PR 2010/18 - Income tax: capital gains tax consequences for a Beneficiary of an Insurance Trust Deed

Product Ruling

Income tax: capital gains tax consequences for a Beneficiary of an Insurance Trust Deed

Contents Para

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

No guarantee of commercial success

The Commissioner **does not** sanction or guarantee this product. Further, the Commissioner gives no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential participants must form their own view about the commercial and financial viability of the product. The Commissioner recommends a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out in the **Ruling** part of this document are available, **provided that** the scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document. If the scheme is not carried out as described, participants lose the protection of this Product Ruling.

Terms of use of this Product Ruling

This Product Ruling has been given on the basis that the entity(s) who applied for the Product Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Product Ruling.

What this Ruling is about

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling section (below) apply to the defined class of entities, who take part in the scheme to which this Ruling relates. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

2. In this Product Ruling this scheme involves the execution of the Business Buy-Sell Agreement (BBSA) and the Insurance Trust Deed (ITD).

3. This Product Ruling does not address:

- any income tax consequences arising from the scheme other than those relating to the capital gains tax provisions;
- the tax consequences arising from the granting or exercise of a Buy or Sell Option; and
- the tax consequences of any increase, reduction, consolidation, sub-division or variation of an Owner's Equity in the Business Entity.

4. **This Product Ruling does not consider whether the Beneficiary is absolutely entitled as against the Trustee to the legally enforceable rights under the Insurance Policy.** It is, however, assumed that the entities that can rely on the Ruling section of this Product Ruling are absolutely entitled as against the Trustee to the legally enforceable rights under the Insurance Policy (see paragraph 22 of this Ruling).

Class of entities

5. This part of the Product Ruling specifies which entities can rely on the Ruling section of this Product Ruling and which entities cannot rely on the Ruling section. In this Product Ruling, those entities that can rely on the Ruling section are referred to as the Beneficiary.

6. The class of entities who can rely on the Ruling section of this Product Ruling consists of those entities that begin to participate in the scheme specified in this Ruling by virtue of their execution of the BBSA, as Principal, and the ITD, as Beneficiary, on or after the date this Product Ruling is made and on or before 30 June 2013.

7. The class of entities who can rely on the Ruling section of this Product Ruling does **not** include:

- entities who enter into this scheme before the date of this Ruling or after 30 June 2013; or
- a Beneficiary who is not absolutely entitled as against the Trustee to the legally enforceable rights under the Insurance Policy.

Superannuation Industry (Supervision) Act 1993

8. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA). The Commissioner gives no assurance that the scheme is an appropriate investment for a superannuation fund. The trustees of superannuation funds are advised that no consideration has been given in this Product Ruling as to whether investment in this scheme may contravene the provisions of SISA.

Qualifications

9. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 18 to 22 of this Ruling.

10. If the scheme actually carried out is materially different from the scheme that is described in this Product Ruling, then:

- this Product Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Product Ruling may be withdrawn or modified.

Date of effect

12. This Product Ruling applies prospectively from 1 September 2010, the date it is published. It therefore applies only to the specified class of entities that enter into the scheme from 1 September 2010 until 30 June 2013. This Product Ruling provides advice to the specified class of entities for the income years up to 30 June 2013 being its period of application. This Product Ruling will continue to apply to those entities even after its period of application has ended for the scheme entered into during the period of application.

13. However the Product Ruling only applies to the extent that there is no change in the scheme or in the entity's involvement in the scheme.

Changes in the law

14. Although this Product Ruling deals with the income tax laws enacted at the time it was issued, later amendments may impact on this Product Ruling. Any such changes will take precedence over the application of this Product Ruling and, to that extent, this Product Ruling will have no effect.

15. Entities who are considering participating in the scheme are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to promoters and advisers

16. Product Rulings were introduced for the purpose of providing certainty about tax consequences for entities in schemes such as this. In keeping with that intention the Commissioner suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling has issued.

