Introduction
On 1 July 2014, changes to the type of total and permanent disablement (TPD) insurance policies which can be owned through superannuation took effect. As TPD policies commonly feature in insurance-funded buy–sell agreements, it is timely to review the various ways these agreements can be structured. This article provides an overview of:
- how most insurance-funded buy–sell agreements operate;
- the alternatives available when determining how the insurance policies should be owned; and
- the taxation consequences of the different ownership approaches.

This article also considers the likely impact on insurance arrangements of the Tax and Superannuation Laws Amendment (2014 Measures No. 7) Bill 2014 (Bill), which at the time of writing is before parliament.

What is an insurance-funded buy–sell agreement?
A buy–sell agreement is a contractual arrangement between members of a jointly owned business (for instance, a company). The agreement is structured so that subject to certain events relating to the departure of a principal, the continuing principals are given the option, or in some cases are obliged, to purchase the interest of the departing principal.

For ease of reading, the word “partner” is used in this article as a short-hand reference to any owner, whether an individual or entity and regardless of whether the business entity is a partnership, company or trust. Similarly, the word “principal” is used to describe the ultimate individual behind each partner.

Why are buy–sell agreements important?
Buy–sell agreements are important for two main reasons.
First, no one is able to know when a death or a traumatic event will occur. As a result, there is often insufficient capital available for the remaining principals to buy out the exiting principal without suffering financial hardship.

Second, if one of the principals in a business dies, significant commercial difficulties can arise. For example, the business might continue to operate for the primary benefit of the exiting owner’s family, even though others are undertaking all the work.

Further, it might be the case that the deceased principal’s spouse (who is unsuited and unskilled in the running of a business) wishes to become involved in a way that could have adverse consequences on the business’ financial sustainability.

The potential consequences of the unexpected exit of a principal are generally unfavourable, reinforcing the reasons why buy–sell agreements are so important for the sustainability of a business. The types of events which are usually dealt with in a buy–sell agreement are:
- death;
- TPD; and
- trauma.

While there are a number of other events which can result in a principal exiting a business, for a combination of reasons, it is often easier to deal only with insurable events under a buy–sell agreement and use a separate partnership agreement to address non-insurable triggering events.

Self-owned policies
Anecdotally, the most common way to structure an insurance-funded buy–sell arrangement is as follows:
- the insurance policies are self-owned by each principal;
- the arrangements between the partners are documented in a put and call option agreement;
- the quantum of insurance is reviewed regularly to ensure that it is adequate in all circumstances; and
- the purchase price under the put and call option agreement is a nominal amount (eg $1) plus the amount by which the market value of the interest transferred (including loans) at the date of the triggering event exceeds the insurance proceeds received by the outgoing partner. Obviously, if the insurance proceeds exceed the market value of the outgoing partner’s interest, then the disposal price will simply be $1.
If there is a claim made under the self-owned insurance policy, the insurance proceeds go directly to the principal who has been affected by a triggering event under the buy–sell agreement or to that principal’s estate.

Once the option has been exercised, the exiting partner is deemed to have disposed of equity and interest in the partnership, at market value, to the remaining partners, who similarly acquire the interest at market value.1

**Capital gains tax (CGT) issues – agreement**

**Mandatory agreements**

Insurance-funded buy–sell agreements normally provide that, on the death of a partner, the continuing partners can purchase, or be forced to purchase, the deceased partner’s interests. The same provisions would apply for TPD and trauma, if insurance has been obtained. In this regard, insurance-funded arrangements are distinguished from other buy–sell arrangements, where it is unusual for the continuing partners to be contractually bound to purchase the retiring partner’s interest, given the funding difficulties which might arise.

Section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (formerly s 160U(3) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) deals with the timing of disposal and acquisition of CGT assets, and provides that the contract is entered into at the time of a CGT event that involves disposal of an asset.

