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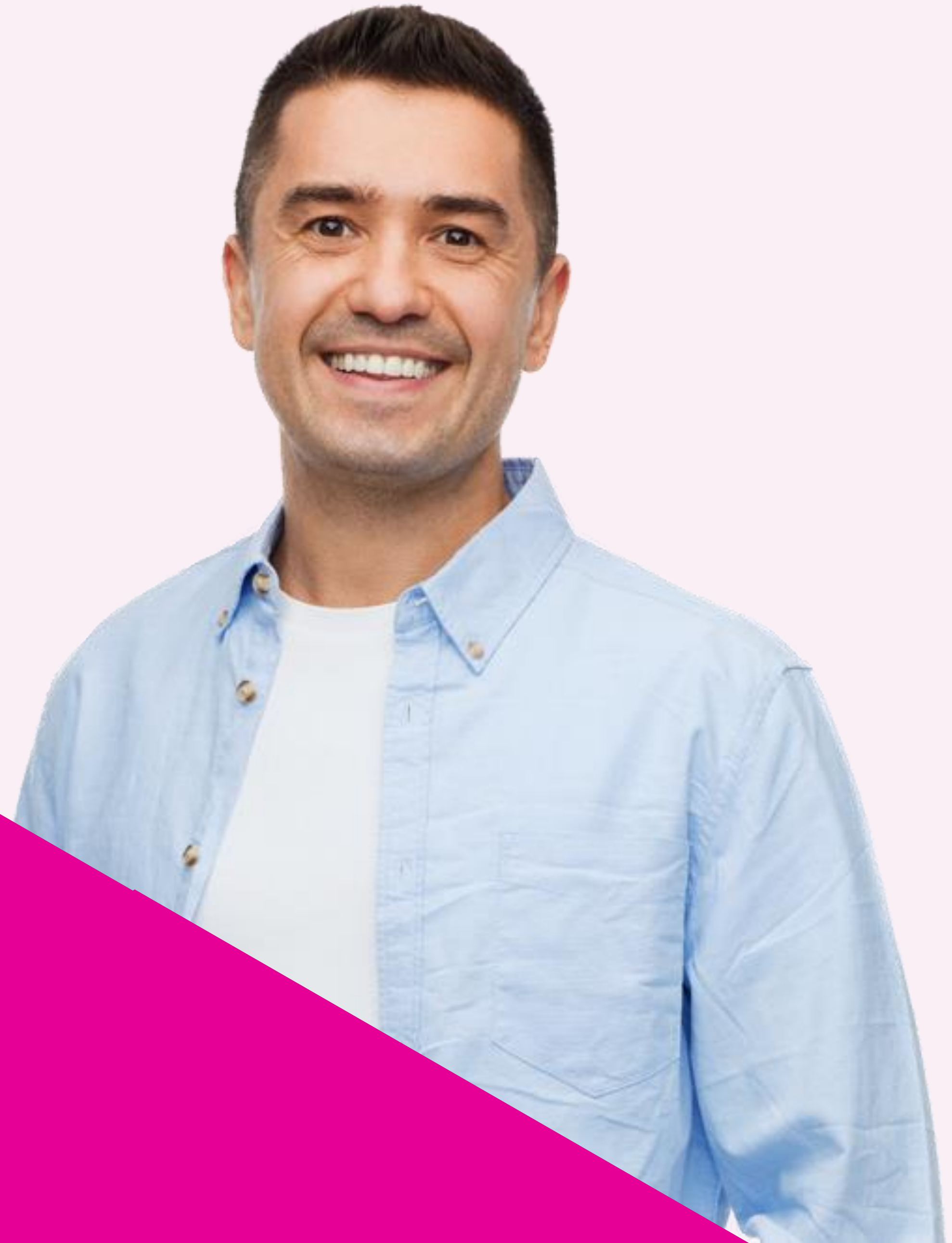
Buy-sell purpose cover



