FOR YOUR CLIENTS

# Understanding business succession
## Client Fact Sheet

## The importance of buy/sell insurance

As a business owner, you know that your business isn't just about work – it's your life and your livelihood. So that means your share in your business is one of your family's most important assets. It funds the lifestyle that you enjoy today – and will continue to enjoy into the future.

A business succession plan is vital to ensure your family is protected in the event you, or one of your business partners, become ill or injured and are unable to stay in the business.

Buy/sell insurance is a mechanism that provides funds for remaining partners to purchase a business share from a departing co-owner, in the event of death, permanent disability or trauma. It means the remaining owners can quickly and efficiently acquire the departing owner's share and continue running the business with minimal disruption.

Buy/sell insurance benefits both the remaining owners and the departing owner.

For the remaining owners, it provides funds to transfer the business share to them, ensuring that the business is not placed at risk.

For the departing owner, or their estate, buy/sell insurance means that they receive funds to compensate them for transferring their

business share – just as though they've 'sold' their share in the business.

**Buy/sell insurance is an integral part of a business succession plan.**

A business succession plan has two elements which include:

- a funding mechanism that provides a source of finance to facilitate a transfer. Funding can be supplied by selling assets, taking out a loan, a gradual buy-out, insurance or a combination of these. Buy/sell insurance is commonly used to cover insurable trigger events such as death, permanent disablement or trauma and it is often the cheapest solution.
- a legal agreement that specifies the terms and conditions of the transfer of a business share including a suitable business valuation method and trigger events.

## Types of insurance

There are three types of risks that can be covered by buy/sell insurance. You can take out cover for the death, total and permanent disablement (TPD) or critical illness (trauma) of a business partner.

As everyone's circumstances are different you should speak to your financial adviser about what types of cover are suitable for your business, and how the insurance package should be structured.

## Ownership of the policy

There are several options available when it comes to policy ownership, and your financial adviser can help you understand the right ownership for your situation.

- Self-ownership – where the person insured is the policy owner. This is the simplest structure and the person insured keeps control of their own policy, even if they leave the business.
- Cross-ownership - where the business owners take out insurance on each other. The policy ownership changes with changes in business ownership.
- Insurance trust – where a trust owns the policies on behalf of all business owners. This means policy ownership is not affected by changes in business ownership.
- ›Business entity (company or unit trust) – where the business or business trust owns the policies on the business owners' lives. Policy ownership is not affected by changes in business ownership, unless the person insured wants the policy assigned to them when they leave the business. The business uses the insurance proceeds to buy back the departing owner's (or their estate's) share.
- Superannuation fund – where the superannuation trustee owns the insurance policies on the business owners through a superannuation fund. The person insured has control of their own policy.

When considering ownership of an insurance policy, you need to consider control of the policy, payment of premiums, the business structure, the potential for ownership changes and tax on the receipt of insurance proceeds.

Your financial adviser, accountant and solicitor can advise you further on the implications of the various ownership options.

## Tax considerations

The cost of the insurance cover you take out to fund a buy/sell agreement is not tax deductible, unless it is held by a superannuation fund. Capital gain tax (CGT) may also apply in some circumstances.

Your accountant or tax consultant can advise you further on the tax implications of buy/sell insurance.

## Business valuation

An important part of a buy/sell agreement is the valuation of your business. Business valuation options include:

- market value at the date of the trigger point
- market value at the date of the agreement with indexation
- an agreed industry formula
- an agreed dollar amount, or
- the engagement of an independent arbitrator.

It is important to ensure that the level of cover of your insurance policies keep pace with changes in the business value, so you don't get caught short if you need to effect your buy/sell agreement. You should also consider any capital gains tax that may apply when you receive the insurance proceeds and transfer the business share.

Your accountant can advise you on the valuation of your business and ownership share.

## Transfer agreements

Obviously, death is generally an automatic trigger to transfer a business share. However, temporary incapacity or the suffering of a trauma incident may not be. The legal agreement would usually specify that the transfer of the business share should happen if the insured person is absent from the business for more than a certain period of time, or with a loss of turnover.

A transfer agreement is a legal document. Your solicitor can advise you of the appropriate legal agreement needed to transfer a business share.

## You and your professional advisers

You don't need to make decisions about buy/sell insurance on your own.

Designing an effective buy/sell insurance package requires your financial adviser, accountant and solicitor to work together. Each professional brings their own unique skill sets.

The functions of your advisers and the expertise they provide are shown below.

**Financial Adviser**

Identifies an insurance solution for your needs with advice on:

- the type of insurance cover
- the amount of cover
- selecting appropriate insurance products and features
- the underwriting process

**Solicitor**

Provides the legal expertise when contracts are required with advice on:

- drafting transfer agreements or other legal documents
- reviewing and updating Wills

**Accountant**

Considers the business structure and taxation with advice on:

- › taxation implications for premiums and insurance proceeds
- › confirmation of your business structure
- › setting up trusts (taxation aspects and ongoing operation)

## Case study

John and Ralph are co-owners of a fast growing building supplies company. Both have young families, so know that their share in the business is their family's main asset, as well as their source of income.

They each take out life policies on their own lives, to the value of their business share, and then draw up a transfer agreement with their solicitor, who is experienced in business transfer agreements.

When Ralph dies in a car accident, his estate receives the life insurance proceeds, and his business share is transferred to John. As per Ralph's will, the insurance proceeds provide a lump sum that his wife can invest for the family's welfare.

John acquires Ralph's business share and can continue operating the business without the financial burden of paying out Ralph's estate.

## Key person insurance – a checklist for business owners

- ☑ Identify the key person(s) in your business.
- ☑ Estimate how long it would take to replace the key person(s).
- ☑ Specify the type and amount of loss to the business if the key person(s) died, suffered total and permanent disablement or a trauma. Your financial adviser and accountant will be able to help you estimate potential loss.
- ☑ With the help of your financial adviser examine the types of insurance required - life, TPD or trauma. Are all three required or just one or two?
- ☑ Discuss policy ownership options with your financial adviser and accountant. The default owner is generally the business, as it is affected by the key person's absence.
- ☑ Confirm with your accountant the tax treatment of the insurance premiums and insurance proceeds.
- ☑ Speak to your solicitor to determine if a legal agreement is required to transfer the insurance proceeds.
- ☑ Consult with your financial adviser and accountant about your personal insurance and buy/sell insurance needs.

**Technical Services**

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