

If I buy, will you sell?

How estate planning relates to your business

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In this article on what risks a business owner may face, we focus on a buy and sell agreement as an exit strategy where there are two or more partners in a business.

Background

A business needs to prepare for the event of one or more of the partners dying or becoming disabled. Putting a buy and sell agreement in place can ensure a smooth transfer of shareholding between partners. This guarantees continuity for the business and peace of mind for the deceased or disabled partner and their family.

The business entity

Replacement of a deceased or disabled partner in a business can take time, sometimes with dire consequences to the operational ability of the business. Offering the shares or member's interest to remaining shareholders or members, or even an outside party, has certain legal requirements. A shareholder's agreement or Memorandum of Incorporation seldom makes provision for all the practical aspects of transferring ownership to new parties. A separate **buy and sell agreement** is therefore required to ensure that all the necessary requirements and relevant processes are set out clearly. In terms of the Companies Act, no other agreement may supersede the shareholder's agreement or Memorandum of Incorporation. It is therefore crucial to align the buy and sell agreement and Memorandum of Incorporation.

Furthermore, if the deceased or disabled partner had a **loan account** owed to him, the executor of the deceased partner's estate will call up the loan account. This affects the value and risk profile of the business.

Example:

X-success (Pty) Ltd is currently valued at R15 000 000. There are loan accounts owing to the shareholders of R3 000 000. Valuation of the business will therefore be as follows:

Market value	R15 000 000
Less: Liabilities (loan accounts)	<u>R 3 000 000</u>
Total value	<u>R 12 000 000</u>

If the loan accounts are not settled first, the value of the business will be R12 000 000 as opposed to R15 000 000. It is therefore important to make provision for both the loan accounts as well as the full market value of the business in the buy and sell agreement and underlying funding.

There is currently some debate about whether the loan account/s should be included in the buy and sell agreement and attached value of the business. Rather seek professional advice for each situation to determine the best structure.

The partners

Some challenges facing remaining owners when a co-owner dies or becomes disabled include not having **resources** to purchase the available shares or having to deal with a **surviving spouse** or family member as a new partner.

They may also be faced with an **executor** who interferes with the business or wants to sell the shares to the highest bidder.

The agreement

A properly drafted buy and sell agreement will ensure certainty for the business entity as well as the owners of the business. Essentially it will provide:

- **Certainty** on what will happen with a partner's share in the business, should he pass away;
- **Mutual agreement** between partners about what valuation method will be used to determine the market value of the business;
- The **timeframe** within which transfer must take place;
- The **funding mechanism** that will be used to buy the deceased partner's share.

Structuring the agreement correctly is of utmost importance. Let's look at some of the important elements of the agreement.

1. Parties to the agreement

It is important to ensure that the real owners of the business are party to the agreement. Issues like whether all parties are selling, and in the same proportion, need to be decided upfront. Also ensure that where a trustee as representative of a trust is involved in the agreement, the necessary resolution and power of attorney have been granted to that trustee.

2. Sale

The transaction needs to clearly offset out who is selling what to whom. It must place an obligation on the seller to sell ownership to a specified buyer who is obligated to buy at an agreed predetermined price.

3. Purchase price

Parties need to agree on what valuation method will be used for the business as there are different ways to do this. Unfortunately, the value of the business is often linked to the life insurance policy taken out to buy the deceased partner's share. The risk in using this value is that the actual market value of the business at date of death may be substantially different from that of the policy proceeds. This will result in donations tax and a possible loss in the estate duty exemption on the buy and sell policy.

4. Funding mechanism

The agreement needs to state what mechanism will be used to fund the purchase and sale transaction. Should the agreed mechanism fail, provision must be made for alternative means.

5. Termination

Termination of the agreement also needs to be specified. It is especially important that provision is made for the event of simultaneous death of all the parties to the agreement.

6. Signatures

The agreement will only be valid if the registered owners of the shares / member's interest sign the agreement. Be careful of in community of property marriages - the spouse will also have to sign the agreement. Many agreements fail because the wrong parties have signed or have signed it incorrectly.

The funding mechanism

Traditionally, a life insurance policy is used to fund the sale and purchase of the shares or member's interest. It is important that the policy be structured to cover the actual market value of the shares or member's interest being purchased.

In terms of section 3(3)(a) of the Income Tax Act, any amount due and recoverable under any policy of insurance which is a **domestic policy** (as defined in section 1 of the Act) upon the life of the deceased is regarded as **deemed property** of the deceased. The requirement for inclusion in the estate of the deceased as deemed property for estate duty purposes is not whether the deceased was the owner of the policy or not, but whether it was his life which was assured. If correctly structured, a policy funding a buy and sell agreement transaction will not be subject to estate duty.

If any of the parties are not insurable for whatever reason, there are alternative ways to address funding of the transaction. An investment account can be set up or the agreement can make provision for the purchase price to be paid in instalments over a specified term.

Conclusion

It is essential that all the elements discussed above be taken into consideration when deciding on how to structure a buy and sell agreement for your business. It requires expertise and knowledge on both legal and insurance aspects to ensure the full benefits will be achieved from the transaction.