Business Insurance Ready Reckoner

Making it easier for you and your clients

A lifetime of hard work, prudence and planning is rewarded by the accumulation of wealth. For a number of Australians their wealth is generated by and locked up in their business, yet so many fail to adequately insure this valuable asset. This guide will assist you to identify all the major issues your clients need to consider when insuring their business and the people in it.

Business Succession Planning

Purpose

The key objective of a comprehensive Business Succession Plan is to ensure that the business survives even after the death or critical illness of one of its principals.

In simple terms, it provides:

- a terminating owner (or their estate) with the option to sell their interest in the business to the remaining owner(s)
- the funding mechanism for the remaining owner(s) to purchase it.

These benefits are achieved by creating a formal agreement. This eliminates concerns by creating ready buyers and sellers at a fair, pre-determined price. In establishing such arrangements, the participants define the circumstances that would trigger the sale and the agreed value. They agree on the legal documentation required and set up a funding plan.

Benefits

A buy/sell provision within the Business Succession Plan provides for business continuation with a minimum of disruption by creating ready buyers and sellers at a fair, negotiated price. It:

- provides the business with every chance of survival
- ensures the terminating owner (or their estate) receives true value after tax
- allows for an orderly transition of ownership rather than forcing a fire sale
- retains key employees
- may reduce or eliminate Capital Gains Tax (CGT) and stamp duty issues, typically associated with mandatory agreements.

How it works?

Even with a Business Succession Plan, to ensure the transfer of a business interest upon death, all problems are not solved. The remaining owners need money to buy out the deceased's family's interest.

A number of funding mechanisms are available. The most successful is a combination of:

- Life Insurance
- Trauma Insurance
- Total and Permanent Disability (TPD) Insurance

All covered by a buy/sell agreement

There are two types of buy/ sell agreements:

- 'mandatory buy-outs'
- 'put and call options'

A mandatory buy/sell agreement does not provide the terminating owner (or their estate) nor the continuing owners with a choice as to whether they buy and sell. There is also the potential for stamp duty to be assessed on the full value of the business as at the date of the mandatory agreement.

Put and call options are arguably the most tax effective way of structuring an agreement to provide the same level of security as a mandatory agreement. A Put and Call option agreement is structured such that if one party to the agreement wishes it to proceed it will. Conversely, it will not proceed if all parties decide to set it aside.

How much cover is enough?	Calculation	Example	Values
TERM			
Gross business value		$1,400,000	(A)
Business debts		$620,000	(B)
Net business value	(A) – (B)	$780,000	(C)
% of business the life insured owns		30%	(D)
Suggested Term insurance cover	(C) x (D)	$234,000	(E)
Existing Term insurance for purpose of partnership protection	–	–	(F)
Term insurance shortfall	(E) – (F)	$234,000	
TRAUMA			
Suggested Trauma insurance cover	(C) x (D)	$234,000	(G)
Existing Trauma insurance for purpose of Business succession	–	–	(H)
Trauma insurance shortfall	(G) – (H)	$234,000	
TPD			
Suggested TPD insurance cover	(C) x (D)	$234,000	(I)
Existing TPD insurance for purpose of Business Succession	–	–	(J)
TPD insurance shortfall	(I) – (J)	$234,000	

Key Person Insurance

Purpose

Key Person Insurance covers the financial consequences caused if a key person dies, suffers a traumatic illness or suffers a total and permanent incapacity.

Who is a key person?

They are the people who provide the ideas, drive, initiative and skills that generate the profits needed for the survival and growth of the business.

Key persons may include:

- managing directors
- computer programmers
- specialist engineers
- working directors
- sales managers

The sudden loss of such a person has inevitable costs, not all of them obvious. As well as reduced sales or profits until a suitable replacement is found, there will be recruiting, specialist training and familiarisation expenses. There invariably is a negative impact on capital value, goodwill and credit rating.

Key person insurance helps these unexpected setbacks to be overcome.

