

# Key person insurance

**Most businesses have one or more individuals whose continued association with the business, as a result of their investment, experience, technical expertise or connections, provide the business with a significant and direct economic gain. Such individuals can be identified as key persons.**

Their loss from a business could result in a significant impact on revenue, profit or other financial aspects of a business eg goodwill, ability to repay debt and other expenses or access to credit, business contacts and customers.

Key person insurance is essentially life, TPD or trauma insurance policies taken out by a business on the life of a key person.

Where this insurance is taken out and a key person either dies or is unable to perform their duties due to an insurable event (disablement or a specified medical condition), the business can use the insurance proceeds to replace lost revenue, repay debt, cover additional expense items or inject required capital into the business.

This ensures that the business is supported financially until a replacement is found or other staff are trained to fulfil a particular role. Hence, key person insurance helps protect the financial stability of a business and reduces business risk.

It is important to understand the distinction between key person insurance and insurance policies used for business succession planning.

Key person insurance is about protecting the ongoing viability of the business. Conversely, business succession planning is about protecting the owner's (and indirectly his or her family's) personal investment in the business.

## **Who is a key person?**

A key person is any person whose continued association with the business provides the business with a significant economic gain.

The term economic gain used in this context can mean any of the following:

- increased sales and revenue
- cost savings
- increased profit
- increased goodwill
- ability to access finance, and
- ability to access or retain customers.

Key persons can include employees, owners of the business, managing directors, even suppliers – generally those persons whose loss would have a significant impact on the financial viability of the business.

Common examples of an employee who may be a key person include:

- a chief executive officer
- a sales representative who has many contacts and has forged successful relationships with the business's larger customers, and
- a technical person who has a specialist skill that the business relies on to either attract customers or to ensure that its manufacturing process can continue to operate.

A key person does not even have to be an employee of the business. For example, an external supplier of a key component/part in the business's own manufacturing process can be a key person of the manufacturing business, even if the supplier is not employed by the manufacturing business.

Similarly, a non-working shareholder, ie a silent partner, who puts up his personal assets as security for the loans of the business may also be considered to be a key person if the business relies on these guarantees to obtain loans.

## **Who is a key person for tax purposes?**

The identification of a key person is also important from a taxation perspective. The ATO defines a key person in Tax Ruling IT 2434:

An employee may be accepted as a key man where the loss of that employee would result in a significant loss of profits being derived by the employer during the continuation of business operations subsequent to that loss. This would be a situation where there is a continuing business and the resulting loss of profits is a matter that would be expected to be overcome as another employee, or a new employee, is trained to replace the expertise lost with the former employee.

However, IT 2434 also explains that a key man for taxation purposes is not seen to exist in a situation where the loss of an employee, such as the owner/manager of a one man incorporated business, could be expected to result in the termination of the business.

### **Capital or revenue purpose**

Key person insurance can be taken out to cover the business against losses of a:

- capital nature, and/or
- revenue nature.

In an accounting context, where key person insurance is taken out for capital purposes it is attempting to protect the balance sheet of the business ie assets, liabilities and shareholders' equity.

Conversely, where key person insurance is taken out for a revenue purpose it is attempting to protect the profit and loss statement of the business.

### **Capital purpose**

Capital purpose reasons for taking out key person insurance may include:

- repaying debt that may be called in by the lenders as a result of the key person's death, disablement or major illness
- protecting the ongoing credit rating of the business
- repaying loans that have been made to the business by the key person
- repaying debt that has been guaranteed by the key person, and
- protecting the goodwill and capital structure of the business.

### **Revenue purpose**

Revenue purpose reasons for taking out key person insurance may include:

- covering the replacement of lost sales revenue or profits as a result of the death, disablement or major illness of a key person
- covering the added expenses of recruitment costs and the costs of finding a temporary replacement for the key person, and
- enabling the business to make an attractive remuneration offer to prospective replacements for the key person.

### **Substantiation of purpose**

Keeping records relating to the purpose for which an insurance policy is taken out is a very important step for a business.

Tax Ruling IT 155 states that:

With regard to the type of evidence which would be required to establish the purpose for which an accident or term insurance policy has been effected and kept in force, information about the taxpayer's minutes or book entries would be of some value, but should not necessarily be regarded as conclusive.

As indicated in the Carapark Holdings case, all the surrounding circumstances may properly be taken into account in seeking to determine the purpose for which a policy was effected. The purpose for which the proceeds are used is relevant not because this governs the issue directly, but because it provides some indication of what the purpose of taking out the policy is likely to have been.

