BUY AND SELL ARRANGEMENTS

What is the purpose of buy and sell agreements?[1]

When shareholders form a company it would seem natural that on the death or disability of one of the shareholders, that the surviving shareholders would want to retain the shareholding in the company. They can do this by entering into an agreement with one another that provides for events such as death and or disability of each other. Normally, although not prohibited, a severe illness is not an event that is covered. The agreement provides for the selling of shares by the affected shareholder and, the buying of the shares by the other shareholders. This is a legal contractual document which then obligates the other (one can call them the surviving shareholders) to buy the shares of the affected shareholder. This places the same obligation on the affected shareholder to sell his shares.

What are the risks for not entering into such agreement?

- In the event of one of the partners/shareholder/member's death one needs to consider who receives their share of the business. They can bequeath it to family members who may have no clue on how to run a business or even have the necessary skills! The Executor may sell to a total 3rd party who may just come and destroy the business. Credibility with clients can go out the window! It would be preferable that the surviving shareholders buy the shares of the deceased partner
- Entering into a buy and sell arrangement provides certainty of 'who will be taking over'. This can be whomever they agree to and need not be the remaining partners/shareholders/ members etc. This can be an employee of the business or someone who has nothing to do with the business but, an agreement assures the other shareholders of who this person will be. They agree to it. Without such an agreement, the shareholders are free to do with their shares as they wish. The Company Act does however provide that they other shareholders must agree to allow in the new shareholder. If not, the business will be difficult to manage until all personal and business issues are resolved.
- A buy and sell arrangement will prevent competitors from taking over the business as well as leaving management in competent hands without interference.
- A buy and sell arrangement will also facilitate the winding up of the deceased estate as the executor need not find a buyer and dependants will at least be compensated in full.
- The deceased estate is guaranteed (in a way) that it will receive cash from policy proceeds which can be used to settle debt and expenses and address any potential bequests made. Without cash from policy proceeds, sitting with shares could mean a delayed period in selling the shares out in the market and therefore, delayed period in liquidity in the deceased estate which can result in additional expenses (the

[1] One can refer to it as an agreement or an arrangement. For the purpose of this document, they have the same connotation.

longer the estate takes to wrap up the more expenses the deceased estate can incur.)

Is it imperative that a buy and sell arrangement be funded by life insurance policies?

No, it is not at all needed to be funded by life insurance policies! But, if life insurance policies are implemented for this purpose, then:

- Provides immediate funds to allow the successor to purchase the deceased's partnership/ members' interest or shareholding. Prevents arrangements being made to repay the capital over periods of time which may be subject to tax[2] and interest!
- Avoids the withdrawing of large capital amounts from the business which can be used more productively
- Successor may lack liquidity which could mean requesting the bank for loans which may either be refused or granted with high interest rates.

Are buy and sell arrangements only for the event of a death of one of the partners/ shareholders and or members?

It is not limited to death only as other events such as disability, resignations and even retirement events can be covered. It is up to the shareholders to decide if an arrangement should be in place and for which particular event or events it should extent to.

In all instances you should look at funding these events with some form of life insurance and or investment.

If buy and sell arrangements are implemented without life insurance policies funding the arrangement, what effect does this have on Estate Duty?

In 'Property' you will always record the deceased's value of his partnership / member's interest and or shareholding as, the shares held are an asset for estate duty. It matters not whether a buy and sell arrangement is in place as the value of the shares are included in property for estate duty purposes.

A buy and sell agreement will not fail if life policies are not in place.

What is important to note though, regardless of the duty payable, is that the Estate may not have sufficient liquidity which may obligate the Executor to sell assets to fulfil the obligation of the buy and sell arrangement. This in itself will increase taxes that will be due and payable.

[2] If capital repayments are made from dividends that the shareholders earn from the same company

Firstly, remember that the value of the deceased's partnership / member's interest and or shareholding is still a value for Property.

Secondly, the mere fact that the deceased is a LIFE ASSURED on a domestic policy and, that the amount is due and payable on his death means that the policy value must be included in Deemed Property!

Section 3(3)(a) of the Estate Duty Act may provide an exemption on these policies. If the policy meets the requirements of this exemption, the policy will be exempt and will therefore not form part of deemed property. One cannot include the value and then deduct the value as no deduction exists for this transaction. The full value of the policy is totally excluded.