Ruling

17. Subject to paragraphs 3 and 4 of this Ruling and the assumptions in paragraph 22 of this Ruling:

(a) The legally enforceable rights under the Insurance Policy to which the Beneficiary is absolutely entitled as against the Trustee are a CGT asset under subsection 108-5(1).

(b) CGT event C2 under section 104-25 happens when rights under the Insurance Policy end. That is, when the Insurer makes a payment of the Proceeds in satisfaction of the rights under the Insurance Policy.

(c) A capital gain will arise under section 104-25 to the Beneficiary (and not to the Trustee) if the capital proceeds from the ending are greater than the cost base of the rights under the Insurance Policy. A capital loss will arise under section 104-25 to the Beneficiary (and not to the Trustee) if the capital proceeds from the ending are less than the reduced cost base of those rights.

(d) The capital proceeds under section 116-20 from this CGT event C2 will be the amount of Proceeds the Trustee receives or is entitled to receive from the Insurer under the Insurance Policy.

(e) The cost base or reduced cost base of the rights under the Insurance Policy to which the Beneficiary is absolutely entitled as against the Trustee includes the insurance premiums (subsections 110-25(2) and 110-55(2)).

(f) In the event of the Beneficiary's death:

(i) A capital gain will arise under section 104-25 to the Beneficiary's estate if the capital proceeds from the ending of the Beneficiary's estate's rights are greater than the cost base of those rights under the Insurance Policy. A capital loss will arise under section 104-25 to the Beneficiary's estate if the capital proceeds from the ending of the Beneficiary's estate's rights are less than the reduced cost base of those rights.

(ii) The capital proceeds under section 116-20 from this CGT event C2 will be the amount of Proceeds the Trustee receives or is entitled to receive from the Insurer under the Insurance Policy.

(g) Any capital gain or capital loss made by the Beneficiary's estate in the event of the Beneficiary's death under section 104-25 upon payment of a death benefit by the Insurer under the Insurance Policy will be disregarded pursuant to item 4 in the table in subsection 118-300(1) because they acquire the right to that payment for no consideration.

(h) Any capital gain or capital loss the Beneficiary makes under section 104-25 upon payment of a non-death benefit by the Insurer under the Insurance Policy in respect of an injury or illness the Beneficiary suffers will be disregarded under paragraph 118-37(1)(b).

(i) Any payment by the Trustee from the Proceeds of a Claim to each Entity, as directed by the Beneficiary under clause 6 of the ITD, is treated pursuant to section 103-10 as if the Beneficiary, or the Beneficiary's estate, had received the Proceeds.

(j) A CGT event will not happen upon the transfer of the Insurance Policy by the Trustee to the Beneficiary.

(k) Provided the scheme ruled on is entered into and carried out as described in this Ruling, the anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to a Beneficiary.

Scheme

18. The scheme that is the subject of this Ruling is identified and described in the following documents:

- application for a Product Ruling as constituted by documents and information received on 2 June 2010, 14 June 2010, 15 August 2010 and 24 August 2010;
- Draft **BBSA**, received on 14 June 2010; and
- Draft **ITD**, received on 14 June 2010.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

19. The documents highlighted are those that a Beneficiary will enter into. For the purposes of describing the scheme to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Beneficiary, or any associate of a Beneficiary, will be a party to, which are a part of the scheme.

20. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

Overview

21. Following is a summary of the scheme:

Business Buy-Sell Agreement

(a) The Owners of a Business Entity agree to grant Buy and Sell Options with respect to the shares held by them in the Business Entity (their Equity) on the terms set out in a BBSA executed between each of the Owners and the Principals. Each Principal is either an Owner or Related to an Owner.

(b) Each Owner:

(i) grants to the other Owners an option to purchase that Owner's Equity (a Buy Option) within the Option Exercise Period for the Purchase Price on the terms and conditions set out in the BBSA upon the occurrence of an Option Event in relation to the Principal of that Owner; and

(ii) is granted an option to require the other Owners to purchase that Owner's Equity (a Sell Option) within the Option Exercise Period for the Purchase Price on the terms and conditions set out in the BBSA upon the occurrence of an Option Event in relation to the Principal of that Owner.

