



Life Insurance Policy Ownership

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Overview

Many Advisors are familiar with managed investments and superannuation but few are familiar with Life Insurance and the role they play.

The Life Insurance Act 1995 (Cth) (LI Act) is the principal controlling legislation of matters relating to life insurance policies. The LI Act provides a detailed description of the issue of life insurance policies and the eligibility to own such a policy. Life insurance policies are contracts of insurance. A policy can only be owned by one or more legal entities (i.e. an individual or a company but owners may act in different capacities).

Life insurance policies are also contracts of insurance and therefore subject to the provisions contained in the Insurance Contracts Act 1984 (Cth).

What follows is an overview of Life Insurance Ownership.

Life Insurance Ownership and the Recipient Beneficiary

A life insurance policy will usually have a number of parties involved, including the life insured, policy owner, being the Life Insurer and nominated beneficiary. This also includes persons who were not a party to the original contract, such as a subsequent assignee (e.g. a mortgagee or trustee). The Financial Product Provider generally will only recognise the interests of the policy owner or subsequent

assignee of the policy, regardless of any interests of the life insured or potential beneficiaries.

The Insurance Provider is not a trustee and the policy is simply a contract to pay the agreed sum to the policy owner or as the policy owner may direct on the occurrence of an insured event.

In this regard the insurer does not recognise the beneficial or equitable interests of other parties involved, only the contractual duties it owes to the policy owner in respect to the Financial Product.

The Life Insurance Act states that the insurer's liability commences when a policy is issued to the legal entity with whom the Insurance Provider has entered into a contract of Life Insurance.

Policy owner

The Life Insurance Act defines the policy owner as either:

- The person to whom the policy is issued, or
- If the rights of that person under the policy have been assigned under the Life Insurance Act or transferred by the operation of the policy, the person who has those rights.

The policy owner owns and controls the insurance policy on the insured's life and is named in the policy schedule which forms part of the policy document issued by the insurer. They can cash, convert or assign the policy, and direct to whom payment of the policy



proceeds is to be paid, as in the case of a nominated beneficiary.

Policy beneficiary

The policy beneficiary is the person who will receive all the money that is paid out by the life insurance policy. The beneficiary is not a part of the policy but will be designated by the policy owner.

Third-party ownership

There are numerous ownership options available for life insurance policies and these are discussed detail below. Life insurance policies are often created with the policy owner and life insured as one and the same. Often, however, policies are taken out with a third party as policy owner. These include policies owned by:

- A spouse
- An employer
- A company
- A trustee
- A lending institution
- A superannuation fund trustee.

Insurable interest

Prior to 1 July 1995, it was a legal requirement that a policy owner have an insurable interest in the life insured at the time the policy was effected, otherwise the policy was void under section 19 of the Insurance Contracts Act.

The concept of insurable interest was carried over to Australian law from English law from the previous century as it was thought necessary to avoid persons profiteering or gambling on the lives of others. Policies were restricted to cases where there was a likelihood that direct financial loss would be

suffered by the policy owner on the death of the life insured.

An insurable interest was only deemed to exist in the following circumstances:

- A husband on the life of his wife,
- A wife on the life of her husband,
- An employer on the life of an employee,
- An employee on the life of an employer,
- A parent on the life of a child under age 21 or a dependent child,
- A dependent child on the life of a parent,
- Anyone on the life of another where there was pecuniary interest. The level of cover was limited to the amount of the pecuniary interest.

No legal requirement for insurable interest

Although today no legal requirement exists for insurable interest to be present, the life insurance company underwriting the risk may want details of the relationship between the policy owner and the beneficiary life insured before deciding whether or not to accept the risk. The classes of recognised insurable risks listed above also serve as a helpful summary of the typical needs analysis situations that commonly arise today.

Assigning ownership of a policy

The process of changing policy ownership is referred to as an 'assignment of the policy'. Assigning the policy can be a more viable option than cancelling or surrendering a policy, particularly where the policy owner is not the life insured. The policy may be highly valued by a life



insured, as they may have gone to considerable trouble to obtain the policy by attending medical examinations and providing financial evidence. They may also no longer be insurable or insurable for the same premium.

Further, a financial adviser should not forget to record the reasons for recommending an assignment of the policy to a client, even though it may not be a requirement of the insurer that a record of this advice be supplied to them at the time of assigning the policy.

Changing policy ownership

An assignment takes place when a dated memorandum of transfer, which is either printed on the policy or annexed to the policy, is completed by the transferor and the transferee, and subsequently registered by the life insurance company. The transferor is the existing policy owner and the transferee is the new owner. If the memorandum of transfer were not registered and a claim subsequently made, the life office has a responsibility to determine why the registration did not take place and whether it should have taken place and who the correct owner is at the time of the claim or payout of the policy.