Benefits

The benefits of key person insurance for a business are;

- Provides funding to cover any out-standing debts and retain credit rating
- Provides extra income in the event of the death or incapacity of a key person
- Stabilises the business if a key person becomes incapacitated or dies

Key person Insurance for Revenue Purpose

Revenue purpose key person insurance is used to:

- cover the cost of replacing the income loss resulting from the death, TPD or trauma of the key person
- compensate the equity owners in the business from loss of profits they would otherwise suffer due to the effect of the loss of the key person's efforts

Key person Insurance for Capital Purpose

Capital purpose key person insurance is used to replace capital losses suffered by the business as the result of the death, TPD or trauma of a key person. It may:

- retire all or part of any debt owing by the business to
  - secured creditors (eg banks)
  - equity participants
  - provide release of guarantee by creditors, holding the benefit of personal guarantees
  - provide discharges of security over a guarantor's property

Types of key person insurance

Insurance can include;

- Life insurance
- Total and Permanent Disablement insurance
- Trauma insurance

Common methods for valuing a Key Person for Revenue purposes

- Salary multiple
- Net revenue multiple
- Replacement cost
- Combination

How much cover is enough?

The example below uses a combination approach. This allows for the capital needed to fund replacement, as well as the income needed to recoup lost net revenue attributable to the key person, over a set period.

How much cover is enough?	Calculation	Example	Values
TERM			
Gross annual salary package of life insured		$100,000	(A)
Gross annual business revenue attributable to life insured		$300,000	(B)
Business expense attributable to life insured			
(including salary package)		$150,000	(C)
Net Business Revenue attributable to life insured	(B) – (C)	$150,000	(D)
Maximum loss of net revenue over 2 years	(D) x 2	$300,000	(E)
Cost of replacement and recruitment	50% x (A)	$50,000	(F)
Suggested Term insurance	(E) + (F)	$350,000	(G)
Existing Term insurance for purpose of key person protection	–	–	(H)
Term Insurance shortfall	(G) – (H)	$350,000	
TRAUMA			
Suggested Trauma insurance cover	(E) + (F)	$350,000	(I)
Existing Trauma insurance for purpose of key person protection	–	–	(J)
Trauma Insurance shortfall	(I) – (J)	$200,000	
TPD			
Suggested TPD insurance cover	(E) + (F)	$350,000	(K)
Existing TPD insurance for purpose of key person protection	–	–	(L)
TPD Insurance shortfall	(K) – (L)	$350,000	

Guarantor Protection

Purpose

Guarantor protection ensures that upon the death, traumatic illness or total and permanent disablement of a business owner providing a guarantee for a loan, the loan can be repaid in full.

Benefits

Protects personal assets.

- ensures the business's operations are free of further financial burdens as the majority of banks treat the tragic event as a default and often seek repayment or at least a renegotiation of the loan.

How it works

Often an owner will secure a loan with their personal assets eg the family home. Only when the loan is repaid in full will the guarantee be extinguished. Guarantor Protection insurance is used to pay out these loans if the business owner dies or becomes incapacitated.

How much is enough?

As a general rule:

1. Where there is joint and several liability, each owner is responsible for 100% of the loan. Regardless of their individual assets, each owner should be insured for the full 100% of the loan. Although this may seem excessive, it must be remembered that the personal assets of all the guarantors are vulnerable until the loan is repaid.
2. Where there is liability for a set proportion of the loan, then only that proportion needs to be insured.

How much cover is enough?	Calculation	Example	Values
TERM			
Total Business loans (property, investment, leasing etc)		$600,000	(A)
% of business life insured is responsible for		50%	(B)
Suggested Term cover	(A) x 100%*	$600,000	
Existing Term insurance for purpose of guarantor protection	–	–	(D)
Term Insurance shortfall	(C) - (D)	$600,000	
TRAUMA			
Suggested Trauma cover	(A) x 100%	$600,000	(E)
Existing Trauma insurance for purpose of guarantor protection	–	–	(F)
Trauma Insurance Shortfall		$600,000	
TPD			
Suggested TPD insurance cover	(A) x 100%	$600,000	(G)
Existing TPD insurance for purpose of loan protection	–	–	(H)
TPD Insurance Shortfall		$600,000	

* on the basis of being liable for the full debt

Business Expenses

Purpose

A Business Expenses Policy will provide you with a monthly income benefit to cover the costs of fixed business expenses while you are unable to work for up to 12 months.