Section 3(3)(a)(iA) of the estate duty act provides for requirements that need to be met to ensure that the policies remain exempt. These are:

Section 3(3)(a) (iA) of the Estate Duty Act is:

> '*the commissioner is satisfied that the policy was taken out or acquired by a person who on the DATE OF DEATH of the deceased was a PARTNER/ held any SHARE or LIKE INTEREST in a company in which the DECEASED on the date HELD any share or like interest, for the PURPOSE of enabling that person to acquire the whole or part of:*
>
> *The deceased's interest in the partnership concerned or*
>
> *The deceased's share or like interest in that company and any CLAIM by the deceased against that company*
>
> *And that NO premium was BORNE by the DECEASED.'*

The words in the sentences above that are underlined are the more important requirements that have to be elaborated on:

A. **DATE OF DEATH:** partnership / membership and or shareholding **must be in existence** at the time of death. Not the business per se, but the relationship with one another in the business. Where a business relationship in relation to a business entity did exist but, on date of death it no longer exists, the policy cannot be exempt as at date of death, the business relationship no longer exists.

NOTE: The insurer only establishes an insurable interest at application stage and not at claim stage. When a claim against a policy is lodged, the insurer is obliged to pay the beneficiary which would be the surviving shareholders. The fact that a business relationship exists or not at the time of a claim, is irrelevant to the insurer.

B. **PARTNER/ SHARE / LIKE INTEREST**: This requirement indicates the relationship that should exist at time of death. If the deceased is a partner in a partnership, if

the deceased is a shareholder of a company and if the deceased is a member of a close corporation then this requirement is met.

It then goes to say that if you are a sole trader and enter into a buy and sell arrangement funded by life insurance with a successor, it will not qualify for the exemption. If you are an employer entering into an arrangement funded by life insurance policies with your employee, it will not qualify for the exemption.

You need to be a partner, shareholder and or member of the entity in which the deceased was a partner, shareholder and or member of the same entity AND, this relationship must be in existence at the time of death of the deceased in order to qualify for the exemption.

C. **PREMIUM** THE deceased cannot have paid any of the premiums on the policy in which he was the life insured.

This requirement is simply said. Whether all the other conditions have been met, this one is nearly and over rider as, if at any stage the life assured (deceased) paid any premium on the policy on his life, the exemption falls away.

This presents a problem. If for any reason such as health issues or age factors and so forth, requires an existing policy to be ceded to the other shareholders for the buy and sell arrangement, surely the life assured/ deceased would have paid premiums?

Consider this: Tom, when he was 30 years old and healthy, took out a policy on his life for the purpose of providing liquidity for his family when he dies. He has to pay premiums on this policy for it to remain active.
At the age of 37, Tom joins a company as a shareholder. There are 4 shareholders in total and they decide to enter into a buy and sell arrangement. Unfortunately, as a result of health problems, Tom had a major heart attack at the age of 35. The insurance companies have declined any new life cover required for the buy and sell arrangement. Tom opts to cede his personal policy that he implemented when he was 30 years old, to the other shareholders for the purpose of the buy and sell arrangement. A few year later Tom passes away. All requirements are met but, he paid premiums on his own policy from the age of 30 until he ceded the policy at the age of 37. For this reason alone, the policy is not exempt.

This would mean that the policy would attract estate duty and the duty that this policy will attract has to be paid by the surviving shareholders. Now one has to consider further that the surviving shareholders must have the capital available to pay the duty as it cannot be paid with the policy proceeds.

The above is possibly the more common problem where a shareholder is not insurable. There are however other possible problems although not common as it can be avoided. The insurer has to collect premiums on these policies. Premiums are apportioned amongst the shareholder in relation to the shareholding they have in the company. An example:

Tom and Bob are shareholders of ABC (Pty) Ltd. Tom has 60% shares and Bob has 40% shares in the company.
Bob is the owner and payor on policy A where Tom is the life assured and the premium on this policy is R1000 per month.
Tom is the owner and payor on policy B where Bob is the life assured and the premium on this policy is R800 per month.

The insurer will collect R1 000 from Bob's account and R800 from Tom's account. Easy right?

Now let us complicate things a little:

Dan, Fred & Tom are shareholders in ABC Pty Ltd. A total of 100 shares have been issued by the company and they each own the following shares:

Dan	40 shares
Fred	35 shares
Tom	25 shares

The total value of the company is R1 000 000.
To fund the agreement, they must take out 3 separate life insurance policies which can be structured as follows:

Policy on the life of Dan:

- Sum assured R400 000 and assume a premium of R500 per month
- Owners, beneficiary and payors of the policy are Fred and Tom.
- The contributions are proportioned:
  - Fred: 35/60 x 500 = R291.67

    Tom: 25/60 x 500 = R208.33

  The ratio is used on their respective shareholding in relation to the other.

