# ASAP

Legal and Technical Update

## Buy and Sell Arrangement

### Common mistakes

**Mistake 1 – The agreement**

The first most common mistake made is that the parties never sign the buy and sell agreement. The agreement places the obligation on the parties to buy and sell each other's interests in a business upon death and/or disability. It can also determine valuation methods, payment terms and dispute resolution provisions, amongst others. Even though a verbal agreement was reached between the parties when the arrangement was set up, expensive court action might be the result if no formal agreement exists.

**Mistake 2 – Agreement not updated**

It is vital to ensure the agreement is updated and reviewed often to adapt as the ownership structures in the business change and as the value of the business fluctuate. If this is neglected, it can result in an unfair agreement or an irrelevant agreement.

**Mistake 3 – Contradictory agreements**

The Companies Act determines that a company's Memorandum of Incorporation overrides any other agreement between the shareholders and therefore it is important to ensure that the buy and sell agreement and this document do not contradict each other. Existing shareholder, membership, partnership agreements should also be considered for any contradictions as it can result in one or both of the agreements being unenforceable.

It is therefore important to review all agreements to ensure they complement each other rather than contradict each other.

## Mistake 4 – Policy structure

Parties often decide that the business should own the policies, even if the transaction is a traditional buy and sell arrangement and not a share buyback.

Practically, the consequences of the business owning the policies can be detrimental. If a party dies, the policy proceeds are paid to the business, however, the obligation to buy the interest rests on the remaining business owners or buying parties. This will result in the business having to declare a dividend to the purchasing parties (which will result in dividends withholding tax of 15%), or the business entering into a loan agreement with the purchasing parties, resulting in the purchasing party buying an asset but also acquiring a new liability in his personal estate.

Where the business owns the policy, the estate duty exemption available to buy and sell policies may also be lost, resulting in an avoidable estate duty liability. In traditional buy and sell arrangements, the policies should be owned by the parties that are obliged to purchase the interest in the business.

## Mistake 5 – Policy premium payment

The first error made is that the business pays the premiums on the policies that are owned by the individual parties. In some instances the business even deducts this premium for tax purposes. The premiums paid to fund a buy and sell policy is not tax deductible, so where a tax deduction is wrongfully claimed, SARS can recoup the tax benefits enjoyed and can apply penalties to that amount.

In other instances the premiums are paid by the business and divided equally between the individual parties, either as salary increases or against the party's credit loan accounts. In this instance some parties will end up paying premiums on policies that are on their own lives, which will result in the estate duty exemption being lost.

If the business pays the premiums on behalf of the policyholders, it is important that the premiums are accounted for properly. Where the parties have credit loan accounts owed to them by the business, the business can write the premium off against that loan account as a part repayment of the loan. If no loan account exists, the business will have to add the premium to the parties' gross income as a fringe benefit.

The business will enjoy a tax deduction in respect of that benefit paid to the party and the policyholder party will pay tax on that fringe benefit (the policyholder party must be an employee in this instance.)

If none of the above alternatives exist – there is no credit loan account and the policyholder is not an employee of the business – the premium must be debited against the personal account of the policyholder.

**Mistake 6 – Under or over-insurance**

This mistake can result in donations tax implications or negative estate duty implications.

In the case of over-insurance it is common for the agreement to be amended to determine that the purchase price is equal to the policy's value. For example, the value of the business is R1 000 000 but the parties insure it for R2 000 000. If R2 000 000 is paid for the R1 000 000 interest, the purchasing party can be liable for donations tax on the excess amount.

On the other hand, the executor might accept this valuation of R2 000 000, which may result in the deceased's estate incurring an estate duty liability on the additional R1 000 000 as well as a capital gains tax liability. So either way, an additional expense can be incurred. It can also place the estate duty exemption at risk.

**Mistake 7 – Valuation of business**

The valuation method used for the business should be realistic. In terms of the Estate Duty Act, the executor has to obtain a formal valuation when valuing unlisted shares, so it is important that the value used in the buy and sell and the value determined by the executor of the estate for estate duty and capital gains tax purposes are in line with each other.

This will also prevent possible disputes between the remaining parties and the beneficiaries of the affected party's estate.

**Mistake 8 – Insured Benefits**

The policies funding buy and sell arrangements should ideally provide cover for death and disability – and on an accelerated basis as the party will only sell the business interest once, on death or disability.

It is important to take note of the type of disability cover that is applied for.  In general own occupation based lump sum disability is ideal, and should be opted for if the party qualifies for it. However, if the party cannot obtain this type of cover, it is necessary to revisit the definition of disability in the agreement and to ensure that the agreement and the type of cover correlate.

Where a party cannot obtain disability cover, the parties can either agree that the uninsurable party does not sell his interest upon his disability or alternatively, they can agree to an instalment sale agreement.

Critical illness is often added to buy and sell policies.  Generally, business owners will not wish to sell their business interests when contracting a critical illness - as incapacity is generally temporary.  Critical illness is typically a personal benefit as the individual with the illness should be the benefactor of the policy proceeds.

**Mistake 9 – Beneficiary nominations**

In the ideal world the policy proceeds should pay to the parties obliged to buy the interest in the business.  However, there are certain instances where parties want peace of mind that the funds in the policy will be paid to a specific person (generally the spouse).  The spouse is then nominated as a beneficiary on the policy – so instead of making payment to the purchasing policyholders, it pays directly to the spouse of the deceased.  There are various risks associate with this practice and it is best to avoid it.

An alternative method to secure the policy payment to the deceased's estate, is to register a security cession over the policy in favour of the selling party – giving the executor the power to invoke that cession should the buying party not perform as determined in the buy and sell agreement.

**Mistake 10 – Estate Duty and Capital Gains Tax**

When structuring a buy and sell arrangement attention is focused on the estate duty consequences attached to the policy funding the arrangement.  Even though the estate duty consequences attached to the policy is important when effecting the policies and determining the correct sum insured, one should not lead the client to believe that this is the only instance of estate duty he should be aware of.

It is important to remember that the shares/member's interest in the business is an asset in the deceased estate for estate duty purpose and can attract estate duty. The reason SARS provides for an estate duty exemption on an insurance policy taken out solely to fund a buy and sell, is to eliminate the 'double taxation' effect this policy can have should it also attract estate duty.

One should also remember, as with all other estate assets, that death is a deemed disposal for capital gains tax purposes and therefore the deceased is deemed to have disposed of the shares upon his/her death in favour of the deceased estate, which may result in a capital gain being realised, which may result in capital gains tax being payable. Therefore, the liquidity needs arising due to the share ownership should not be ignored erroneously, due to the assumption that the estate duty exemption on the policy takes care of it. The estate duty on the actual shares and the capital gains tax upon death is not linked to the estate duty exemption on the policy funding the buy and sell arrangement in any way.

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