GUIDE TO BUY/SELL FUNDING AND INSURANCE OWNERSHIP STRUCTURES

HEALTHIER, LONGER, BETTER LIVES

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This guide provides a summary of the different policy ownership structures that are available when funding a business succession plan with insurance. Included are the key advantages and disadvantages to consider when advising clients on how the policy should be owned for buy/sell cover.

Self-ownership

Under the self-ownership option, each person owns an insurance policy on their own life. If a business owner exits the business due to death, TPD or crisis recovery (trauma), the following will generally occur:

- The insurance proceeds are paid to the departing owner or their estate
- The recipient (ie. the departing owner or their estate/beneficiaries) accepts the insurance proceeds as consideration/payment for the departing owner's interest in the business, and
- The departing owner's business interest is transferred to the remaining business owners.

Below are the advantages and disadvantages of self-owned buy/sell insurance.

Advantages / Benefits	**Disadvantages / Risks**
Simple: easy to implement and administer, maintain privacy and explain ownership structure to business owners.	Success depends on an effective buy/sell agreement: insurance proceeds are paid to the departing owner (or their nominated beneficiary) as deemed consideration for the transfer of the ownership interest to the surviving owners. If there is no buy/sell agreement then the departing owner/beneficiary retains both the insurance proceeds and business ownership interest.
Ease of administration: new owners coming into the business take out their own policy in accordance with the prevailing buy/sell agreement, avoiding the need for remaining business owners to alter ownership percentages of existing policies.	Perceived inequality: some business owners may pay a higher premium relative to other owners in the group (ie. due to age, health conditions, etc). However, this can be addressed in a number of ways (eg. owners may wish to pool the premium payments, etc).
Flexible and portable: owners departing the business can retain their policy for personal protection purposes with no assignments or transfers of ownership required.	Perception and understanding of owners: the self-ownership structure is not necessarily a natural or traditional commercial transaction – each business owner is effectively funding their own buyout from the business.
Tax effective: no CGT payable on life insurance proceeds if the recipient is the original owner of the policy (or they acquired the policy for no consideration). CGT is not payable on TPD or crisis policies as the life insured is the owner of the policy.	Potential inefficient tax outcomes: can result if the operating entity (ie. company) pays premiums on behalf of the business owners without declaring the amounts as salary or wages, dividends, or distributions (e.g. Division 7A provisions or fringe benefits tax liability may be triggered, or premium payment may be deemed a repayment of shareholder loan).

Cross ownership

Under the cross ownership option, an insurance policy is set up for each business owner and is owned by the other business owner(s). If a business owner exits the business due to death, TPD or crisis recovery, the following will generally occur:

- The insurance proceeds are paid to the remaining business owner(s)
- The remaining business owner(s) pay the insurance proceeds to the departing owner or the estate/beneficiaries of the departing owner
- The recipient (ie. the departing owner or their estate/beneficiaries) accepts the insurance proceeds as consideration/ payment for the departing owner's interest in the business, and
- The departing owner's business interest is transferred to the remaining business owners.

Below are the advantages and disadvantages of cross owned buy/sell insurance.

Advantages / Benefits	Disadvantages / Risks
Simple: easy to understand and implement. There is a logical flow of cash in the event of claim as insurance proceeds are paid to the surviving business owner/s and are used to purchase the business interest of the outgoing owner.	Success depends on an effective buy/sell agreement: it needs to enforce transfers and reduce any risk that the remaining owner/s will use the insurance proceeds to start a new business, leaving the departing owner with no insurance proceeds and an interest in a non-existent business.
Ease of administration: this structure works well when there are only a small number of business owners and there are unlikely to be any changes to the proprietorship.	Perceived inequality: some business owners may pay a higher premium relative to other owners in the group (ie. due to age, health conditions, etc). However, this can be addressed in a number of ways (eg. owners may wish to pool the premium payments, etc).
Certainty: the remaining business owners have control of the funds.	Inflexible: if new owners come into the business or an owner leaves, the ownership percentage interests in all the policies need to be altered via assignment. Thus, there is difficulty in adding new business owners.
	Portability: if an owner leaves, they are reliant on the other owners all assigning the policy across to them. This is important where the departing owner may no longer be insurable and wants to maintain the policy for personal protection purposes.
	Potential inefficient tax outcomes: can result if the operating entity (ie. company) pays premiums on behalf of the business owners without declaring the amounts as salary or wages, dividends, or distributions (e.g. Division 7A provisions or fringe benefits tax liability may be triggered, or premium payment may be deemed a repayment of shareholder loan).
	Taxation: unless the business owners are related, CGT will be payable on TPD or crisis proceeds.

Insurance trust ownership

There are two types of trust ownership structures when structuring insurance for buy/sell purposes – insurance trust ownership and family trust ownership.

Generally speaking, the trust ownership approach usually involves the establishment of a special purpose insurance trust, often with an independent trustee appointed, to acquire the insurance policies and then distribute proceeds on the exit of a business owner in accordance with the terms of the trust deed. However, if the trading entity is itself a trust or owned via a trust (for example, a discretionary trust owning shares in a trading company), then it may not be necessary to establish a separate trust structure.