Policy on the life of Fred

- Sum assured R350 000 and assume a premium of R450 per month
- Owners, beneficiary and payors of the policy are Dan and Tom.
- The contributions are proportioned:
  - Dan: 40/65 x 450 = R276.92

    Tom: 25/65 x 450 = R173.08

Policy on the life of Tom

- Sum assured R250 000 and assume a premium of R350 per month.
- Owners, beneficiary and payors of the policy are Dan and Fred.
- The contributions are proportioned:
  - Dan: 40/75 x 350 = R186.66

    Fred: 35/75 x 350 = R163.33

In a structure such as above, it is difficult for the insurer to debit each partner's bank account according to their proportion on 3 separate life policies. To overcome this difficulty, the Insurer debits the total premium on all policies, against the company bank account instead.

Now this is not the problem whatsoever. The company accountant is responsible for collecting, from the shareholders income earnings (assume that they are all employees also) the premiums or, where the shareholders are not employees, the account has to debit the shareholders loan account.

The problem lies in the fact that the accountant does not transact as required. Could this not be seen as the life assured having possibly paid his own premiums?

Where the company never clears their 'bank account' and or the debit to the loan account remains unpaid it could prove to be an issue as"

a. In relation to a shareholder only, it can be deemed that the company is paying this premium on behalf of the shareholder which could trigger a deemed dividend.

   The deemed dividend provision requires:

   i. A loan, advance or debt provided by the company
   ii. To a person who is not a company
   iii. To a person who is a resident
   iv. The borrower (in this case our shareholder/partner) must be a connected person in relation to the company.

   The deemed dividend would be calculated on the difference between any interest actually paid by the shareholder and the official rate +1[3]. The official rate as pronounced by treasury.

b. In relation to a shareholder who is also an employee, it can be deemed that the company is paying the premium on behalf of the employee, which results in a fringe benefit [4] .

[3] The same official rate as that of the Section 7C

In the event that the shareholder is also an employee, a fringe benefit is raised and not a deemed dividend.

D **PURPOSE**: the purpose[5] must be to purchase the deceased's interest in a partnership or, the deceased share and (or) loan account in a company which includes a close corporation. Note how the section of the act makes no specific mention of including in the buy and sell arrangement, a loan in a partnership.

When would 'purpose' present a problem?

Where and if the purpose is not to purchase the shares of the deceased or, where and if the proceeds are used for something other than buying the deceased's share, it will not meet the requirement and would therefore not be exempt. This is one of the reasons why an actual written agreement is important as it can 'show" the intentions of the parties.

Two difficulties can arise:

1. If the surviving shareholders are not buying the deceased's share in the same company, the policy is not exempt and the full value of the policy is dutiable.

   One way of not being able to meet this requirement is a sole trader entering into a succession plan with any other or, one shareholder only.

   If there is only one shareholder and this shareholder enters into a succession plan with another shareholder of another company or even with their own employee, it cannot be said that they are buying the deceased share in the same company in which they are a shareholder. Over and above this, one can also not say that they are shareholders of the same company at the time of death of the deceased.

2. What if there are two shareholders, one with a 60% shareholding and the other with a 40% shareholding. One shareholder is a natural person and the other is a Trust.

   A trust is not recognised in the Estate Duty Act but a trustee[6] of a trust is. Remember that the trustee only owns the assets in the trust in his fiduciary capacity and not in his personal capacity.
   One cannot affect a policy on the Trust as the trust does not die. The most one can do is insure the most important trustee of the trust.

   When the trustee does and the proceeds by the natural person shareholder, the shareholder will use this to buy the shares from the trust. The natural person shareholder is not buying the trustee's shares as this is not the trustee's shares, it is the trust's shares.

[4] Para (2)(f), (h) or (k) of the 7th Schedule.
[5] Or intention of some people call it
[6] Natural person

It is for this reason that the policy on the life of the deceased trustee is not exempt from estate duty as the intention requirement fails. It was the intention to buy the Trust shares and not the trustee's shares.

