Key person capital purpose cover

Presented by Alex Koodrin
National Technical Manager

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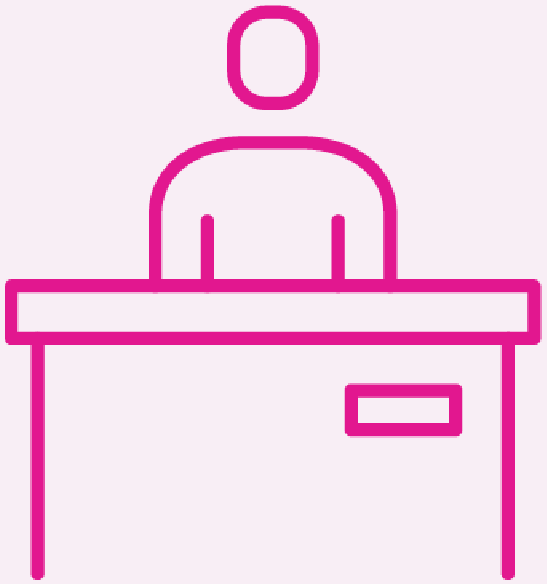
Is succession and key person planning really necessary?

"NO, HE'S NOT ON YOUR CALENDAR...HE SAYS IT'S ABOUT SUCCESSION PLANNING..."

Agenda

- Australian small business statistics
- What is key person capital purpose cover?
- Debt reduction and guarantor protection
- Personal guarantees, loan accounts and goodwill
- ClearView debt reduction calculator
- Documenting capital purpose cover
- Policy ownership options
- Case study



Learning outcomes

At completion of the presentation, participants will be able to:

- Demonstrate knowledge of the main components of key person capital purpose cover: debt reduction, goodwill, guarantor protection and credit standing
- Develop appropriate key person capital purpose insurance solutions and strategies for business owners and businesses
- Differentiate between the tax treatment of life insurance policy proceeds based on various ownership structures
- Demonstrate an understanding of the tips and traps associated with key person capital purpose planning and advice

Glossary

The acronyms and abbreviations in the presentation have the following meanings:

ABS	Australian Bureau of Statistics
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investment Commission
ATO	Australian Taxation Office
CGT	Capital gains tax
ITAA97	Income Tax Assessment Act 1997
RBA	Reserve Bank of Australia
SME	Small to medium enterprise

Australian small business statistics

As at 30 June 2023, Australia had over 2.5 million actively trading small businesses, representing **over 97%** of all businesses