Thus, insurance trust ownership is generally used where the business interest/share is not personally owned by the business owner/life insured, that is, the owner of the business interest/share is a related entity of the business owner/life insured (eg. a family trust or company). As a result, this method of ownership generally suits businesses with a large number of business owners.

In summary, under the insurance trust ownership structure the trustee owns the policies on behalf of all the business owners. If a business owner exits the business due to death, TPD or crisis recovery, the following will generally occur:

- The insurance proceeds are paid to the trust
- As the business owner (life insured) is the beneficial owner of the insurance policy, the trustee will distribute the insurance proceeds based on pre-determined instructions of the business owner/life insured
- The recipient will typically be the estate/beneficiaries of the departing owner who will accept the insurance proceeds as consideration/payment for the departing owner's interest in the business, and
- The departing owner's business interest is transferred to the remaining business owners.

Below are the advantages and disadvantages of insurance trust owned buy/sell insurance.

Advantages / Benefits	**Disadvantages / Risks**
Ease of administration: multiple insurance policies may be owned by the trust (either an independent trustee or one including a representative of each of the business owners), and administration of policies and premium payments are centralised. Thus this structure works well when there are a large number of interest holders (partners, shareholders, unit holders) and where new interest holders are likely to be admitted.	Complex: trust ownership may seem more complicated than other types of ownership if business owners have limited expertise.
Flexibility: if a new owner comes into the business the trustee can simply take out a new insurance policy(s) on that owner's life – ownership of existing policies does not need to be altered. Further, business cover (ie. key person and buy/sell cover) and personal cover can be combined in one insurance policy, which can provide premium cost savings.	Portability: unlike self-ownership, if an owner departs the business, the policy must be assigned/transferred by the trustee in order to be retained by the departing business owner for personal protection purposes.
Certainty: trust deed provides rules covering application of policy proceeds and transfer of equity according to pre-agreed intentions of all parties. Thus business owners may be confident in knowing that insurance proceeds will not be paid to the departing business owner (or their beneficiary) until the relevant ownership interest is transferred to the remaining business owners.	Costs: unless a suitable trust exists, this model requires the establishment and ongoing maintenance of a trustee entity and trust deed.
Tax effective: no CGT payable on life insurance proceeds (as the trust/recipient is the original owner of the policy). CGT is not payable on TPD or crisis proceeds where recipient/beneficiary of the trust is the life insured or relative of the life insured.	Taxation: appropriate trust structuring and distribution of any capital to relevant beneficiaries is required to ensure CGT free payments, particularly for TPD and crisis cover.

Family trust ownership

Rather than setting up a special purpose insurance trust, business owners who have their own existing family trusts may decide to use their own trusts to hold insurance policies on their behalf. This can be particularly beneficial when the equity in the business is owned by the respective family trusts of the business owners. As the family trust of the departing business owner is disposing of the business interest, the family trust will be liable for any CGT payable on that disposal of equity. The injection of insurance proceeds from the policy owned by the family trust can support the payment of any CGT due (rather than some other recipient of the proceeds lending the money to the family trust to pay tax, for example).

Below are some of the key differences of family trust ownership when compared to insurance trust ownership:

- Ease of administration/simple: each business owner's policies are owned by their own family trust. This may work well if the trading entity is itself a trust or owned via a trust (for example, a discretionary trust owning shares in a trading company) as it may not be necessary to establish a separate insurance trust structure to own multiple policies on behalf of all business owners.
- Minimise costs: using an existing trust structure can keep costs down as there is no need to establish and maintain a separate trust entity and trust deed.
- Review existing family trust deed:
  - It is important to determine whether the insurance proceeds would form part of the income or capital of the trust as the trustee must ensure that any distributions of income or capital are made in accordance with the trust deed, and
  - The trustee is not generally able to distribute income or capital to an entity that is not a beneficiary under the terms of the trust deed.

  The above two points may not be an issue in an insurance trust as the insurance trust deed would typically address these issues.
- Taxation implications:
  - The taxable income of a trust is generally taxed in the hands of the beneficiaries of the trust who are presently entitled to the distributable income of the trust by the end of the financial year. If the insurance proceeds are treated as trust capital then the recipients of the capital distributions should not be taxed on the taxable income of the trust. However, if the proceeds are classified as income of the trust then the beneficiaries may be taxed on the taxable income of the trust under the proportionate approach (as per section 97 of ITAA 1936).
  - CGT may be payable on TPD or crisis proceeds if a trustee has discretion and distributes the proceeds to an individual who is not the life insured or relative of the life insured. Thus, it is critical that appropriate trust structuring and legal agreements are in place which direct the trustee to pay the insurance proceeds to the appropriate beneficiaries to benefit from the CGT exemption.

Company ownership

Under the company ownership structure, the company operating the business owns the insurance policies on the life of each business owner. If a business owner exits the business due to death, TPD or crisis recovery, the following will generally occur:

- The insurance proceeds are paid to the company
- The shareholder and buy/sell agreements may have the option for the company to use the insurance proceeds to buy-back the departing owner's business interest/shares (or the remaining business owners may be able to purchase the shares from the departing owner or their estate) which results in the departing owner's shares being cancelled (or units in the unit trust redeemed)
- The cancellation of the shares (or redemption of units) under a share buyback effectively distributes full ownership of the departing business owner's business interest/shares across to the remaining business owner(s).

