



## Wealth & Estate Planning

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## Planning for the unplanned: using insurance funded buy/sell agreements

A person's business interest is an important element of their financial profile. Realising the value locked inside this asset in the event of an untimely death or serious illness or injury should be an essential component of a business client's wealth creation/preservation plan.

The untimely death or serious illness or injury of a business-owner may result in significant financial hardship for that person's family and the remaining business-owners. In a worse case scenario it may result in the outgoing owner selling their business interest for a substantial undervalue or may even result in the liquidation of the business.

The implementation of an effective business succession plan that includes an insurance funded buy/sell agreement can ameliorate such hardship. In this article we consider what are commonly known as insurance funded buy/sell agreements.

A buy/sell agreement is a document entered into by the business-owners which sets out the funding methodology and terms for the disposal of a business-owner's interest in the business where that person unexpectedly dies or suffers serious injury or illness.

The disposal of that person's business interest will usually be to the remaining business-owners but, given the unexpected timing of that person's death or incapacity, those remaining business-owners are unlikely to have sufficient capital or cashflow available to acquire the outgoing owner's business interest.

As such, the funding arrangements set up in the buy-sell agreement ensure that:

- the remaining business-owners are able to acquire the outgoing owner's business interest; and
- the outgoing owner or his family receive necessary funds from the disposal of that business interest.



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To facilitate this funding arrangement, the central feature of an insurance funded buy/sell agreement is the availability of insurance proceeds as the purchase price of the relevant business interest. The insurance proceeds are paid, tax-free, to the outgoing owner or his family and the relevant business interest is transferred to the remaining business-owners – providing significant tax and cashflow advantages to both the outgoing owner or his family and to the ongoing business and the remaining business-owners<sup>1</sup>.

MBP can customise an insurance funded buy/sell agreement for your particular needs. We can also review and advise on the adequacy of your current arrangements given that this is a changing area of the law and provide legal and taxation assistance in relation to your current or future business succession arrangements.

Various methods for funding a buy/sell agreement have been developed over the years. This article will not review each of these funding methods but will instead review the benefits of the self-insurance model for funding a buy/sell agreement.

Insurance funded buy/sell agreements can be used for all business structures. As such, in this article when we refer to a 'business interest' this term may include a shareholding, a unit holding or a partnership interest.

## The effect of an unexpected exit from the business

The impact of an untimely death or serious disability<sup>2</sup> of a business-owner not only results in the business losing the benefit of that person's skill, services, experience and business relationships but requires the remaining business-owners to fund, on short notice, sufficient funds to purchase the outgoing owner's business interest.

If the remaining business-owners are unable to find sufficient funds then:

- (a) the outgoing business-owner or his<sup>3</sup> family will continue to own an interest in a business that they have no real involvement or minimal involvement in the operation of;
- (b) the remaining business-owners will be subject to the input and opinions of the outgoing owner or his family as ongoing owners in the business;
- (c) the outgoing business-owner or his family may receive little income or other financial return from their ownership in the business because of a reduction in business turnover – particularly if the business is small, the cost of employing and retaining a skilled person to replace the outgoing business-owner will limit funds available to the business-owners especially if the outgoing owner was instrumental to the sales and revenue of the business; and
- (d) neither the outgoing business-owner or his family nor the remaining business-owners will be able to effectively move forward until the matter has been resolved.

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1 This is provided the buy/sell agreement and insurance arrangements are properly drafted and implemented and maintained.

2 Where 'serious illness or injury' or 'disability' are used in this article these terms refer to a business-owner suffering such illness or injury as to entitle a trauma or total permanent disability (TPD) insurance payout. These insurance provisions usually require the business-owner to be unable to undertake work for a continuous period of at least 6 months.

3 We use 'his' for ease only – naturally the outgoing owner may be either male or female and may even be a corporation or trust entity.



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### Plan now

Ideally, on the death or serious disability of a business-owner resulting in them being unable to continue to participate in the business for a period of time<sup>4</sup>, funding and legal arrangements should be in place to facilitate the purchase of their business interest by the remaining business-owners at market value from:

- (a) the legal personal representative of the outgoing owner on their unexpected death; or
- (b) the outgoing business-owner himself if he suffers a serious injury or illness.

This results in the outgoing owner or their family receiving well-needed funds and the business continuing to be effectively operated by the remaining business-owners.

### Funding and legal arrangements - options

There are various ways in which these funding and legal arrangements may be achieved. For example, the remaining business-owners may obtain bank funding to fund the purchase of the outgoing owner's business interest, or alternatively, may introduce into the business a third party who is willing to acquire such business interest.

Both of these alternatives are uncertain and may not provide a reliable solution when required.