Historically, the Australian Taxation Office (ATO) has argued that the entry into a buy–sell agreement obliging the continuing partners to purchase an outgoing partner’s interest will amount to a disposal of that partner’s interest at the time of entering into the buy–sell agreement, and not at the time the continuing partners actually acquire the outgoing partner’s interest following death, TPD or trauma.2

While it was accepted that the consideration received for disposal of the partnership interest was determined at the time of actual transfer following the triggering event, for CGT purposes, the time of the CGT event was taken to be the date of entering into the buy–sell agreement. For obvious reasons, many advisers in this area had considerable difficulty in accepting the historic ATO view.

In particular, s 104-10 should not be seen to apply to the buy–sell agreement; rather, it applies to the agreement created on the occurrence of a triggering event.

A buy–sell agreement does not involve any acquisition or disposal of an asset; the agreement merely records an arrangement whereby, if a triggering event occurs at some time in the future, then the continuing partners will acquire the deceased partner’s interest at that time, based on a formula contained in the document.

The issue of when a contract is made involves consideration of difficult issues of contract law, and it is fair to say that the law is not entirely clear.

**Buy and sell options**

Due to the longstanding (and at times significant) uncertainty surrounding “standard” buy–sell agreements, many specialists in this area structure the contractual arrangements using options. In particular, the use of appropriately drafted put (sell) and call (buy) options essentially avoids any argument that the agreement might have been entered into at a time before the triggering event.

The use of put and call arrangements can also allow for greater flexibility in structuring the general estate planning objectives of the partners. For example, option-based arrangements mean partners might choose to dispose of their interests in the partnership on death via their wills (if this suits their objectives), thereby ensuring that no CGT or stamp duty is payable on the disposal.

This would not be the case had the disposal taken place pursuant to a mandatory buy–sell agreement.

Under a put and call option arrangement, the continuing partners have an option to acquire an interest of an outgoing partner on the occurrence of a triggering event (call or buy option), and the outgoing partner has an option to sell the partnership interest to the continuing partners for a specified time after the triggering event (put or sell option).

The granting of an option constitutes the acquisition of a CGT asset by the grantee, pursuant to s 109-5 ITAA97, but is not otherwise a CGT event for the grantee. For the grantor, CGT event D2 will be triggered when the option is granted.

In both instances, as there is usually no payment for the granting of the option and the market value is essentially nil, there should be no CGT consequences on execution of a buy–sell agreement containing either or both a put or call option. These outcomes have been confirmed by the ATO in its withdrawn discussion paper.3

A variation on the put and call option arrangements is simply to hold unexecuted contracts in escrow until the predetermined triggering event takes place; this approach, however, is less common than the put and call option agreement.

**Deemed market value substitution rule**

It is generally accepted that, where a business succession plan is structured with self-owned insurance policies and a buy–sell deed using put and call options, the deemed market value substitution rules apply for taxation purposes.4 As a result, the seller is deemed to have received market value for their interest and the buyer receives a market value cost base for their acquisition.

This outcome occurs notwithstanding that the transfer has been funded (either wholly or partly) by insurance.

**ATO discussion paper**

It should be noted that the ATO has withdrawn its insurance-funded business succession discussion paper.

As a result, in its December 2010 minutes, the National Tax Liaison Group (NTLG) stated that the ATO had confirmed that the withdrawn discussion paper should not be relied on and that members should instruct practitioners to refrain from relying on the discussion paper.5

This said, the discussion paper remains the only substantive document released by the ATO in this area and, despite its withdrawal, is often referenced as a potentially indicative guide on many of the relevant principles. For example, the application of s 104-10 to buy–sell arrangements is dealt with in some detail in the ATO’s discussion paper.

Despite years of suggesting the contrary, the ATO appears to accept that, where an agreement is clearly drafted on the basis that it is not to come into effect until after a triggering event, then the time of disposal will be delayed until the triggering event.

In the discussion paper, the ATO places significant emphasis on the distinction between conditions precedent to formation of the contract and conditions precedent to formation of the contract and conditions precedent to formation of the contract.
performance of the contract (also referred to as conditions subsequent).