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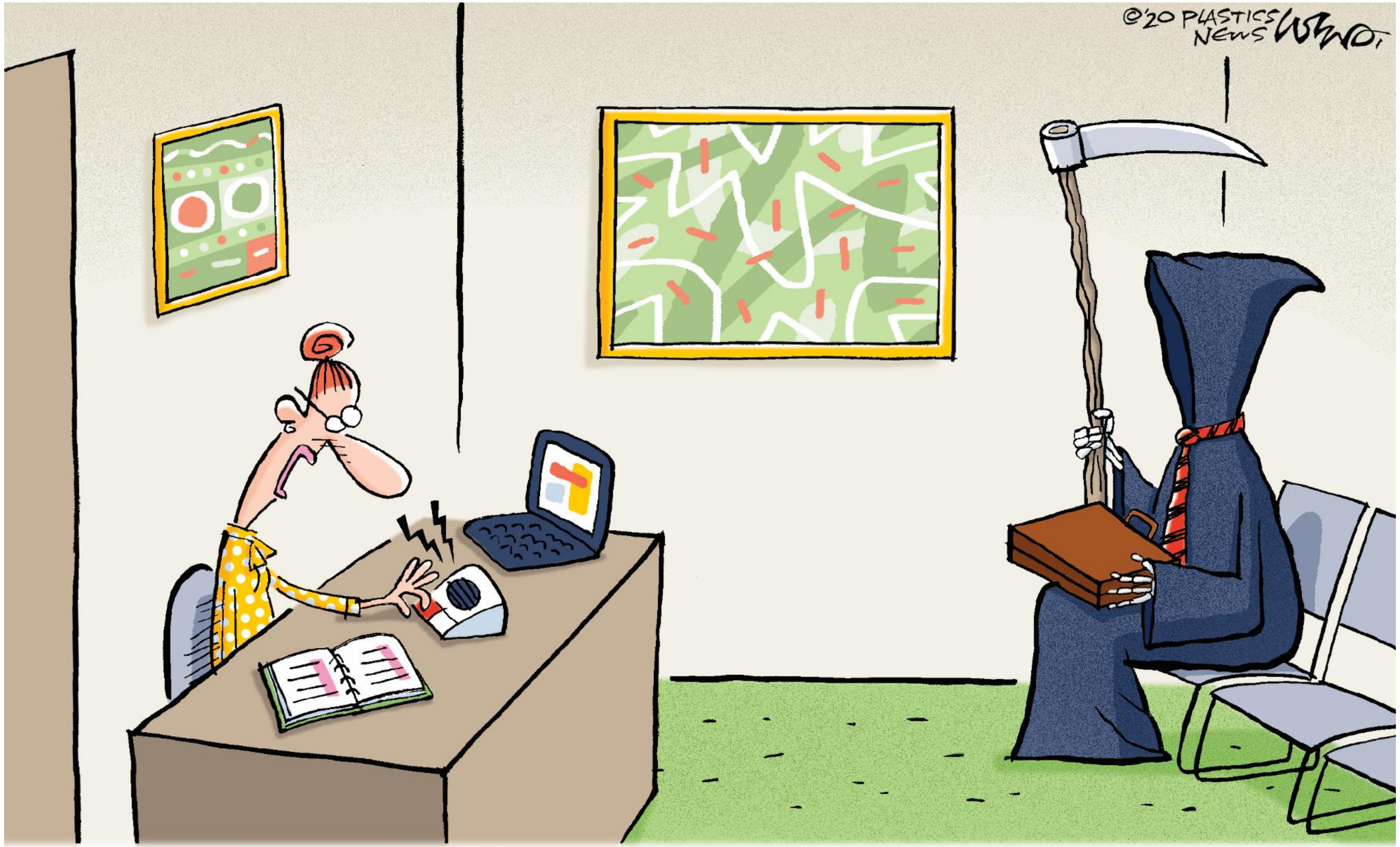
Is succession planning really necessary?



