BUY/SELL AGREEMENT BUSINESS OWNERSHIP INSURANCE

The survival of a small to medium-sized business, as well as the well-being of all owners' families, can be severely compromised by the demise or health issues of one of the owners.

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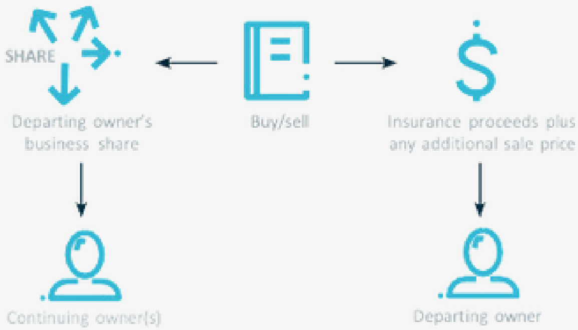
A business succession plan or buy/sell agreement safeguards the interests of all owners and their families by facilitating the smooth and prompt transition of business ownership in case of the passing, permanent disability, critical illness, or injury of any owner or owners.

It's crucial for the buy/sell agreement to encompass a transfer process and a funding arrangement. Collaborating with your lawyer, accountant, and financial planner is essential to ensure that your business succession plan remains current and functional.



Benefits of an effective Buy/Sell Agreement

A well-crafted buy/sell agreement facilitates the remaining owners in acquiring the departing owner's interests, enabling them to sustain business operations. In return, the outgoing owner or their estate receives fair compensation for their share of the business. This arrangement allows business owners to negotiate buy-out terms in a structured manner, rather than engaging in negotiations with the legal representative during emotionally challenging times, such as the death or disability of an owner. The stability achieved through this careful advance planning should not be underestimated.

This stability also brings considerable reassurance to other stakeholders in the business, including employees, creditors, customers, and financiers. They can be confident that:

1. Professional arrangements and financial resources are in place for the orderly transfer of ownership.
2. The business can continue to function under the capable guidance of the remaining owner(s).
3. The business won't be compelled to tap into cash reserves, sell assets, or incur new debt during a potentially financially vulnerable period.

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Furthermore, the outgoing owner or their estate benefits from a clear valuation of their business interests, which can support their ongoing personal needs or the well-being of their loved ones. Previously held personal loans or guarantees can also be eliminated through this process.

How it works

Business succession planning - Buy/Sell Agreement

A Buy/Sell Agreement constitutes a formal written contract among business owners that outlines the course of action regarding their respective stakes in the business in the event of one owner's resignation, retirement, illness, disability, or passing.
An effective Buy/Sell Agreement encompasses several critical components, including:

Transfer Agreement:

- Identification of business owners, encompassing related entities like companies and trusts.
- Determination of events triggering the transfer of business ownership.
- Specification of when the obligation for business owners and related parties applies to sell or purchase the departing equity.

Funding Agreement:

- Valuation methodology for the business and each owner's share.
- Mechanism for sourcing funds to compensate a departing owner (or their estate) in return for transferring their equity to the remaining owners.
- Recognition of succession events or scenarios that cannot be insured against.
- Provision for the removal of security or personal guarantees previously provided by the departing owner.
- Repayment terms for loans between the business and the departing owner.
- Consideration of tax implications, such as Fringe Benefits Tax and Capital Gains Tax.
- Outline of how insurance premiums will be financed to ensure the policies remain in force, if insurance is part of the arrangement.

Funding the Buy/Sell Agreement:
The Buy/Sell Agreement should detail the funding strategy for meeting the buy/sell obligations. Generally, there are three options for funding a business succession plan's capital requirements: selling assets, borrowing, or shifting the funding responsibility to an alternative mechanism like insurance. Insurance is often the most efficient method for ensuring sufficient funds to settle business equity and any personal loans or guarantees, especially when an owner is departing

due to death, disability, or trauma. Insurance proceeds are usually received tax-free.

Ideally, the capital needed to facilitate the transfers should consider the following:

- The individual equity holdings of each owner (or those owned by related parties). If possible, this should allow for a growth cushion over a three-year period, particularly if insurance funding is chosen as a capital source.
- Adequate capital to settle any outstanding loan balances.
- Permanent elimination of any personal guarantees by clearing borrowings.
- Implications for Capital Gains Tax, where applicable.

It is imperative to ensure that any buy/sell funding arrangements are legally documented to guarantee that the remaining owners receive business shares, and the departing owner receives appropriate compensation. Without proper legal documentation, insurance proceeds may be disbursed to the insurance owner, such as the departing owner, without a corresponding change in business control.

Insurance Policy Ownership

There are several options available for how to structure the ownership of insurance policies within a buy/sell agreement. These options include individual ownership, co-owner ownership, business ownership, or ownership through an insurance trust. Each choice has its advantages and disadvantages, so it's advisable to seek professional tax and legal guidance.

- SELF-OWNERSHIP

Self-ownership is the most straightforward and flexible approach. In this setup, each owner individually owns their insurance policy. If a claim is approved, the departing owner receives the insurance payout, and the buy/sell agreement facilitates the transfer of their business share to the remaining owner(s).