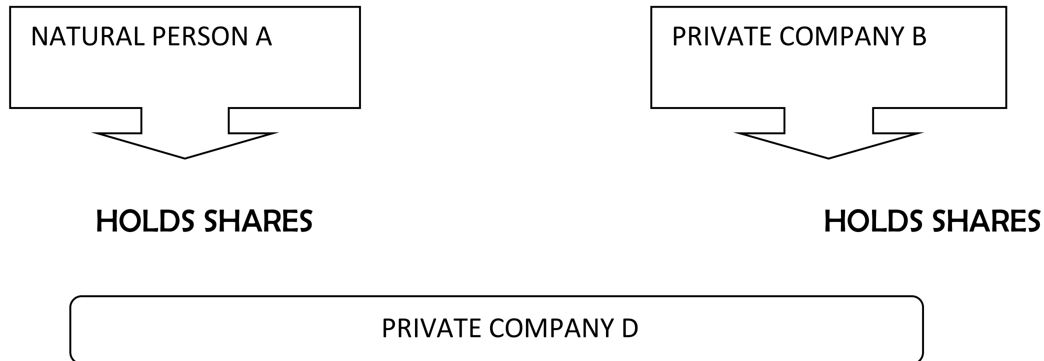
3. There are possible difficulties if the value of the policy is clearly overvalued and one cannot substantiate the reason for the overvaluation.

   It is best explained using an illustration:
   Assume the market value of a company is R10 000 000. There are two Shareholders each with 50% shareholding in the same company. Any policy that funds this buy and sell arrangement should be valued at R5 000 000 for each shareholder. Assume that the policy implemented is actually valued at R9 000 000 each instead or even only the one shareholder has a policy to the value of R9 000 000.
   Can this be motivated or explained. If one cannot motivate then one questions the intention of this policy. If the value of the shares that will be purchased on the death of one of the shareholders is R5 000 000, why is the policy valued at R9 000 000? What is the intention of the other R4 000 000?
   If one can motivate this by showing that the company value has declined from the day that the agreement was funded to the date when a shareholder died, the policy will remain exempt. If one cannot motivate this, the policy will not be exempt/
   The motivation needed is for the Receiver of Revenue should this be queried by them.
   The amount that is estate dutiable in the example used above will be the full R9 000 000 and not any portion thereof.
   One can even go further and consider if there is a donation in this transaction. Consider that the surviving shareholder is obligated to pay the deceased estate R9 000 000 in return for shares worth R5 000 000. A R4 000 000 donation by the surviving shareholder to the deceased estate? This also applies where the deceased estate is transferring shares to a surviving shareholder which has a greater value than the proceeds being received.

Some time has to be spent in clarifying the concept of "the purpose must be to buy the deceased's share in the company"

The following examples are extracted from a guide issued by SARS specifically on policies that fund buy and sell arrangements.

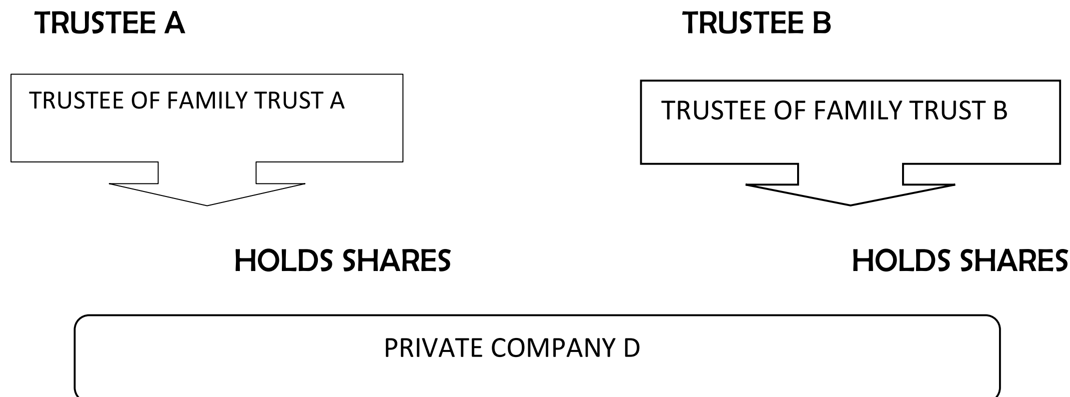
Scenario 1



A and B own shares in Company D and Company B took out a policy on the life of A to enable company B to purchase A's shares in Company D when A dies. Assume all other requirements are met. Discuss whether this policy will be exempt from estate duty or not.