(c) The Purchase Price is intended to reflect the market value of the Equity and shall be equal to the same percentage of the Business Value as the Owner's Equity represents as a percentage of the total number of issued shares in the Business Entity.

(d) Option Events are the death, total and permanent disablement or trauma/illness of a Principal.

(e) Where there is more than one grantee of an Option, the Option may only be exercised by all grantees, unless otherwise agreed in writing by all grantees. The purchasing Owners must, unless agreed otherwise between them and provided the selling Owner is notified of this prior to expiration of the applicable Option Exercise Period, purchase the Equity of the selling Owner in proportion to their respective ownership interests in the Business Entity at that time.

(f) The operation of the BBSA is conditional upon each Principal executing and becoming bound by a separate ITD as sole Beneficiary at the same time as becoming bound by the terms of the BBSA.

(g) The Purchase Price payable upon exercise of an Option is reduced by the amount of Proceeds paid or payable under the Insurance Policy as a consequence of the occurrence of an Option Event which is applied under the ITD towards payment of the Purchase Price (provided the Purchase Price shall not as a result be reduced below zero).

(h) The BBSA also sets out provisions relating to:

- the completion of the sale and purchase of Equity;
- the termination of the BBSA; and
- the admission of new parties to the BBSA.

Insurance Trust Deed

(i) Pursuant to the terms of each ITD executed between the Trustee and the Beneficiary, the Trustee agrees to effect with the Insurer (an insurance company) the Insurance Policy, the proceeds of which are, among other things, to be used to fund the purchase by each of the Owners under the BBSA (other than the Beneficiary's Related Owner) of the Beneficiary's Related Owner's Equity.

(j) The Trustee under each of the ITDs will be a company whose directors and shareholders are the same as the directors and shareholders of the Business Entity and whose shareholders each own one ordinary share in that company.

(k) The Trustee will hold the Insurance Policy in its own name as bare trustee for and for the benefit of the Beneficiary on the terms set out in the ITD.

(l) The life insured under the Insurance Policy will be the Beneficiary. That Insurance Policy will be issued on the normal terms and conditions of a domestic insurance company under a Product Disclosure Statement.

(m) The Insurance Policy will be a policy of insurance on the life of an individual for the purposes of section 118-300, and will provide for an amount to be paid by the Insurer upon the incurrence of an Insured Event, being an Option Event as that term is defined under the BBSA.

(n) The Insurer is not a party to the ITD.

(o) The Beneficiary promises to pay on time all insurance premiums required by the Insurer to effect and maintain the Insurance Policy.

(p) When notified by the Beneficiary (or the Beneficiary's executor or administrator) of the circumstances which allow for a claim to be made under the terms of the Insurance Policy, the Trustee must make a Claim. The Trustee is required to be notified of the occurrence of an Insured Event within 5 business days of the occurrence.

(q) The Trustee will hold the Proceeds of a Claim under the Insurance Policy on trust for the Beneficiary. The Trustee shall not be entitled to any interest in or benefit in, or to, the Proceeds.

(r) The ITD intends to establish the Beneficiary's absolute entitlement as against the Trustee to the rights under the Insurance Policy. Despite this express intention, this Product Ruling does not consider whether the Beneficiary is absolutely entitled as against the Trustee to those rights.

(s) The Beneficiary's interest in the Insurance Policy and in the Proceeds is, according to the ITD, vested in possession and indefeasible. The Beneficiary may call for the Insurance Policy or the Proceeds to be transferred to them or to a third party at any time in accordance with the ITD.

(t) The Beneficiary directs the Trustee, and the Trustee agrees, to pay from the Proceeds each Entity (the Business Entity, the Beneficiary, the Beneficiary's Related Owner and the other Owners) the Amount which corresponds to that Entity for each Purpose within 7 days of the receipt of those Proceeds by the Trustee from the Insurer. The Trustee will upon receipt of the Proceeds open and maintain as many separate bank accounts as there are Purposes.

