Brien Leibinger LAWYERS

Why Do I Need A Buy Sell Agreement?

Business Succession Planning Information Sheet

Why There Is A Need?

A lot of a business owner's wealth can be tied up in their business. They have worked for years to build it up. Instead of using the income from their business to build up assets and wealth outside the business they may have re-invested the income to grow the business. The income from the business is often the major or sole income source for the owner and their family. How will the family fare if they no longer receive that income?

When starting or buying into a business most business owners give little thought about how they might be forced to depart the business involuntarily because of serious illness or accident. The need for appropriate legal agreements between business owners may seem painfully self-evident but some sources indicate that as many as 95% of businesses may not have the right kind of agreements in place.

If a business owner suddenly dies or is not able to work in the business, this can lead to immense problems for the business, for the surviving business owner(s) and for the departing owner and their family. It's often very difficult to sell a share in a private business, let alone being able to sell it for anywhere near its true value

Not having a formal Buy Sell Agreement and appropriate insurance funding in place when an owner dies or can no longer work in the business can lead to disputes between the surviving owner(s) and the departing owner and their family about:

- The terms on which the surviving owner(s) may be willing to acquire the departing owner's interest;
- The value of the business (e.g. the surviving owner(s) may argue the value of the business has been reduced due to the lack of contribution by the departing owner); or
- The departing owner's family may choose instead to take an active role in the business – whether or not they truly want to, are qualified to do that, or more importantly whether the other owners want them involved.

Whatever the situation the consequences can be disastrous - it is potentially fraught with emotion, the probability of disputes and unwanted distractions from the operation of the business. What can be guaranteed is that everyone involved will be unhappy with the ultimate outcome.

What's in the Buy Sell Agreement?

A Buy Sell Agreement – sometimes referred to as a "Business Will" – is a contract between business owners that sets out exactly what the rights and obligations of each are if one of them involuntarily and unexpectedly departs the business.

The main elements of the agreement are:

- Trigger events – those situations in which the agreement is to be "triggered" (usually the death, critical illness/trauma or total and permanent disability of an owner);
- Call options – the right of one owner to acquire another's business interest if a trigger event happens;
- Put options – the right of one owner to force the other(s) to purchase their business interest if a trigger event happens;
- Agreed price – the price at which the business interest will be sold or acquired if a trigger event occurs and an option is exercised.

How Is The Transfer Of Ownership Funded?

The ownership transfer is usually funded by way of insurance policies held by each owner. These insurance policies are recorded in the Buy Sell Agreement as having been taken out to cover the owner's interest in the business.

These, or other policies, can also include amounts for personal estate planning needs but it's important that the Buy Sell Agreement records the different uses to which the insurance is to be put (i.e. personal, business equity, tax etc.).

How Is The Purchase Price Decided?

The agreement usually provides that the purchase price is:

- The value of the business agreed between the owners or as determined by an independent valuation at the time of a trigger event occurring; or
- The amount of the insurance benefits.

It is critical for the owners to agree on or determine the business value and get adequate insurance coverage when the agreement is signed.

As the business value may change over time, it is important for the value of the business to be reviewed regularly and for the value of the insurances to be updated (if possible) so that they are kept in step with any increase in the business value.

If that isn't done and a trigger event happens, the insurance proceeds are then deemed to be part of the purchase price and the remaining owners are usually then obliged to pay the difference between that amount and the purchase price for the departing owner's business interest. The difference is often payable by instalments over an agreed period.

This caters for situations, where for example, there isn't enough insurance in the place to cover the full value of a departing owner's interest. For example, the business may have increased in value over the years but if the owner's health has deteriorated they may not be able to get additional insurance cover.

The agreement should, of course, be tailored to fit the requirements of the owners.

What Are The Tax Consequences?

When the business interest is transferred from one owner to another or others, following the insurance payout, capital gains tax may be payable by the departing owner or their estate.

If the value of the departing owner's business interest has increased above what they paid for the interest when they bought into the business then they may have a capital gains tax liability. Sometimes that liability may be able to be reduced or negated by the use of capital gains tax concessions. However, all business owners should seek their own tax advice on that possibility before or at the time of entering into the Buy Sell Agreement.

Where it isn't possible for any tax liability to be reduced or negated then the potential liability can be funded by additional insurance, subject to affordability of premiums.

It is important to understand that although the owners may have agreed in the Buy Sell Agreement that if a trigger event occurs all the departing owner receives is the insurance proceeds for their business interest, any potential capital gains tax liability will be calculated on the difference between the departing owner's cost base for that interest and the market value of the interest at that time.

Will Any Queensland State Duty Be Payable

If the business interest being transferred under the Buy Sell Agreement is an interest in a partnership or units in a unit trust then Queensland duty will be payable. No duty is usually payable where shares in a private company are transferred unless the company is "land rich" or, less likely, a trustee of a discretionary trust.

Duty will generally be payable on the greater of the purchase price under the agreement or the market value of the interest being transferred. The "purchaser" of the business interest is usually obliged to pay any duty under the Buy Sell Agreement.

Conclusion

Whenever two or more people own a business, it is essential to have a proper Buy Sell Agreement in place to ensure a seamless and dispute free transfer of an owner's business interest if one owner has to leave the business involuntarily.

The funding to give effect to the agreement, usually appropriate linked insurance, is also needed to ensure that all parties come away with the best possible outcome.

Even if the owners have appropriate insurance cover, the continuity of the business can be at real risk if the business does not have a properly worded supporting Buy Sell Agreement in place.

Unfortunately, too many businesses today don't. However putting the appropriate documentation in place is not an expensive or insurmountable task, especially when compared to the disastrous financial and other costs to a business owner and their family if that isn't done.

Brien Leibinger Lawyers is able to prepare Buy Sell Agreements which are tailored to the individual requirements of a business.

Disclaimer: This information sheet is for general information only and should not be relied on as, or substituted for, professional legal advice.