
Insurance
Business Risk
Insurance explained
smart
BUSINESS SOLUTIONS
Financial Planning

Insurance

BUSINESS RISK INSURANCE

SUMMARY

Business owners often have unique risks that might not be adequately covered by their personal insurance.

Business Insurance can be used to protect against the loss of a key person and the possible resulting drop in revenue, as well as provide the ability to repay debts and protect assets from creditors. It can also be used to fund a business succession agreement, in the event an owner of the business needs to sell their share (as a result of permanent disability or death).

INSURANCE OPTIONS

BUY / SELL INSURANCE

KEY PERSON (CAPITAL) INSURANCE

KEY PERSON (REVENUE) INSURANCE

BUSINESS EXPENSES INSURANCE

Buy / Sell Arrangements

Pre-determined agreed price

+

Smooth business interest transfers to surviving business owner/s

+

Funding available to fund the transfer

=

Buy / Sell Arrangement

1. BUY/SELL INSURANCE

Buy/Sell insurance is designed to manage the risk to the business if a business owner is forced to exit due to illness, injury or death. Buy/Sell insurance pays a lump sum that ensures the remaining owners can acquire the departing owner's equity, and continue to run the business. It also enables agreed compensation for the share held by the departing owner or their estate.

The risks that can be covered by Buy/Sell insurance are:

- ✓ Death of a partner (life insurance)
- ✓ Total and permanent disability (TPD insurance)
- ✓ Trauma such as heart attack, stroke, cancer and paraplegia (trauma insurance)

1. BUY/SELL INSURANCE

Every small company or partnership should have a buy-sell agreement. This sets out what will happen to the business if there's a specific event – like the death or illness of one of the shareholders or partners – or if one of the business owners wants to sell their share.

1. BUY/SELL INSURANCE

Buy/Sell agreements are sometimes likened to a ‘business will’ as they can help minimise the risk, such as:

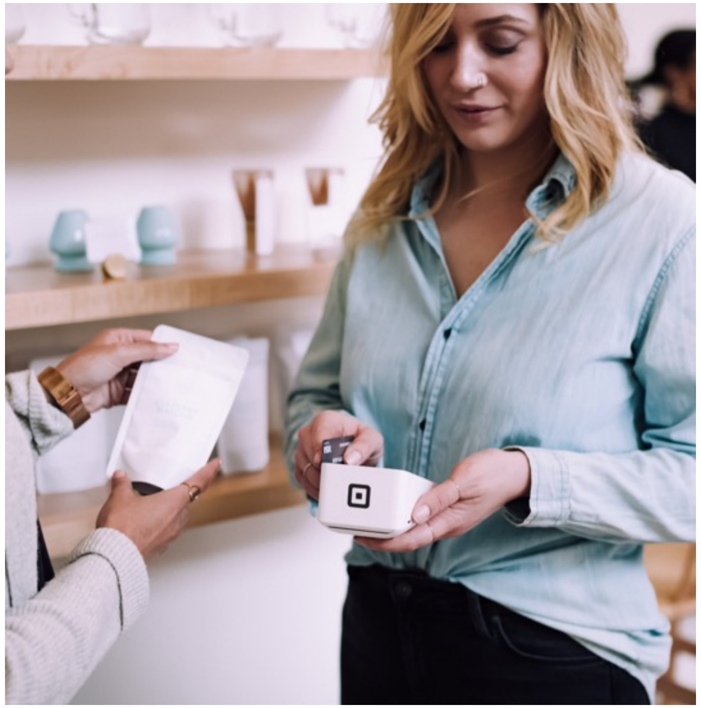
- ✓ Remaining owners needing to sell the business or to take out additional borrowings to pay out the departing owner or their estate
- ✓ Assets being frozen due to legal issues created by the departing owner, their family or estate
- ✓ A departing owner’s family deciding to become an active business partner, against the wishes of the continuing partners
- ✓ The departing owner’s spouse or family taking up their legal right to claim business profits without working in the business
- ✓ A departing owner’s spouse or estate selling their share to an unsatisfactory third party

BUY / SELL INSURANCE

HOW MUCH TO COVER?

To determine the level of cover that you and your business partner/s may need, consider the value of each owner’s share of the business. This value amount should generally reflect the sum insured on the buy and sell life insurance agreement. It is important that the business owners review this amount on an annual basis to ensure adequate cover is in place.