"NO, HE'S NOT ON YOUR CALENDAR...HE SAYS IT'S ABOUT SUCCESSION PLANNING..."

Agenda

- Australian small business statistics
- What is buy/sell purpose cover?
- The drafting and benefits of buy/sell agreements
- Buy/sell trigger events
- Valuation methods
- Policy ownership options
- Case study

Learning outcomes

At completion of the presentation, participants will be able to:

- Demonstrate knowledge of buy/sell insurance and the applicable trigger events and terms of buy/sell agreements and their relevance to the commercial realities of a business
- Develop appropriate business succession and insurance solutions and strategies for business owners and businesses
- Differentiate between the tax treatment of life insurance policy proceeds based on various ownership structures
- Demonstrate an understanding of the tips and traps associated with business succession planning and advice

Glossary

The acronyms and abbreviations in the presentation have the following meanings:

ABS	Australian Bureau of Statistics
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
ITAA97	Income Tax Assessment Act 1997
RBA	Reserve Bank of Australia
SIS Act	Superannuation Industry (Supervision) Act 1993
SIS Regulations	Superannuation Industry (Supervision) Regulations 1994
SMSF	Self-managed superannuation fund
Super	Superannuation

The three levels of an Enterprise

The **Business Entities**

Business Entities are the legal structure via which the Enterprise is run

A Business Entity:

- Carries on a business activity directly; or
- Holds an asset used by another Business Entity to carry on a business activity

A Business Entity can be an individual, a partnership, a company or a trust.

The **Proprietors**

- A Proprietor holds equity in a Business Entity
- A Proprietor may be an individual, a company or a trust
- If a person or legal entity holds equity in a Business Entity, they are a Proprietor of the Enterprise.

The **Principals**

- Principals are the 'ultimate controllers' of the Enterprise
- Principals are always individuals
- Principals own or control the Proprietors
- It is possible for a Principal to also be a Proprietor (e.g., where a person is an individual partner in a partnership or an individual shareholder in a company).

Australian small business statistics

As at 30 June 2022, Australia had over 2.5 million actively trading small businesses, representing **over 97%** of all businesses.

In 2021-22 the number of actively trading businesses in Australia **increased by 7% (167,646)**, of which 140,102 were non-employing businesses.

Of the **2,569,900 businesses**, there were 1,550,151 (60%) non-employing and 1,019,749 (40%) employing businesses.

Source: ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2018 to June 2022

Businesses by employment size range

Australian business pyramid

Large firms

200+ employees

4,533 (0.2%)

Medium-sized firms

20-199 employees

59,355 (2.3%)

Small firms

5-19 employees

227,102 (8.8%)

Micro-enterprises

0-4 employees

2,278,910 (88.7%)

Source: ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2018 to June 2022

Private sector business legal structures in Australia

Companies	1,052,213 (41%)
Sole Proprietors	798,209 (31%)
Trusts	487,261 (19%)
Partnerships	231,839 (9%)
Total	**2,569,522**

Source: ABS: 8165.0 Counts of Australian Businesses, Including Entries and Exits, June 2018 to June 2022

A scenario to consider

The widow knelt at the graveside as her husband's coffin was lowered. She looked across at her late husband's business partner and thought:

'I'll make him pay double if he wants my husband's half of the business.'

The business partner looked at the grieving widow and thought:

'I'll offer her one tenth. She won't know what it's worth and she needs the money.'

What is buy/sell purpose cover?

Life insurance cover purchased in connection with buy/sell agreements (**buy/sell purpose** cover) facilitates the orderly transfer of equity from the departing business proprietor to the remaining proprietor/s

The policy's sum insured can provide funding for the business proprietor's interest in the business entity as outlined in the terms of the buy/sell agreement. The life insurance products used in buy/sell purpose cover are:

Death and terminal illness

Total and Permanent Disability (TPD)

Trauma

What is buy/sell purpose cover?

