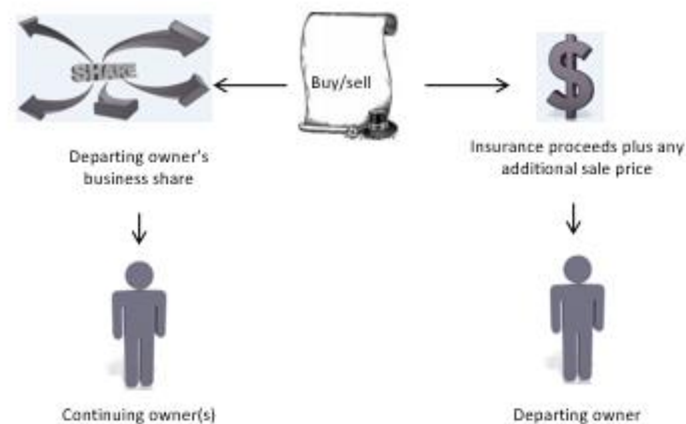
Business Insurance – Business Succession Agreement and Funding

The death, permanent disability or critical illness of an owner in a small-medium business can be detrimental to the ongoing viability of the business as well as the families of all owners.

For business owners, a Business Succession Agreement funded by insurance protects all owners and their families by enabling the timely and orderly transfer of ownership in the event of death, total and permanent disablement or critical illness or injury of one or more of the owners.

A successful strategy has two components: a business succession agreement and a funding mechanism. It is important that these two components are structured together. This will generally require a financial planner, lawyer and accountant to work together.



Benefits

This strategy can enable the remaining owners to acquire the interests of the outgoing owner so they can continue to run the business. The outgoing owner (or their estate) will receive adequate compensation in exchange for their share of the business.

How it works

The agreement

A business succession agreement involves the business owners entering into a written legal agreement to detail what will happen to their respective interests in the business should one of them die, become disabled or suffer a trauma. This type of agreement is sometimes referred to as a Business Will.

This document ensures the ownership of the business is transferred to the remaining owners. Essentially, the agreement should provide for the departing business owner (or their estate) to transfer their interest to the remaining owners, and for the remaining owners to acquire the departing owner's interest in the business.

If the business is operated through a company or trust, the agreement should be structured to require the owners of that entity to sell/purchase the business share. The owners of the shares or units in an operating entity are often the trustees of the respective owners' family (discretionary) trusts rather than the owners personally.

Funding

The agreement should also recognise the means of funding the buy/sell obligations.

There are generally three options for funding the capital requirements of a business succession plan - sell assets, borrow, or transfer the funding to an alternative mechanism like insurance. Insurance is often the most efficient means of ensuring adequate funds are available if the owner is departing due to death, disability or trauma.

If you have insurance funding in place without an implemented legal agreement, you run the risk of the insurance proceeds being paid to the departing owner, but the remaining owners not receiving control of the business share if there's no agreement between the parties about the price.

Ideally, the capital required to fund the transfer should reflect:

- each owner's individual (or related party-owned) equity holdings; if possible this should allow a cushion for growth over a three year period, particularly if insurance funding is selected as a source of capital
- alternative funding arrangements should insurance for an owner be unavailable or not a viable option.

The importance of business succession

Properly drafted and funded Business Succession Agreements obviously come into their own during periods of great stress for a business, such as the death or disablement of an owner. The stability that such careful forward planning brings at these times cannot be underestimated.

This stability will also be of considerable comfort to other stakeholders in your business, such as staff, creditors, customers/clients and financiers who will know that:

- Professional arrangements, and the funds to back up those plans, are in place for the orderly transfer of ownership, and
- The business can continue to operate under the experienced guidance of the remaining owner(s).

Furthermore, having adequate funds available for the settlement of an owner's interest removes the pressure on the business or the other owners at a time of possible capital vulnerability.

Insurance Policy Ownership

There are a number of alternatives for how to own insurance policies as part of a buy/sell agreement. For example, the policies could be self-owned (by each owner), cross-owned (by each owner on life of the other owners), owned by a business entity or the owners' family trusts.. There are benefits and disadvantages with each option and you should seek professional legal advice on this matter.

Self-ownership
Self-ownership is the simplest and most flexible option. The outgoing owner (or their estate) receives the insurance proceeds if a claim is triggered. If you have a spouse, you could nominate your spouse as beneficiary so they receive the payment directly.

