Understanding Business Succession

The importance of buy/sell insurance

As a business owner, you know that your business is not 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 in to 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 business shares from a departing co-owner in the event of death and permanent disability or trauma. It means the remaining owner 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 owners.

For the remaining owners, it provides fund 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 integral part of 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 buys out insurance or a combination of these. Buy/sell insurance is commonly used to cover insurable trigger event such as death, permanent disability or trauma and it is often the cheapest solution.
- A legal agreement that specifies the term and conditions of the transfer of business share including 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 death, total permanent disability (TPD) or critical illness (trauma) of a business partner.

As everyone's circumstances are different you should speak to your financial adviser about what type of cover is 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 - were 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 - were 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 owner's 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 gains tax (CGT) may also apply in some circumstances.

Your accountant and 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 policy keeps pace with changes in the business value, so you don't get caught short if you need to affect 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.

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

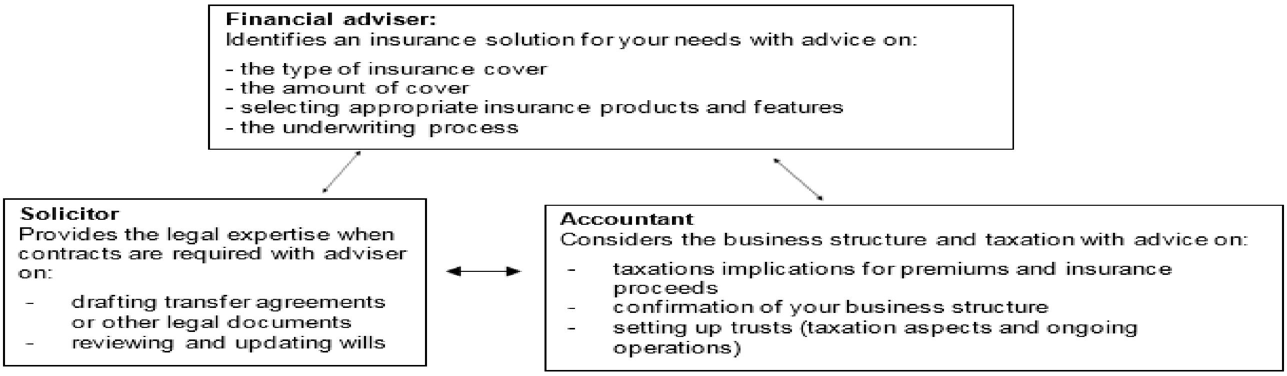
Transfer agreement
Obviously, death is generally an automatic trigger to transfer a business share. However, temporary incapacity or the suffering of a trauma incident may not be. The legal agreement would usually specify that the transfer of the business share should happen if the insured person is absent from the business for more than certain period of time or with the 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 work together. Each professional brings their own unique skill set.

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



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 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 the business transfer agreements.

When Ralph dies in a car accident, his estate receives the life insurance proceeds which provide a lump sum that his wife can invest for the family welfare.

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

Buy/sell insurance - a checklist for business owners

- Confirm the business structure with your accountant.
- Estimate the value of your business and the owner's business shares, your accountant will be your primary contact in valuing your business.
- Specify the triggers for an exchange of a business share. Your solicitor can help you determine these triggers.
- With the help of your risk adviser, examine the types of insurance required - Death, TPD or Trauma, are all three required or just one or two ?

Discuss policy ownership options with your risk adviser, accountant and solicitor. The default option is usually self-ownership but factors such as control and the business structure may mean you decide on a different option.

Taking in to account your desired ownership option, confirm with your accountant the tax treatment of your insurance premiums and insurance proceeds.

- Speak to your solicitor about the legal agreement required to transfer the business share and, if necessary, the insurance proceeds.
- Review your will and your superannuation death benefit nominations (if necessary) with your solicitor.

Consult with your risk adviser and accountant about your personal insurance and key person insurance needs.

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