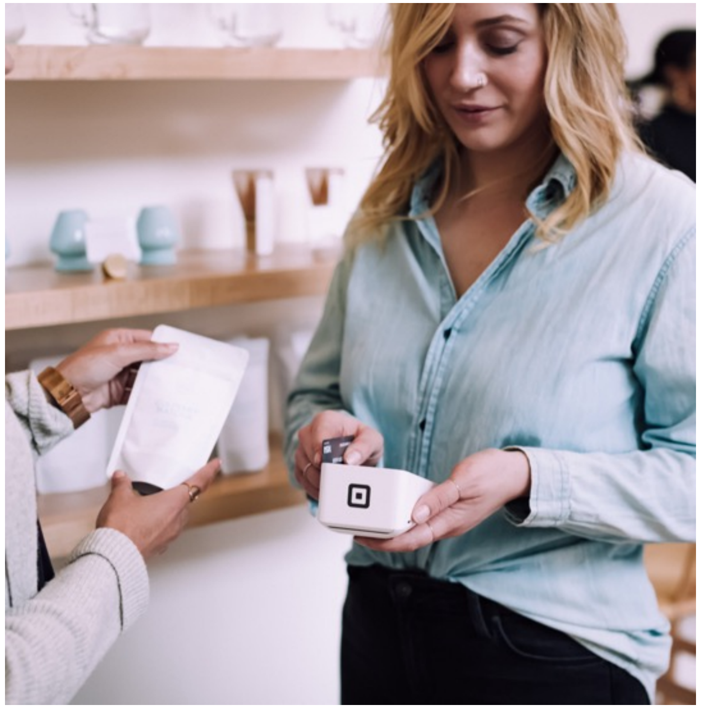
EXAMPLE: If the business has two owners and each has an equal share of a business with a value of $2 million, the amount insured on the life of each partner should be $1 million on a buy/sell life insurance agreement that will provide cover for death, TPD and possibly trauma.



BUY / SELL INSURANCE

HOW MUCH TO COVER?

An important element of the Buy/Sell agreement process is reaching consensus on how the business is valued. Current market value is commonly used, and should be updated regularly. Other valuation methods include indexing the value to inflation, or to the expected business growth rate.



1. OWNERSHIP & TAXATION

Depending on the business structure and the manner in which the buy-sell agreement operates, the insurance policies may be

- ✓ Self-owned by the owners;
- ✓ Cross-ownership over the lives of the other owners
- ✓ Company ownership
- ✓ Trust ownership or
- ✓ Superannuation ownership

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The ownership of the insurance policies and payment of the insurance proceeds on the occurrence of a triggering event will raise various taxation issues therefore it is critical to review your specific situation, the business and consider the potential for ownership changes, and tax implications, to ensure we can recommend the most appropriate ownership structure for you.

1. WHAT ARE THE ALTERNATIVES TO BUY/ SELL INSURANCE?

When a co-owner exercises an option to buy or sell their equity in the business a liability will arise for the continuing co-owner(s) to pay an amount for the value of the outgoing co-owner's equity in the business.

The buyout of the shares of the departing owner is typically funded through insurance policies so that a lump sum will be received under the policy to pay the purchase price when an option is exercised.

1. WHAT ARE THE ALTERNATIVES TO BUY/ SELL INSURANCE?

An alternative could be a Vendor Finance Agreement or a combination of vendor financing and personal insurances, however this should be all included in the buy/sell agreement.

If you didn’t have insurance, how would you buy these shares?

What if you couldn’t get the funds to buy them?

Key Person (Capital) Insurance

Losing a Key Person can cause revenues to go down, and business costs to increase.
Key Person Insurance proceeds can be used to:

Replace the revenue the key person would have generated

+

Paying out debt or funding debt

=

Key Person (capital) insurance

2. WHAT IS KEY PERSON INSURANCE ?

Key person insurance provides a cash injection to your business to help offset the reduction or loss in revenue following the death or incapacity of a ‘key person’ or employee.

Who is a key person?

A key person is someone whose continued association with a business provides that business with a significant and direct economic gain. It does not have to be an owner but it usually is for smaller businesses. It can be a salesperson, technical expert or a silent partner whose reputation, contacts or specialised knowledge gives your business an advantage.

2. TYPES OF KEY PERSON INSURANCE

There are two main types of key person cover:

1. **Revenue:** Key person revenue provides compensation to a business for the loss of an employee, through death, disability or critical illness, which may have an adverse effect on the profit and revenue of the business.