Certain tax-exempt annuities and lump sums including structured settlements cannot be assigned.

Section 200 of the Life Insurance Act

Section 200 of the Life Insurance Act specifies that after assignment the transferee becomes the absolute owner of the policy and acquires all the rights, powers and liabilities of the transferor. The Life Insurance Product Provider concerned discharges its obligations to pay money under

the policy if it pays it to the transferee.

Ownership options

As noted in section 1, life insurance policies can be owned by one or more legal entities (i.e. individuals or companies). The ownership options include:

- Self-ownership
- Third-party ownership
- Joint tenants
- Tenants in common
- Equitable interest.

The implications for the claim settlement process of each of the methods of ownership is not dealt with this Strategy Update.

What follows is an overview of the various ownership options outlined above and also examines specific requirements related to:

- Insurance held by trustees
- Insurance held by companies.

Individual Owned Life Insurance (IOLI)

Self-ownership is where the policy is issued with the life insured named as the policy owner. Self-ownership has traditionally been the most popular form of ownership, but should be reviewed as to whether it is the most appropriate form of ownership for the client's particular circumstances.

Some of the reasons for choosing self-ownership of a policy include the following:

- Client need: Personal Business, Other.
- Convenience: It may be more convenient for the life insured to own their policy.



- **Control:** The life insured may want control of the policy on their life.
- **Capital gains tax:** Self-ownership minimises the capital gains tax (CGT) on payment of proceeds.
- **Cope Out:** Advisers and Clients do not know better.

In other instances, the self-ownership choice might be made without full information or proper advice as to its consequences.

- **Change compliance systems:** deficient
- **Concept or Product design:** favours IOLI

IOLI Ownership and Third Party Payment

Any legal entity may own a policy on the life of another person subject to the acceptance of the risk by the LIFP Provider. As noted above, many life insurance policies are taken out by a policy owner who is not the life insured. The policy owner may be a trustee, business associate or company (e.g. the insured's employer), or anyone who needs funds to protect themselves against the risk of financial loss on the death of a life insured.

A needs analysis should identify who needs the funds generated by the policy. The party identified as needing the funds should be a policy owner or nominated beneficiary so that they can receive a direct payment from the insurer.

IOLI Ownership and Third Party Payment

There are several risks to consider in deciding whether a third-party ownership arrangement or self-ownership is appropriate with the nomination option. These are as follows:

- The policy owner may cancel or permit the policy to lapse due to non-payment of premiums.
- Where there is an investment component, the policy owner may surrender, charge or encumber the policy.
- The life insured may not remain in good health and may be unable to effect further insurance.
- The needs of the life insured may change in the future, requiring an increase in the cover to be arranged.
- The policy owner may die and the future ownership of the policy may become uncertain.

For example, the chance of divorce is much greater than the chance of dying during the average working life and policy ownership may cause problems with property settlement arrangements. A spouse, as the policy owner, may refuse to transfer the policy ownership to the life insured after the relationship is terminated. The inability of the life insured to call for or compel the transfer of a policy often comes as a surprise to the life insured.

Joint Tenant Life Insurance (JOLI)

A Life Insurance Policy can be owned jointly by two or more legal entities. For example, a husband and wife can own a policy on the life of the husband as joint tenants. The principal of joint tenancy in respect of life insurance policies is no different to the way it applies to other assets, in the event of the death of one of the joint tenants.

When one policy owner dies, the ownership of the policy vests in the surviving joint tenant absolutely or equally as between the surviving joint



tenants. If there is only the husband and wife involved in the ownership of the policy as joint tenants, in the event of the husband dying, the policy is automatically owned by the wife and therefore does not form part of the husband's estate. Policy proceeds do not pass through the husband's Will and are therefore paid directly to the Spouse.

Where there are more than two joint tenants, each is entitled to an equal share in the policy proceeds and policy owners cannot own disproportionate interests.

Where more than one owner is indicated on the insurance application form, the insurer will treat the owners as joint tenants and therefore they will be entitled to an equal share in the policy proceeds.

Joint Insurance Life Insurance (JILI)

Joint tenancy should not be confused with 'joint lives insured'. Some insurers offer the option of insuring more than one life under the one contract of insurance. In the case of joint lives insured, where one spouse dies, the other receives the death benefit and the policy continues with the surviving spouse as the absolute owner of the policy on their own life.

