WHAT IS

a Buy/Sell Arrangement?

A Buy/Sell arrangement is a contract that allows transfer of a business to remaining owners if one owner dies or suffers a serious illness/injury and is unable to stay in the business. This is often coupled with insurance policies to provide the money to buy out the departing owner's share. This allows remaining owner(s) to continue running the business and helps to ensure that the departing owner or their estate will be fairly compensated for giving up their rights to the business.

A Buy/Sell arrangement allows a business to buy a partner's share if certain events happen, like death, permanent disability or, in some cases, major medical trauma. The business holds a call option to buy the shares, and each partner holds a put option to sell their shares.

If a trigger event occurs, the business can buy the shares at a set price, or the departing partner (or their estate) can sell the shares to the business at that price. Once either option is exercised, the other party must comply with the contract terms.

Therefore, when it comes to business estate planning, the big question you need to ask is:

> **Would your business be able to buy a departing owner's share of the business if that person died or suffered a serious illness or injury?**

If your answer to this question is no, you need to consider transferring that financial risk to an insurance company.

Your financial adviser can help you do that, as well as answer any questions you have about Buy/Sell insurance, and calculate how much insurance you need to safeguard your business in the event something should happen to one of the partners.

And, if you wish, your adviser can assist you and your business partners to find the right cover at a competitive price by canvassing Australia's major insurance providers.[1]

1. Insurance cover is subject to eligibility criteria

What is a Buy/Sell Arrangement?

Why is Buy/Sell insurance important?

A Buy/Sell agreement, funded by insurance, can help minimise the risk of:

- The remaining owners having to sell the business to pay out the departing owner or their estate.
- The control of the business or its assets being frozen due to legal difficulties created by the departing owner, their spouse or their estate.
- A departing owner, their spouse or estate, taking legal action over a valuation or pay-out figure.
- A departing owner's spouse deciding (against the wishes of the continuing owners) to become an active partner of the business (rather than taking the pay-out).
- The departing owner's spouse or family taking their legal right to claim a share of the business profits without having to work in the business, or
- A departing owner's spouse or estate selling their share of the business to an unsatisfactory third party.

Types of insurance

There are three types of risks that can be covered by Buy/Sell insurance:

- The death of a business partner (life insurance)
- Total and permanent disablement (TPD insurance)
- Suffering a trauma such as heart attack, stroke, cancer, or a range of motor function diseases with long-term implications (trauma insurance).

Ownership of the policies

There are several options available when it comes to policy ownership:

Self-ownership – where the person insured is the policy owner. This is the simplest structure, and the person insured keeps control of their own policy, even if they leave the business.

Cross-ownership – where the business owners take out insurance on each other. The policy ownership changes with changes in business ownership.

Insurance trust – where a trust owns the policies on behalf of all business owners. This means policy ownership is not affected by changes in business ownership.

Business entity – where the trading entity owns the policies on the business owners' lives. Policy ownership is not affected by changes in business ownership, unless the person insured wants the policy assigned to them when they leave the business. The business uses the insurance proceeds to buy back the departing owner's (or their estate's) share.

When considering ownership of a policy, you need to consider control of the policy, payment of premiums, the business structure, the potential for ownership changes and tax on the receipt of insurance proceeds. Depending on the ownership structure you choose, this may also impact your ability to get additional cover in your own name. The policy ownership structure also needs to match the Buy/Sell Agreement. Getting sound financial advice is key to ensuring your insurance and Buy/Sell agreement are structured correctly.

Taxation considerations

The cost of the insurance cover you take out to fund a Buy/Sell agreement is generally not tax deductible. Depending on the ownership structure chosen, income tax, capital gains tax and fringe benefits tax may apply – which is an important reason why professional advice is essential to achieving the best outcome for all parties.

What is a Buy/Sell Arrangement?

Business valuation

An important part of a Buy/Sell agreement is reaching a consensus with your partners on how your business is valued. It is also important to ensure that the level of cover on your insurance policies keeps pace with changes in the business value. You should also take into consideration any capital gains tax that may apply when you receive the insurance proceeds.

Payment of insurance premiums

For all ownership options, the business owners need to determine how premiums will be paid and an appropriate method for sharing costs. The premium cost for each owner is likely to vary due to age, health and other underwriting requirements. The owner of the policy is responsible for paying premiums. However, in practice the business entity often pays the premium as a non-deductible or FBT expense. If paid by a company the payment may be deemed to be a dividend or could be deducted from the owners' loan accounts. Owners may agree to combine premiums, and each pay a portion of the total cost based on their share of ownership.

You and your professional advisers

Designing an effective buy/sell insurance arrangement requires your financial adviser, accountant and solicitor to work together.

Case study

Ben and Anthony are co-owners of a fast-growing firm. Both have young families, and they know that their share in the business is their family's main asset, as well as their source of income. They each take out life insurance policies on their own lives, to the value of their business share, and then have a transfer agreement drawn up. When Anthony dies in a car accident, his estate receives the life insurance proceeds, as per the agreement his share of the business automatically transferred to Ben. Now that he owns the company outright, Ben can continue operating the business without the financial burden of paying out Anthony's estate. And Anthony's wife can invest the insurance payout to provide for her family's welfare.