Buy/sell purpose insurance cover is often taken in conjunction with a buy/sell agreement.

A buy/sell agreement (or Business Will) generally involves the business proprietors entering into a written agreement specifying how they must deal with their respective business interests on the occurrence of a voluntary or involuntary trigger event.

The agreement generally provides a mechanism whereby the departing business proprietor can sell their business interest to the continuing proprietor(s), i.e., the disposal mechanism. The agreement generally also recognises the means of funding the buy/sell obligations of the respective proprietors, i.e., the funding mechanism.

These mechanisms can help to ensure:

- the departing proprietor (or the estate) receives true value after tax
- the remaining proprietor(s) do not have to find funding for the buy-out (if full insurance cover)
- continuity of the business.

How is a buy/sell agreement set up?

1. Business principals would generally discuss, negotiate and agree:
    - the trigger events (death and terminal illness, TPD and traumatic illness)
    - how the business interests will be valued
    - their respective buy and sell obligations should a trigger event occur
2. The appropriate insurance applications are lodged to meet agreed funding obligations upon the occurrence of a trigger event.
3. The relevant legal documentation is prepared by a specialist legal professional.

Tip

Clients should work closely with their accountant and legal expert, coordinated by the financial adviser.

Question

Which of the following statements best describes buy/sell purpose cover?

a) It provides funds to pay a retiring business principal a lifetime pension

b) It provides funding and a structure for a proprietor’s business interest to be transferred to the other proprietors upon the occurrence of an insurance trigger event

c) It provides the funds to pay off business debts should one of the business principals dies, becomes totally and permanently disabled or suffers a traumatic illness

d) It provides the funds for business proprietors to buy out another proprietor who has been declared bankrupt.

Benefits of a buy/sell agreement

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Having a buy/sell agreement can help:

- Eliminate estate claims to the management rights of the business
- Prevent an external sale and introduction of new owners with incompatible agendas
- Provide funding to complete the purchase of business interest
- Afford security and peace of mind for creditors, suppliers and staff
- Assure stability and continuity of the business with minimal disruption and financial pain
- Provide assured purchasers for the business at a guaranteed and fair price
- Minimise delay between suffering the event and receipt of funds
- Overcome disparity in vendor-purchaser expectations
- Avoid protracted and expensive litigation

Other buy/sell trigger events

- Prolonged illness
- Bankruptcy
- Divorce or permanent relationship breakdown
- Fraud or loss of professional licence
- Criminal activity
- Resignation or retirement
- Unacceptable performance of a principal
- Permanent relationship breakdown between principals
- Deadlock over a decision

Trigger events: Mandatory obligations v put/call options

Trigger events in a buy/sell agreement can either result in mandatory obligations or put/call options.

Mandatory obligations:

- Where the trigger event results in a mandatory obligation, the exiting party must sell their business interest to the remaining party(ies) and the remaining party(ies) must purchase
- If the trigger event is a condition precedent to the formation of the agreement, there is generally no CGT event until the trigger event occurs
- If the trigger event is a condition subsequent, a binding contract exists when the agreement is entered into, so a CGT event could occur many years before the disposal of the business interest by the exiting party
- In some jurisdictions mandatory obligations upon a trigger event would incur stamp duty (NSW, SA, WA and NT).

Trigger events: Mandatory obligations v put/call options

Put and call options:

Use of put and call options in the buy/sell agreement means that unless all business principals do not wish the buyout to proceed, it will proceed

Put and call options are a combination of two options exercisable by the vendor (estate) or purchaser(s)

- A put option enables the vendor (estate) to require the other business proprietor(s) to purchase their interest in the business on the occurrence of a trigger event
- A call option enables the other business proprietor(s) to call on the vendor or the estate to sell its interest in the business on the occurrence of a trigger event

Note

Agreements with either conditions precedent or put-and-call options would mean there is no disposal of the equity in the business until a trigger event occurs.