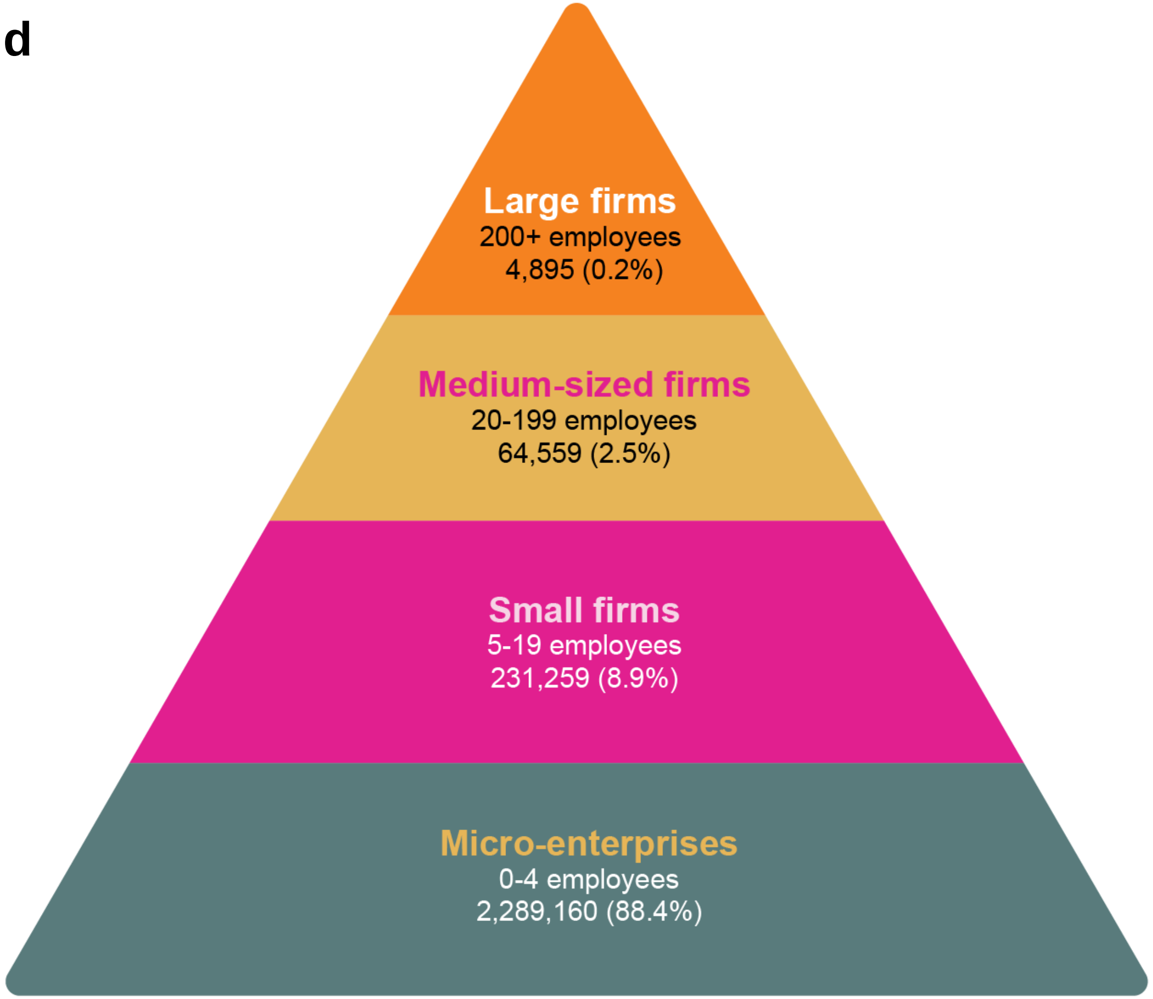
In 2022-23 the number of actively trading businesses in Australia **increased by 0.8% (19,973)**

Of the **2,589,900 businesses**, there were 1,585,693 (61%) non-employing and 1,004,180 (39%) employing businesses.

Source: ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2019 to June 2023

Businesses by employment size range

Australian business pyramid



Source: ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2019 to June 2023

Private sector business legal structures in Australia

Companies	1,052,213 (41%)
Sole Proprietors	798,209 (31%)
Trusts	487,261 (19%)
Partnerships	231,839 (9%)
Total	**2,569,522**

Small business lending statistics

Total loans $ million	Residentially secured $ million	Fixed Rate $ million	Variable Rate $ million
167,358	77,296	57,061	110,297

A business is classified as small if the financial institution has an exposure to the business of less than $1 million and the business has a turnover of less than $50 million

Source: RBA: Lending to Business: Business Finance Outstanding by Business Size and Interest Rate Type as of 30 November 2023

Question

Approximately what percentage of all small business loans are residentially secured?

a) 50 per cent

b) 60 per cent

c) 70 per cent

d) 80 per cent

Answer:

a) **50 per cent**

A scenario to consider?

Bill was tragically killed in a car accident. He had worked hard with his fellow business owner to build the business to the point where it provided a financially stable environment for his family.

Bill, like many business owners, took out a significant loan to build the business. He gave personal guarantees but did not really understand what that meant.

Bill's business debts did not disappear on his death. His debts went beyond the grave as his estate became liable for the loan.

Bill's wife Barbara was left with insufficient cash to pay out the loan. She had to sell Bill's share of the business quickly or lose the family home. The 'fire sale' proceeds were enough to pay out the loan but left little else.

If Bill had taken out business debt reduction cover (key person capital purpose), he could have provided the financial security he wanted for his family.

What is key person capital purpose cover?

Losing a key person can adversely affect the capital value of a business, which can be offset by key person insurance proceeds.

