Business Protection Insurance

This document contains factual and general information only to assist you in understanding financial planning concepts. It is designed to be used in conjunction with a Statement of Advice.

> Would your business be able to maintain its revenues and profits if one of its key people died or couldn't work for an extended period due to a serious illness or accident?
>
> You've worked hard to build your business, making sure it's protected at a time of need makes 'good business sense'.

Business Protection Insurance protects businesses and business owners from the consequences of the death or disablement of a key person. It can be structured to provide the following:

- Asset Protection
- Revenue Protection
- Ownership Protection

The purpose of asset protection is to provide the business with sufficient cash to preserve its asset base if a business owner or key employee dies or is disabled. These funds would be available to the business to:

- Repay debts and free up cash flow
- Protect the business's goodwill
- Maintain its credit standing

The purpose of revenue protection is to provide the business with sufficient cash to compensate for the loss of revenue and staff replacement costs, if a business owner or key employee dies or is disabled. These funds would be available to the business to:

- Advertise and find a replacement employee
- Supplement a drop in cash flow while a replacement is found
- Fund business expenses normally covered by the revenue generated by a key employee

The purpose of ownership protection is to fund the transition of shareholding in the business to ensure ownership remains with those who have an active interest in the business's success.

No matter what the protection needs of your business are, the financial equation is usually the same; you need the right amount of cash,for the right person,at the right time.

To overcome potential financial problems following the death or disablement of a key person, a business needs a readily available cash reserve. Business protection insurance can provide a unique and cost-effective solution. This is usually at only a fraction of the cost of alternative solutions.

Asset Protection

The most important asset in a business is the intellectual capital provided by key people. Without their input, the long-term success of the business may be in jeopardy. The loss of a key person can be more disastrous than any loss or damage to physical assets. Material assets can always be repaired or replaced.

When a key person dies or is disabled, they are lost to the business forever, which can create immediate financial problems. Without the security provided by that key person, the business could be forced to sell assets. This may occur when:

- Creditors press for payment and debtors withhold payment.
- Customers and suppliers lose confidence in the trading capacity of the business.

- Lenders are not prepared to extend credit.
- Outstanding loans need to be repaid immediately.

Revenue Protection

A drop in revenue is often inevitable when a key person is no longer there. Finding a suitable replacement, if one doesn't already exist, may take a substantial amount of time. The lag time, to find and train someone, will add to the losses incurred and place additional pressure on the business.

Business Expenses Insurance

Business expenses protection is specifically designed for small business. Without business expenses protection and income protection insurance, many small business owners would not be able to provide for their families or keep their business afloat if they were absent due to sickness or injury, even for a short time. Business expenses protection allows a small business owner to insure against loss due to sickness or injury, for the proportion of their gross income that normally meets the business's regular operating expenses. These are expenses that must be paid whether the business generates revenue or not.

Business expenses insurance covers fixed costs such as:

- A lease on office space or interest on a property loan.
- Salaries and superannuation for employees who do not generate revenue.
- Equipment leases
- Accounting fees
- Utility bills
- Car lease payments
- Insurance premiums and security costs
- Costs of a doctor

Ownership Protection

Some forms of ownership protection include Buy/Sell arrangements and Key Person Insurance. If a business owner dies, funding the buyout of the Estate can be a problem.

For Partnerships

Under partnership law, a partner's death automatically dissolves the partnership and without a pre-arranged right to purchase the deceased partners' interest and the right amount of cash, the surviving partners have only the two following options:

- Liquidate the business
- Reorganise the business

A legal documents for a buy/sell arrangement can be put in place by a solicitor to allow the remaining partner to purchase the business and insurance can be established to fund the purchase.

For Proprietary Companies

A proprietary company structure continues unaffected by the death of a shareholder. However, the same cannot be said for the operational structure of the business if there is a change in the people who hold shares in the business. For example, where the original shareholders were three engineers working in a contracting business and one of the 3 owners dies leaving the shares to his adult children, there can be conflicting views on what is expected from the investment in the business. In this case, an active interest (where the shareholder takes an active role in the success of the business) has become an inactive interest (as shares are passed to family members or others not involved in the business).

