Business continuity – the buy and sell arrangement

Business owners have the need to ensure that there will be continuation of the business upon the death or disability of a co-owner. They further want security in knowing that the disposal of their business interests will be dealt with in an orderly manner.

The risks upon the death or disability of a co-owner

- The remaining owners may not have sufficient cash available to buy the deceased's business interests.
- The heirs do not have the security that they will be paid a fair price for the deceased's business interests, if sold in the open market.
- The remaining business owners may not have immediate and clear ownership of the business; and negotiating with heirs or delays relating to winding-up of the estate might complicate matters.
- In funding the purchase of the deceased's interest, the capital resources of the business might be drained, jeopardising the continuation of business.

The solution

The co-owners of the business enter into a buy-and-sell agreement. Upon the death or disability of one of the parties, the remaining owners buy the deceased's business interest at a pre-determined price. The purchase price is funded by life insurance policies affected by the co-owners on each other's lives.

The importance of the agreement

The agreement contains all the terms and conditions applicable to the sale transaction. It secures the following:

- The obligation on the remaining parties to buy the deceased's interest in the business;
- The obligation on the disabled party or the deceased's estate to sell the interest to the remaining parties;
- The actual purchase price or the method for determining the price;
- The method of funding this buy-and-sell transaction;
- The consequences should the business relationship between the parties be terminated; and
- The procedure to follow in the event of the simultaneous death of all or some of the business owners.

Benefits for the co-owners

- The seamless continuation of the business is ensured;
- No outsiders will be involved in the business and they can continue unhindered; and
- The funds are available to ensure that the transaction can be concluded swiftly.

Benefits for the dependants/ beneficiaries

- They will inherit a capital amount instead of an interest in a business they have no knowledge of;
- The capital received can be invested to replace the loss of income experienced; and
- The capital can assist with the overall estate planning of the co-owners and their families.

Buy and sell arrangement – technical information

The structure

There are two structures that can be considered when implementing a buy and sell arrangement. It will be illustrated by using the following example:

A, B and C are shareholders in the company ABC (Pty) Ltd. A owns 40%, B 35% and C 25% of the shares in the company. The parties wish to enter into a buy and sell arrangement and would like to insure each other's lives for this purpose.

Traditional structure

The traditional structure entails that each shareholder has one policy on his/her life with the remaining shareholders being the co-owners of that policy. In the above scenario this will result in the following structure:

Policy on the life of A - Owned by B and C

Policy on the life of B - Owned by A and C

Policy on the life of C - Owned by A and B

The ownership of the policy will be according to the proportionate shareholding of each shareholder.

Alternative structure

The alternative structure is generally used where there are a larger number of shareholders and also provides for ease of administration when accounting for the premium payments. It entails that each shareholder owns one policy on the lives of all the other shareholders. In the above scenario the structure will be as follows:

A owns a policy on the lives of B and C

B owns a policy on the lives of A and C

C owns a policy on the lives of A and B

The sum insured on each life will be equal to the proportionate sum that is required by that policyholder to purchase his/her proportionate share.

Premium payments

The policyholders should pay the premiums on the policies they own.

In the case of the traditional structure, the premiums are accounted for in such a manner that each policyholder effectively pays the part that he or she owns – therefore the premium is proportioned in the same manner as the policy ownership.

In the case of the alternative structure the premium is paid by each policyholder.

It is common practice that the business facilitates the payment of the premiums. This can be done as long as the premiums are accounted for properly. There are two general options:

1. The premium is added to the salary of the policyholder. In this case the premium plus the tax payable on that amount must be added to the salary to result in a net amount after tax equal to the premium payable, or
2. The premium is written off against a credit loan account that is owed to the policyholder.

Income tax considerations

The premiums paid by the policyholders in respect of the policies funding a buy-and-sell arrangement are not tax deductible. Upon a successful claim, the proceeds will be paid tax-free.

Estate duty implications

The Estate Duty Act provides for a general rule in section 3(3)(a), that all policy proceeds payable due to the death of the deceased will be included in his/her estate as a deemed asset.

However, an exemption is granted in section 3(3)(a)(iA) if all the following requirements are met:

- The policy must have been taken out by a person who was a co-business owner of the deceased on the date of death;
- The policy must have been taken to enable the owner of the policy to acquire a whole or a portion of the deceased's interest in the business; and
- The deceased must not have borne any premium in relation to the policy.

Should all the above requirements not be met, the amount included in the deceased estate as a deemed asset will be reduced by an amount equal to premiums plus 6% interest.