Question

Which of the following is not an involuntary buy/sell trigger event?

a) Terminal illness

b) Total and permanent disablement

c) Traumatic illness

d) Resignation

Trauma in a buy/sell agreement

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A trauma condition may not be a desirable immediate trigger event for a business exit as there is potential for the affected owner to return to work at full capacity after a period of recuperation.

Conditions precedent or put/call options in the agreement can be postponed until a satisfactory test as regards the insured's fitness to continue in the business has been satisfied.

In the meantime, trauma proceeds may be:

- credited by the insured (potential vendor) and the amount subtracted from a future sale price, or
- may be held in trust and distributed according to the agreement, free from CGT (ATO ruling recommended).

Subsequent sale may take place if:

- insured is unable to resume fulltime, active employment within a specified time frame
- insured's condition worsens and is forced to leave the business, or
- insured becomes permanently disabled or dies.

Not so super buy/sell

In May 2015, the ATO confirmed in ATO ID 2015/10 that an SMSF trustee had breached the sole purpose test where it had acquired a life insurance policy pursuant to the terms of a buy/sell agreement

- Husband-and-wife SMSF trustee intended to purchase a life policy over the husband for the market value of his business interest in a company jointly owned by his brother pursuant to the terms of a buy/sell agreement

ATO said this contravened the Superannuation Industry (Supervision) Act 1993 as follows:

- Contravened sole purpose test in section 62
- Contravened provision of financial assistance to a relative of member using SMSF resources (section 65)

Although not a binding public ruling, it outlines ATO's position on buy/sell in super.

Tip

Clients should seek independent professional advice.

Question

What is the problem of having buy/sell purpose cover inside superannuation?

a) It could be viewed as breaching the sole purpose test under SIS legislation

b) There will be CGT payable on term life and TPD insurance proceeds

c) All super fund trust deeds prohibit buy/sell insurance inside super

d) Product limits are much lower inside super than outside

Valuation methods

Market value:
The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length (ATO, referring to typical valuers' definition).

Market based approach:
Market value of shares estimated by comparing the subject company with those that have been recently sold or whose interests are publicly traded (in a liquid and active market).

Income based approach:
The market value of a business is derived by capitalising the estimated future maintainable earnings (**EBIT/EBITDA/EBITD**) using an appropriate multiple (3-5 times).

Asset based approach:
Value of business based on the market value of its assets and liabilities.

Comparable sales method:
Comparing sales of similar businesses in the same industry and in the relevant market.

Policy ownership options

1. Cross-ownership

- Generally, this was a common method of ownership before the introduction of CGT
- Each business principal owns an insurance policy on the life of each of the other principals
- Insurance proceeds were paid to the remaining principal/s (i.e., purchaser(s)), who then paid them to the estate or departing principal in exchange for the transfer of business equity
- If TPD and/or trauma cover is included in the policy, CGT would apply on the payment of insurance proceeds as the recipient is not the person insured, a spouse or a defined relative
- Still requires a professionally drafted buy/sell agreement

2. Self-ownership

- Currently the most common ownership option as it avoids CGT on term life, TPD or trauma policies
- Policies are portable, so if the principal were to leave the business, they could take their own policies with them – no need to assign policies and no change in ownership
- A professionally drafted buy/sell agreement is vital
- While self-ownership is appropriate where individuals own the shares, units or interest in a business, it is not desirable where the business equity is owned by a different entity such as a trust or holding company.

Policy ownership options

3. Operating entity (company or unit trust) ownership

- Operating entity receives insurance proceeds, company buys back shares from the estate or departing proprietor and cancels them (or units in a unit trust are redeemed)
- Transfer of ownership is definite, there is no direct entitlement of shareholders or their beneficiaries to the operating entity's assets
- If a company or fixed unit trust owns a TPD or trauma policy, there may be a CGT liability (full or partial) on the insurance benefit
- Upon cancellation of shares (or redemption of units) the remaining proprietors effectively acquire more equity but do not increase the CGT cost base for those shares (or units).

