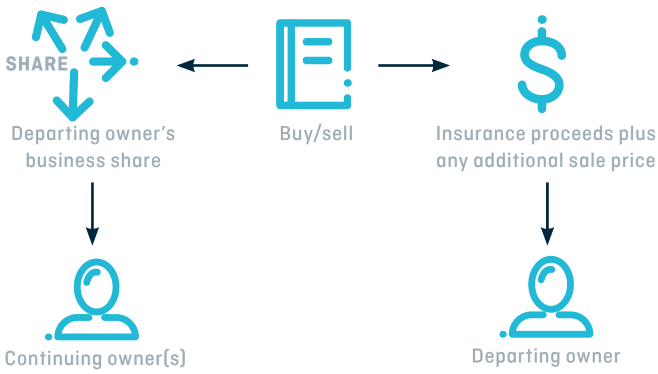
BUY/SELL AGREEMENT- BUSINESS OWNERSHIP INSURANCE

ISSUED: JULY 2020
VERSION: JULY 2020

The death or 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.

A business succession plan or buy/sell agreement protects all owners and their families by enabling the timely and orderly transfer of business ownership in the event of death, total and permanent disablement, critical illness or injury of one or more of the owners.

It is important that the buy/sell agreement includes a transfer mechanism and a funding arrangement. Your lawyer, accountant and financial planner should work together to ensure that your business succession plan is up to date and effective.



BENEFITS OF AN EFFECTIVE BUY/SELL AGREEMENT

An effective buy/sell agreement allows the remaining owners acquire the interests of the outgoing owner so they can continue to run the business and the outgoing owner (or their estate) will receive adequate compensation in exchange for their share of the business.

Business owners are able to negotiate buy-out arrangements at an orderly time, rather than negotiate with the legal personal representative at a time 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).
- the business will not be required to utilise cashflow, sell assets or undertake new borrowing at a time of possible capital vulnerability

The outgoing owner (or their estate) will benefit from certainty of valuation of their business interests, which can assist in their ongoing personal needs or the ongoing wellbeing of their loved ones. Previously held personal loans or guarantees can also be removed.

HOW IT WORKS

BUSINESS SUCCESSION PLANNING- BUY/SELL AGREEMENT

The Buy/Sell Agreement is a written legal agreement between the business owners which details what will happen to their respective interests in the business should one of them resign, retire, suffer an illness, become disabled or die.

An effective Buy/Sell Agreement documents the transfer of a departing owner's share of the business to the remaining owners and includes the following elements:

Transfer Agreement

- Who are the business owners, including related party companies and trusts?
- Which events will trigger transfer of business ownership?
- When does the obligation for business owners and their related parties apply to sell/ purchase the departing equity?

Funding Agreement

- How the business and each owner's share will be valued?
- How will the business obtain funds to pay out a departing owner (or their estate) in exchange for transferring their equity to the remaining owners?
- Identifies the succession events or situations that can not be insured
- Provides for the removal of security or personal guarantees for the business by the departing owner
- Repayment of loans between the business and the departing owner.
- Consideration of tax implications, such as Fringe Benefits Tax and Capital Gains Tax
- Outlines, if insurances are put in place, how premiums will be funded to ensure the policies stay current.

Funding the Buy/Sell Agreement

The Buy/Sell Agreement should document the funding strategy for paying 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 cost of funding to an alternative mechanism like insurance. Insurance is often the most efficient means of ensuring adequate funds to settle business equity and any personal loans or guarantees that may have been in place if the owner is departing due to death, disability or trauma. Insurance proceeds may be received tax-free.

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
- sufficient capital for the settlement of any **loan accounts**
- permanent cancellation of any **personal guarantees** through the elimination of the borrowings.
- implications for Capital Gains Tax, if applicable

It is important to ensure that any **buy/sell funding arrangements are legally documented** to ensure that the remaining owners receive business share, and the departing owner receives compensation. Without legal documentation, insurance proceeds will be paid to the insurance owner, such as the departing owner, without a corresponding change in business control.

INSURANCE POLICY OWNERSHIP

There are a number of alternatives for how to own insurance policies as part of a buy/sell agreement.

An insurance policy could be owned individually or owned by another business partner, the business or an insurance trust. There are benefits and disadvantages with each option and you should seek professional tax and legal advice.

SELF-OWNERSHIP

Self-ownership is the simplest and most flexible option. If a claim is paid, the departing owner receives the insurance proceeds and the buy/sell agreement transfers their share of the business to the remaining owner(s).