Obtaining new funding to acquire the outgoing owner's business interest adds considerable and unexpected costs into the existing business and changes the business dynamics for the remaining business owners. That is, the ongoing financial resources of the business will come under pressure as a result of the remaining business-owners having to generate sufficient cashflow to fund these additional financing costs.

The introduction of a new business partner into the business of course introduces a whole new set of dynamics and if it is not "a successful business marriage" then the business may become deadlocked by conflict and confrontation – all of which would have disastrous financial consequences for the ongoing business-owners.

### Having no business succession plan - disastrous

The absence of a business succession plan setting out an agreed procedure to be adopted on the unexpected death or TPD of a business-owner often leads to tense and acrimonious negotiations between the ongoing business-owners and either the legal personal representative and family of the deceased owner or in cases of TPD, the outgoing owner himself.

In a best case scenario this tension will be resolved - but it will all too often result in financial detriment to the outgoing owner or his family because of an imposed substantial devaluation in the value of that owner's business interest. This substantial devaluation often occurs:

- (a) because of the emotional and financial vulnerability of the outgoing owner or his family who are, given the circumstances, unable to cope with stress, conflict and animosity,
- (b) where it may be more financially realistic for the existing business to be wound up and for the ongoing business-owners to 'start again',
- (c) but more often because the remaining business-owners are unable to purchase the business interest and the business is unfeasible with the outgoing owner or his family remaining a part of the continuing business.

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<sup>4</sup> This serious disability is referred to throughout this article (and by most insurance policies) as TPD.



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As such, the value of the business itself and therefore the outgoing owner's interest in that business are significantly devalued.

Different methods for funding the disposal of a business interest pursuant to a buy/sell agreement have been developed but not all of these methods will provide the parties with the CGT benefits potentially available.

A self-insured buy/sell agreement properly drafted, implemented and maintained will provide the outgoing business-owner or his family and the continuing business-owners with substantial tax and cash flow benefits.

### So how do buy/sell agreements work?

Simply, the proceeds from an insurance policy are used to fund the purchase price of the business interest of the outgoing owner.

#### Requirement to sell

Under the agreement, business-owners are required to be insured in respect of death and/or TPD<sup>5</sup> in an amount equivalent to the market value of their business interest. As the value of their business interest may change, each business-owner must review their insurance arrangements on a regular basis to ensure that sufficient insurance proceeds will be received to cover the market value of their business-interest on their unexpected death or TPD.

#### Insurance proceeds = purchase price

When this unexpected death or TPD event occurs, the outgoing business owner<sup>6</sup> is required to sell their interest in the business for an agreed value to the remaining business-owners. The agreed purchase price is funded by the insurance proceeds that are paid by the insurer to the outgoing business-owner or his estate.

#### Tax consequences

##### *Insurance Proceeds:*

It is very important that the insurance proceeds are received by the business-owner or his family tax free. This is dealt with briefly in the section below.

##### *Disposal of business interest:*

The disposal of the outgoing owner's business interest may attract capital gains tax if a 'net capital gain' is derived by the outgoing business-owner or his family<sup>7</sup>.

Such a taxable net capital gain may be reduced by the CGT 50% discount and the various small business CGT concessions<sup>8</sup> and if circumstances permit, the net capital gain may end up being tax free.

<sup>5</sup> Depending on your circumstances, you and your fellow business-owners may decide to insure against one or both of death and/or TPD – this is a customised feature of your business succession plan.

<sup>6</sup> And in the event of death, their legal personal representative of their estate – being the executor or trustee named in their will.

<sup>7</sup> Or the beneficiaries of his deceased estate if his family does not inherit the business interest.

<sup>8</sup> We do not discuss these concessions further in this article but recommend that you contact us if you would like further information.



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## Maximising tax benefits of your buy/sell agreements

### Tax free receipt of insurance proceeds

It is absolutely essential that the insurance proceeds paid on the death or TPD of a business-owner are received tax free. If tax is payable on these insurance proceeds then the funds available for the purchase of the relevant business interest will be reduced – this may result in the remaining business-owners themselves having to fund the balance of the purchase price, which they may not have the resources to do.

Under the relevant tax provisions:

- (a) death and terminal illness insurance proceeds are exempt from capital gains tax;<sup>9</sup> and
- (b) trauma and TPD proceeds are only exempted from CGT provided they are paid as compensation you receive for any injury or illness you or your relative suffers personally.<sup>10</sup>

To ensure that tax is not payable on the insurance proceeds, the recommended method of funding a business succession plan using life insurance is using a *self owned* insurance policy and this self insurance model has become most popular because of its simplicity and because it maximises the available tax benefits.

### CGT implications

Although the insurance proceeds themselves may be received tax free, when they are used to fund the purchase price of the business interest, tax will potentially be payable on the CGT disposal of that interest as explained briefly in section 3 above.

