OWNERSHIP PROTECTION & BUY/SELL AGREEMENT

Business Succession Planning

July 2023 | By the AIA Technical and Education Centre of Excellence (TECE) team

Whether your client's business is structured through a partnership, company or trust, few have effective mechanisms in place for the transfer of equity and/or control if something should happen to one of the owners. If your clients have equity in a business they own with other people, they should consider establishing a buy/sell agreement funded by life insurance.

A buy/sell agreement is a legal contract that outlines the details of how the ownership of the business will be managed on the death or disablement of a partner or shareholder. This provides certainty regarding the future ownership and operation of the business for the owners in the business.

Why should a client have ownership protection?

What might happen to the control and future ownership of the business if one of the partners or shareholders should die, become seriously disabled or have a crisis event? What if one partner wants to exit the business to pursue other interests but wants to ensure they will receive a fair price for their share of the company?

There are two key issues that you need to address in this situation:

- The legal transfer of control and ownership of the business
- The way that the transfer of the business will be funded

A buy/sell agreement outlines how these two issues will be dealt with. Think of the agreement as a business will.

Without an agreement surviving owners have to negotiate with the spouse or other beneficiaries to buy out their share of the business. Funds may not be available, the value of the business may be under contention, and beneficiaries may be forced to take whatever is on offer.

Alternatively, the beneficiaries may choose to take an active role in the business - whether or not they are qualified to. More importantly, do the surviving owners want them involved?

For example the appropriate life insurance can provide the funds for the business to purchase a shareholders equity interest on the unexpected death, serious disablement or illness of a partner or shareholder, to enable the purchase of their shares or business interest.

Here's how the agreement can be used to keep your business going:

- helps create or find a future owner(s) for the business
- provides the means whereby an existing business owner can receive a fair price for his or her business interest
- helps to provide financial security for existing partners as they may not need to find additional funds to pay for the departing partner's interest in the company

The agreement usually specifies:

"Trigger events" – those situations in which the contract is to be "triggered" (usually on the death, crisis event or total and permanent disablement (TPD) of a business owner).

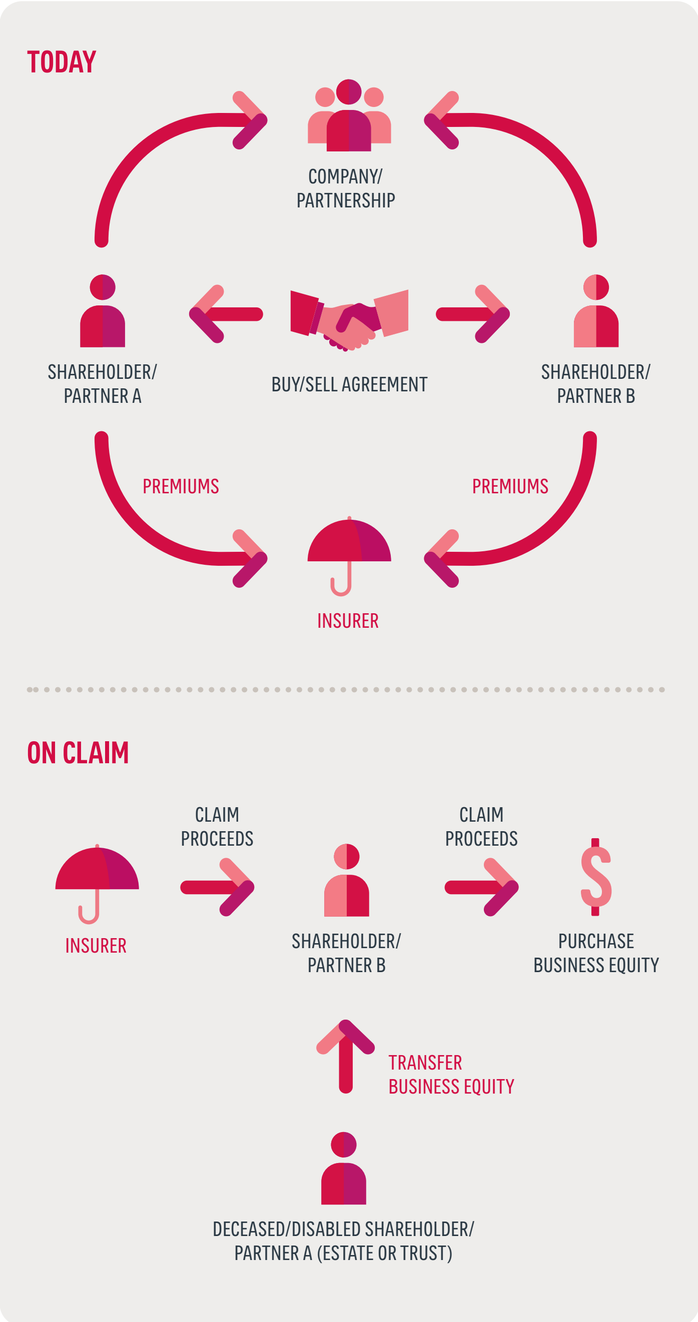
"Call options" – the right of one proprietor to purchase another's equity under specified circumstances.