It is also important to realise that a business's circumstances may change. According to IT 155:

The taxpayer might change his plans from time to time and renew the same policy from year to year for varying purposes.

This may occur where a company takes out key person insurance for the purpose of repaying a debt to a director's estate on the director's death. At the time of taking out the life insurance policy it would appear that the purpose of the cover was capital purpose.

However, a number of years later, when the insurance policy proceeds are received on the death of the director, the business no longer owes the director any money, as the loan to the director has already been repaid in full.

Tax Ruling IT 155 commentary indicates that:

This type of situation would call for enquiries to ascertain whether the debt was in existence at the time of the latest renewal. If the debt had been cleared beforehand, evidence such as minutes indicating that the insurance was originally taken out for the purpose stated by the company could be discounted as being irrelevant in the changed circumstances.

Therefore, it is advisable to record in the formal documents of the business, such as a company's minutes or other formal notes, that a decision was made in relation to the purpose for which the cover was obtained and the rationale behind this decision. However, this in itself cannot be relied on as evidence and the ATO may want to consider all the circumstances surrounding the insurance in assessing whether any claimed deductions are valid.

### **Income tax treatment of insurance premiums and proceeds**

The taxation treatment of both the insurance policy premiums and any benefits paid will be determined by whether the benefit is considered to be for capital or revenue purposes. To a large extent this will be determined by how it is likely that the benefit will be used.

The tax implications of key person insurance are also discussed in Tax Ruling IT 155. In this ruling the ATO quotes from a judgement of the High Court in *Carapark Holdings Ltd versus FCT 1966* as to whether the proceeds of an accident or term policy are assessable under section 25(1) of the ITAA 1936:

In general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt which the event insured against has prevented from arising or of any outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by consideration of morality or expediency.

The ruling goes on to say that the above proposition may also be used as a basis for the determination of claims for the deduction of premiums under section 51(1) of the ITAA 1936, which has been rewritten as section 8-1 of the ITAA 1997.

Broadly speaking, for risk only policies for death, TPD and trauma insurance, where the policy is taken out for:

- capital purposes, the insurance premiums will not be tax deductible under section 8-1 of the ITAA 1997 and any proceeds will not be assessable as income
- revenue purposes, the insurance premiums will be tax deductible under section 8-1 of the ITAA 1997 and any proceeds will be assessable as income.

In addition to the income tax implications of receiving the proceeds of an insurance policy taken out on the life of a key person, there may also be CGT implications.

### **Capital gains tax**

According to subsection 118-300(1) of the ITAA 1997, if a CGT event happens to a life insurance policy or an annuity instrument, a capital gain or loss made from it by:

- the original beneficial owner of the policy or instrument, or
  - an entity that acquired the interest in the policy or instrument for no consideration, or
  - the trustee of a complying superannuation entity for the tax year in which the CGT event happened,
- is ignored for CGT purposes.

The term original beneficial owner is defined in Tax Determination TD 94/31 as:

An original beneficial owner of any of the rights, or any interest in any of the rights, under a policy of life assurance is the first person who:

- i) at the time the policy is effected, holds such rights, or any interest in such rights, and
- ii) possesses all the normal incidents of beneficial ownership (for example, is entitled to the benefits of the policy proceeds and has the power of management and control over the policy as well as the power to transfer, grant as security, surrender or otherwise dispose of the policy).

Therefore, unless the recipient of the life insurance policy is not the original beneficial owner of the policy and the recipient acquired the interest in the policy for money or other consideration, life insurance policy proceeds will not be subject to CGT.

According to Tax Determination TD 94/34 consideration in this context refers to actual consideration and does not include a premium paid under the policy.

In Tax Determination TD 2007/4, the ATO confirmed that the term 'life insurance policy', for the purpose of receiving the CGT exemption in subsection 118-300(1) of the ITAA 1997, includes a life insurance policy that provides for the payment of a terminal illness benefit.

A terminal illness benefit is a pre-payment of a death benefit which is generally payable upon the diagnosis of an illness which will result in the death of the insured within 12 months, regardless of any treatment that they may receive.

Therefore, the CGT exemption in subsection 118-300(1) of the ITAA 1997 can be utilised on the pre-payment of a death benefit under a terminal illness benefit clause, even though the life insured has not yet died.

It is important to note that the CGT exemption under subsection 118-300(1) of the ITAA 1997 only applies to life insurance policies and not disability policies such as TPD or trauma insurance.