Eligible Business Expenses may include:

- **Premises expenses**
  Cleaning, insurance, interest and fees on loan to finance the premises, property rates/taxes, rent, repairs and maintenance, security costs
- **Services expenses**
  Electricity, fixed telephone and fax lines, gas, internet service provider, mobile telephone, postage and couriers, water and sewerage
- **Equipment**
  Depreciation, motor vehicle leasing, insurance of vehicles and equipment, registration of vehicles, repairs and maintenance
- **Salaries and related costs**

Salaries of employees who do not generate any business income, payroll tax and superannuation (SGC) contributions for these same employees

- **Other eligible expenses**

Account keeping fees, accounting and auditing fees, bank fees and charges, business insurances, professional association membership fees, regular advertising costs (eg yellow pages)

Benefits

To ensure that funding is available to cover the fixed business expenses that must be paid if the business owner is ill or injured and unable to work.

How it works?

Generally the business owner takes out the appropriate level of insurance to cover their eligible monthly business expenses.

Taxation issues

The taxation treatment of risk insurance depends on a number of factors including:

- The purpose of the premium;
- Who pays the premium; and
- Policy ownership.

Premium deductions

The taxation treatment of risk insurance premiums and benefits depends on whether the insurance is for revenue or capital.

Where the purpose of the insurance is for income or revenue (e.g. Income Protection), the premiums are deductible[1] and any proceeds are assessable as income[2].

Where the purpose of the insurance is for capital, premiums are generally non deductible however the insurance may be subject to CGT if there has been a change in beneficial ownership or the proceeds are paid to certain recipients.

Fringe Benefits Tax

If an employer is the owner of risk insurance, the payment of premium may be subject to Fringe Benefits Tax (FBT). However for FBT to apply, the payment of premium must be in respect of employment of an employee.

If FBT applies, the premium will be treated as an expense payment fringe benefit, however the amount subject to FBT will be reduced by the amount the employee is otherwise entitled to claim as a tax deduction (known as the "otherwise deductible rule").

CGT considerations

An insurance policy is a CGT asset and is subject to the CGT rules of the Income Tax Assessment Act 1997.

The proceeds of term insurance will be subject to CGT where there has been a change in the original beneficial ownership and the disposal (or transfer) was for consideration . However, where the disposal (or transfer) of ownership was for no consideration there are no CGT implications.

Whilst taxation law provides a specific exemption for term insurance, the proceeds of TPD and trauma insurance will be assessable for CGT unless the policy owner/s is an individual and the benefit is paid to the policy owners, their spouse or relative.[4]

1 Section 8–1, Income Tax Assessment Act 1997
2 Section 6–5, Income Tax Assessment Act 1997
3 Section 118–300, Income Tax Assessment Act 1997
4 Section 118–37, Income Tax Assessment Act 1997

