



Guide To...

Establishing a “Will” for your business

A Buy/Sell agreement can ensure the simple and efficient transfer of a person’s share in a business to the remaining owner(s) on the occurrence of certain events. By using this strategy, you can maintain control over your business if one of your business partners unexpectedly dies or is permanently disabled. If this happens, the following issues will be relevant:

- How is the interest of the outgoing owner to be dealt with?
- Will the dependants of a deceased owner become the surviving owner’s new business partners, or will the surviving owner(s) need to negotiate to buy them out?
- Where will the money come from to fund a buy out?

When this occurs, the expectations and intentions of the surviving owner(s) may be quite different from those of the outgoing owner (or the incoming spouse or beneficiary as new part owner). For example, the surviving owner(s) might want to buy out the interest of the outgoing owner/spouse. However, the outgoing owner (or that person’s representatives):

- may not want to sell; or
- may want to sell, but to someone other than the surviving owner(s) (they may even sell their interest in the business to a competitor!); or
- may want to sell, but at a price the surviving owner(s) do not consider reasonable.

All of these scenarios can put extra pressure on a business. To assist in protecting business owners from these threats, a Buy/Sell agreement should be considered. It makes good business sense to plan ahead.

How does the strategy work?

A Buy/Sell agreement defines the process for the orderly transfer of ownership of the business to the surviving owner(s), should one of several trigger events, such as death or serious disability, occur. If such an event was to occur, the remaining owner(s) would need to raise sufficient capital to buy the departing owner’s share of the business.

There are a number of ways that business owners may generate the funds to purchase a deceased or disabled business owner’s share of the business, however, life insurance is generally recognized as the most cost-effective solution. Other funding methods, such as borrowing, may not be readily available - lending institutions may not be willing to extend credit to a business immediately after the death or disability of a business owner.

A properly funded Buy/Sell agreement can be thought of as estate planning for your business – think of the Buy/Sell agreement as a ‘Business Will’ and the insurance proceeds as the assets of this Will.

The Benefits

- A funded Buy/Sell agreement can provide immediate funds to enable the purchase of the deceased's share of the business.
- Provides a guaranteed market for the business interest at an agreed price, protecting the value of your share of the business.
- Provides peace of mind for the continuing partners/owners/shareholders.
- Can pacify creditors and stabilise the business.
- Can reduce the chance of disputes between continuing business owners and a deceased owner's estate.

Case Study

Alex and Bill are 50/50 owners in a medium-size engineering business. The business has been very successful but is thrown into turmoil when Bill suddenly dies.

Without a Buy/Sell agreement

Alex and Bill had never thought about what they would want to happen to their business in such an event. On Bill's death, he left his share of the business to his wife, Lynn, through his Will.

Lynn was not interested in helping to run the business (and didn't have the foggiest idea about engineering!), but Alex didn't have any money to buy out her share of the business. Alex found many financial institutions were reluctant to lend him the money to fund the buy-out.

Even though Lynn cannot (and does not want to) help in running the business, she is still entitled to the same management and financial rights and share of profits as Bill. Alex is trapped in the situation where he cannot afford to buy Lynn out, but he is doing 100% of the work yet only receiving 50% of the profits.

With a funded Buy/Sell agreement

Alex and Bill had the foresight to enter into a Buy/Sell agreement, funded by insurance. Alex and Bill ensured the value of their insurance was equal to their share of the business (and increased their insurance to also account for anticipated taxes such as capital gains tax). The solicitor advising on the agreement (see Tips and Traps) suggested that each business partner own the insurance policy on the other's life (ie. Bill is the owner of Alex's insurance policy and vice versa).

On Bill's death, the insurance money is paid to Alex. Backed by the Buy/Sell agreement, Alex can use that money to buy out Bill's share of the business from Bill's estate.

Alex can gain full control of the business and Lynn (as sole beneficiary of Bill's estate) can realize and receive the full value of Bill's share of the business.

Tips and Traps

- Take the time to calculate the value of your business and contingency plans if something should happen to one of your business partners.
- As the Buy/Sell agreement is the document which affects your legal rights, it should always be prepared by a solicitor (preferably one that specialises in this area).
- There are a number of different ways to structure the ownership of the insurance policies used to fund a Buy/Sell agreement. As each ownership method will have differing legal, tax and stamp duty issues, the ownership should also be recommended by the advising solicitor after having regard to your personal and business situation.
- It is prudent to make sure all family members are aware of the arrangements made.
- Ensure your insurance cover is updated in line with the (increasing) value of your business. Failing to do this may lead to a funding shortfall. You should consider insurance policies which allow you to increase your level of insurance cover in the future without medical evidence when the value of your business increases.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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