2. **Capital:** Key person capital provides an injection of funds to maintain the capital value of a business and ensure its ongoing survival after the loss of a key person through death, disability or critical illness.

Key Person (Revenue) Insurance

Losing a Key Person can cause revenues to go down, and business costs to increase.
Key Person Insurance proceeds can be used to:

Replace the revenue the key person would have generated

+

Pay the extra costs the business incurs in funding a suitable replacement

=

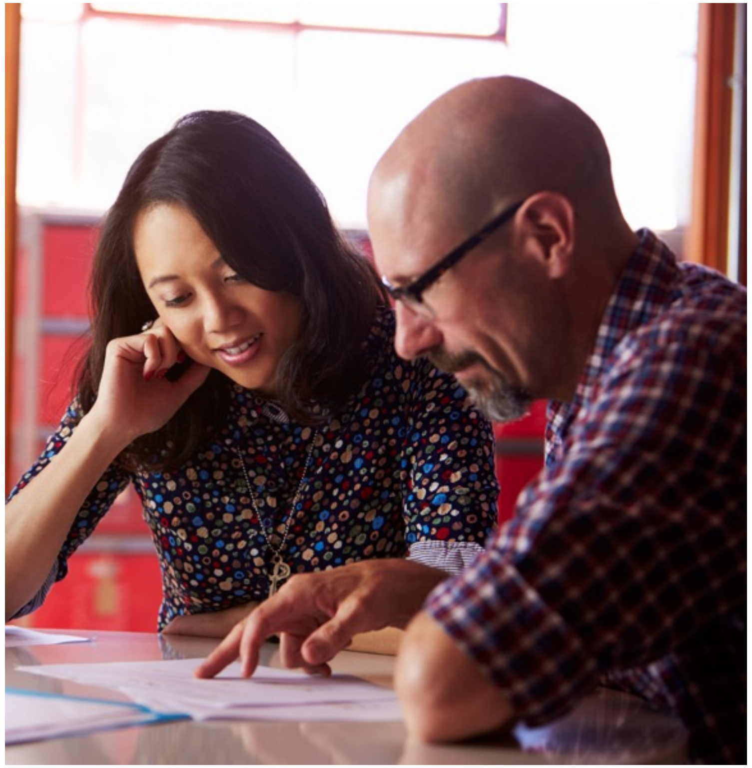
Key Person (revenue) insurance

KEY PERSON REVENUE INSURANCE

HOW IT HELPS?

From a revenue perspective, the cash injection will support the business during this transition as well as:

- ✓ Compensate for a loss in sales while a replacement is found.
- ✓ Assist with recruiting costs to find the right candidate.
- ✓ Cover training costs where specialist skills are needed.
- ✓ Help manage organisational changes – some staff may need to take on extra duties and have added pressure to perform while external clients may also reconsider their ongoing relationship with the business.

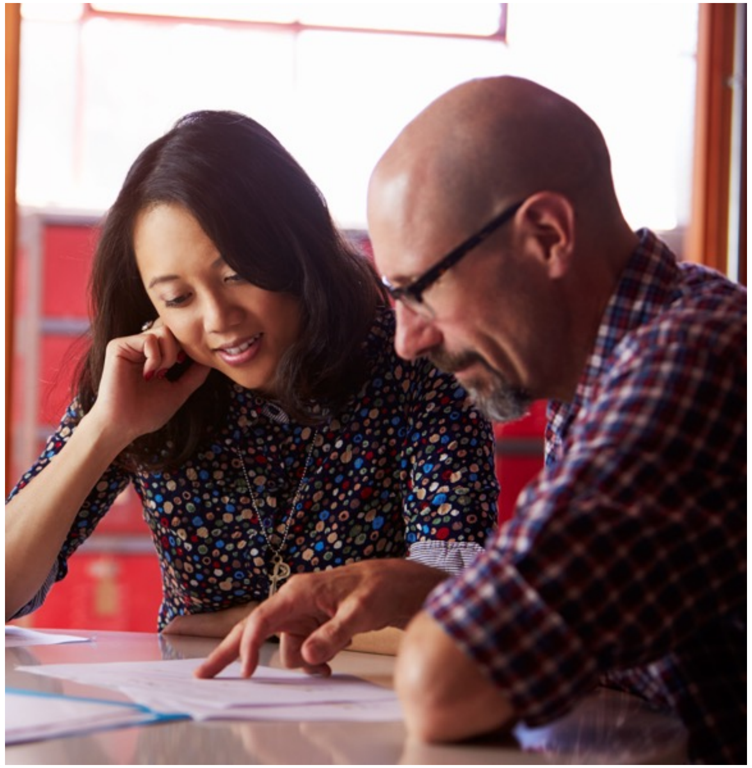


KEY PERSON CAPITAL INSURANCE

HOW IT HELPS?