Because the policy is acquired by a person on the life of natural person A and, they are shareholders at time of death, private company B would be buying the `DECEASED' Share – it will be exempt of estate duty

Scenario 2

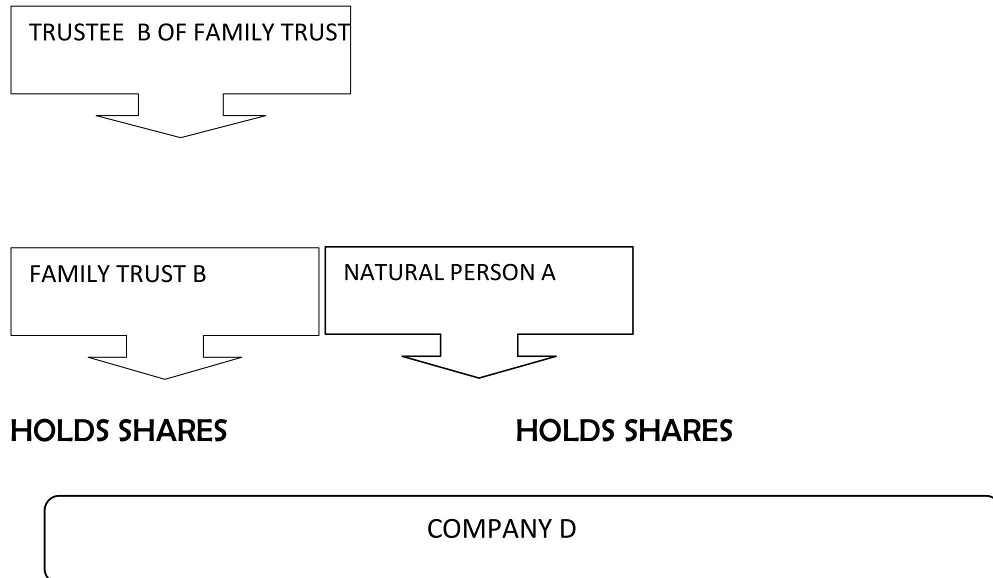


Trustee B take out a policy on Trustee A and Vice Versa. Discuss whether these policies will be exempt from Estate Duty.

The Trustees in their fiduciary duty, on behalf of the Trust acquired the policy, they (the trusts) are shareholders at time of trustees" death, however, they are not acquiring the

DECEASED share – they are acquiring the TRUST's share – neither of these policies will be exempt of duty.

Scenario 3



Trustee B takes out policy on life of A to purchase his shares and Natural Person A takes out a policy on the life of Trustee B to pay the Trust's shares. Discuss whether these policies will be exempt or not.

The policy acquired by the Trustee on the life of natural person A. A and Trust are shareholders at time of death, and the Trustee, in his fiduciary capacity and on behalf of the trust, is acquiring the deceased's share. This policy will be exempt from estate duty.

The policy acquired by the natural person A on the life of the trustee, although all other requirements are met, natural person A is not `acquiring the deceased share, A is acquiring the Trusts' shares – hence this policy will not be exempt from estate duty

Buy and Sell for disability, ill health or retirement

Huge emphasis is placed on an arrangement when a death, disability and at times, an illness takes place. What happens on retirement though? What if the shareholder no longer wants to be a shareholder, would the other partners not want an opportunity to buy his shares?

ON A DISABILITY

There are various degrees of disability. It can be temporary or permanent. Temporary should not be a concern as one would doubt that any shareholder would want to sell his shares when it is a temporary event. Permanent disability is a different event all together.

One has to be very critical and analytical of the type of lump sum disability that is or forms part of a benefit. Benefits such as own occupation, similar, impairment, permanent and so forth.

The buy and sell agreement has to be explicitly clear under which conditions a shareholder will sell his shares. Too general a clause in an agreement to the effect of 'deemed to have disposed of my shares when the policy proceeds are paid' can have unintended effects. If a shareholder has minor disability / severe illness and policy proceeds are paid on this claim, it would then, as per the agreement, deemed that the shareholder will sell his shares!

HEALTH / SEVERE ILLNESS

This benefit generally pays claims for events such as heart attack, stroke, cancer, HIV, kidney failure etc. These are events that do not disable a person but does result in a change of lifestyle as it can have devastating effects on one's ability to function normally or even the ability to be actively working a full day. These are all events that can have an impact but perhaps not severe enough to warrant the disposal of one's shares.