Key person capital purpose cover can be used to:

- to repay or reduce any external debt of the business (debt reduction and/or guarantor protection)
- repay loan accounts owed to departing business principal or vice versa
- compensate the business for any loss of goodwill following the loss of a business principal
- minimise any impact on the business's credit standing

Why is capital purpose cover important?

Key person capital purpose cover allows the business to free up cash flow and maintain its credit standing despite the loss of a business owner.

This cover enables the business to repay/reduce external and internal debt and compensate for loss of capital value without:

- **using business profits**
- **accessing cash reserves**
- **borrowing funds**
- **selling assets**

Debt reduction and guarantor protection

When a business principal signs a guarantee, it generally means they have secured a business loan directly or indirectly using all or some of their personal assets.

The guarantee is usually extinguished only when the loan is repaid in full. A lender may be able to call on the guarantee in the event or death, disablement or critical illness. Debt reduction/guarantor protection has a dual purpose:

1. Protect the guarantor and their estate. The insurance proceeds are available to extinguish the guarantee, releasing the guarantor and the estate from the lender's security over the family's personal assets

2. Provide a benefit to the business and the remaining business principals: if the debt is wholly or partly repaid, the financial burden on the business is reduced and other guarantors could be released from their guarantees.

Question

Generally, what is the treatment of a joint and several personal guarantee upon the death of the guarantor?

a) It is automatically extinguished by the creditor

b) Any other guarantors are liable for the full amount of the debt

c) The deceased estate continues to be liable under the guarantee

d) Both b) and c)

Answer:

d) Both b) and c)

How much debt reduction/guarantor protection is needed?

If possible, determine how much of the business debt should be repaid in order to release the principal's personal guarantee and any other personal securities.

The amount of debt reduction/guarantor protection cover required depends on the type of guarantee signed. Most bank loan or overdraft guarantees are joint and several.
The choices for a business with loan of $1.5 million, which has three principals with equal equity and a joint and several guarantee are:

1. Assume (or hope) that the lender will request repayment of only their share of the debt – in the case, one third or $500k, and insure each principal for that amount

2. Assume that the lender will most likely recall the total of the loan. On that basis, insure each principal for the full loan amount, i.e., $1.5 million.

Internal debt: At-call loan accounts, directors' loan accounts

In general, an ‘at call’ loan is a loan that does not have a fixed repayment term and is repayable on demand by the lender.

An example of an ‘at call’ loan: Directors' loan accounts

These are loans to/from a director/shareholder. Amounts owed to a director are recorded in the company’s financial record as a creditor while amounts due from the director to a company are recorded as a debtor

This is usually a general unsecured debt so it's last in line to be paid if a business needs to be liquidated, unless there is a general security agreement with the company, registered on the Personal Property Securities Register (PPSR)

Tip

Clients should look at refinancing, if possible, to separate business debt from personal (removing security for a business loan)

ClearView Debt Reduction Calculator

Introducing the new ClearView Debt Reduction Calculator

Loans the business principal is jointly and severally liable for

- Cover based on a sliding scale, taking into account the total debt and number of business principals

Generally, 100% of loans owing to or owed by the business principal

Ratio of replacement (cover vs loan)

No. of Partners	1st $1m	2nd $1m	3rd $1m	4th $1m	Balance
2 Partners	100%	100%	75%	75%	75%
3 Partners	100%	100%	60%	60%	50%
4 Partners	100%	100%	30%	30%	30%

ClearView Debt Reduction Calculator

Business rules:

- Maximum loan for calculator is $10m; individual consideration loans above this amount
- Maximum TPD (if all for business purposes) is $5m
- Maximum of 4 business owners (all owners, not 4 out of 6)
- Not available with Business Guarantee Option
- Cannot be used to determine trauma benefit
- Keep in mind all cover (debt + buy/sell + keyperson + personal)

Goodwill hunting

What is goodwill?

Goodwill is the intangible value of a business such as its reputation, branding, location, market penetration, customer loyalty, and other value that makes the business. It is what makes the purchase price of a business higher than just the fair market value of all its assets less liabilities.