To determine which type of condition precedent applies, the ATO suggests there must be an examination of whether the parties to the buy–sell agreement are bound by the agreement (meaning there is no doubt that, at some time in the future, there will be a disposal of an interest pursuant to the buy–sell agreement). If this is the case, then a triggering event will be a condition precedent to performance of obligations of the parties (not to formation of the agreement) and the relevant date under s 104-10 will be the date on which the agreement is entered into.

If the parties are able to dispose of their interest in the partnership before the triggering event occurs, then the ATO concludes that such an agreement is not certain and the time of the CGT event for s 104-10 purposes will be the occurrence of the triggering event. In other words, there is a condition precedent to the actual formation of the agreement. Thus, the intention of the parties to delay the disposal date of their interests should be clearly set out in the buy–sell agreement. Commercially, the easiest way to document the intention is well-structured options.

CGT issues – policies

Life insurance

Section 118-300 ITAA97 provides that the proceeds received on disposal of a life insurance policy (eg on the death of the life assured or on surrender of the policy) are exempt from CGT. This exemption, however, is only available to:
- the original beneficial owner of the policy; and
- an assignee of the policy who did not acquire the rights or interest in the policy for an amount of money or other consideration.

This section has also led to some uncertainty in the structuring of life insurance policies supporting buy–sell arrangements, and a number of variations have developed. The major difficulty arises where there is change in the constitution of a partnership, particularly when new members join the partnership.

Incoming partners who acquire an interest in existing life insurance policies are not “original beneficial owners”. Furthermore, it is arguable that the incoming partners do in fact pay “an amount of money or other consideration” in acquiring their interest in the policy.

TPD and trauma insurance

Section 118-37 ITAA97 contains a CGT exemption for non-death insurance benefits, including TPD and trauma insurance. The exemption applies to “compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally”.

“Relative” is defined as a person’s spouse, parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child, and those people’s respective spouses. Consequently, this has meant the conservative approach was that TPD or trauma proceeds were only exempt from CGT where they are received by the injured person or their relative. This position is subject to the amendments contained in the Bill, discussed later in this article.

Superannuation (including SMSF) policy ownership

For many years, the ownership of insurance policies for buy–sell arrangements through a self-managed superannuation fund (SMSF) — or, for that matter, corporate funds — has been popular, at least anecdotally.

The primary advantages of policy ownership via superannuation being utilised to fund buy–sell arrangements include:
- the premiums in relation to the insurance policies are normally deductible, “freeing up” money outside the superannuation environment that would otherwise be needed to fund insurance premiums;
- the insurance proceeds can often be utilised within the superannuation fund to generate tax effective income streams via pensions; and
- binding death benefit nominations (whether lapsing or non-lapsing) can be used to ensure that the proceeds from the policy pass as intended by the exiting partner.

When deciding whether or not to structure insurance ownership through superannuation, there are numerous issues that need to be considered, including:
- the impact of contribution limits, which can significantly undermine the usefulness of the strategy in many situations;
- the possibility that CGT might be payable on any component of an insurance payout in relation to trauma or TPD;
- whether there are circumstances surrounding the structure, which might jeopardise the ability of the superannuation fund to satisfy the sole purpose test, set out under the superannuation legislation; and
- whether the arrangements are likely to fall foul of the general anti-avoidance provisions under Pt IVA ITAA36.

Historically, the ATO has confirmed in various private documents that, when structured appropriately, a superannuation fund can own an insurance policy designed to assist the funding of a buy–sell arrangement, without breaching any tax or superannuation laws. While some organisations and specialists have received confirmation from the ATO in this area, there are no publically available statements at least in relation to industry funds.

In relation to SMSFs, the ATO has indicated that there may be difficulties in satisfying the sole purpose test, presumably where the fund has few, if any, other investments of activities.

It should also be remembered that there is the ongoing risk that some form of cap (not dissimilar to the former “reasonable benefit limit” system) will be imposed on withdrawals from superannuation.

July 2014 changes

Best practice often dictates that clients should obtain TPD insurance protection on the basis of their inability to work in their “own” occupation, as opposed to “any” occupation.

The satisfaction of the “own” occupation test is obviously easier than the condition of release set out under the superannuation legislation, that is, that a member must be incapable of working in “any” occupation.

