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The pros & cons of the different ownership structures for insurance cover for business estate planning

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Business estate refers to planning how a business will be managed in the event of death, illness, injury or retirement of one of its key stakeholders. Business estate planning generally involves seeing an accountant to value the business and a solicitor who then drafts the most appropriate method of passing the business interest to the party or parties. A buy/sell agreement is usually used to determine how the change of ownership will be funded.

A buy/sell agreement is a contract usually entered into between business owners pursuant to which the surviving owners are bound to buy out the departing owner's interest in the business should a trigger event occur.

Specific events which may trigger a buy/sell agreement include death, divorce, long-term disability, retirement or bankruptcy.

The agreement is often linked to an insurance policy on each owner's life, where the trigger event is insurable. The policy provides the surviving owner's with the money to buy out the departing owners interest.

Why is insurance needed?

Death, total and permanent disability (TPD) or traumatic illness can have a dramatic effect on a business. Some of the problems that can occur are:

- The terminating business owner (or, in the case of death, his or her estate) may make demands on the business for it to be wound up, to be paid out for his or her interest in the business, or for repayment of loan account balances;
- In the case of death, the estate may insist on immediate and direct involvement in the control and operation of the business, but may not have the expertise to handle this;
- In the case of death, the estate of the deceased business owner may be forced by circumstances to sell his or her interest in the business to an outside buyer at fire sale values;
- In the case of traumatic illness (eg heart attack), there may be uncertainty over the likelihood of the business owner recovering or ever returning to work; and
- The continuing business owners may end up doing all of the work, but splitting the profits with a non-working owner.

What are the methods for determining the amount of insurance cover on a buy/sell agreement?

1. Book value
2. Agreed value
3. Appraised value; or
4. Capitalisation of earnings

The amount and type of insurance must be determined before the insurance is put in place.

What are the ownership structures available?

The most appropriate means of owning a life policy in any buy/sell arrangement depends on:

- Who the parties are; and
- The circumstances of those parties to the arrangement.

Each approach to ownership has its advantages and disadvantages. Since "one size doesn't fit all", it is important to review each case on its own merits.

1. Cross-ownership

In this situation, each owner of the business owns a policy on the life of the other business owner(s). When an insurable trigger event occurs, through death for example, the policy proceeds are payable to the survivor(s). The proceeds would be used to purchase the deceased's interest in the business from their estate.

Advantages:

- Documentation is usually simple and easy to follow.
- The remaining business owner's have control of the funds.
- This structure works well when there are only a small number of owners or stakeholders and there are unlikely to be any changes to the proprietorship.

Disadvantages:

- Policies are normally assigned when an existing owner leaves (ie a departing business owner assigns their policy to the new business owner). If it is deemed that there is consideration in respect of the change of owner on a life policy, capital gains tax (CGT) may apply in the event of a payout.
- CGT may apply to the proceeds of a TPD or trauma policy where the recipient of the proceeds is not the insured or a relative of the insured.
- Cross-ownership generally results in CGT on the insurance proceeds in the case of TPD or trauma.
- Different cost of premiums for individuals in the same policy, especially where there is an age gap. The interest holders may, however, agree to pool the premium payments, ie pay equal amounts.

2. Self-ownership

In this situation, each of the owners of the business owns the policy on their own life. When an insurable trigger event occurs for one of the owners the proceeds are payable to them or their estate.

A separate buy/sell agreement must be created. If the agreement is not made or is incorrectly executed, the departing owner of their estate could potentially end up with the insurance proceeds and the interest in the business.

Advantages:

- It is simple to understand and put in place.
- Unlike cross-owned policies, there is no need to assign policies with changing business owners. Accordingly there should be no CGT implications.
- Proceeds from trauma and TPD policies should not be subject to CGT as the life insured is the owner of the policy.

Disadvantages:

- If the succession planning documentation is not adequately completed, the estate of the departing owner or their estate may unintentionally receive both the policy proceeds and the business interest. As a consequence, offsetting arrangements need to be carefully drafted into the agreement. For example, a spouse could receive 50% of the business as well as the insurance proceeds, and the business then still retains the debt.
- There may be a disproportionate cost of premiums on the policies held by each principal, particularly where a large age gap exists. (The interest holders may, however, agree to pool the premium payments.)

3. Trust ownership

In this situation, a trustee owns policies on behalf of all the business owners.

The entry of new owners into the business won't create any re-assignment of policy, so there are no capital gains tax implications.

This method of ownership is particularly appropriate when there are a large number of shareholders and new business owners are likely to be admitted.