There are essentially **three types** of goodwill:

- Enterprise (Commercial) goodwill
- Personal (Professional) goodwill
- Non-transferrable personal goodwill

Personal goodwill derives from and attaches to the people or to an individual in the business because of their know-how, experience, expertise, ability and the personality to attract and retain customers.

The ATO does not distinguish between personal goodwill and enterprise (‘site’ and ‘name’) goodwill. Goodwill of a business is a single CGT asset (TR 1999/16).

Question

Which type of goodwill should a business consider insuring to compensate for the loss of a key person?

a) Enterprise goodwill

b) Commercial goodwill

c) Transferable personal goodwill

d) Non-transferable personal goodwill

Answer:

d) **Non-transferable personal goodwill**

Capital gains tax (CGT) exemptions – term life policies

Section 118-300 ITAA 1997 – a CGT exemption on death or terminal illness proceeds applies if they are paid to the original owner of the policy. Also exempt if paid to someone other than the original policy owner, provided that person or entity did not pay money or give any other consideration for the acquisition of the rights or interest in the policy.

Consideration:

- An agreement to do something in return for something else
- A payment of money in exchange for an item or a right
- An exchange of life policies, i.e. dual assignment
- The acquisition or disposal of a right
- Giving, or receiving the benefits of promises, or
- An exchange of property (excludes payment of future premiums on that policy)

Capital gain is also disregarded if proceeds are received by a beneficiary of a trust (from a trustee) or as LPR of a beneficiary of a trust.

Capital gains tax (CGT) exemptions: TPD and trauma policies

Section 118-37 ITAA 1997 – a CGT exemption applies to TPD and trauma proceeds if they are paid to the insured person or a relative (as defined in section 995.1 ITAA1997)

1. the person's spouse; or
2. the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of that person's spouse; or
3. The spouse of a person referred to in paragraph (b)

The 2015 amendment extends this exemption to proceeds received as a trustee of a trust or received as a beneficiary from a trustee of a trust.

Substantiating the purpose of the cover

It is important to document the purpose of the cover:

When cover is first taken out, record the purpose through minutes, book entries or file notes

Annual reviews should confirm the purpose of the insurance

Application of the proceeds after receipt should reflect the purpose

If not using an insurance trust, have separate policies for key person capital and revenue purpose cover (note: ClearView does not charge a policy fee so no extra cost and we aggregate the sums insured for separate policies for the same product).

Question

Which of the following is the best way for a company to demonstrate the purpose of key person capital cover?

a) At policy inception, the business principals need to verbally agree as to the purpose of the cover

b) At policy inception, the company needs to write to the ATO advising it of the purpose of the cover

c) At policy inception, the purpose of the cover needs to be recorded in company minutes

d) At policy inception, the purpose of the cover needs to be noted in the policy schedule

Answer:

c) At policy inception, the purpose of the cover needs to be recorded in company minutes

Policy ownership options

1. Business entity (company) ownership

Key person capital cover (including debt reduction cover) has traditionally been owned by the company or business. This has no adverse tax consequences for term life cover but has CGT implications for TPD and trauma cover. Company-owned TPD and trauma cover proceeds would generally incur a CGT liability of 30%, requiring a gross-up of cover. For instance, a $1 million debt would require a sum insured of $1,428,571 to obtain the appropriate net proceeds.

2. Self-ownership (guarantor protection)

Each director who has provided a personal guarantee self-owns term life, TPD and trauma cover. No need to gross up the cover. Upon the occurrence of an insurance event, the director (or the estate) discharges the bank loan via a contractual debt reduction agreement, thereby releasing personal guarantees. But what are the CGT consequences of a debt reduction agreement?

Policy ownership options

3. Hybrid strategy

Some commentators promote this strategy as a solution for companies. Assume a $600k debt and a business with three equal partners worth $1.2m, with a personal cover requirements of $400k. Each principals takes $1m self-owned life, TPD and trauma cover. Equity to be transferred and proportion of debt to be repaid on death, TPD or trauma of a principal (subject to release from all guarantees and security arrangements).

