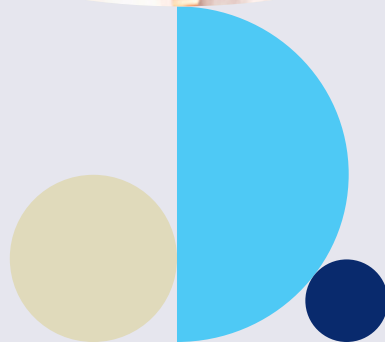


# Insurance solutions for business



# Some statistics



## What are the chances?

Each week:

- 2,830 Australians die<sup>1</sup>
- 1,000 suffer a stroke<sup>2</sup>; and
- 2,320 will be diagnosed with cancer<sup>3</sup>.

There is a three in five chance<sup>4</sup> you will be disabled for at least a month before you turn 65, and a one in three chance you will be disabled for at least three months before age 65<sup>5</sup>.

### Your chances, statistically



Unable to work for a month: 3 in 5



Unable to work for 3 months or more: 1 in 3

### Chances of one partner dying or becoming totally disabled

Partners in business	Dying before aged 65#	Dying or becoming totally disabled before age 65#
2 Partners	35 in 100	52 in 100
3 Partners	47 in 100	67 in 100
4 Partners	57 in 100	77 in 100
5 Partners	66 in 100	84 in 100
6 Partners	77 in 100	89 in 100

# Zurich mortality and morbidity calculator, 2004

## Businesses remain underinsured

Despite these sobering statistics, it is an unfortunate reality that small business owners (SBO's) are amongst the most underinsured segments in the entire community.

A survey by the Cameron Research Group - 'The Australian Small Business Market for Financial Services: 2010' - contained some alarming statistics about small business owners and life insurance:

- 100 per cent of Small Business Owners (SBO's) have heard of Life Insurance  
But only 65 per cent of them have cover
- 57 per cent of SBO's have no TPD cover
- 88 per cent of SBO's with loans have no loan protection in place
- 76 per cent of SBO's have no Trauma cover
- 57 per cent of SBO's have no Income Protection cover.



# Business succession planning

## Business succession planning

### Purpose of business succession planning

The key objective of a comprehensive Business Succession Plan is to ensure that the business survives even after the death or critical illness of one of its principals.

In simple terms, it provides:

- a terminating owner (or their estate) with the option to sell their interest in the business to the remaining owner(s)
- the funding mechanism for the remaining owner(s) to purchase it.

These benefits are achieved by implementing a formal agreement. This eliminates concerns by creating ready buyers and sellers for the business at a fair, pre-determined price. In establishing such arrangements, the participants define the circumstances that would trigger the sale and the agreed value. They agree on the legal documentation required and set up a funding plan.

### Benefits

A buy/sell provision within the Business Succession Plan provides for business continuation with a minimum of disruption in the event one or more owners need to exit at short notice.

This plan:

- provides the business with every chance of survival
- ensures the terminating owner (or their estate) receives true value after tax
- allows for an orderly transition of ownership rather than forcing a fire sale
- helps retain key employees
- may reduce or eliminate the Capital Gains Tax (CGT) and stamp duty issues typically associated with mandatory agreements.

### How it works

Even with a Business Succession Plan to ensure the transfer of a business interest upon death, all problems are not solved. The remaining owners need money to buy out the deceased's family's interest.

A number of funding mechanisms are available. The most successful is a combination of:

- Life insurance
- Trauma insurance
- Total and Permanent Disability (TPD) insurance.

All these can be covered by a buy/sell agreement.

### Buy/sell agreements

There are two types of buy/sell agreements:

- 'mandatory buy-outs'
- 'put and call options'.

A mandatory buy/sell agreement does not provide the terminating owner (or their estate) nor the continuing owners with a choice as to whether they buy and sell. There is also the potential for stamp duty to be assessed on the full value of the business as at the date of the mandatory agreement.

Put and call options are arguably the most effective way of structuring an agreement to provide the same level of security as a mandatory agreement. A put and call option agreement is structured such that if one party to the agreement wishes it to proceed it will. Conversely, it will not proceed if all parties decide to set it aside.

