Fact Sheet

Buy/Sell Agreements

The running of a business can be severely impacted if a business owner dies or is unable to work due to illness.

Incorporating a buy/sell agreement into a business' succession plan can help facilitate a smooth transition of ownership to remaining owners.

What are the benefits?

- A buy/sell agreement enables remaining business owners to gain full control of a business if one business owner dies or can't work again due to illness or injury.
- It can enable the departing owner (or the beneficiaries) to sell their share for an agreed price.
- It can enable a business to continue operating with minimal disruption.

How do buy/sell agreements work?

A buy/sell agreement allows business owners to plan how their interests in a business will be transferred to the remaining owners in the event they die or are unable to work. A buy/sell agreement often includes two parts – a legally binding agreement and a funding mechanism.

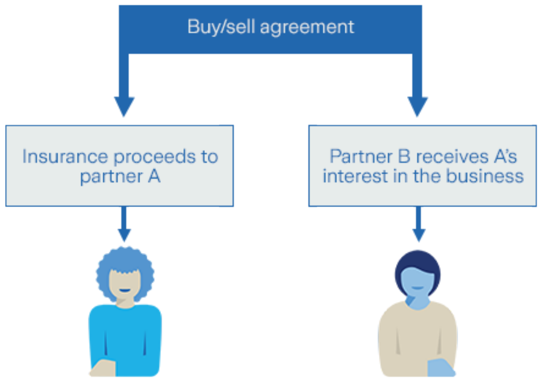
Legal document

The first part, the buy/sell agreement, is a written contract outlining how a business owner's interest is transferred to the remaining owner(s) if the person suffers a trigger event. Trigger events could include death, serious illness or injury, permanent disability, retirement or resignation.

The buy/sell agreement should be drafted by a lawyer to meet any specific needs and the business structure. The agreement would typically include details on:

- the trigger events to be covered,
- how the sale price will be determined,
- payment arrangements, and
- the process to follow if triggered.

Having this agreement in place can help to avoid future disputes. The departing owner (or their beneficiaries/estate) will receive an agreed value for their share of the business and the remaining owner(s) are able to continue to run the business the way they want to.



Funding mechanism

The second part is how to pay for the departing owner's business share. Insurance is commonly used as it avoids the need for remaining owners to use personal savings or borrow money.

Insurance can only be used to cover trigger events such as death, total and permanent disability or serious illness or injury that also meets the terms of the insurance policy. Other funding options (such as savings, loans or deferred purchase agreements to make payments over a number of years) need to be considered for any trigger events in the agreement that are not covered by the insurance. Examples are retirement or resignation along with disability, illness or injury that is less severe than the level required by the insurance policy.

Ownership of life insurance

If insurance is going to be used to fund a buy/sell agreement, a decision needs to be made on who should own the life insurance policies. It is important that the ownership of the insurance policies matches the operation of the buy/sell agreement and its other details. Some of the ownership options available are discussed below.

Self-ownership

- Each business owner owns a policy on their own life. In the event of a claim, the insurance proceeds are paid to that person or their estate.
- This option is relatively simple because each person retains control over their insurance policy and it is easier to manage if new partners join the business.
- The buy/sell agreement would generally require the departing owner's business share to be transferred to the surviving owners if a trigger event covered by the agreement occurs. Where a trigger event under the agreement is also covered by the insurance policy, the agreement would state that the receipt of the insurance proceeds is considered a full or part payment for the departing owner's business share.
- The proceeds of the policy in this instance are generally received by the departing owner or their estate tax free.

Joint ownership

- All business partners are joint owners of an insurance policy over each other owner's life. In the event of a claim, the proceeds are paid to the surviving policy owner(s) to then pay to the departing owner as part or full payment for their share of the business.
- This structure may be appropriate if no changes to the business partners are expected.
- As part of the buy/sell agreement, the receipt of the insurance proceeds can be used to buy the departing owner's business share.
- Payments on death are generally tax free but capital gains tax (CGT) may apply in some cases. CGT may also apply to TPD or trauma policies.

Cross ownership

- Each business owner owns an insurance policy on the other owners.
- As part of the buy/sell agreement, the receipt of the insurance proceeds can be used to pay for the departing owner's business share.
- This option may be complex if there are more than two business owners and may give rise to tax liabilities for CGT on TPD and trauma if the business owners are not close relatives.

Discretionary trust

- The insurance policies are owned by a discretionary trust specifically set up to hold insurance cover. In the event of a claim, the insurance proceeds are paid into the trust and the trust deed determines how to pay the money.
- This structure provides flexibility, especially if there are a number of business owners, changes in owners, or a person needs to own several insurance policies for different purposes. Additional costs will apply to set up and maintain a trust.
- Tax may apply on insurance proceeds depending on the structure of the arrangement and the recipient of the payment from the trust.

Company ownership

- The company owns the insurance policies for each business owner and receives the insurance proceeds if an insured event happens.
- The buy/sell agreement in this scenario generally requires the company to use the proceeds to buy back the departing owner's shares. These shares are cancelled and the shares held by the continuing owners will effectively increase in value.
- Proceeds from life insurance policies are generally tax free. CGT may apply for TPD or trauma policies. The remaining owners may have a negative CGT impact on their shares as the value of each share will increase but there is no change to the cost base.

Superannuation fund (excluding SMSF)

- Under this structure each business owner's superannuation fund owns the insurance policy. In the event of a claim, the insurance proceeds are paid tax free into the superannuation fund and added to the person's account balance. If the amount is withdrawn from super, lump sum tax may be payable in some circumstances.
- The buy/sell agreement would generally require the departing owner's business share to be transferred to the surviving owners if a trigger event covered by the agreement occurs. As with self-ownership where a trigger event under the agreement is also covered by the insurance policy, the agreement would state that the superannuation fund's receipt of the insurance proceeds is considered a full or part payment for the departing owner's business share.
- This option may create extra complexity. There are legal constraints around releasing superannuation money before retirement, superannuation fund assets being unable to be affected by charges or other interests over fund assets and the classes of people eligible to receive money from the fund that superannuation law imposes. Legal advice should be sought.
- The ATO have issued an interpretive decision (ATO ID 2015/10) which indicates that holding insurance inside an SMSF for buy/sell purposes (in a particular set of circumstances) is a breach of the sole purpose test. ATO ID 2015/10 can be viewed from the legal database at www.ato.gov.au.

Other things you should know

- Legal advice should be sought to establish a buy/sell agreement. Legal advice may also be required to ensure the insurance policies are structured correctly for the business purpose.
- For insurance policies that are not self-owned, consideration may need to be given as to how insurance proceeds can be paid out of the structure and whether restrictions apply.
- Tax advice should also be sought to understand the tax implications, including how the insurance proceeds are taxed (because this can vary depending on the ownership and who receives the proceeds) and how to structure the insurance policy ownership.
- Buy/sell agreements and any associated insurance cover should be reviewed on an ongoing basis to ensure they continue to be appropriate for the needs of the business.

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