From a capital perspective, key person insurance can help fill the void, by offering an alternative source of funds. The capital value of a business can be reduced by a number of factors following the loss of a key person including:

GOODWILL: is what clients bring to a business and the loss of a key person with specialist knowledge, a unique skill set, or high quality business contacts may impact important client relationships.

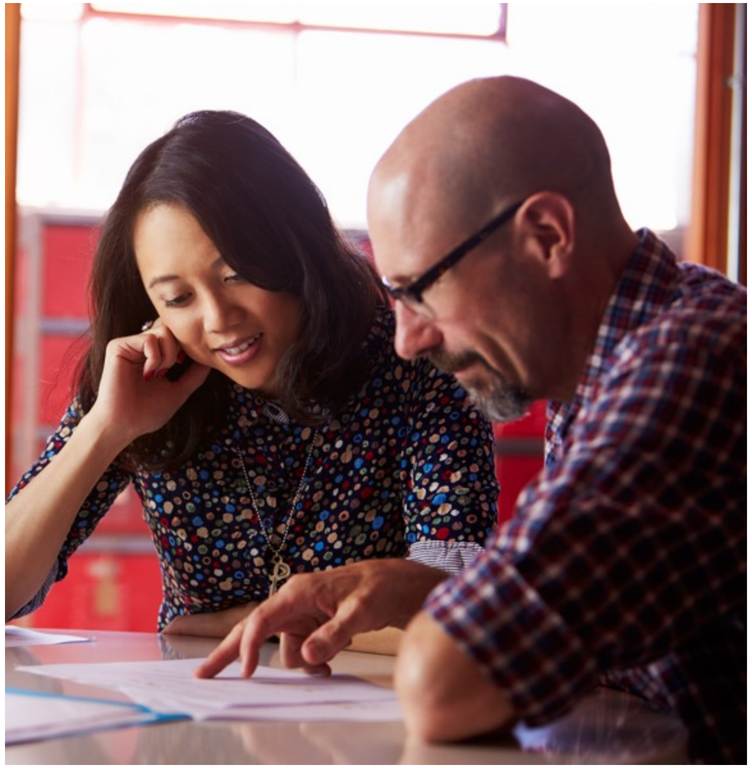


KEY PERSON CAPITAL INSURANCE

HOW IT HELPS?

From a capital perspective, key person insurance can help fill the void, by offering an alternative source of funds. The capital value of a business can be reduced by a number of factors following the loss of a key person including:

ACCESS TO CREDIT: With the loss of a key person who was able to access credit easily or have sufficient personal assets to secure the business debt, it may prove difficult to access further borrowings.

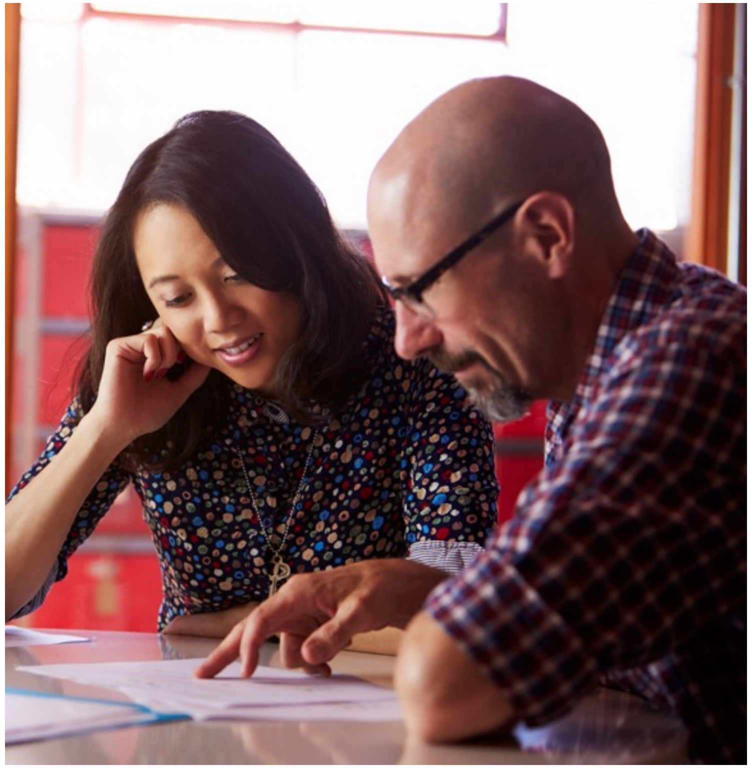


KEY PERSON CAPITAL INSURANCE

HOW IT HELPS?