Tenants in Common Life Insurance (TILI)

The principle of tenants in common, in respect of life insurance, is no different from other assets. Tenants in common policy ownership requires each policy owner's share of the policy to be specified, and that specified percentage to remain with the respective owners and pass subsequently to their estate. Therefore, if a policy is owned 30% by the husband and 70% by the wife and

the husband dies, then 70% of the value of the policy proceeds will be paid to the wife and the other 30% will be paid: to the husband's estate to be distributed according to the husband's will or the laws of intestacy.

There are no particular rules or requirements in respect of the percentage shares in tenant in common ownership, and there can be as many tenants as there can be in a joint tenancy situation. This form of ownership is far less common and the life insurer should be consulted before a recommendation is made to a client to accept tenant in common policy ownership instead of a joint tenancy. If tenant in common ownership is not available, then nomination of beneficiaries can be employed to divide the policy proceeds between different owners.

Equitable Interest Life Insurance

An equitable interest in a life insurance policy may be required by a third party (usually a lending institution) that will hold the policy as security for a loan or other debt of the policy owner. The institution may require the policy owner to complete the transfer of the policy and the lender will retain the original policy with an unregistered assignment of the policy.

If the insured dies or is disabled, or if the third party wishes to claim against the policy as the policy owner, it registers the assignment with the life insurer and then proceeds with the claim.

If the policy is no longer required as security, the third party will usually cancel the unregistered memorandum of transfer and return the policy to the policy owner.



Trustee Owned Life Insurance

To deal with the trustee as the policy owner, without mentioning the trust. When completing the application for insurance or on transferring a policy to a trustee, the insurer will only accept the risk and issue the policy in the names of the trustees, unless in the case of a superannuation fund.

There may also be CGT implications where a trustee owns a policy. Section 118-300(1) of The Income Tax Assessment Act 1997 (Cth) (ITAA 97) provides protection for certain trustees, including superannuation fund trustees. The position of trustees disposing of a life policy is unclear because these trustees are not included in item 5 of section 118-300(1) and, as they are not 'the original beneficial owner', they are not covered by the exemption in item 2 of section 118-300(1). Trustees are the legal owners but not the beneficial owners.

Taxation Determination TD 94/31 addressed the issue of beneficial ownership, stating that the trustee would be regarded as the 'beneficial owner'. Nevertheless this has not been included.

Business Owned Life Insurance (BOLI)

A company, as a legal person, can enter into a contract of insurance as the policy owner. It is a common form of ownership where a business insurance need is established and the proceeds will be used by the company for either a capital or income-replacement purpose.

Caution should be exercised if the company must distribute or intends to distribute untaxed profits, such as the proceeds of a life insurance policy, to

the shareholders. In this case, a component will be distributed as a non-franked dividend.

For this reason the Australian Taxation Office (ATO) will accept split ownership arrangements, which means the company and the life insured can share in the policy ownership, with the company entitled to a predetermined amount of the cover and the balance to be paid to the life insured or their estate.

Companies frequently own a policy as trustee for a trust. The policy is not an asset of the company but remains an asset of the trust and the policy proceeds are distributed by the company in accordance with the terms of the trust.

Funding, taxation and ownership

Once the particular purpose of the need for the Life Insurance Policy is ascertained the adviser should assess which name or names should be entered in the policy owner section of the application form for each policy. This should only be done after the individual client needs analysis has been conducted.

There are several key funding needs that should be addressed for each client. There are also several major ownership advantages that might be taken up and pitfalls that might need to be avoided if insurance is to be a valuable investment for the client. Hence, there is a need for careful assessment of the ownership of insurance.

It is suggested that this assessment be done in three steps:

- Identifying funding needs
- Identifying potential immediate and future tax concessions



- Ensuring that any pitfalls of insurance ownership are avoided.

Particular Circumstances and Clients Funding Needs and Possible Funding Solutions

It is important for an adviser to be clear as to who their client is. The client is the person to whom the recommendation is made, who may or may not be a policy owner or life insured. Then the adviser must determine what funds might be needed in the event of an insurance claim and for what purpose.

Some common funding needs related to insurance, in the event of the client dying or suffering a health crisis, include:

- Ensuring ongoing disposable income is available to provide adequate financial provision for the client and/or for the client's spouse or domestic partner and dependent children
- Clearing or reducing personal debt (e.g. home mortgages or borrowings for negatively geared investments)
- Clearing or reducing business debt to ensure the ongoing viability of the business or the release of exiting principals or their estates from personal guarantees. (With the loss of a key principal from the business, it may be in the interest of whoever takes over the business, e.g. the continuing principals or other family members such as children, to ensure that existing debt is significantly reduced or eliminated)
- Providing the client's business with replacement 'key person' revenue to enable the business to maintain income levels during

the period following the exit of a business principal

- Maintaining adequate income streams for seriously ill business principals, executives and other staff during the course of their illnesses
- Providing continuing business principals with the funding, directly or indirectly, to take over the equity of the exiting business principal
- Covering the payment of taxation liabilities such as CGT that might accrue, particularly when business assets are realised.