For a number of years, where “own” occupation TPD insurance was owned via superannuation, there was a risk that the fund may not be able to release an insurance payout to the member until some other condition of release was satisfied (for example, reaching the retirement age). In addition, the deductibility of premiums for “own” occupation TPD insurance has been a point of contention.

From 1 July 2011, “own” occupation premiums were only deductible to the
extent the policy was attributable to “any” occupation cover.9

From 1 July 2014, legislative amendments prohibit the acquisition of “own” occupation TPD policies through superannuation.11 These changes also effectively prohibit ownership of trauma policies via superannuation.

Existing policies can, however, be maintained under grandfathering arrangements.

Cross-owned insurance arrangements between partners

Cross-owned insurance is an arrangement where each partner has a fractional interest in the policies on the lives of other partners. Specifically, partners join together to take out an insurance policy on all partners, other than themselves.

The beneficiaries of each cross-owned insurance policy are the other partners. On the death of any partner, the continuing partners use the insurance proceeds to purchase the interest of the deceased partner.

Under cross-owned policy ownership, a CGT exemption normally applies in relation to death benefits, but non-death benefits (ie TPD and trauma) usually incur CGT liability due to the interaction of ss 118-300 and 118-37(1)(b) ITAA97. In particular, while s 118-300 generally exempts any life policy proceeds as long as they are received by the original beneficial owner of the policy (regardless of who that owner might be), as outlined above, s 118-37(1)(b) only exempts non-life insurance proceeds if they are received by the injured person or their relative.

In addition to the CGT consequences of cross-ownership, the structure also has a number of practical difficulties associated with it:

- having received the proceeds of the policy following another partner suffering a triggering event, a continuing partner may decide to start up a new business. This ultimately leaves the estate of the exiting partner with no insurance proceeds and an interest in a non-existent business;

- if the partnership dissolves, it is not possible for partners to take their respective policies, as they do not in fact own them. This can cause significant problems, particularly where one, or more, of the partners becomes uninsured after the original policy has been acquired; and

- cross-owned insurance allows few, if any, planning opportunities following a triggering event; a formal disposal must always take place because the continuing partner has the proceeds of the insurance, while the estate of the exiting partner retains an interest in the business.

For these reasons, specialists rarely recommend cross-ownership for buy–sell arrangements and most historical cross-owned arrangements only remain in place where there are prohibitive costs in restructuring the existing arrangements.

Insurance via a special purpose trust

The use of a trust ownership model to facilitate policy ownership and the legal framework of the buy–sell agreement is the final substantive approach to be considered.

While there is a significant amount of industry literature in relation to the trust ownership model, unfortunately, as with many other aspects of insurance-funded arrangements, the ATO’s position has, until the release of the Bill, been somewhat unclear.

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 structure.

The core benefit of an insurance trust is often its ability to centralise the ownership of all insurance policies and facilitate the efficient transition of a partnership interest following a triggering event. However, many of the practical issues related to cross-ownership, outlined above, also have an impact on a trust ownership model. Given that with the trust ownership model superannuation ownership is impossible, the disadvantages often seem to outweigh the potential advantages.

Historically, from a tax perspective, the level of uncertainty (compared with that of other ownership models outlined above) has undermined the trust ownership approach.

If an insurance policy is taken out by a trustee (who is also the beneficiary of the policy) over the partners of the business, proceeds paid directly to the trustee are likely to be exempt from CGT pursuant to s 118-300. However, due to a lack of guidance from the ATO, many advisers believed the same CGT problems, as summarised in relation to cross-owned insurance above, were likely to apply where there is an addition of a partner to the trustee or insurance policy.

Assuming the Bill (discussed in more detail below) is passed as currently drafted, most of the previous tax-related concerns with trust ownership will be addressed.

ATO ruling

The ATO has released a product ruling (PR 2010/18) in relation to the CGT consequences for the beneficiary of what is generally seen as a “standard” insurance trust deed.

In many respects, the ruling reflects what most specialists in this area have advised for many years, namely, that a properly crafted insurance trust deed should provide appropriate protection for the principals of a business without any significant tax detriment, notwithstanding that there might be other commercial issues to consider regarding the structure.