4. Insurance trust ownership

Insurance (absolute entitlement) trust owns term life, TPD and trauma policies of $1m. Upon the occurrence of an insurance event, trustee is directed via agreement to repay debt by first crediting the proceeds to the continuing Proprietors, who then lend the proceeds to the business so it can repay bank/creditor, thus creating new loan accounts owning to the Proprietors in substitution for the external debt to the bank/creditor.

5. Bank ownership

Financial institutions may insist they own a debt reduction policy as a condition of the loan. From a CGT perspective, it would make sense for the person insured (the business principal) to own the policy initially and transfer it to the institution via Memorandum of Transfer (MOT).

Case study: P&S Engineering Pty Ltd

- **Paul** (aged 54) and **Steven** (aged 46) are directors of an engineering and mechanical repair business, P&S Engineering Pty Limited
- The company is owned by four individual equal shareholders (25% each): Paul and his wife Lily (aged 49) and Steven and his wife Amanda (aged 38), but the wives are not active in the business
- Business is valued at $3 million, net profit last year was $600,000
- Company has an $800,000 business loan, supported by personal guarantees, and all shareholders are jointly and severally liable for the loan
- The couples injected $400,000 ($200,000 each) into the business at inception as a loan
- How much capital purpose cover (debt reduction) is required and who should own?

Case study: P&S Engineering Pty Ltd

Paul	$	$
Repay full amount of bank loan	$800,000	$1,142,857
Repay loan account	$200,000	$285,714
Total cover required	$1,000,000	$1,428,571

Steven	$	$
Repay full amount of bank loan	$800,000	$1,142,857
Repay loan account	$200,000	$285,714
Total cover required	$1,000,000	$1,428,571

Case study: P&S Engineering Pty Ltd

Option 1: Company ownership

- **Steven** and **Paul** agree to take $1,428,571 term life, TPD and trauma insurance cover respectively on their lives for key person capital purpose (debt reduction)

- Policies are to be company owned and need to be grossed up to cover CGT component

- The purpose of the insurance cover will be documented via company minutes

- As the policies are for capital purpose and properly documented, the premiums are not tax deductible and the proceeds are not assessable

- If Steven or Paul suffer an insurable event and proceed to a successful claim, the insurance proceeds (after CGT liability) will pay out the $800,000 bank loan, thereby releasing personal guarantees and pay out the departing principal’s $200,000 loan account.

Case study: P&S Engineering Pty Ltd

Option 2: Self-ownership

- **Steven** and **Paul** both agree to take $1,000,000 term life, TPD and trauma insurance cover on their own lives for key person capital purpose (debt reduction)
- Policies are to be self-owned
- There is no need for documenting the purpose of the cover for the bank loan
- If Steven or Paul suffer an insurable event and proceed to a successful claim, the insurance proceeds will pay out the $800,000 bank loan, thereby releasing personal guarantees and the claimant will retain the $200,000 excess to extinguish the loan account
- Ensure the repayment of the loan account is documented via minutes, etc.

Case study: P&S Engineering Pty Ltd

Option 3: Business insurance trust ownership

- **Steven** and **Paul** agree to take $1,000,000 term life, TPD and trauma insurance cover respectively on their lives for key person capital purpose (debt reduction)
- Policies are to be owned by the trustee of an insurance trust, satisfying CGT insurance exemptions
- The purpose of the insurance cover will be documented via minutes
- Policies are for capital purpose and properly documented, the premiums are not tax deductible and the proceeds are not assessable
- If Steven/Paul suffers an insurable event, the claim proceeds will pay out the $800,000 bank loan, release personal guarantees and pay out the departing principal’s $200,000 loan account
- Repayment of business debt can be achieved by one of the following:
  - Payment to the bank directly
  - Payment to the business (then the financier) or debtor (loan account)
  - Payment to the continuing proprietors

Summary

Key person capital purpose cover is an important component of key person planning

It can be used to repay internal and external debt, release personal guarantees and compensate for the loss of good will

Key person capital cover premiums are not tax deductible to the business and not assessable for income tax; however, they may be subject to CGT

Key person capital purpose cover should be documented at inception and reviewed annually