## Case study

Peter runs a small but successful real estate agency with his business partner Anthony. When Anthony dies from cancer, Susan inherits Anthony's interest in the business. Susan had never been involved with the business. She did not want to learn the business and told Peter she would camp on his doorstep until he purchased Anthony's half from her.

Susan did not work herself and had relied on Anthony's wage, needing it to support herself and their 2 children.

### Peter would have been happy to pay Susan her share of the value of the business if:

- He knew what the business was worth
- Susan agreed with that value
- Peter could find the money to pay Susan

### If the right arrangements had been in place:

- Susan could have then required Peter to purchase her share of the business for a pre-determined price
- Alternatively, Peter could have required Susan to sell her share of the business for a pre-determined price



## How much cover is enough?

TERM COVER	Calculation	Example	Values
Gross business value		\$2,000,000	(A)
Business debts		\$800,000	(B)
Net business value	(A) – (B)	\$1,200,000	(C)
% of business the life insured owns		40%	(D)
Suggested term cover for business succession purposes	(C) x (D)	\$480,000	(E)
Existing term for business succession		0	(F)
<b>Term cover shortfall</b>	<b>(E) – (F)</b>	<b>\$480,000</b>	
TRAUMA COVER			
Suggested trauma cover for business succession	(C) x (D)	\$480,000	(G)
Existing trauma cover for business succession		0	(H)
<b>Trauma shortfall</b>	<b>(G) – (H)</b>	<b>\$480,000</b>	
TPD COVER			
Suggested TPD cover for business succession	(C) x (D)	\$480,000	(I)
Existing TPD cover for business succession		0	(J)
<b>TPD shortfall</b>	<b>(I) – (J)</b>	<b>\$480,000</b>	



# Key person insurance

## Key person insurance

### Purpose of key person insurance

Key person insurance covers the financial consequences caused if a key person dies, suffers a traumatic illness or is totally and permanently incapacitated.

### Who is a key person?

A key person is someone who provides the ideas, drive, initiative and skills that generate the profits needed for the survival and growth of the business.

Key persons may include:

- managing directors
- computer programmers
- specialist engineers
- working directors
- sales managers.

The sudden loss of such a person has inevitable costs, not all of them obvious. As well as reduced sales or profits until a suitable replacement is found, there will be recruiting, specialist training and familiarisation expenses. There invariably is a negative impact on capital value, goodwill and credit rating of the business.

Key person insurance helps to overcome these unexpected setbacks.

### Benefits

The benefits of key person insurance for a business are that it:

- provides funding to cover any outstanding debts and retain credit rating
- provides extra income in the event of the death or incapacity of a key person
- stabilises the business if a key person becomes incapacitated or dies.

### Key person insurance for revenue purposes

Revenue purpose key person insurance is used to:

- cover the cost of replacing the income loss resulting from the death, total and permanent disablement or trauma of the key person
- compensate the equity owners in the business from loss of profits they would otherwise suffer due to the effect of the loss of the key person's efforts.

### Key person insurance for capital purposes

Capital purpose key person insurance is used to replace capital losses suffered by the business as the result of the death, total and permanent disablement or trauma of a key person. It may retire all or part of any debt owed by the business to:

- secured creditors (eg banks)
- equity participants
- creditors holding the benefit of the guarantor's personal guarantee over a property as security.

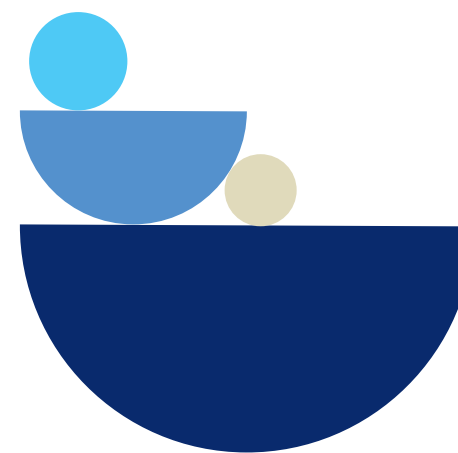
### Types of key person insurance

Key person insurance can include:

- Life insurance
- Trauma insurance
- Total and Permanent Disablement insurance.