Identifying potential tax concessions and other advantages

Depending on the purpose and type of insurance cover (e.g. death cover, disability and critical illness), there are tax issues that need to be addressed to ensure that the insurance ownership is appropriate. These issues include:

- Deductibility of premiums
- Exemption on payment of benefits
- Excepted income from investment of death benefits.

In a worst-case scenario, as outlined in the summary of pitfalls in section 3.3, there is no deductibility of premiums, exemption for benefits, or excepted income for income earned on benefits, making the insurance an expensive proposition.

Avoiding the pitfalls of insurance ownership

A good financial adviser becomes obvious when potential problems are anticipated and avoided. This is particularly true with insurance benefits. The key to avoiding having the



value of a large insurance payment diminished or eliminated lies in ensuring that the choice of ownership of a policy takes into account the client's needs and circumstances. Reviewing the policy ownership as needs, circumstances and laws change is particularly important because the factors affecting policy ownership can radically change over time.

Common errors of insurance ownership

Currently, the significant common errors of insurance ownership for individuals and small business include the following:

- Capital or private-purpose (including debt reduction) life, total and permanent disability (TPD) or critical illness insurance (after 19 September 1985):
 - in a company, the benefits are usually taxed in the hands of the shareholder or member as income, even though no deduction is available for the premium, and
 - in a fixed unit trust, the benefits reduce the cost base of the unit holder and are usually taxed in the hands of the shareholder or member as a taxable capital gain, even though no deduction is available for the premiums,
- Capital or private-purpose TPD or critical illness insurance by a person other than the insured or a defined relative of the insured. No deduction is available for

the premiums and the benefits are taxed in the hands of a non-relative as a taxable capital gain

- Life insurance by a person other than the insured, the insured's spouse or domestic partner or other non-risk relatives where there is any risk that the creditors of a business or the policy owner might take advantage of the limitations of the protection offered by the Bankruptcy Act 1966 (Cth),
- Life insurance by a person who is not the original beneficial owner, who paid money or other consideration to become the beneficial owner of the policy,
- Insurance being used to fund a disputed estate or litigation via the Superannuation Complaints Tribunal,
- Insurance owned by a superannuation fund and no longer subject to a binding nomination (e.g. because the nomination was not renewed within the three-year period),
- Insurance beneficially owned by a beneficiary that the insured no longer wishes to benefit (e.g. a former spouse, estranged child or former business partner),
- Critical illness insurance policies owned by a superannuation fund (with some limited exceptions), given the potential difficulties a seriously ill, but not necessarily retired, insured might face in accessing the policy proceeds from the fund,
- Business debt clearance insurance owned by a superannuation fund. Complying superannuation fund should not be entering into



such business or commercial arrangements,

- Insurance beneficially owned by a person who is no longer appropriate (e.g. a now ex-spouse or a hosiile child). There is a lot to be said for the insured being the legal owner of the policy and being able to nominate beneficiaries,
- Insurance beneficially owned by the trustee of a superannuation fund where a member no longer has dependants for tax purposes (tax applies to the benefits paid), and

Revenue-purpose insurance by anyone other than the person or entity entitled to claim the income tax deduction for the premiums,

Avoiding these pitfalls and identifying the funding needs and potential concessions to enhance the value of insurance will mean that a quality service is delivered to the client.

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Ownership and Third Party Payment

Item	IOLI	JOLI	TILI	EILI
Establishment	Simple	Simple	More Complex	More Complex
Purpose	Personal	Personal	Personal	Personal
Premium Payment	Individual	JTs	Tenants in Common	Individual
Recipient of Proceeds	Estate	Surviving Tenant	Estate and Tenant	Owner with rights to third party
Control	Individual	JTs	Tenants in Common	Third Party

Life Insurance Ownership

Item	IOLI	TOLI	BOLI	SOLI
Establishment	Simple	Complex	Complex	Simple
Control	Individual	Trustee	Business	Trustee
Purpose	Family Provision Debt Cancellation Estate Conservation Other	Beneficiary Recipient	Capital Revenue	Dependant
Recipient of Proceeds	Estate	Trustee / Beneficiary	Business Entity	Dependant or Estate
Taxation Premium Deductibility	NA	?	Depends	Yes
Proceed Payments	Not taxable	?	Depends	No
Payment to Third Party	No	?	Depends	No

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