However, paragraph 118-37(1)(b) of the ITAA 1997 disregards a capital gain or capital loss upon the receipt of compensation for any injury or illness to the person insured or a relative, as defined in subsection 995-1(1) of the ITAA 1997.

Subsection 995-1(1) of the ITAA 1997 defines a relative of a person as:

- a) the person's spouse, or
- b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of that person, or of that person's spouse, or
- c) the spouse of a person referred to in paragraph b).

If a business has received the proceeds of a key person life, TPD or trauma insurance policy that was taken out for revenue purposes the proceeds would be assessed as income under the general income provisions.

Under these circumstances, even where the proceeds do not fall under any of the CGT exemptions mentioned above, the capital gain would not need to be included in the assessable income of the business a second time. This is because under section 118-20 of the ITAA 1997 the same income cannot be taxed under two sections of the ITAA.

However, where a business received the proceeds of a key person life, TPD or trauma insurance policy that was taken out for capital purposes and the amount was not assessed as income under the general income provisions, the proceeds may still be subject to CGT if the exemptions mentioned above cannot be satisfied.

### **Ownership of insurance policies**

As the purpose of key person insurance is to ensure the ongoing viability of a business, insurance policies taken out to protect the business against the death, disablement or major illness of a key person should be owned by the business.

Premiums on these insurance policies should also be paid by the business. This is particularly important where the key person insurance policies are taken out for revenue purposes, and the premiums can be claimed as a deduction under section 8-1 of the ITAA 1997, that the entity claiming the deduction actually incurs the expenditure.

One disadvantage of the business owning TPD and trauma insurance for capital purposes is that businesses often trade as either companies or trusts and therefore there may be CGT payable on any TPD or trauma insurance proceeds received.

#### **Case study**

Tony and Barry run a company called ABC Pty Ltd together. Tony has provided personal guarantees for ABC Pty Ltd's loans.

ABC Pty Ltd has taken out a life and TPD insurance policy on Tony's life so that if he died or became permanently disabled the business would be able to repay the debt guaranteed by him. ABC Pty Ltd owns the insurance policy and pays the premiums, which are not claimed as a tax deduction.

A year later Tony has an accident that leaves him permanently disabled and ABC Pty Ltd receives the proceeds of the TPD insurance policy.

From the facts that have been disclosed it appears that the TPD insurance policy was taken out for capital purposes. Therefore, it would not be assessable as income.

However, as the proceeds were received by someone (ABC Pty Ltd) other than the life insured or a defined relative of the life insured, the proceeds of the TPD insurance policy will be subject to CGT at the company tax rate of 30 per cent.

## **Alternative ownership structures for debt reduction insurance**

Strictly speaking, capital purpose key person insurance policies which are established to pay off a debt owed by a business in the event of the death, disablement or major illness of a key person who is a guarantor for the loan, are referred to as debt reduction or guarantor protection insurance.

As has already been illustrated in the case study, if a company receives the proceeds from a TPD or trauma insurance policy there will be CGT to pay.

As a result of this some advisers recommend that, where insurance policies are used to protect the business against the death, disablement or major illness of a guarantor, any insurance policies taken out should be owned by either the:

- guarantor, or
- an insurance trust, where the guarantor is absolutely entitled to the proceeds from the insurance policy.

Under this type of arrangement, a legal document called a debt reduction agreement needs to ensure that there is a legal obligation for the guarantor or their estate to pay the insurance proceeds to the lender, so that the proceeds can be used to extinguish the business debt that has been guaranteed. To a large extent the success of this strategy hinges on the strength of the agreement.

An advantage of this approach is that if any TPD or trauma insurance proceeds are received by the life insured or a specially drafted insurance trust then the exemption in paragraph 118-37(1)(b) of the ITAA 1997 can be used and no CGT will be payable.

However, care must be taken with this type of arrangement as it might give rise to a right of contribution by the insured/guarantor or their estate, unless this right is specifically excluded in the agreement.

A right of contribution usually gives rise to a loan account being established by the business in favour of the insured or their estate. This loan subsequently needs to be repaid to the insured or their estate by the business.

The net effect for the business is that it still has a debt, which instead of having to be repaid to the lender now needs to be repaid to the insured or their estate. This defeats the purpose of taking out the insurance policy in the first place.

There is even a school of thought that this type of strategy gives rise to a CGT event.

It is important that your clients seek professional tax advice on these matters prior to entering into an arrangement whereby they take out insurance policies for debt reduction purposes under a self ownership or insurance trust ownership structure, as described in this section.

### **References**

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