ATO VIEW ON FUNDING BUY/SELL AGREEMENTS THROUGH SUPER

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Have you ever come across a situation where a business owner has been advised to take out a life insurance policy inside a self-managed superannuation fund (SMSF) as part of an underlying buy/sell agreement? If yes, then according to a Australian Taxation Office Interpretative Decision (ATOID 2015/10), and a case study published by the Tax Office on its website, that SMSF may be failing the sole purpose test.

Let's first refresh our memory – what is a buy/sell agreement?

A buy/sell (or business succession) agreement is like a will for a business. When the agreement is well-executed and funded, it is an effective mechanism for business owners to transfer equity and/or control if something should happen to one of the owners.

Take Bob and Ed, business partners who run their business through a company. If Bob passed away tomorrow, his shareholding in the company would form part of his estate and be distributed to someone under his Will. Assuming his wife inherits the shares, the entitlements attached to these and the options with regards to selling them are all important considerations that she would have to eventually deal with. But, it's probably the last thing on her mind.

Meanwhile Ed is contemplating the impact Bob's death will have on the future operations of the company. As it stands, he's just lost his business partner and their company is now part-owned and controlled by Bob's widow, by virtue of the shares she inherited from Bob.

In this situation a buy/sell agreement can help. If Bob and Ed had established a buy/sell agreement, Ed could have used it to acquire the shares from Bob's wife at a predetermined price. The agreement provides transparency to everyone involved and a platform for Ed to assume full control of the company moving forward.

However a buy/sell agreement invariably needs to be funded. Just like an ordinary share trade, Bob's wife will need to be compensated for relinquishing the shares to Ed. Under the buy/sell agreement Bob's wife is to receive fair value for her share of the business in a timely manner.

This is where the expertise of a financial adviser is usually called upon as a life insurance policy can play a critical role in providing Ed with the necessary funding to acquire the shares from Bob's wife. The problem is, in the past, some advisers may have recommended that the life insurance policy be held inside the business owner's SMSF. It is this exact scenario that has caught the attention of the Tax Office and triggered the release of ATOID 2015/10.

What this means for financial advice

If you identify the need for a life insurance policy to fund a buy/sell agreement then ensure the recommendation is for the policy to be owned outside of the superannuation environment. Some alternative non-super options have traditionally included self-ownership, cross-ownership or trust ownership. Ultimately the appropriateness of a particular ownership structure will depend on the circumstances of the client.

If, on the other hand, a client currently owns a life insurance policy within their SMSF as part of a buy/sell agreement, then arrangements may need to be made for ownership of the policy to be reissued outside of the SMSF.

A review of the structure of insurances in super should be undertaken where:

- the insurance was taken out for the purpose of funding a buy/sell agreement,
- the calculation of the benefit under the insurance policy is based on the valuation of the share of the business and not on the future needs of the member's dependants, or
- the proceeds of the insurance policy are compensation for the deceased's share of the business.

Be sure to discuss the process and implications of cancelling and reissuing policies with the relevant insurer. For example, new disclosure requirements could be invoked (if high sums insured are involved) and/or level premium policies could be impacted. The actual buy/sell agreement itself will also need to be reviewed by a legal expert to ensure it's aligned with any change to policy ownership.

Finally, keep in mind that the purpose of ATO ID 2015/10 is to provide the public with insights into how the Tax Office might interpret whether the sole purpose test has been breached in circumstances where an SMSF holds a life insurance policy pursuant to a buy/sell agreement. As always, make sure you obtain expert technical and legal advice prior to making any decision in light of ATOID 2015/10 or request SMSF specific advice from the ATO.