Unfortunately, the positive aspects of the ruling are largely undermined by the fact that the outcomes are based on the assumption that the insurance trust deed will in fact create absolute entitlement for
each beneficiary in the relevant insurance policy.\textsuperscript{2}

The expressed views of the ATO concerning absolute entitlement are, however, somewhat contentious and the ATO continues to refer to a draft ruling that has never been finalised — despite being issued in 2004.\textsuperscript{3} The Bill addresses these issues, as summarised below.

One practical issue in this regard is that the product ruling confirms that, in order to ensure absolute entitlement, the relevant beneficiary must be able to call for the asset at any time. This largely undermines one of the main commercial reasons why advisers have historically recommended insurance trusts, being that the trustee will be able to control the payment of any insurance proceeds received.

A further practical issue, given the way in which many providers have traditionally structured trust arrangements, is that the product ruling only relates to insurance trust deeds where the company acting as trustee is an entity owned and controlled by the principals involved in the business entity and the relevant insurer is not a party to the arrangements.

**ATO ruling**

Minutes released from an NTLG meeting in 2010 provide further insight into the ATO views in relation to insurance trust deeds.\textsuperscript{5} In summary, the minutes state:

- the status of the taxation ruling on absolute entitlement (TR 2004/D25) remains unclear;
- the ATO considers the finalisation of TR 2004/D25 as intricately linked to how it will deal with bare trusts, which again remains an unresolved issue;
- the ATO confirms that the product ruling released by the ATO in relation to one provider’s insurance trust arrangement is based entirely on the assumption that absolute entitlement was created. This assumption might be an unwise one to make, given the ATO’s apparent attitude in this area; and
- while the ATO flags that they will further consider providing appropriate guidance, they specifically confirm that the 2000 ATO discussion paper, on business succession arrangements, cannot be considered current (as set out above).

Traditionally, the ATO has adopted a very narrow interpretation as to what in fact constitutes a bare trust. This narrow approach was confirmed by the ATO in the yet to be finalised TR 2004/D25.

Ultimately, given the complexities in this area and the uncertainty created by the ATO discussion paper, TR 2004/D25, and the product ruling, many advisers have traditionally recommended obtaining a private ruling on any proposed trust arrangement documenting an insurance-funded buy–sell agreement from the ATO before implementing the strategy. Again, this issue is addressed by the Bill.

**Company-owned business succession insurance**

A number of issues arise where a trading company obtains insurance policies for death, TDP and trauma over each of the core principals who also control the ownership of the shares in the company. Two of the most important issues are:

- the tax consequences of receipt by the company of the insurance proceeds; and how, practically, the transfer of shares to the surviving principals will take place.

For commercial and tax planning (particularly Div 7A ITAA36) reasons, company ownership of business succession insurance can be attractive, but the disadvantages normally outweigh the benefits. For example, on receipt of the insurance payout by the company, further steps need to be taken to:

- have the funds transferred to the exiting shareholders or their estates; and
- ensure that the exiting shareholders transfer their shares.

There are other specific concerns, generally applicable to insurance policies, that are intended for business succession arrangements and owned by a trading company, including:

- while CGT should not be payable on receipt of life insurance proceeds, it will be payable on any TPD or trauma proceeds that are paid to a company. In contrast, no CGT should be payable on receipt of the insurance proceeds where the policies are self-owned;
- there can be significant practical difficulties in accessing insurance proceeds from a company to the appropriate recipient. This is particularly important when the main purpose of the policy is for an equity payment, as opposed to debt cover; and
- where insurance proceeds need to be accessed by the exiting principal (or the principal’s estate), this is usually only achievable via a share buyback or dividend. Generally speaking, both alternatives will have inefficient tax outcomes, at least compared to an individual or trust disposing of a capital asset.

**Proposed changes**

The Bill was introduced to the House of Representatives in December 2014 and is expected to be passed by both houses of parliament.