Under this arrangement, each individual maintains control over their policy, which is fully portable and can continue after their retirement from the business. However, they are also responsible for paying the policy premiums, which are not tax deductible. The insurance proceeds are typically tax-free if the policy is paid and owned by the insured individual. The owner can also designate a beneficiary, such as their spouse, to directly receive the payment. Tax implications may arise if the proceeds are paid to a related party, like a family trust or company. If the business pays the premiums, Fringe Benefits Tax may apply.

- CROSS-OWNERSHIP

In cross-ownership, each business owner owns or jointly owns a policy on the lives of the other owners. If a claim is approved, the policy owners receive the insurance payout to buy out the departing owner's business share.

Under this structure, the policy is controlled by individuals other than the insured person. The insurance coverage on the life insured can be canceled if it's no longer required by the business

Premiums are typically not tax-deductible, and the proceeds may be taxable if there is a claim for disability or if the policy is owned by a company. Tax implications can also arise when there is a change in the ownership of the insurance policy, such as changes in business ownership or partnership details. Agreements are needed to determine how premiums will be funded to ensure that the policies remain in force.

- BUSINESS OWNERSHIP

If the business operates as a company, the insurance policy could be owned by the company itself. The business succession agreement would then require the company to buy back the departing owner's shares and cancel them. The value of the insurance policy is added to the business's capital and may be subject to Capital Gains Tax when the remaining owner's shares are eventually sold.

Similar to cross-ownership, the policy is controlled by individuals other than the insured person, and the coverage can be canceled if it's no longer needed by the business. Premiums are not typically tax-deductible, and proceeds may be taxable in case of disability claims or if the policy is owned by a company. Changes in business ownership will impact the policy's ownership and may also have tax implications.

- INSURANCE TRUST OWNERSHIP

If flexibility is required to manage tax implications differently for death and disability claims, or if there are numerous business owners or expected changes in business ownership, using a dedicated insurance trust could be advantageous.

In this scenario, claim proceeds are paid to the trustees of the insurance trust and distributed in accordance with the trust agreement, aligning with the desired outcomes outlined in the Business Succession Agreement. The trustees may allocate funds to the departing owner or their estate (in exchange for the transfer of their business share) or to the remaining business owners for the purchase of the departing owner's interest in the business. The insurance premiums are covered by the trustee of the insurance trust and are generally not tax-deductible. Tax consequences vary based on the insurance type and the beneficiary structure.

Nominations

Insurance proceeds can be designated to a beneficiary or beneficiaries of your choosing, as specified in your insurance policy. If you hold life insurance outside of a superannuation plan, you have the option to nominate an individual, a company, or a trust as the recipient
Making a beneficiary nomination ensures that the funds are distributed according to your specific instructions. However, it's not obligatory to make such a nomination.

If you choose not to designate a beneficiary, the insurance payout will be received by the policy owner. In the event that the owner has passed away, the proceeds will be distributed in accordance with the owner's instructions as outlined in their will or subject to the laws of intestacy.

The tax liability associated with the insurance policy and the nominated beneficiary will vary depending on the type of insurance policy and the beneficiary's identity.
A nomination on a personally-owned life insurance policy will exclude the insurance proceeds from being included in your Will. This means that creditors and potential claimants, such as former spouses and adult children, whom you may not wish to receive the funds, cannot challenge the receipt of the proceeds because they do not constitute part of your estate. In cases where life insurance nominations were made to companies or trusts that no longer exist, the proceeds will be directed to your estate.

Premium Equalisation

Insurance premiums are determined by several factors, including life expectancy, health status, and the required sum insured for business ownership. Generally, older shareholders are more likely to face an insured event, making the premiums higher for them compared to their younger counterparts. Since the business succession plan allows for the transfer of business equity regardless of age or health, younger shareholders or partners stand to gain if the cost of individual premiums is not distributed among all shareholders.

Key Considerations

• The Business Succession Agreement is a pivotal component of your business protection strategy. It is advisable to seek expert legal counsel to establish the agreement and ensure its alignment with your objectives, including the ownership structure of insurance policies.
• Collaborating with your accountant is essential to evaluate potential tax implications and the impact on your business structure.
• Business valuations will fluctuate over time. The Agreement is more likely to outline the method for calculating value rather than specifying a fixed amount. If insurance is the chosen funding method, it's crucial to periodically review the insurance coverage to ensure it remains sufficient.
• Changes in business ownership, such as alterations in partnerships, can influence the tax considerations related to insurance policies.
• Business owners and their families should regularly review and update their personal Wills and beneficiary designations to ensure efficient asset distribution and control in the event of their passing.
• All business owners should establish Enduring Powers of Attorney to manage their affairs in case of incapacity.
• Consider alternative funding mechanisms if the Agreement addresses non-insurable events, such as retirement.
• Always carefully review the Product Disclosure Statement (PDS) and policy documents for your chosen insurance policy and store these documents securely.

References

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

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

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