### Common methods for valuing a key person for revenue purposes

- Salary multiple
- Replacement cost
- Net revenue multiple
- Combination.





## Case study

Renee and Sophie are the two driving forces behind a successful cosmetics business. From its origins as a small home-based operation, their business turns over \$5million every year.

Renee is the design and manufacturing expert, and Sophie the skilled marketer.

They recently secured a new account worth \$2m over 2 years.

- 3 weeks after the contract is secured, Renee dies in a motor vehicle accident.
- The design and manufacturing expertise has now been lost.
- This leaves Sophie in a financially vulnerable position.
- She needs to replace the design expertise quickly to ensure the contract timeframes are still met, otherwise she will incur penalty fees of \$500,000.
- It will take time to replace Renee with a suitable equity partner.
- Sophie has to go to the market to quickly find a replacement, which could be difficult and costly.



## How much cover is enough?

The example below uses a combination approach. This allows for the capital needed to fund the replacement of the key person as well as the income needed to recoup lost net revenue attributable to them over a set period.

TERM COVER	Calculation	Example	Values
Gross annual salary package of life insured		\$150,000	(A)
Gross annual business revenue attributable to life insured		\$500,000	(B)
Business expense attributable to life insured (including salary package)		\$220,000	(C)
Net business revenue attributable to life insured	(B) – (C)	\$280,000	(D)
Maximum loss of net revenue over 2 years	(D) x 2	\$560,000	(E)
Cost of replacement and recruitment	50% x (A)	\$75,000	(F)
Suggested term insurance	(E) + (F)	\$635,000	(G)
Existing term insurance for purpose of key person protection		0	(H)
<b>Term cover shortfall</b>	<b>(G) – (H)</b>	<b>\$635,000</b>	
TRAUMA COVER			
Suggested trauma cover for key person protection	(E) + (F)	\$635,000	(I)
Existing trauma cover for key person protection		0	(J)
<b>Trauma shortfall</b>	<b>(I) – (J)</b>	<b>\$635,000</b>	
TPD COVER			
Suggested TPD cover for key person protection	(E) + (F)	\$635,000	(K)
Existing TPD cover for business succession		0	(L)
<b>TPD shortfall</b>	<b>(K) – (L)</b>	<b>\$635,000</b>	



# Guarantor protection



## Guarantor protection

### Purpose of Guarantor protection

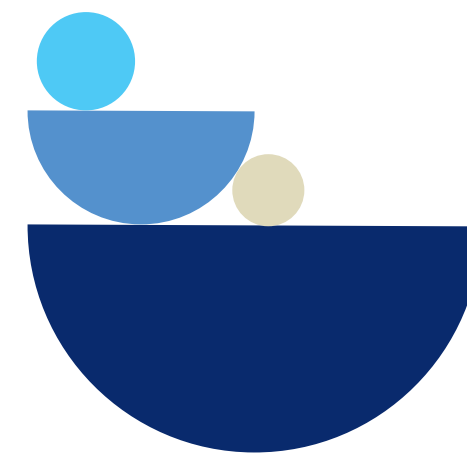
Guarantor protection ensures that a loan can be repaid in full upon the death, traumatic illness or total and permanent disablement of a business owner who provides a guarantee for a loan.

### Benefits

Guarantor protection ensures the business operations are free of further financial burdens given the majority of banks treat the tragic event as a default and often seek repayment or at least a renegotiation of the loan. It protects the guarantor's personal assets.

### How it works

Often an owner will secure a loan with their personal assets, for example the family home. Only when the loan is repaid in full will the guarantee be extinguished. Guarantor protection insurance is used to pay out these loans if the business owner dies or becomes incapacitated.





## How much is enough?

As a general rule:

1. Where there is joint and several liability, each owner is responsible for 100% of the loan. Regardless of their individual assets, each owner should be insured for the full 100% of the loan. Although this may seem excessive, it must be remembered that the personal assets of all the guarantors are vulnerable until the loan is repaid.
2. Where there is liability for a set proportion of the loan, then only that proportion needs to be insured.