Below are the advantages and disadvantages of company owned buy/sell insurance.

Advantages	**Disadvantages**
Cash flow benefits: premiums can be funded directly out of the company's assets.	Potential inefficient tax outcomes for operating entity: can result if the company pays premiums on behalf of the business owners without declaring the amounts as salary or wages, dividends, or distributions (e.g. Division 7A provisions or fringe benefits tax liability may be triggered, or premium payment may be deemed a repayment of shareholder loan).
Ease of administration: multiple insurance policies are owned by a single entity and administration of policies and premium payments are centralised.	Taxation: CGT will be payable on TPD or crisis proceeds received by the company.
Flexibility: if a new owner comes into the business, existing policies do not need to be altered.	Portability: if an owner leaves, they are reliant on the business entity (other owners) assigning the policy across to them. This is important where the departing owner may no longer be insurable and wants to maintain the policy for personal protection purposes.
	Potential inefficient tax outcomes for departing owner: • It can be difficult to get the insurance proceeds from the company out to the departing owner (or their estate) tax effectively. This will generally require a share buyback or dividend, which is likely to provide a poorer tax outcome particularly when compared to direct disposal of the business interest/assets by the departing owner, and • This ownership structure may compromise the ability of the departing owner from taking advantage of small business CGT concessions they may otherwise have accessed had they sold their business interest/assets directly.
	Potential inefficient tax outcomes for remaining owner/s: the cost base of their interest remains unchanged despite their overall equity stake in the company increasing follow injection of insurance capital proceeds.

As the disadvantages outweigh the advantages (particularly from a tax perspective), it is generally recommended to avoid company ownership for buy/sell insurance.

Superannuation fund ownership

Under the superannuation owned structure, the trustee of the business owner's superannuation fund owns the insurance policy. If a business owner exits the business due to death, TPD or crisis recovery, the following will generally occur:

- The insurance proceeds are paid to the trustee and then form part of the business owner's superannuation benefits, which will be paid to the estate/beneficiaries of the departing owner
- The recipient (ie. the departing owner or their estate/beneficiaries) accepts the insurance proceeds as consideration/ payment for the departing owner's interest in the business, and
- The departing owner's business interest is transferred to the remaining business owners.

Below are the advantages and disadvantages of superannuation owned buy/sell insurance.

Advantages / Benefits	**Disadvantages / Risks**
Tax effective: insurance premiums can be funded from pre-tax or tax deductible superannuation contributions (subject to the concessional contribution cap).	Breach of super laws: the ATO has indicated that holding buy/sell cover in superannuation may breach the sole purpose test and the prohibition on provision of financial assistance to a member or relative (refer to ATO ID 2015/10).
Tax effective options post claim: a surviving spouse may retain the death benefit within superannuation via the commencement of a death benefit income stream (subject to prevailing transfer balance cap).	Whilst superannuation ownership is generally not recommended, if this structure is used, a successful outcome will depend on an effective buy/sell agreement. Please note: The trustee/s of the superannuation fund are not able to enter into the buy/sell agreement in their capacity as trustee/s. Nor may they be bound by directions under the agreement. Care must be taken to ensure the sole purpose test is met for the superannuation fund, i.e. the purpose of the insurance is to meet dependant beneficiary needs and not for the express purpose of funding a buy/sell agreement in relation to the members'/ trustees' personal business interests. Therefore a retail superannuation fund arrangement may be more suitable. If using an SMSF, it is crucial that the SMSF does not reference any buy/ sell agreement in the SMSF minutes. Instead, the SMSF minutes should document whether the members need insurance (no need for decision making rationale). Further, there should be a crediting provision in the buy/sell agreement to ensure that when the departing owner transfers their ownership interest to the remaining business owner/s, there is deemed credit received in the form of the insurance proceeds that have been funded separately.
Retention and cash flow: insurance premiums can be paid from accumulated retirement savings where necessary, minimising the impact on the client's cash flow and ensuring the policy stays intact.	Taxation: tax will apply to the extent that a lump sum death benefit is paid to non-tax dependants (ie. adult children). Tax may be levied on disability superannuation benefits if paid out prior to age 60 (e.g. if TPD proceeds are accessed on the grounds of permanent incapacity).
	Depletion of retirement savings: premiums deducted from superannuation or contributions utilised to pay premiums rather than investing in assets may result in poorer retirement outcomes. The ability to supplement superannuation account balances that fund insurance premiums, by making additional contributions, is limited due to reduced contribution caps.
	Inappropriate distribution of death benefits: non-binding or invalid nominations may result in superannuation death benefits being paid to unintended beneficiaries. Note, this may be addressed through the use of valid binding death benefit nominations and will require an effectively worded buy/sell agreement that addresses this potential outcome.
	Limited policy features: since 1 July 2014, no new TPD 'own' occupation policies or crisis cover can be taken out within super.