From a capital perspective, key person insurance can help fill the void, by offering an alternative source of funds. The capital value of a business can be reduced by a number of factors following the loss of a key person including:

LOANS & DEBTS: If the key person loaned money to the business this would need to be repaid to their estate. If the business defaults on an external business loan, the financiers could call in the loans.



2. OWNERSHIP & TAXATION

Key person revenue insurance must be owned by the business. In most circumstances, the entity operating the business should also be the owner of key person – capital cover. This is because, in the event of a claim, the business needs to receive the proceeds to pay expenses and/or repay loans.

2. OWNERSHIP & TAXATION

Key person revenue insurance must be owned by the business. In most circumstances, the entity operating the business should also be the owner of key person – capital cover. This is because, in the event of a claim, the business needs to receive the proceeds to pay expenses and/or repay loans.

- ✓ Key person insurance premiums for **revenue** purposes are tax deductible. However, in the event of a claim, the proceeds will be assessed as income and taxable.
- ✓ Key person insurance premiums for **capital** purposes are not tax deductible and the proceeds will not be treated as assessable income, however Capital Gains Tax may apply.

2. WHAT ARE THE ALTERNATIVES TO BUY/ SELL INSURANCE?

There is no direct alternative to key person insurance, but there are other options which might be preferable for your business in the event of the loss of a key person:

Take out a loan.

This is another way to access funds at a crucial time and because it’s done after the loss of your key person, you can accurately judge how much you’ll need. However, lenders may be hesitant to offer money to a company that’s just lost a key person — or they may offer poor rates.

2. WHAT ARE THE ALTERNATIVES TO BUY/ SELL INSURANCE?

There is no direct alternative to key person insurance, but there are other options which might be preferable for your business in the event of the loss of a key person:

Cover the loss with company profits.

If you’ve accumulated a reserve for emergencies, you can recover from the situation with the current year profits. Naturally this is only an option if your business is sufficiently profitable, but it might not be best for the bottom line.

2. WHAT ARE THE ALTERNATIVES TO BUY/ SELL INSURANCE?

There is no direct alternative to key person insurance, but there are other options which might be preferable for your business in the event of the loss of a key person:

Sell off assets.

This can help you raise money fast, but you generally won’t get your money’s worth. Businesses generally don’t hold unnecessary assets, so you’ll likely be selling off useful equipment.

Business Expenses Insurance

This cover is generally available where:

The owners efforts are largely responsible for generating the business' cash flow

+

If the owner were unable to work, that cashflow would significantly decline or even cease

=

Business Expenses Insurance

3. WHAT IS BUSINESS EXPENSES INSURANCE?

Do you know your expense cover trend? This shows how many days' worth of expenses can be covered by the closing bank balance and receivables. If your business is growing then cashflow will be critical to continue feeding this growth. What happens if the business owner is unable to work which would cause a significant drop in revenue or for it to cease?

Business overheads insurance provides a regular reimbursement of eligible business expenses, thus assisting the financial viability of the business.

3. WHAT IS BUSINESS EXPENSES INSURANCE?

Eligible expenses which can be reimbursed include rent, loan interest repayments (not principal), business expenses required in maintaining the property (utilities, telephone, cleaning, property rates and taxes), general insurance premiums, salaries of and costs for non-income producing staff and other general expenses.

3. OWNERSHIP, TAXATION & ALTERNATIVES

Business expenses insurance must be owned by the business, this is because, in the event of a claim, the business needs to receive the proceeds to pay expenses.

Business expenses insurance premiums are tax deductible. However, in the event of a claim, the proceeds will be assessed as income and taxable.

The alternative available would be:

- ✓ Using existing cashfunds in the business
- ✓ Obtaining a bank overdraft or loan in the business
- ✓ Using personal cash or equity to lend the business funds

SMART BUSINESS SOLUTIONS Financial Planning

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