### Alternative insurance models – potential tax implications

Whilst we prefer and recommend the self insurance model for buy/sell agreements, there are a number of insurance policy ownership structures available which can be used to fund buy/sell agreements instead of the preferred self funded model.

Some clients and associates may have implemented either a cross ownership policy structure or an insurance trust policy structure – both of which we comment on briefly below. For most people, these structures appear to be more natural and sensible in that they involve:

- (a) the payment of insurance proceeds on the death or TPD of a business-owner to the remaining business-owners, and
- (b) the subsequent payment of such proceeds to the outgoing business-owner as the purchase price for their business interest being acquired.

As you will see in section 5 of this article, the self insurance model is different and simpler.

### The Cross Ownership model

This model has been historically popular for business-owners to fund buy/sell agreements using what are known as cross ownership policies. Under this policy structure, the benefits and proceeds paid in respect of an insured event that occurs to a business-owner (the insured) are paid by the insurer to the other business-owners (the beneficiaries). The proceeds are then paid

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<sup>9</sup> ITAA97 section 118-300.

<sup>10</sup> ITAA97 section 118-37(1)(b). This means that trauma and TPD proceeds paid to a non relative (as defined) will be subject to CGT.



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by the other business-owners to the outgoing business-owner who is selling their business interest because of their unexpected death or TPD.

Tax problems arise with cross ownership of trauma and TPD policies because, unless the remaining business-owners who receive the insurance proceeds are a relative of the outgoing owner, the receipt of these insurance proceeds will be taxable. These tax consequences do not, however, arise in respect of the payment of life insurance proceeds to the remaining business-owners as a result of the death of the outgoing owner.

### **Insurance Trust model**

Another popular structure has been the Insurance Trust model. If the insurance trust is funded by a TPD or trauma policy payment then specific advice should be sought from MBP as to whether these proceeds are taxable – as they may well be for the same reasons as discussed above for cross ownership.

## **Self insurance model for buy sell agreements – the way to go!**

### **Control of the funds**

Under the self-insurance model for funding a buy/sell agreement:

- (a) the insurance proceeds are not paid to the remaining business-owners who then pay them to the outgoing business owner or his family, but instead
- (b) those proceeds are paid directly to the outgoing business-owner or his estate as the purchase price for his business interest which is then transferred to the remaining business-owners.

This allows the outgoing business-owner or his estate to directly control the funds because they are paid directly by the insurer without passing through the hands of the remaining business-owners.

This model is simple. The outgoing business-owner is both the insured and the beneficiary under the policy. As such, on their unexpected death, the policy proceeds are paid directly to their estate. On their unexpected TPD, they are paid directly to the outgoing business-owner. The insurance proceeds on both death and TPD are received tax free under this structure.

Because the insurance proceeds, whether paid in respect of death/terminal illness or trauma/TPD, are invariably received by the outgoing business-owner or his family, the self insurance model is not burdened with tax issues that may arise under alternative insurance structures where a non-relative receives trauma/TPD insurance proceeds.

### **Sale of the business interest**

The buy/sell agreement contains mechanisms to compel the outgoing business-owner or his estate to transfer the relevant business interest to the remaining business-owners on receipt of the insurance proceeds.

You may have noticed that under this self insurance model, no consideration is actually paid by the remaining business-owners to the outgoing business-owner on the basis that the outgoing business-owner has, in reality, received the value for their business interest in the form of the insurance proceeds.



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Under a self owned insurance model, the receipt by the outgoing business-owner or his estate of the insurance proceeds triggers the exercise of an option contained in the agreement resulting in the sale of the business interest by the outgoing owner or his estate.

### How does CGT apply?

The CGT treatment of this sale is rather interesting.

Because the outgoing owner's business interest is sold for less than its market value<sup>11</sup>, the CGT market value substitution rule<sup>12</sup> applies for tax purposes (not for enforcement purposes). Under this rule, where a transaction is not an 'arm's-length transaction'<sup>13</sup> and if the proceeds from the sale are nil or minimal then those proceeds are taken to be replaced with the market value of the business interest being sold.

For tax purposes a reference to parties dealing at arm's length, or to a specific transaction being at arm's length, is generally determined by considering whether the terms of the transaction are such as would be entered into between independent parties. An arm's length dealing refers to the nature of the dealing rather than the relationship that exists between the parties - as such, parties do not need to be related in order for dealing to be non arm's length.

In relation to a self insured buy/sell agreement, because the purchase price is not paid from the purchaser's own funds but is effectively paid by insurance proceeds sourced from an insurance policy in which the outgoing owner was both the insured and the beneficiary, the purchaser in effect pays nothing for such interest. This situation would not be considered to be an 'arm's length transaction' and the CGT market value substitution rule will operate<sup>14</sup>.