Term	Calculation	Example	Values
Total business loans (property, investment, leasing etc)		\$750,000	(A)
Share of business life insured is responsible for		50%	(B)
Suggested term cover for purpose of guarantor protection	(A) x 100%*	\$750,000	(C)
Existing term cover for purpose of guarantor protection		0	(D)
<b>Term insurance shortfall</b>	<b>(C) – (D)</b>	<b>\$750,000</b>	
<b>TRAUMA</b>			
Suggested trauma cover for guarantor protection	(A) x 100%	\$750,000	(E)
Existing trauma cover for guarantor protection		0	(F)
<b>Trauma shortfall</b>	<b>(E) – (F)</b>	<b>\$750,000</b>	
<b>TPD</b>			
Suggested TPD cover for guarantor protection		\$750,000	(G)
Existing TPD cover for guarantor protection		0	(H)
<b>TPD shortfall</b>	<b>(G) – (H)</b>	<b>\$750,000</b>	

\* As surviving partner would liable for full debt, possibly with a business which is no longer viable without the deceased partner.

## Case study

Nathan was only 43 when he suffered a sudden brain haemorrhage and died. He had worked hard to build his business to the point where it provided a financially stable environment for his family.

As Margaret and her two young children said their farewells on the day of Nathan's funeral, they did not realise their pain and suffering was about to worsen.

- Like many small business owners, Nathan had taken out a significant loan and gave personal guarantees without fully realising the potential consequences.
- Nathan's business debts did not disappear with his death, as many people think will be the case. His estate became fully liable for the loan.
- Already under pressure to take time off work to look after her young children, Margaret was left with insufficient funds to discharge the loan and was forced to sell personal assets, including the family home, to meet the liability.

Loan Guarantor (or Guarantor protection) insurance would have provided the financial security that Nathan had always intended for his family.





# Business expenses cover

## Business expenses cover

### Purpose of business expenses cover

A business expenses policy will provide the business owner with a monthly income benefit to cover the costs of fixed business expenses while they are unable to work for a period of up to 12 months.

### Eligible business expenses may include:

- **Premises expenses**  
Insurance, interest and fees on loans to finance the premises, property rates/taxes, rent, repairs and maintenance
- **Services expenses**  
Electricity, fixed telephone and fax lines, gas, internet service provider, mobile telephone, postage and couriers, water and sewerage
- **Equipment**  
Leasing or loan repayments on equipment, motor vehicle leasing, insurance of vehicles and equipment, registration of vehicles, repairs and maintenance

- **Salaries and related costs**

Salaries of employees who do not generate any business income, their payroll tax and superannuation (SGC) contributions

- **Fixed contract costs**

Contracted maintenance costs for upkeep of your premises eg. cleaning and security

- **Other eligible expenses**

Accounting and auditing fees, bank fees and charges, business insurances, interest and fees on business loans not related to premises, professional association membership fees, regular advertising costs (eg. Yellow Pages).

### Benefits

Business expenses cover can help ensure that funding is available to cover the fixed business expenses that must be paid if the business owner is ill or injured and unable to work.

### How it works

Generally, the business owner takes out the appropriate level of insurance to cover 100% of their eligible monthly business expenses.

### Case study

Peter is a plumber, who reports a net taxable income of \$92,000. Having previously experienced periods off work due to sporting injuries, Peter is only too aware of the importance of protecting his income, and two years ago took out a personal income protection policy.

However, Peter never considered those fixed business expenses that continue on, regardless of whether he is able to work or not.

Peter's fixed business expenses include the monthly lease on his van (\$950), some yellow pages and online advertising (\$400) and storage rental costs (\$365), totalling \$1,715 every month.

Whilst Peter's personal income protection policy would pay a benefit of up to \$5,750 per month (75% of his net pre-tax income) in the event he was temporarily disabled, he would need to meet his fixed business expenses from this benefit.

Effectively this leaves him only \$4,035 (\$5,750 - \$1,715) – or 53% of his pre-disability income - to support himself and his family each month.



# Taxation issues

The taxation of insurance can be complex. We recommend you seek professional advice as to how the rules may impact you or your beneficiaries. The taxation treatment of risk insurance depends on a number of factors including:

- the purpose of the premium
- who pays the premium
- policy ownership.

## Premium deductions

The taxation treatment of risk insurance premiums and benefits depends on whether the insurance is for revenue or capital purposes.