(u) If after a Claim is made the amount of the Proceeds from that Claim are for any reason less than the total of all the Amounts, then the Trustee will apply those Proceeds to pay the Amounts in the order set out in clause 6.4 of the ITD.

(v) If after a Claim is made the amount of the Proceeds from that Claim is in excess of the total of all the Amounts, then the Trustee will pay the Excess in accordance with clause 10 of the ITD.

(w) The ITD also sets out provisions relating to:

- the variation of an Entity, Amount and/or Purpose under Schedule 2 of the ITD; and
- the duties of the Trustee.

Assumptions

22. This Ruling is made on the basis of the following assumptions:

(a) the Beneficiary is a natural person;

(b) the Insurance Policy effected by the Trustee will be a policy of insurance on the life of an individual for the purposes of section 118-300, issued by a domestic Insurer under a Product Disclosure Statement;

(c) the Beneficiary is absolutely entitled as against the Trustee to the legally enforceable rights under the Insurance Policy;

(d) the insurance premiums payable by the Beneficiary to effect and maintain the Insurance Policy will not constitute assessable income of the trust estate;

(e) all dealings between the Beneficiary, Trustee and Insurer will be at arm's length; and

(f) the scheme will be executed in the manner described in the Scheme section of this Ruling, the BBSA and ITD mentioned in paragraph 18 of this Ruling.

Commissioner of Taxation
1 September 2010

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Absolutely entitled beneficiary

23. If a beneficiary is absolutely entitled to a CGT asset as against a trustee of a trust (disregarding any legal disability), the CGT provisions apply to an act done by the trustee in relation to the asset as if the beneficiary had done it (section 106-50). Effectively, the trust relationship is ignored and the beneficiary is taken to be the owner of the CGT asset and the relevant taxpayer if a CGT event happens to that asset.

24. Taxation Ruling TR 2004/D25[1] explains the circumstances in which a beneficiary of a trust is considered to be absolutely entitled to a CGT asset of the trust as against its trustee. That ruling provides that the core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in an entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction.

Section 108-5 – CGT asset

25. Under subsection 108-5(1) a CGT asset is any kind of property or a legal or equitable right that is not property.

26. The rights under the Insurance Policy of an absolutely entitled Beneficiary as against the Trustee are legally enforceable rights and therefore a CGT asset according to the definition in subsection 108-5(1).

Section 104-25 – CGT event C2

27. Where the Insurer makes a payment of the Proceeds in satisfaction of the Beneficiary's contractual rights under the Insurance Policy, the Beneficiary's ownership of those rights are discharged or satisfied. This discharge or satisfaction of the contractual rights gives rise to CGT event C2 (paragraph 104-25(1)(b)).

28. In the event of the Beneficiary's death, the rights to which the deceased Beneficiary was absolutely entitled as against the Trustee under the Insurance Policy will pass to their estate. CGT event C2 will happen to them upon the ending of those rights.

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[1] Taxation Ruling TR 2004/D25 Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*.

29. The Beneficiary, or the Beneficiary's estate in the event of the Beneficiary's death, will make a capital gain from this CGT event if the capital proceeds from the ending of the ownership of their asset are more than the asset's cost base or, alternatively, a capital loss from this CGT event if those capital proceeds are less than the asset's reduced cost base (subsection 104-25(3)).

30. The Beneficiary's, or the Beneficiary's estate's in the event of the Beneficiary's death, capital proceeds will be equal to the amount of Proceeds the Trustee receives or is entitled to receive from the Insurer under the Insurance Policy (section 116-20).

31. At the time of the Trustee's acquisition of the Insurance Policy the Beneficiary acquires a CGT asset with a cost base or reduced cost base that includes, as its first element, the insurance premium (subsections 110-25(2) and 110-55(2)).