4. Business Insurance trust ownership (and agreement)

- The trustee of an insurance (absolute entitlement) trust is the legal owner of term life, TPD and trauma policies on behalf of business principals (beneficial owners), thereby satisfying CGT exemptions for those insurances
- Allows all business and personal insurance cover to be included in one policy, held by one owner, for each insured person
- Creates a facility within which cover can be reallocated based on changes to individual needs
- Securely directs all policy components (insurance products) to the appropriate recipients.

Question

What buy/sell insurance ownership structure avoids CGT on TPD and trauma cover?

a) Self-ownership

b) Cross-ownership

c) Insurance trust ownership

d) Both a) and c)

Buy/sell insurance needs assessment

Some questions to ask your clients:

- How important is continuity of the business and why?
- What business succession strategies do the owners have in place in case of death or permanent disablement?
- Will the remaining business owners enjoy working with the family members (usually the spouse) of a departing owner?
- Can the departing owner’s family members skilfully contribute to the management of the business or will they hinder the business while still drawing a full share of profits?
- How much will the business pay the departing owner (or the estate) for their business interest, over what period of time and where does the money come from?

Case study:
P&S Engineering Pty Limited

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- Paul (aged 54) and Steven (aged 46) are directors of an engineering and mechanical repair business, P&S Engineering.
- The company is owned by four equal shareholders: Paul and wife Lily (aged 49) and Steven and his wife Amanda (aged 38), but the wives are not active in the business.
- Business is valued at $3 million, net profit last year was $600,000

Paul

- is responsible for the managing the finances of the business and staff, and customer/supplier relations
- has salary package of $150K pa
- Shares equally in profit

Paul has

- a non-working wife, Lily
- a young son, Billy
- adult children from his first marriage
- A mortgage of $500,000

Steven

- is responsible for updating, maintaining and calibrating machinery and equipment
- has salary package of $150K pa
- Shares equally in profit

Steven has

- a non-working wife, Amanda
- two young children, Cam and Florence
- a mortgage of $350,000

Case study:
P&S Engineering Pty Limited

What buy/sell recommendations could you provide to P&S Engineering?

As the 'active' shareholders, Paul and Steven could be insured for $1.5 million each, reflecting their own and their wives' shareholding.

If the business does not qualify for small business CGT concessions, the CGT component on the transfer of the shareholdings can be approximated and insured for.

Any stamp duty payable by purchasers and transactional costs of both vendors and purchasers can be insured for as well.

Term life, TPD and trauma policies should be owned individually or via a business insurance trust, supported by a professionally drafted buy/sell agreement.

Case study:

P&S Engineering Pty Limited

Steven, a keen cyclist, is hit by a truck one morning while on his bike. He suffers brain damage and becomes a quadriplegic.

- The business has just signed a new supply contract
- It cannot proceed without Steven as Paul does not have the expertise.
- Amanda expects and needs Steven's income and will require cash for out-of-pocket medical and rehabilitation expenses (if Steven survives).
- Steven had no insurance, except for an accidental death policy.
- He is incapable of returning to the business.

Summary

- There are opportunities to provide buy/sell purpose cover to Australian small businesses.
- As with personal risk protection, buy/sell purpose cover aims to direct insurance proceeds to the appropriate recipients as soon as practicable whilst legally minimising tax consequences.
- Buy/sell purpose cover has a number of working parts that need to be well understood by advisers so they can engage with and explain the concepts to business owners.
- Advisers need to ask the right questions leading to the engagement of and recognition by business owners of the their vulnerabilities and the need for buy/sell purpose cover.
- Advisers need to involve the expertise of legal and tax professionals in drafting the buy/sell agreement and to assist their clients in formulating their business succession strategy.