Where the purpose of the insurance is for income or revenue (eg income protection), the premiums are deductible<sup>1</sup> and any proceeds are assessable as income<sup>1</sup>.

Where the purpose of the insurance is for capital purposes, premiums are generally non-deductible. However the insurance may be subject to Capital Gains Tax (CGT) if there has been a change in beneficial ownership or the proceeds are paid to certain recipients<sup>2</sup>.

## Fringe benefits tax

If an employer is the owner of risk insurance, the payment of premium may be subject to Fringe Benefits Tax (FBT). However for FBT to apply, the payment of premium must be in respect of employment of an employee.

If FBT applies, the premium will be treated as an expense payment fringe benefit. However the amount subject to FBT will be reduced by the amount the employee is otherwise entitled to claim as a tax deduction (known as the "otherwise deductible rule").

## CGT considerations

An insurance policy is a CGT asset and subject to the CGT rules of the Income Tax Assessment Act 1997.

The proceeds of Term insurance will be subject to CGT where there has been a change in the original beneficial ownership of the business and the disposal (or transfer) was for consideration. However, where the disposal (or transfer) of ownership was for no consideration, there are no CGT implications.

Whilst taxation law provides a specific exemption for Term insurance, the proceeds of TPD and trauma insurance will be assessable for CGT purposes unless the policy owner/s is an individual and the benefit is paid to them, their spouse or defined relative<sup>3</sup>.

1 Section 6–5, Income Tax Assessment Act 1997  
 2 Section 118–300, Income Tax Assessment Act 1997  
 3 Section 118–37, Income Tax Assessment Act 1997

# Ownership

## Choosing the right approach

There are a variety of ways to structure ownership. What may seem the cheap option now may have considerable costs in the long run. Ownership should be properly structured from the outset to ensure certainty in the event an insurance claim arises or a succession agreement is activated.

Owner	Advantages	Disadvantages
Life Insured	<ul style="list-style-type: none"> <li>• Transportable</li> <li>• Sometimes covers more than 'Business Will' obligations</li> <li>• Flexible – can take changes to business structure</li> </ul>	<ul style="list-style-type: none"> <li>• Pay out of proceeds means transfer of assets must happen. Sometimes illogical if partner could easily continue</li> <li>• Unless complicated deeming provisions are used, CGT problems can result</li> <li>• Delays due to difficulties in the deceased's estate</li> <li>• Policy owner can direct proceeds elsewhere via S48 beneficiary nomination</li> </ul>
Cross ownership	<ul style="list-style-type: none"> <li>• Payments are made directly to the parties needing it</li> </ul>	<ul style="list-style-type: none"> <li>• Not transportable</li> <li>• Inflexible for future business expansion, making future planning difficult</li> <li>• Owner's interest in the policy is an asset for CGT purposes</li> <li>• Any change in the original beneficial ownership (ie entitlement to proceeds) may result in CGT on payment of benefit</li> </ul>
Insurance Trust	<ul style="list-style-type: none"> <li>• Dispersal of policy proceeds is easy</li> <li>• Flexible for changes in structure</li> <li>• If structured appropriately, proceeds may not be subject to CGT</li> <li>• External supervision of arrangements</li> </ul>	<ul style="list-style-type: none"> <li>• Need for a trustee</li> <li>• May incur extra costs – initially and ongoing (compliance requirements and taxation in particular)</li> <li>• Trust's interest in the policies (Term or Trauma) is an asset for CGT purposes and certain proceeds may be subject to CGT</li> </ul>

Source:

1. Australia's Health 2012, Australian Institute of Health and Welfare.
2. National Stroke Foundation, 'What is a stroke? Facts, figures and statistics 2012'.
3. Cancer in Australia, an overview 2012, Australian Institute of Health and Welfare, 2014.
4. Australian Disability Table, 1AD 89-93 Class 2.
5. Interim Report of the Disability Committee Institute of Actuaries Australia 2000.





Zurich Australia Limited  
ABN 92 000 010 195, AFSLN 232510  
118 Mount St, North Sydney NSW 2060  
[www.zurich.com.au](http://www.zurich.com.au)

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