Each individual maintains control of their own policy. The policy is fully portable so can continue after retirement from the business but the owner is also responsible for paying the premiums on their own policy. The premiums are not tax deductible and the proceeds are received tax free (if paid and owned by the insured).

The owner can also nominate who 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. Tax implications will apply if the insurance proceeds are received by a related party, such as a family trust or company.

It is possible to pay these premiums via the business. Fringe Benefits Tax will apply if premiums are paid by the business, so you should seek tax advice from your accountant.

CROSS-OWNERSHIP

Under cross-ownership, each business owner will own (or jointly own) a policy on each of the other owners. If a claim is paid, the policy owners will receive the insurance proceeds to buy out the departing owner's share of the business.

Under this option, the policy is controlled by people other than the insured individual. The insurance cover on the life insured can be cancelled if not required by the business. The premiums are not tax deductible and the proceeds will be taxable if there is a claim for disability or ownership is via a company. Tax is also payable if there is a change to the ownership of the insurance policy, this generally occurs when there is a change in business ownership, such as partnership details.

An agreement will be needed on how premiums are to be funded to ensure the policies stay current.

BUSINESS OWNERSHIP

If the business is run under a company structure, the insurance policy could be owned by the company. The business succession agreement then compels the company to purchase back the departing owner's shares and cancel them. The insurance policy is added to the capital of the business and will be subject to Capital Gains Tax, when the remaining owner's shares are eventually sold.

Under this option, the policy is controlled by people other than the insured individual. The insurance cover on that life insured can be cancelled if not required by the business. The premiums are not tax deductible and the proceeds will be taxable if there is a claim for disability or ownership is via a company. A change to business ownership will affect the ownership of the policy, so will also be subject to tax.

INSURANCE TRUST OWNERSHIP

If flexibility is needed to deal with insurance proceeds from a death claim differently to a disability claim to manage tax implications, or if there are a large number of owners of the business or changes to business ownership are likely, holding the insurance policies through a special purpose insurance trust may be advantageous.

The claim proceeds are paid to the insurance trust trustees and are distributed in accordance with the trust agreement. This needs to match the required outcomes under the Business Succession Agreement. The Trustee may pay the funds to the departing owner or their estate (in exchange for transfer of that person's business share to the remaining owner), or to the remaining business owners to purchase the departing owner's interest in the business.

The insurance premiums are paid for by the trustee of the insurance trust and are not tax deductible. Tax outcomes depend on the insurance type and underlying beneficiary.

NOMINATIONS

Insurance proceeds can be directed to a beneficiary or beneficiaries nominated on your insurance policy.

If life insurance is held outside superannuation, you can nominate to a person, company or a trust.

Nominating your beneficiary ensures that funds can be distributed as per your instructions.

You are not required to make a nomination. If you do not make a nomination, the insurance proceeds will be received by the owner. If the owner has died, the proceeds will be distributed as per the owner's instructions contained in their will or will be subject to intestacy laws. Tax payable is dependent on the type of insurance policy and the beneficiary nominated.

A nomination on a self-owned life insurance policy will exclude the proceeds from your Will. The receipt of the insurance proceeds can not be challenged by creditors or by potential estate claimants that you do not wish to receive the funds, such as former spouses and adult children, as the proceeds do not form part of your estate. Life insurance nominations made to companies or trusts no longer in existence will also have the proceeds directed to your estate.

PREMIUM EQUALISATION

Insurance premiums are based on life expectancy, health status and the sum insured requirement for business ownership. There is a greater chance of an insured event happening to an older shareholder than younger counterparts, so the premium is generally higher for the older insured person. As the business succession plan permits business equity transfer irrespective of age or health status, younger shareholders or partners will benefit if the cost of individual premiums is not shared across shareholders.

WHAT YOU NEED TO CONSIDER

- 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. The Agreement is more likely to specify the approach to calculating the value than a dollar amount. 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.
- Changes to business ownership, such as partnership changes, can impact on the tax paid on insurance policies
- Business owners and their families should review and update their own personal Wills and nominations 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.

- Other funding mechanisms should be considered if the Agreement deals with non-insurable events such as retirement.
- 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.

REFERENCES

You may wish to refer to the following websites for further information about buy/sell agreements:

- www.ato.gov.au
- www.moneysmart.gov.au

The information in this document is of a general nature and does not take into account your own financial objectives, circumstances or needs. You should consider your own personal situation and requirements before making a decision.

Affinia Financial Advisers Limited ABN 13 085 335 397 AFSL No. 237857
Level 16, 363 George Street Sydney NSW 2000
t 1300 AFFINIA (1300 233 4642)
e hello@affinia.com.au
w www.affinia.com.au