434 provides limited guidance on how to determine whether an employee is a key person, i.e., in general, an employee may be accepted as a key person where the loss of that employee would result in a significant loss of profits (generally accepted by most insurers as being at least 20 per cent, based partly on the 'meaning of significant individual' under section 152.55 of ITAA 1997).

Tax treatment of proceeds

Term life, TPD or trauma insurance proceeds taken out for a revenue purpose may be assessable as income of the business. Notionally, CGT may also be payable on TPD or trauma proceeds paid to a company or trust (i.e., not the life insured, spouse or defined relative) however, any capital gain is reduced by the amount of assessable income (section 118-20 of ITAA 1997).

Substantiating the purpose

It is important to document the revenue purpose of the cover in order to substantiate it for taxation purposes. Though not conclusive as to the purpose of the policy, a taxpayer's minutes or book entries are of some value. ClearView's recently published Business Insurance Guide on pages 34 and 35 provides draft minutes (for companies) and file notes (for sole traders) to assist in documenting the purpose of the insurance cover[3]. It may assist a business to set up separate policies if there is a requirement for key person cover for both revenue and capital purpose cover (if not using a business insurance trust).

Note that ClearView is one of few insurers that do not charge a policy fee so there would be no extra cost for multiple policies, and the sums insured are aggregated for separate policies for the same product. This usually results in lower overall premium costs due to benefit amount discounts, which may be even more relevant when an individual takes out cover for both personal and business purposes.

2 https://fsc.org.au/news/media-release/media-release-downloads/2048-fsc-media-release-detailed-data-reveals-top-causes-of-claim-for-theindustry/file

3 ClearView Business Insurance Guide, March 2024

Summary

Sole traders or directors/shareholders of one-person companies cannot generally insure themselves for key person revenue purposes and claim a tax deduction for the premiums. However, there are situations where this is possible if the business is to be continued as a going concern.

Alex Koodrin

National Technical Manager

CVE 0429 12/24 V1