Insurance

Buy/sell agreements

Aon Hewitt Financial Education Series

When an owner of a business dies, or becomes disabled, injured or ill, or chooses to leave the business, the surviving business partner/s will often desire ownership and control of the business, and the Estate will want funds to maintain their lifestyle. Buy/sell insurance arrangements can provide the money to fund some of these needs. It allows the surviving business partner/s of a business to buy out the deceased or disabled owner's interest in the business.

Most business owners don't leave their tangible assets (buildings, plant, equipment and stock) uninsured for a single day. Yet it isn't their tangible assets, but themselves, their business partners and their key people, who make the business successful.

What is a buy/sell agreement?

A buy/sell agreement involves the owners of a business entering into a written agreement to plan for:

- the voluntary exit of a business owner e.g. retirement (insurance cannot be used to fund the transfer), and
- the involuntary exit of a business owner e.g. death, illness or accident (insurance can be used to fund the transfer).

A documented buy/sell agreement will set out how:

- the transfer of ownership interest would occur, and to whom
- the value of the business will be determined, and
- the purchase of the ownership interest being transferred will be funded.

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 or partnership.

Careful structuring of the buy/sell agreement as well as the application of the small business capital gains tax (CGT) concessions will assist in reducing potential taxes.

The buy/sell agreement should cover such issues as:

- the events that will trigger the transfer of the business interest e.g. death, permanent incapacity, and/or serious illness,
- the value (or formula for determining the value) at which the business interest will be transferred,
- who will receive the outgoing owner's business interest e.g. remaining shareholders, partner(s) in partnership etc,
- how often the arrangement will be reviewed to ensure the value of the business is accurately reflected in the agreement,
- how the transfer will be funded e.g. using insurance, own funds, borrowed funds etc, and

- if funding is via insurance:
  - who will own the insurance policy(ies)
  - who will pay the insurance premiums
  - who will receive the proceeds
  - how often the level of cover should be reviewed

Structure of a buy/sell agreement

You can structure a buy/sell agreement in several ways, including:

- a mandatory agreement to buy/sell, or
- an agreement to use put/call options (non-mandatory).

Mandatory buy/sell

The business owners can enter into a legally binding agreement specifying that upon the occurrence of an event covered in the agreement (e.g. permanent disablement or death of a business owner), the agreement compels the outgoing owner to sell their business interest and compels the other party(ies) to buy this interest.

Put/call options

Under a put/call option agreement, following the occurrence of an event specified in the agreement, a put option arises to the outgoing owner, giving them the right to sell the interest in the business. Simultaneously, a call option arises to the remaining business owner(s) providing them with the right to buy the outgoing owner's share in the business.

Like all options, they don't have to be exercised, however should one party exercise their legal right to sell (put option) or buy (call option), the other party(ies) must transact with them i.e. buy/sell as per their agreement.

This gives the remaining business party(ies) the first option at purchasing the other share of the business.

Advice specialists

A business must obtain advice from a number of specialist advisers when establishing a buy/sell arrangement, including legal, accounting/tax advice and financial planning advice.

The table below outlines the roles of the various professionals

Financial Adviser	Tax Adviser	Legal Adviser
Coordinator/facilitator	Business valuation	Drafting buy/sell agreements
Advice about insurance funding	Tax planning	Drafting or updating Wills
	Financial statements	

In the drafting of the buy/sell agreement, an accountant/tax adviser would also need to be consulted on the potential CGT liabilities of any arrangements. Once a trigger event has arisen, the exercising of either a put (the right to sell the ownership interest) or call (the right to buy the ownership interest) option will result in the transfer of the business ownership interest.

Funding for this can occur through bank loans, self-insurance, or through the purchase of term life (including total and permanent disablement) insurance.

Insurance policy ownership

Buy/sell insurance policies are generally owned and paid for by the business owners. There are a number of different methods for owning buy/sell insurance policies including:

- self ownership (you own the policy on your own life)
- cross-ownership (you own the policy on the other business owners life, and they own your policy)
- Corporate ownership (the company owns the policy)
- policy holding trust ownership (a trust is set up to hold the policy)
- super ownership (the policy is held through your super)

It is important to note that there is no single correct way to structure buy/sell agreements and policy ownership. This will come down to your individual circumstances.

Taxation

There are elements of tax that need be taken into consideration when a buy/sell agreement is in place, including deductibility of premium and the CGT at the time of claim. It is extremely important that you seek specialist advice on the suggested insurance policy ownership requirements. Incorrect policy ownership may lead to unnecessary payment of tax and complications in the transfer of the business.

Scenario

Cathy, Bill and Sandy are directors and partners in a small company; they each have an equal shareholding in the business that has an annual turnover in excess of $5m, and an estimated value of $6m. All three are married with children.

What would happen if Bill were to die? Cathy and Sandy have a number of options:

- They could bring Bill's spouse into the business as a director – after all, as Bill's beneficiary, she now owns 33% of a successful business.
- They could buy out Bill's spouse shareholding, but would need $2m to do so.
- They could offer a financial arrangement with Bill's spouse to pay her some form of income – but in order to continue with the business development plans, would also need to employ someone to take Bill's place.

Here we have a small business dilemma. Cathy and Sandy do not want to work with Bill's spouse – she is untrained and unskilled in this field of work – but she has in fact inherited a one-third ownership of the business. The business cannot afford to borrow $2million to buy the spouse's share of the business. Cathy and Sandy are trapped, and Bill's family has few options and no income.

If Cathy, Bill and Sandy had put in place a buy/sell agreement and used life insurance proceeds held on the life of Bill to fund the purchase then they would not be in this position. The life insurance proceeds would be used to fund the purchase of the business from Bill's spouse. This will result in Sandy and Cathy owning 100% of the business and Bill's spouse receiving $2million in return.

A buy/sell agreement is a process that involves a number of steps. In simple terms:

- The business owners take out insurance policies on each other to cover an agreed amount.
- A legally-binding agreement is signed by each business owner whereby, in the event of their death or permanent incapacitation, the proceeds from the insurance policy would be passed on to the partner's family in return for their shareholding in the company.

In this way, the business can continue without undue disruption and the family of the deceased person gets adequate financial compensation.

This is a simple summary of a process that can be very demanding. However, when you consider the alternatives outlined in the scenario above, the process could well be worth every minute spent on it.

Aon Hewitt Financial Advice Limited | ABN 13 091 225 642 AFSL No 239183

This information may be regarded as general advice. That is, your personal objectives, needs or financial situations were not taken into account when preparing this information. Accordingly, you should consider the appropriateness of any general advice we have given you, having regard to your own objectives, financial situation and needs before acting on it. Where the information relates to a particular financial product, you should obtain and consider the relevant product disclosure statement before making any decision to purchase that financial product.

This document, including all tax and super calculations, has been prepared using legislation in place as at the 1 July 2018.

© July 2018 Aon Hewitt Financial Advice Limited