The consequence of the market value substitution rule applying is that:

- (a) the outgoing owner or their estate will be taken to have received capital proceeds equal to the market value of the business interest being sold, and
- (b) the remaining business-owners will be taken to have a cost base for CGT purposes equivalent to the market value of that business interest.<sup>15</sup>

### Worked example

We set out below a worked example which illustrates how a self insurance funded buy/sell agreement operates at a commercial level.

#### The facts.

*Tom, Dick and Harry all met in 1984 whilst studying for a Civil Engineering degree at UNSW. In 1997 they incorporated a company and commenced a building materials prefabrication business at Mascot. At this time MBP established a discretionary trust for each of them and arranged for each family trust to have a 1/3<sup>d</sup> shareholding in the operating company. Each family trust subscribed for this 1/3<sup>d</sup> shareholding of 200,000 shares by the payment of \$200K to the company – the payment of \$1 per share.*

<sup>11</sup> that is, the purchasing owners have not actually paid anything for the interest

<sup>12</sup> ITAA97 section 116-30.

<sup>13</sup> See further explanation of 'arm's length transaction' below.

<sup>14</sup> ATO Buy/sell Discussion Paper 2000.

<sup>15</sup> ITAA97 section 112-20.



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*In 2006 at his annual check up Tom was diagnosed with high cholesterol which led to daily medication for its future control. Tom's health scare resulted in all of them taking out life and TPD self insurance cover. Their life insurance cover was \$1M for each of them and \$1M TPD cover for Dick and Harry. The premium cost for \$1M TPD cover was prohibitive for Tom and Tom took out \$500K TPD cover only.*

*MBP suggested that they use these policies to fund a buy/sell agreement. MBP instructed their accountant to value the company and the company's business was subsequently valued on future maintainable earnings basis in the amount of \$3M. In late 2006, the respective family trusts entered into a buy/sell agreement in which it was agreed that on the death or TPD of any one of Tom, Dick or Harry, the respective family trust would sell its 1/3<sup>rd</sup> shareholding in the company to the remaining shareholders. It was agreed that because Tom's TPD was for \$500K only, the \$500K balance of the agreed purchase price not covered by Tom's TPD insurance proceeds would be paid by Dick and Harry over a 3 year period by instalments.*

*Unfortunately in late December 2008, Harry died in a skiing accident in Japan. Under the self funded buy/sell arrangements, these unfortunate and unexpected events could be accommodated.*

1. *Because Harry was self insured, Harry's death resulted in \$1M being paid to the legal personal representative of Harry's deceased estate. These \$1M proceeds were received tax free.*
2. *Under the buy/sell agreement, on receipt of the \$1M life insurance proceeds, Harry's Family Trust transferred some 100,000 shares to Tom's Family Trust and 100,000 shares to Dick's Family Trust. Neither Tom's Family Trust or Dick's Family Trust paid any purchase consideration to Harry's Family Trust.*
3. *On the sale of shares by Harry's Family Trust:*
  - *Harry's Family Trust made a net capital gain of \$800K being the difference between the \$1M deemed market value<sup>16</sup> for the shares (as per the accountant's valuation) and the \$200K cost base for such shares,*
  - *MBP structured the distribution of this net capital gain so that the beneficiaries of Harry's Family Trust could use the CGT 50 % discount and the CGT small business concessions – the result being that no tax was payable; and*
  - *each of Tom's Family Trust and Dick's Family Trust acquired their new 100,000 shares for a market value cost base of \$500K – namely \$5 per share.*
4. *As such, the beneficiaries of the family trust, namely Harry's wife and children received the life insurance proceeds. No tax was payable on the life insurance proceeds or on the sale of the shares.*
5. *Each of Tom's Family Trust and Dick's Family Trust increased their shareholding in the company to some 300,000 shares, being the original 200,000 shares having a cost base of \$200,000 (\$1 per share) and the freshly acquired 100,000 shares having a cost base of \$500,000.*
6. *MBP would suggest to Harry and Tom that they now restructure their buy/sell agreement to reflect the change in shareholding, the change in shareholding value and take out further life insurance to fund such increased value in the event that Harry or Tom also suffer an early death or TPD.*

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<sup>16</sup> Under the market value substitution rule.



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## Essentials for establishing and maintaining a buy/sell agreement

In establishing an effective buy/sell arrangement a client will need input from:

1. their accountant on the value of the business,
2. their insurance broker or financial planner on the appropriate insurance, and
3. MBP who will ensure that the arrangement is properly documented and tax effective.

Thereafter the arrangement needs to be reviewed on a regular basis – we suggest every 2 years or so. This is because if the insurance proceeds are not equivalent to the market value of the relevant business interest then the remaining business-owners will need to fund the balance. In this event the effectiveness of a buy/sell agreement is reduced.