"Put options" – the right of one proprietor to force the other(s) to purchase their equity in the business under specified circumstances.

"Agreed price and/or Valuation method" – the price at which the equity will be sold and how it is determined.

The Process

A specialist lawyer can prepare the buy/sell agreement after you have discussed and agreed on your options for each scenario. The agreement should be reviewed annually to make sure that all owners are still in agreement with the terms and they still accurately reflect the current needs and business value.



Some things to consider

Who owns the policy?

The insurance cover would usually be self-owned, that is, each business owner/partner would purchase a policy on their own life. In the event of a claim, the proceeds may be paid to the estate of the deceased partner. The deceased partner's shareholding may then be transferred to the remaining partner(s) in accordance with the buy/sell agreement.

The insurance cover can also be 'cross-owned'. For example, the business owner/partner A would insure and own the cover on business owner/partner B, and vice versa. In the event of a claim, the proceeds would be paid to the surviving partner who would utilise the proceeds to purchase the deceased partner's shareholding from his or her estate, in terms of the buy/sell agreement.

Tax treatment of policy

The tax treatment of the policy will depend on the ownership structure of the insurance policy.

Looking at self-owned and cross-owned policies, the tax treatment of both ownership structures means:

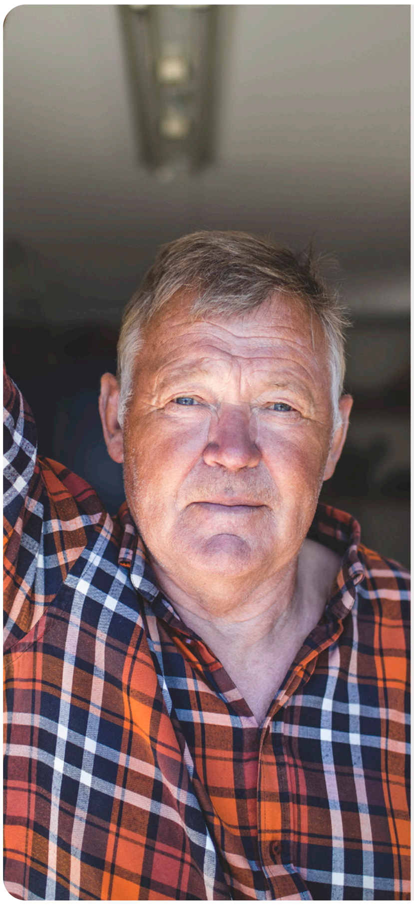
- Premiums are not tax deductible
- Proceeds are not assessable for income tax purposes, and
- Capital Gains Tax (CGT) may apply where:
  - A TPD or trauma claim is paid to someone who is not the life insured or a relative of person insured, or
  - A death or terminal illness claim is paid to someone other than the original owner and some consideration was paid for the policy
- CGT may also be payable by the person/estate upon transfer/disposal of his/her equity in the business.

Role of the Financial Adviser

As the financial adviser you can co-ordinate the process with the client and professionals such as the tax and legal advice. You can ensure the client's needs are identified and are met, manage the insurance applications, and assists with policy ownership decisions. Depending on your Licensee Standards you can manage the Succession Planning process end to end.

Because of the varying tax consequences for scenarios, each taxpayer should take advice from his or her tax adviser in regards to their specific circumstances.

Legal advice on the buy/sell agreement and related documents should also be considered, as specific circumstances vary.



Case study

Succession plan kicks into action

When Pete and Richard went into business together more than 20 years ago, they did not imagine that their combined talents would build a $2 million injection moulding business. As a specialised plastics engineer, Pete's abilities were perfectly complemented by Richard's ability to market and sell their products.

As the business grew, they recognised the need for ownership protection with a buy/sell agreement. Richard and Pete sat down and discussed how the business would continue if one or both of them were sick, injured or died. As part of the agreement they agreed to arrange insurance for each of them to the value of $1 million each.

Two years ago Richard, aged 52 at the time, arrived at work complaining of chest pain and three days later suffered a severe heart attack and passed away.

Richard's death triggered an event under the buy/sell agreement. Richard's share of the business value, $1 million, was paid to his family from his insurance policy leaving Pete with100% ownership of the company. Pete was able to hire a sales and marketing manager to step into Richard's shoes.

A buy/sell agreement allows business partners to discuss their options on the future ownership and operation of the business at a time when they are able to make decisions without financial or emotional strains.

Don't forget about your client's and their family

Disability or death can also impact their personal life, especially if banks and creditors try to claim family assets to pay for business debt.

Think about steps you can take to protect your clients' financial security with insurance policies that can protect them for:

- Treatment for illness
- Current debts
- Future expenses/income requirements
- Keeping family assets safe