The active interest, represented by the continuing shareholders would more likely be concerned about the ongoing business development. Since they derive income largely from salary and allowances for work done, they may view dividends of a secondary importance. The inactive interest, represented by the deceased shareholder's heirs, would be more likely to view dividends of primary importance.

Without a pre-arranged right to purchase deceased shareholder's equity and the right amount of cash to do so, the continuing shareholders face potential conflict with the deceased shareholder's heirs, whose participation in the business is likely to be unwelcome.

To keep the ownership of the business among themselves, the existing owners would need:

- A buy-sell arrangement granting the continuing owners the option to buy a deceased or disabled owners interest in the business
- A life insurance policy for an amount likely to enable the purchase of the outgoing owner's interest.

Key Person Life Insurance for debt

Who needs it?

- Business owners who have borrowed to provide their enterprise with working capital or other assets and have placed a charge over family assets or given personal guarantees
- Sole traders who want protection to cover borrowings secured by a mortgage over personal assets (e.g. private residential property used as security for business borrowings).

What needs to be done to implement and maintain it?

The Employer entity (company or trustee) arranges life insurance on the life of the key business principal. The business needs to prepare a Board minute that is signed by the directors indicating the capital repayment purpose of the cover and details of the policy affected. The amount of cover should be sufficient to cancel all business debt, it should be reviewed at least annually and the purpose reaffirmed in the books of account.

Where total and permanent disablement and trauma insurance is required, an alternate course of action should be considered. The policy can be affected by the principal on his/her own life. If necessary the business entity can be registered as a third party nominated beneficiary as per the Insurance Contracts Act to give creditors comfort (if the policy permits).

Taxation

As the purpose of the insurance is to insure against a capital loss, the premiums are not tax deductible and there is no tax payable on any lump sum benefit paid if it is used for a capital purpose or generally if paid to a deceased estate. Total and permanent disablement and trauma insurance payments may be subject to capital gains tax if not paid to the life insured or spouse. If these types of covers are required it is recommended that they be effected on an own life basis.

Key Person Insurance for lost revenue

Who needs it?

- Businesses where profits are largely dependent upon the efforts of one or a few key individuals

What needs to be done to implement and maintain it?

The Employer entity (company or trustee) arranges life insurance on the life of the key business principal. A Board minute needs to be prepared and signed by the directors. It should highlight the need to replace business income if a key individual is lost through death, TPD or medical trauma. It also needs to include details of the policy.

The amount of the policy should represent the best estimate of the potential loss taking into account impact on profits, the cost in finding a replacement and the potential time lag before the replacement is fully equipped to maintain past revenue. The impact of taxation on the proceeds of the insurance also needs to be considered.

The level of cover should be reviewed at least annually and the purpose reaffirmed in the books of account.

Where total and permanent disablement and trauma insurance is required an alternate course of action should be considered. The policy can be effected by the principal on his/her own life. If necessary the business entity can be registered as a third party nominated beneficiary as per the Insurance Contracts Act to give creditors comfort (if the policy permits).

Taxation

As it is the intention of the business to insure against lost revenue the premiums for term insurance are deductible for the employer. Permanent life insurance policies (whole of life) are always treated as being for a capital purpose and premiums are generally not deductible.

The proceeds of a term insurance policy payable in the event of death, total and permanent disablement and trauma would be assessable income to the employer.

Premium Structure

Stepped premiums are initially cheaper than level premiums however they are likely to increase as you get older. This will limit the impact of your premiums during the earlier years of the policy.

Level Premiums are initially higher than stepped premiums however they will remain constant (with rises based on inflation and indexation of the sum insured) for the term of the policy. This will limit the impact of premiums over the life of the policy.

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