Risk insurance – Taxation Issues

<table>
<tr><th>Purpose of Insurance</th><th>Who owns the policy & pays premium</th><th>Insurance</th><th>Tax treatment of proceeds</th><th>Tax treatment of premiums</th></tr>
<tr><td rowspan="4">Personal /self ownership</td><td rowspan="4">Individual/Individual</td><td>Term</td><td rowspan="3">Not assessable[1]</td><td rowspan="3">Not deductible</td></tr>
<tr><td>TPD</td></tr>
<tr><td>Trauma</td></tr>
<tr><td>Income protection</td><td>Assessable (as salary and wages)</td><td>Deductible</td></tr>
<tr><td rowspan="4">Employer (on employees life)</td><td rowspan="4">Individual/Employer</td><td>Term</td><td rowspan="3">Not assessable[1]</td><td rowspan="3">Deductible[2]</td></tr>
<tr><td>TPD</td></tr>
<tr><td>Trauma</td></tr>
<tr><td>Income protection</td><td>Assessable (as salary and wages)</td><td>Deductible[2]</td></tr>
<tr><td rowspan="3">Cross ownership</td><td rowspan="3">Individual/individual</td><td>Term</td><td>Not assessable[1]</td><td rowspan="3">Not deductible</td></tr>
<tr><td>TPD</td><td rowspan="2">Assessable (unless benefit is paid to the insured, their spouse or relative)</td></tr>
<tr><td>Trauma</td></tr>
<tr><td rowspan="3">Key person (revenue)</td><td rowspan="3">Business/Business</td><td>Term</td><td rowspan="3">Assessable</td><td rowspan="3">Deductible</td></tr>
<tr><td>TPD</td></tr>
<tr><td>Trauma</td></tr>
<tr><td rowspan="3">Key person (capital)</td><td rowspan="3">Business/Business</td><td>Term</td><td>Not assessable[1]</td><td rowspan="3">Not deductible</td></tr>
<tr><td>TPD</td><td rowspan="2">Assessable as capital gain (unless benefit is paid to the insured, their spouse or relative)</td></tr>
<tr><td>Trauma</td></tr>
<tr><td>Pay fixed business expenses</td><td>Individual</td><td>Business Expense Insurance</td><td>Assessable[3]</td><td>Deductible</td></tr>
<tr><td rowspan="2">Insurance trust</td><td rowspan="2">Trustee/Business</td><td>Term</td><td>Not assessable[1]</td><td rowspan="2">Not deductible</td></tr>
<tr><td>TPD</td><td>Assessable (unless benefit is paid to the insured, their spouse or relative)</td></tr>
</table>

1 Term insurance will be subject to CGT if there has been a change in beneficial ownership and the policy was acquired for consideration.
2 Subject to FBT, FBT will be reduced where employee is entitled to claim a tax deduction.
3 Business expenses incurred are deductible (net effect is not assessable).

Ownership

Choosing the right approach

There are a variety of ways to structure ownership. What may seem the cheap option now may have considerable costs in the long run. Ownership should be properly structured from the outset to ensure certainty in the event an insurance claim arises or a succession agreement is activated

Owner	Advantages	Disadvantages
Life Insured	• Transportable • Sometimes covers more than 'Business Will' obligations • Flexible - can take changes to business structure • No CGT on receipt of proceeds	• Pay out of proceeds means transfer of assets must happen. Sometime illogical (eg. Trauma) if partner could easily continue • Unless complicated deeming provisions are used, CGT problems can result • Delays due to difficulties in the deceased's estate • Policy Owner can direct proceeds elsewhere via S48 beneficiary nomination
Cross Ownership	• Payments are made directly to the parties needing it	• Not transportable • Inflexible for future business expansion, making future planning difficult • Owner's interest in the policy is an asset for CGT purposes • Any change in the original beneficial ownership (ie. entitlement to proceeds) may result in CGT on payment of benefit
Insurance Trust	• Dispersal of policy proceeds is easy • Flexible for changes in structure • If structured appropriately, proceeds may not be subject to CGT • External supervision of arrangements	• Need for a trustee • May incur extra costs – initially and ongoing (compliance requirements, taxation in particular) • Trust's interest in the policies (life or trauma) is an asset for CGT purposes and certain proceeds may be subject to CGT
Superannuation Trust ownership	• Policies owned by a Superannuation Trustee. • If partners/principles change or if there are significant changes to the business structure the policies can be re-adapted to suit the changes. • Personal insurance requirements including total and permanent disability and term life policies can be included with little or no difficulty. • Tax deduction through contributions on premium payments.	• Upon claim, proceeds are paid to beneficiaries and/or the life insured's estate. Beneficiaries may not consider that these proceeds are an adequate representation of the remaining partners/principals share of the business, if a clear "buy/sell" agreement is not in place. • There may be delays in obtaining the policy proceeds if there are difficulties with regards to the estate. • If Trauma cover is required a separate non-superannuation policy must be arranged. • Satisfaction of 'sole purpose' test (SIS Act). The sole purpose of superannuation is to provide for the financial support of the member (and his or her dependants) in retirement. It is not intended to fund other activities such as Business Succession. If it is so used, it could fail the test and become 'non complying', thus losing the tax concessions normally allowed to 'complying' superannuation.

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