Among other changes, the Bill amends the way insurance payments are taxed in certain circumstances. In particular, if passed, the Bill will amend the ITAA97 to:

- remove the requirement that, in order to access the exemption under s 118-300, the insurance proceeds are received by the original “beneficial” owner of the life insurance policy. The amendment removes the reference to “beneficial” to clarify that a trustee is eligible for the exemption, where they hold the beneficial interest in the policy for a beneficiary;
- extend the exemption for compensation for injury/illness (ie TPD/trauma insurance proceeds) in s 118-37 to apply where the proceeds are received by the trustee of a trust or superannuation fund (subject to the policy ownership prohibitions outlined above) if the injured/ill person is a beneficiary of the trust; and
- insert a CGT exemption where a trustee makes a payment to a beneficiary (or their legal personal representative) in respect of life, TPD or trauma insurance proceeds. This change also ensures that where the relevant trust is a unit trust, CGT event E4 does not apply.

The proposed amendments appear likely to make trust and superannuation fund ownership of life, TPD or trauma insurance policies more attractive in some circumstances, given the new clarity regarding the tax treatment of the insurance proceeds.

Importantly, the Bill also confirms that, as the changes reflect the intended administrative position, they will apply from 1 July 2005 and taxpayers adversely impacted who would otherwise be out of time will be granted an extension to amend their returns.

**Taxation determinations**

The CGT cell of the ATO has issued a series of taxation determinations
concerning different aspects of s 118-300 that are relevant in the context of buy–sell arrangements. A summary of the conclusions reached in each determination is outlined briefly below.

**TD 94/31**
The original beneficial owner is the person who first takes out the policy and holds the policy in their own right and for their own benefit.

Where a trustee takes out a life insurance policy on behalf of beneficiaries of a trust, the trustee is not the original beneficial owner. Thus, if the trustee pays an amount of money or other consideration to acquire the rights under the policy, then the trustee would be subject to CGT on the proceeds received on disposal of the rights under the policy, unless:

- item 5 of the table at s 118-300 applies (in other words policies are owned via complying superannuation funds); or
- the trustee is a bare trustee, that is, there is a beneficiary who is absolutely entitled to the rights under the policy as against the trustees (in which case, s 106-50 ITAA97 deems the disposal to be by the beneficiary).

For completeness, this determination is likely to be amended or revoked if the Bill passes, in light of the amendments to s 118-300.

**TD 94/32**
Section 112-20 ITAA97 will not apply to deem a market value consideration for s 118-300 purposes where no amount of money or consideration is given for the acquisition of rights under a life insurance policy.

**TD 94/33**
The exemption from CGT on disposal of a life insurance policy under s 118-300 is available on any disposal of the policy by an original beneficial owner, and not just in the specific instances mentioned in s 118-300. Again, the Bill is likely to see this determination amended or revoked.

**TD 94/34**
Where an assignment of rights under, or an interest in, a policy is made by way of gift (and therefore no money or other consideration is given), then payment of the ongoing premiums by the assignee will not be taken to be amounts of money paid to acquire those rights or interest so as to deny the CGT. Therefore, the CGT exemption provided by s 118-300 will remain available.

**Conclusion**
Succession planning is a critical issue for any jointly owned business. The unexpected exit of a principal can result in a range of adverse ramifications for the profitability (and potentially the ongoing viability) of a business together with unintended revenue consequences; however, appropriate structured insurance funding can be an important step in mitigating these risks.

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**References**
1 Pursuant to the market value substitution rule in ss 116-30 and 112-20 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
2 ATO, Discussion paper in relation to buy–sell (business concession) agreements, released 2000 and subsequently withdrawn. Please contact the authors if you would like a copy.
3 Ibid p 9.
4 Ss 116-30 and 112-20 ITAA97.
5 NTLG minutes, December 2010, at item 9.
6 Defined in s 995-1 ITAA97.
7 S 62 of the *Superannuation Industry (Supervision) Act 1993* (Cth).
8 Ss 177-A to 177-G ITAA36.
11 Reg 4.07D of the *Superannuation Industry (Supervision) Regulations 1994* (Cth).
12 Para 4 of PR 2010/18.