Section 118-300 – payment of death benefits under Insurance Policy

32. Section 118-300 exempts certain capital gains and losses made in respect of a policy of insurance on the life of an individual. The meaning to be given to the expression 'policy of insurance on the life of an individual' includes, but is not limited to, life insurance policies within the common law meaning of that term. It can apply to other life insurance policies as defined in subsection 995-1(1) but only to the extent that those policies provide for a sum of money to be paid if an event happens that results in the death of an individual (Taxation Determination TD 2007/4).[2]

33. Item 4 of the table in subsection 118-300(1) provides that a capital gain or capital loss you made from a CGT event happening in relation to a CGT asset that is an interest in rights under a life insurance policy is disregarded where that CGT event happens to an entity that acquired the interest in the policy for no consideration.

34. A deceased Beneficiary's estate would be taken to have acquired the deceased Beneficiary's rights under the life insurance policy for no consideration. A deceased Beneficiary's estate will therefore be entitled under item 4 in the table in subsection 118-300(1) to disregard any capital gain or capital loss they make under section 104-25 from the receipt of a payment of a death benefit from the Insurer.

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[2] Taxation Determination TD 2007/4 Income tax: capital gains tax: is a 'policy of insurance on the life of an individual' in section 118-300 of the *Income Tax Assessment Act 1997* limited to a life insurance policy within the common law meaning of that expression?

Section 118-37 – payment of non-death benefits under Insurance Policy

35. Section 118-37 disregards a capital gain or capital loss relating to compensation or damages received by a taxpayer as a result of any wrong, illness or injury they or their relative suffered.

36. A receipt of an amount under an insurance policy for a non-death benefit such as trauma or total and permanent disablement constitutes a form of compensation or damages covered by paragraph 118-37(1)(b) where the amount is received for a wrong, injury or illness suffered personally by the recipient or the recipient's relative.

37. Any capital gain or capital loss the Beneficiary makes under section 104-25 upon payment of a non-death benefit by the Insurer under the Insurance Policy in respect of an injury or illness suffered by the life insured (being the Beneficiary) will be disregarded under paragraph 118-37(1)(b).

Payment of Proceeds to Entities

38. Under the ITD, the Beneficiary directs the Trustee to pay part of the Proceeds to each Entity set out in Schedule 2 of the ITD. Section 103-10 provides that the CGT provisions (including sections 118-37 and 18-300) apply as if you had received money or other property if it has been applied for your benefit or as you direct.

39. Accordingly, the payment of the Proceeds by the Trustee to an Entity other than the Beneficiary will be treated as if it were a payment by the Trustee to the Beneficiary (or the Beneficiary's estate) for the purposes of sections 118-37 and 118-300.

Transfer of Insurance Policy to Beneficiary

40. No CGT event happens when the legal title in an asset to which a beneficiary is absolutely entitled as against the trustee is transferred to the beneficiary. Therefore, no capital gain or capital loss will arise on the transfer of the Insurance Policy by the Trustee to the Beneficiary in accordance with the terms of the ITD.

Part IVA – anti-avoidance

41. Provided that the scheme ruled on is entered into and carried out as disclosed in this Ruling, it is accepted that the scheme is an ordinary commercial transaction and Part IVA of the ITAA 1936 will not apply.

Appendix 2 – Detailed contents list

42. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2004/D25; TD 2007/4

Subject references:

- capital gains tax
- financial products
- insurance policies
- product rulings
- public rulings
- tax avoidance
- taxation administration

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1997
- ITAA 1997 103-10
- ITAA 1997 104-25
- ITAA 1997 104-25(1)(b)
- ITAA 1997 104-25(3)
- ITAA 1997 106-50
- ITAA 1997 108-5
- ITAA 1997 108-5(1)
- ITAA 1997 110-25(2)
- ITAA 1997 110-55(2)
- ITAA 1997 116-20
- ITAA 1997 118-37
- ITAA 1997 118-37(1)(b)
- ITAA 1997 118-300
- ITAA 1997 118-300(1)
- ITAA 1997 995-1(1)
- SISA 1993
- TAA 1953
- Copyright Act 1968

ATO references

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