

## Business Insurance

Business insurance is an integral and often overlooked part of running a small business. The business owners need to consider the impact of the loss of the key personnel due to retirement, death, total and permanent disablement or a critical illness. In many cases, the departure of an owner or a key employee can have detrimental effects on the business.

### Business Succession Planning

It is important to have a succession plan in place for the business taking into account how the share of the outgoing owner is to be transferred and the mechanisms to acquire sufficient funds to continue the business. A business succession plan, therefore, involves two components—establishment of an agreement among the owners, known as Buy/Sell agreement, and a funding arrangement.

A business succession agreement or buy/sell agreement is a legal contract which provides the surviving owners the right to purchase the outgoing partner's share in the business. The agreement should also provide for the departing partner (or the estate) to sell their share to the remaining owners at an agreed price. Where the ownership is held within a company or trust, the agreement should place the buying/selling requirement on the entities involved.

There are generally two steps involved when preparing a business succession agreement. First, the owners need to determine what would happen to the business in certain situations (such as death or disablement). This is usually achieved by entering into a transfer agreement which is a contract providing for the transfer of business.

The second step involves the owners putting in place a funding agreement which provides the money for buying out the departing owner's interests. Life insurance is considered as a cost effective way for the continuing owners to raise sufficient capital for this purpose. As part of this funding arrangement process, the owners need to decide the ownership of insurance policies i.e. which entity will own the policies. The ownership structure is crucial as it has implications for tax, control and the cost of the insurance as well as on the buy/sell agreement itself.

### Insurance Proceeds for Business Succession Purpose

The insurance policy proceeds may be treated as follows: -

- **Self owned policy with nominated beneficiary:** The proceeds will be paid tax free to the deceased's spouse who is the nominated beneficiary. The proceeds will not form part of the estate and will not be subject to the provisions of the deceased's will. It is important that a legal agreement is in place for this type of structure to ensure that the beneficiary does not receive both the proceeds and the business interest.
- **Self owned policy with no beneficiary:** The proceeds will be paid tax free to the deceased's estate and will be distributed in accordance with the deceased's will. It is important that the owner's estate planning affairs are up to date. A legal agreement must be in place if self ownership structure is used to ensure that the beneficiary does not end up with both the proceeds and the business interest. In the event of a trauma or TPD, the proceeds will be paid tax free to the policy owner.

- **Business owned policy:** The proceeds will be payable to the business entity and are taxed as a dividend. A deemed dividend, a fringe benefit or a form of taxable remuneration where the business distributes the funds to the remaining shareholders or where the funds are paid to the outgoing shareholder as part of the share buy back.
- **Trust owned policy:** The proceeds will be paid to the Trustees owning the insurance policy on the life of the deceased owner. The proceeds will then be distributed in accordance with the trust agreement. The trustee may pay the funds to the departing owner or their estate, or to the remaining owners to purchase the departing owner's interest. The agreement can be set up in a way that the proceeds are paid to various parties to make payments for capital gains tax and equity purposes.
- **Super fund owned policies:** The proceeds will be paid to the trustee(s) of the deceased's super fund. If there is a valid binding death nomination in place then the proceeds will be paid to the nominated beneficiary(ies) in the form requested (lump sum and/or pension). It is important that the principal's binding death nomination remains up to date and valid.

In the event of a Total and Permanent Disablement, the proceeds will be paid to the trustee(s) of the super fund. These proceeds will be paid to the departing owner as long as a "condition of release" has been satisfied. Under the SIS legislation, the Trustees may not pass benefits to a person unless it has satisfactory proof that the person will never be able to work in any occupation he/she is reasonably suited to by education, experience or training. Once this condition is satisfied, the trustee is able to release the funds. A potential problem can arise with the "own occupation" TPD definition - if the departing owner can still work then the SIS regulations may not permit the release of the benefit from the fund by the trustees.

The taxation implications upon payment will depend on a number of factors such as the tax free/taxable components of the benefit, period of the membership, how it is paid and to whom it is paid. There is a limit on how much an individual can contribute into superannuation. There are penalties for exceeding the annual contribution cap. We recommend that you seek professional advice from your accountant in relation to the taxation issues.

## Tax Treatment of Insurance Premium for Business Succession Purpose

**Self owned non-superannuation policy:** The insurance premiums for self-owned non-superannuation policies are generally non-tax deductible to the business owner.

**Business owned policy:** The premiums for the policies owned by the business owners and funded by the business are generally tax-deductible to the business but will be subject to Fringe Benefits Tax. This can increase the cost of the insurance.

**Trust owned policy:** The premiums paid for by the trustee of the trust are not tax deductible.

**Super fund owned policies:** The premiums for the policies owned by the super fund are tax deductible to the trustees of the fund. The premiums are treated as super contributions. If the business owner makes additional contribution to the super fund, it may be tax deductible to the business or to the owner.

## Key Person Insurance

Most businesses rely on owners and/or some employees to run the company. Their knowledge, experience and management skills are crucial for the growth, continuity and profitability of the business.

Examples of key personnel include business owners, directors, key employees and any person whose departure may have an adverse effect on the business.

The unexpected death or disablement of the key personnel could significantly impact on the viability of the business. The financial effects that may affect the business are of a revenue (affecting business profitability) or capital (affecting the business value) in nature. The revenue insurance will provide funds to compensate for the decline in revenue of the business and assist with the cost of recruitment & training of the replacement and/or temporary staff. Capital insurance is generally used for compensating the owners for the loss of goodwill, repayment of the loans made by the key person to the business, repayment of other business liabilities and potentially replace any personal guarantees made by the key person.

### Tax Treatment of Insurance Proceeds and Premium for Key Person Policy

Policy proceeds are paid to the business if a claim is successful where the policy is owned by the business entity. The tax position of the proceeds depends on the purpose.

The proceeds from the insurance policies used to protect against the loss of profits (revenue purpose) are treated as assessable income to the business, and the insurance premiums are usually deductible. The proceeds from the policies used to repay loans or other liabilities (capital purpose) are not assessable to the business, however TPD or trauma benefits are assessable as a capital gain (if the benefits are not paid to the life insured or a tax dependant). Premiums for capital purpose policies are not deductible.