BUSINESS INSURANCE

INTRODUCTION

Business Insurance is a complex area with various strategies that can be applied within your business. We strongly recommend that you speak to your Financial Adviser before applying any of these strategies, to ensure they suit your particular circumstances.

PARTNERSHIP AND SHAREHOLDER INSURANCE

Two of the most common forms of business structure are:

- The partnership between two or more people; and
- The proprietary limited company with two or more shareholders.

Each partner or shareholder's interest in the business will, on the death of the partner or shareholder, form part of the estate and, in most cases, pass to his or her spouse or children.

Basically there are five possibilities as to what will happen to the business in such a situation. These are:

- The business could be wound up.
- The heirs of the deceased could take that person's place in the business.
- The heirs of the deceased could sell their interest to an outsider.
- The surviving partners/shareholders could sell their interest in the business to the heirs of the deceased.
- The surviving partners/shareholders could buy the deceased's interest from the heirs and continue with the business.

The most favoured of these possibilities or options is currently the last-mentioned, and partnership and shareholder insurance is designed to provide the finances needed to enable this action to be taken.

To ensure that the deceased's interest is sold to the surviving partners/shareholders, it is necessary to have a formal agreement drawn up by their legal advisers (known as a buy/sell agreement).

Section 104-25(2) of the 1997 Income Tax Assessment Act provides that where a contract is entered into for the purchase or sale of an asset, the date of purchase or sale is deemed to be the date of entering into the contract. This creates a capital gains tax liability on completion of an agreement to buy or sell a share in a business. Therefore, it is now more common for a renounceable agreement to be drawn up granting an option to sell and an option to buy, thereby avoiding the immediate capital gains tax implication.

The best way of guaranteeing that a set sum of money will be available at an unknown future time is to effect life insurance. Therefore, taking out life insurance in conjunction with a buy and sell option agreement is normally the only way in which the partner/shareholder can be sure of having the necessary cash to buy out a deceased partner's share.

When this is done, it is normal for the agreement to refer to the life insurance policies to be effected - the agreement is then often referred to as a Funded Buy and Sell Option Agreement, as it not only sets out the terms of the agreement, but also the manner in which the funds needed by the survivors will be provided.

Strategy 1: Capital Purpose Key Person Protection
Protect personal and business assets from creditors in the event of the death or disablement of the business owner(s).

Strategy 2: Guarantor Protection
Avoid the consequences of one director/partner being jointly and severally liable for total debt of a business because of personal guarantees.

Strategy 3: Revenue Purpose Key Person Protection
Replace lost business revenue in the event that the business loses the services of the main profit maker(s) because of:

- Death.
- Total and permanent disablement.
- Major medical trauma.

Strategy 4: Business Succession or Buy Sell Protection
Secure the interests of the joint owners of a business in the event that one dies, is permanently disabled or has a major medical trauma and cannot continue.

Strategy 5: Disability Income Protection
Protect against the loss of personal income from the business because of accident or sickness.

BUY/SELL AGREEMENTS

A buy/sell agreement defines the process for the orderly transfer of ownership of the business to the surviving/remaining owner(s) of the business should one of several trigger event occur, such as death, serious illness or retirement. Such an agreement is suitable for unrelated principals in partnership, joint venture, or company who wish to continue operating an enterprise without interference, should one of them die or become disabled.

There are a number of ways that business owners may generate the funds to purchase an outgoing owner’s share of the business, however, life insurance is generally recognised as the most effective cost solution.

The benefits of establishing a buy/sell agreement are:

- A funded agreement can provide immediate funds to enable the purchase of the deceased’s share of the business.
- Provides a guaranteed market for the business interest at an agreed price, thus protecting the value of the client’s share in the business.

- Provides peace of mind for continuing partners.
- Can pacify creditors and stabilise the business.
- Reduces the chance of disputes between continuing business owners and a deceased owner's estate.

Action required

Determine the value of each principal's share of the business. It is useful to adjust this estimate to take account of any capital gains tax (based on the original cost base of the equity) and stamp duty that may be payable if certain assets are included.

Each principal effects a life policy (or uses an existing one) for the amount of cover required (including appropriate coverage for benefits required on their own life - death, total and permanent disablement benefits and medical trauma).

A legally binding agreement is put in place covering the principals and their estate beneficiaries. This establishes the rights and obligations for the transfer of the deceased's share of the business to the surviving principals in consideration for payment of proceeds of the policy and the circumstances when such a transfer will occur - this is called a Cross Purchase agreement.

Tax implications

The premiums of the policy are treated as being of a capital nature, therefore they do not provide a tax deduction for each principal.

The proceeds of the policies are not assessable if payable to the deceased's estate or the spouse.

CONCLUSION

Each strategy is not exclusive. You and your financial adviser can establish what combination of strategies is best for you.

Any taxation and other information in this document:

- Is based on the continuation of present laws and interpretations that are current on the date of issue.
- Is a general summary only and individual circumstances may be quite different

Professional advice should be obtained before applying the information to particular circumstances.