There are, however, extra costs in establishing and administering a trust together. Also capital gains tax implications may exist on assignment of a policy to the insured and create problems similar to those for cross ownership.

It is difficult to discuss the effect of trust ownership on life insurance as the type and circumstances of each trust could vary significantly, and will have a major impact on the ownership structure. An example of this would be where the trustee of a discretionary trust owns the policies on behalf of all principals or interest holders and on the death of a principal, the proceeds are paid to the trust and distributed to the continuing owners. The continuing owners can then use the money to purchase the deceased's interest. Other types of trusts would provide different results.

Most importantly the Australian Tax Office (ATO) must consider the trust is a "bare trust". A bare trust is a trust in which the beneficiary is absolutely entitled to the trust assets. If this condition is not satisfied, CGT may be payable on the proceeds.

Advantages:

- There is no need to assign policies with changing business ownership and accordingly there should be no CGT implications.
- Policies are indirectly self-owned, therefore the beneficial owner is the life insured and the proceeds are exempt from CGT.

- This method is appropriate where there are a large number of interest holders (partners, shareholders, unit holders) and where new interest holders are likely to be admitted.

Disadvantages:
- Costs in establishing and administering a trust.
- Trust ownership may be more complicated than other types of ownership.
- The trust needs to be a bare trust under which the beneficiaries are absolutely entitled to the trust assets, otherwise CGT may be payable with respect to the trauma and TPD proceeds.

4. Corporate ownership (within a corporate entity redemption agreement)

In this situation, the corporation owns the life insurance policy. If a triggering event such as death occurs, the business buys back the interest in the business from the deceased's family and the shares are cancelled (or units in a unit trust are redeemed).

Advantages:
- Simple to understand.
- Original policy holder is not altered by a principal entering or exiting the business.
- Corporate entity owns and pays for the policy, the after tax cost of the premium may be reduced due to the tax rate differentials.
- The transfer of ownership is definite. The owner of the shares is the owner of the business. There is no entitlement of the shareholder or their beneficiaries to other assets of the operating entity.

Disadvantages:
- There may be significant taxation consequences to the departing interest holder (ie the remaining principals are effectively acquiring more equity but not getting a CGT cost base for it. They may therefore be subject to unnecessary tax).
- Whenever a share buy-back occurs with a private company, the company needs to ensure that no breach of the capital streaming or share streaming occurs. These provisions are breached when one shareholder is provided with an advantage or opportunity (ie share buy-back) that is not provided to other shareholders. If a breach occurs, adverse taxation consequences may apply to either the shareholder or the operating entity, or both.
- It is often difficult to place a value or determine the cost base of the shares if they are not widely held or publicly traded (ie private company). This may lead to confusion when any share buy-back occurs, as the share buy-back offer may be less than anticipated by the original shareholder.

5. Superannuation fund trustee ownership

In this situation, insurance is held within superannuation.

Advantages:
- Original policy holder is not affected by a principal entering or exiting the business.
- Premiums may be cheaper, and possibly less stringent underwriting requirements will apply.
- Premiums are tax deductible to the super fund.
- Death benefit is received tax free when paid to a tax dependant.
- Contributions made into the super fund to cover the cost of insurance may be tax deductible if contributed by a person who is eligible to make deductible contributions to super. For example, a self employed or substantially self employed person.

Disadvantages:
- Can be substantial tax payable if a death benefit is received by a non-dependant.
- Need to ensure that a binding nomination is used and that it is kept up to date. Where the nomination is not binding or not up to date the death benefit may be paid to someone other than the intended recipient.
- There may also be tax payable on TPD and trauma benefits depending on the age and tax-free component of the benefit.
- Must meet the SIS conditions of release to receive TPD or trauma benefits.
- The super fund needs to ensure that it meets the sole purpose test under the SIS Act.
- Trauma insurance is not recommended to be held within superannuation. Although the policy proceeds may be paid, a condition of release will not necessarily be met, and therefore proceeds may be trapped in the super fund.
- If the succession planning documentation is not adequately completed, the departing owner or their estate may unintentionally receive both the policy proceeds and the business interest. As a consequence, offsetting arrangements need to be carefully drafted into the agreement.
- If inadequate provision has been made for a beneficiary in the will of the deceased, they have the right to challenge the terms of any distribution and request that the trustee of the superannuation fund to pay the proceeds to them (binding death benefit nominations do not solve this dilemma).

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- Car finance
- Personal estate planning
- Business estate planning
- Personal risk insurance
- Business risk insurance

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