BROWN WRIGHT STEIN

LAWYERS

Buy Sell Agreements

Why have a buy/sell agreement?

1. A buy/sell agreement is a contract entered into between business proprietors (for example, partners in a partnership, shareholders in a company and/or unitholders in a unit trust) under which the proprietors contract to buy the interest or equity of another proprietor should a specific event occur.
2. The buy/sell agreement is structured by way of put and call options.
3. Specific events which may trigger an option to purchase under a buy/sell agreement include:
   (a) death;
   (b) divorce;
   (c) long-term illness or disability;
   (d) retirement; or
   (e) bankruptcy.
4. For the purposes of funding, the buy/sell agreement is often linked to an insurance policy on each proprietor's life. The insurance policy ensures that upon a trigger event, funds are available to pay out the outgoing proprietor for their interest. Other funding options are also available including self-insurance and vendor finance arrangements, or a hybrid of these.
5. The buy/sell agreement is adaptable to all business structures involving more than one business proprietor. As such, the parties to a buy/sell agreement may be individuals, partnerships, trusts, companies and/or other entities.
6. In the event of the death of a business proprietor, the buy/sell agreement will take precedence over provisions of the deceased proprietor's will, allowing business owners to plan in advance for the succession of their business structures.

Types of agreements

7. Most commonly, a buy/sell agreement is structured as a cross-purchase agreement. This is an arrangement under which, upon a trigger event, the continuing proprietors purchase the outgoing proprietor's interest in the relevant business entity by exercising the put and call options granted under the agreement.
8. In some situations, a corporate entity redemption agreement may also be appropriate. Under this arrangement, the company will buy back the interest of the outgoing proprietor.

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Valuing the business entity

It is essential that the buy/sell agreement sets out how the value of the relevant business entity will be determined when an option is triggered. Commonly, the value will be determined by reference to:

(a) an agreed value recorded by the business proprietors from time to time;

(b) the appraised value of the entity at the time the option is triggered;

(c) the book value of the entity; or

(d) the capitalisation of earnings at the time of the specific event.

9. Sound legal, tax, and financial advice is important in helping formulate a suitable arrangement for each client.

Funding the agreement

10. The buy/sell agreement is usually funded through insurance. Again, good legal, tax and financial advice is key to ensuring that the most practical and tax effective funding strategy is adopted.

11. Depending on the parties and their circumstances, the insurance policies can be held under any of the following arrangements:

    (a) principal ownership, where each proprietor holds an insurance policy on themselves;

    (b) cross ownership, where the proprietors of the business hold policies on each other;

    (c) discretionary trust, where the trustee holds the policies on behalf of all of the proprietors; and

    (d) company ownership, where the business holds the policies on behalf of all of the proprietors.

12. In most cases, principal ownership is preferred to avoid adverse capital gains tax (CGT) consequences.

Capital gains tax implications

13. If a buy/sell agreement triggers payment of a life insurance policy, it will be exempt from CGT provided the gain or loss is made by:

    (a) the original beneficial owner of the policy;

    (b) an entity that acquired the policy for no consideration; or

    (c) the trustee of a complying superannuation fund.

14. A trauma or total and permanent disability insurance policy is subject to CGT if it is owned by the business. Only a trauma or total and permanent disability insurance policy owned by the insured is exempt from CGT. As the buy/sell agreement results in the sale of the business, a CGT liability will arise to the vendor (i.e. the outgoing proprietor). The small business CGT concessions may operate to reduce this CGT liability.