It is not normally recommended to have illness cover on a buy and sell arrangement but then, it is really left to the shareholders to decide.

RETIREMENT

Retirement is often overlooked and yet the more obvious one. Serious consideration has to be applied to a retirement event as this could happen long before a shareholder dies.

Where a shareholder no longer wants to participate in the business and wishes to retire, the shareholder may want to remain a shareholder retaining only some of the functions, may want to donate his shares or sell his shares to a family member or even sell it to a total third party.

The remaining shareholders then face the same dilemma as when a shareholder dies; - uncertainty of the next shareholder's ability, skill, character and all other important character and skill required for the business. It would most definitely assist if the

shareholders have capital available or an agreed plan on how these shares can be bought and retained with the current shareholders.

How can a buy and sell agreement for retirement be funded? Some possible suggestions:

a: Risk policies with an investment component. This product can kill two birds with one stone. It has a risk component in the event that the shareholder does die before retirement and it builds up an investment which can be used for the purpose of buying shares should the shareholder retire before death. Clearly, if the policy is young when the shareholder decides to retire, there will not be sufficient cash build up to pay-out the shareholder. One of the reasons to commence an investment policy in the early stages of the formation of the company or business relationship.

b: Separate risk policies and investment policies.
A life policy can be implemented to cover the event of death and disability and, an investment policy can be implemented for retirement purposes.
The life policy, from an estate duty perspective has been discussed. The investment policy, assuming a sinking fund, will not be estate dutiable unless the OWNER of the policy dies.

c. An endowment policy which is a pure investment or a combination of life cover and an investment component. All the tax implications and considerations as per point A and B above apply.

<u>CAPITAL GAINS TAX ON BUY AND SELL POLICIES</u>

Paragraph 55 of the 8th Schedule to the Income Tax Act provides for exclusions of life insurance policies (risk and investments) if, requirements are met.

Due to the fact that 99% of policies to fund buy and sell arrangements include only risk benefits, most are exempt under paragraph 55(e). This sub-paragraph exempts pure risk policies only.

Should one come across a structure in which a policy has both risk and an investment component, as a result of the risk component, the other exemptions are of importance.

Summary:

Para 55(1) of the 8th Schedule refers: 'a person must disregard any capital gain or capital loss in respect of a disposal that resulted in the receipt/accrual of an amount [] (a) is the original beneficial owner (summarised) (c) In respect of a policy that was taken out to insure against the death, disability or illness of that person by any other person who was a partner of that person, or held any shares or similar interest in a company in which that person held any shares or similar interest, for the purpose of enabling that other person to acquire, upon death, disability or illness of that person, the whole or part of.. That person's interest in the partnership concerned or That persons' share or similar interest in that company and any claim by

that person while that other person was the beneficial owner of the policy.

If the risk only exclusion fails, then Para 55(1)(c) will most definitely assist.

A quick short summary on buy and sell arrangements funded using life insurance policies:

1. If the policy meets ALL the requirements in Section 3 (3)(a)(iA) then the policy is exempt and therefore EXCLUDED from deemed property.

2. If a policy does not meet ALL of the requirements in S3(3)(a)(iA) then the policy is NOT exempt and the FULL amount [not part!] is included in Deemed Property for Estate Duty purposes. This is for calculations purposes only as the insurer is still obligated to pay the beneficiary (the surviving shareholders) and does not pay the deceased estate.
   This policy will attract estate duty only and not executor fees as a nominate beneficiary exists and therefore the executor would not handle the proceeds.

3. Where the policy is not exempt, the value that is included in Deemed Property is the value of the policy proceeds less premiums plus 6% (SARS allows compound). It is the net value that is included in deemed property. It is incorrect to include the full value and then deduct premiums + 6% as no such deduction is available.

4. Estate duty, if the policy is dutiable, is apportioned and payable by the surviving shareholders. It is important to establish whether estate duty will be payable as the policy has to ideally be grossed up to cater for estate duty. [value of policy / 0.8]

5. Premiums paid on a policy funding a buy and sell arrangement cannot be deducted from taxable income and the policy proceeds will also not attract any capital gain tax.

It is wise to mention that a buy and sell agreement is a legal contractual document which obligates the parties to buy and sell their shares. One sided agreement also exists and has the same contractual obligations.

Where a shareholder has entered into such an arrangement and makes mention of the bequest of the same shares to another person other than the shareholders that are part of the buy and sell agreement, the bequest in the will fails as the will is a "wish" and does not override a legal agreement.