Adviser Information

MAKE A DIFFERENCE insurance

Buy / Sell Agreement - A Business Will

If you're in business with a partner you'll want to protect the ongoing viability of the business should specific events occur.

A buy/sell agreement is a contract usually entered into between business partners pursuant to which the surviving partners are bound to buy out the other partner's interest in the business should a specific event occur. Specific events which may trigger a buy/sell agreement include death, divorce, long-term disability, retirement or bankruptcy.

The agreement is often linked to an insurance policy on each partner's life. The policy provides the surviving partners with the money to be able to buy out the deceased/disabled/departing partner's interest.

Generally the agreement is structured in such a way that it does not matter what business structure has been used to own the business i.e. family trust, company, partnership.

Strategy analysis

A business may be transferred on the death of an owner either by:

- gifting the business via a will; or
- selling the business via a buy/sell agreement

The buy/sell agreement will take precedence over the will because the business will be transferred pursuant to the contract.

The agreement must identify the owner of the interest being disposed of and the type of interest disposed of (shares, units, partnership).

The agreement must also specify who is to acquire the interest (business partners, key personnel).

Types of agreements

There are two types of buy/sell agreements:

Cross-purchase Agreement

This is an arrangement where the remaining owners are to be the purchasers. Upon the death or serious illness of the owner the other business owner/s shall purchase the outstanding share. In a common scenario the executor of the estate will be required to sell the deceased's share, and the co-owners will be required to purchase it.

Corporate Entity Redemption Agreement

Under this agreement the company will buy back the interest of the deceased/disabled owner. The owner, or their estate, will receive cash from the company, and the company will purchase and cancel the shares.

Funding the agreement

The buy/sell agreement is normally funded through an insurance policy. Depending on the parties and circumstances, the policies can be held under any of the following arrangements:

- cross ownership, where the owners of the business hold policies on each other;
- principal ownership, where the owner holds the policy on himself/herself;
- discretionary trust, where the trustee holds the policies on behalf of all of the owners;
- company ownership, where the business holds the policies on behalf of all of the owners.

The buy/sell agreement will need to state either the value of the business or how the value is to be determined when the agreement is triggered.

The agreement will state whether the value to be applied shall be:

- the book value;
- the agreed value;
- the appraised value at the time of the specific event;
- capitalisation of earnings at the time of the specific event.

Clients will need legal and tax advice on what is the most suitable arrangement for them.

Capital gains tax implications

If a buy/sell agreement triggers payment of a life insurance policy, it will be exempt from CGT provided the gain or loss is made by:

- the original beneficial owner of the policy;
- an entity that acquired the policy for no consideration;
- the trustee of a complying superannuation fund.

A trauma or total and permanent disability insurance policy is subject to CGT if it is owned by the business. Only a trauma or total and permanent disability insurance policy owned by the insured is exempt.

Consideration can therefore be given to the business owner holding the policy on himself/ herself. As the buy/sell agreement results in the sale of the business, a CGT liability will arise to the vendor. The small business CGT concessions may operate to reduce this CGT liability.

Deductibility of premiums

The essential characteristic of a deductible insurance premium is that it be intended to provide an income.

A self-employed business owner can claim a deduction for premiums on a policy which will pay income during a period they are disabled. Normally, if a policy includes a component to pay a sum on death or disability, the component relating to death cover will not be deductible. However, it may be deductible if the following four criteria are met:

- the premium is paid for a revenue purpose;
- the policy's purpose is to advance the business;
- the policy is owned by the employer;
- the employer is the beneficiary of the policy.

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