Each owner is responsible for paying the premiums on their own policy but you can come to an agreement to pay these through the business. Where premiums are paid by the business, they are generally both tax deductible and subject to Fringe Benefits Tax, with the proceeds received tax free. You should seek tax advice from your accountant.

The Business Succession Agreement needs to be drafted to ensure that the share of business is transferred with the insurance payment counting towards to the sale price.

Cross-ownership
Each business owner will own (or jointly own) a policy on each of the other owners. If a claim is paid this gives the remaining owners control over the money to pay for the transfer of the departing owner's share under the terms of the agreement.

This option is often less tax-effective if ownership changes are likely as Capital Gains Tax (CGT) may be payable on claim proceeds. Additionally CGT may be payable on TPD and trauma claims where an insured owner is not related to the other owners.

Where premiums are paid by the business, they are generally both tax deductible and subject to Fringe Benefits Tax. You should seek tax advice from your accountant.

Family Trust Ownership
It is common for owners to own shares in a company or units in a trust that operate a business or own business assets via their respective family trusts.

Where this is the case, owners could consider holding the insurance in their family (discretionary) trusts. If a buy sell trigger event occurs to an owner, the agreement will require their family trust to transfer its shares or units to the continuing owners (or their respective trusts) and the policy proceeds will be paid tax-free into the family trust of the owner who has had the insurance event.

If the business pays the premiums, they are usually tax deductible but Fringe Benefits Tax is payable. The FBT rate is the top personal rate of 47% so this is effectively equivalent to an owner on this personal rate paying for the premiums out of their after-tax money. You should seek tax advice from your accountant.

Superannuation ownership
Owners could consider holding the insurance in a retail superannuation fund.

If the owner dies, the insurance will be paid into their member account and can be on-paid to their chosen beneficiary or estate. If the payment is made to certain beneficiaries, such as their spouse, it will be tax-free. Spouses may also have the option of taking a pension subject to the Transfer Balance Cap. Payments made to other beneficiaries such as independent adult children will attract lump sum tax. The exiting owner's beneficiary or estate will then transfer their interest in the business to the continuing owners or related entities.

If the owner is totally and permanently disabled, the owner can take their benefit as a pension subject to the Transfer Balance Cap or lump sum. A lump sum will attract tax if the owner is under age 60. The exiting owner will then transfer their interest in the business to the continuing owners.

Premiums are tax deductible to the business as concessional contributions to superannuation and are not subject to FBT. They will be counted towards the owner's $25,000 concessional contribution cap.

Equalising premiums

It is important that the insurance policies continue to have premiums paid so they remain in place.

The policy owner is responsible for payment but the other business owners also have an interest to make sure the premiums are paid. It is common for some form of premium "equalisation" or "pooling" to occur so that effectively the total premium is shared according to shareholder interests.

Insurance premiums are based on the insured's life expectancy and health, and are more expensive for older lives. There is a greater chance of an insured event happening for an older shareholder than younger counterparts, so it can be fair if the latter subsidises the former's premium cost as they have more chance of increasing their stake in the business. That is, in the event of the death, disablement or trauma of the older (or less healthy) owner, the younger owners stand more chance of gaining the greater benefit from the arrangement.

Risks and Consequences

- The Business Succession Agreement is a crucial part of your business protection plan. You should seek expert legal advice to have an agreement established and ensure its structure and the insurance policy ownership are consistent with your objectives.
- You should also work with your accountant to consider taxation and business structure implications.
- Business values will regularly change. If the transfer is to be funded using insurance it is important to review the insurance levels on a regular basis to ensure they remain adequate.
- Business owners and their families should review and update their own personal Wills on a regular basis to ensure efficient distribution and control of the assets in the event of their death.
- All business owners should have Enduring Powers of Attorney in place to look after their affairs if they become incapacitated.
- Business owners who own their interest in the business via their family (discretionary) trusts should also have the trust deed reviewed as part of the business protection plan.
- Other funding mechanisms should be considered if the Agreement deals with non-insurable events such as retirement or if one or more of the business owners are not insurable or cannot obtain insurance on similar terms to the other owners.
- You should always carefully read the Product Disclosure Statement (PDS) and policy document for your selected insurance policy and keep these documents in a safe place.

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