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## Business Succession Planning

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by

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## INTRODUCTION

Business Succession planning encompasses a very broad arena involving numerous strategies for the transfer of the ownership and management and/or the control of a business on retirement and intergenerational transfers of the family business on the occurrence on one of the three "D's" Death Divorce and Disability.

In this session I focus only on fully the funded buy sell agreement between business owners. We will further principally look at the funded buy sell arrangement in today's one hour session. Such arrangements are also termed succession plans, business succession plans or having a "Business Will".

### **Objective**

At the end of the session you should have hopefully developed an appetite for lunch and some awareness of the various strategies to assist your clients as well as an understanding of some of the traps and pitfalls involved.

### The issue

The fate of a business on the death of an owner is usually determined by:

- gifting the business through a will;
- transferring the business through a pre agreed contract whether it is a partnership agreement of share/Unitholder agreement
- the heirs continuing the business
- the liquidation and asset sell off if a purchaser cannot be found

## A FEW STATISTICS

- Evidence suggests that very few family businesses survive beyond the first generation.
- A third of family businesses continue into the second generation, and less than a sixth (that is 16%) survive to the third generation.
- Less than 30% of business owners aged 51 to 60 have a written Business Succession Plan, and more than 70% have no plan at all.

In Victoria, of third and fourth generation firms:

- 33.7% have a succession plan for the future ownership of the business
- 15.6% have an ownership succession plan in writing
- 9.4% have an ownership succession plan implemented

Source: AXA Australia Family Business Research Unit at Monash University

As for the risk of death occurring

- For 2 male business partners both aged 35, the probability that one will die or become totally and permanently disabled before aged 65 is 52%.
- For 4 partners the risk increases to 77% and with 6 partners 89%!! Women on the other hand statistically make for a better risk.

## BUSINESS SUCCESSION PLANNING

Business succession planning is not about selling life insurance, legal documents or detailed financial plans. It is about developing a strategic plan to ensure a smooth and trouble free hand over of the business following disablement or death.

The strategy is available to all forms of business including the family business and professional services practices.

There are other options that can be incorporated into the document effecting the transition arrangement such as the retirement, bankruptcy, or divorce of an owner and these can be incorporated into the arrangements but for the sake of keeping the issue as simple as possible for the clients it is generally advisable in a funded arrangement using insurance to focus on the event that is an insurable event.

Example:

John runs a small, successful real Estate company with his business partner Keith. Keith developed cancer and died. He left everything in his Will to his wife Nicole who inherited Keith's interest in the real estate business.

Nicole had never been involved with the business. Not only did Nicole not want to have anything to do with the business, she told John she would camp on his doorstep until he purchased Keith's half of the business from her.

In the meantime Nicole wanted Keith's usual wage. Nicole needed money to support herself and the children.

John would have been happy to pay her half of the value of the business IF:

- John knew what the business was worth;
- Nicole agreed with the value (and wanted to sell); and
- John could find the money to pay her.

After many fruitless arguments and telephone calls John decided that enough was enough and decided to sell the business and divide the proceeds. Neither are happy about the price they ultimately receive for the business.

### What is the answer?

John and Keith together with their Adviser, Accountant and Tax Lawyer could have prepared a Business Succession Plan.

Nicole could then have required John to purchase her half of the business for a predetermined price. Alternatively, John could have required Nicole to sell her half of the business for the same pre-determined price.

Forward risk planning by John and Keith could have ensured

- there was a planned transition of ownership to relieve the spouse from responsibility in the business
- that Nicole received a fair value for the business interest
- that prevented the forced sale of the business
- that ensured the ongoing stability and profitability for John and the employees.

### HOW TO IDENTIFY PROSPECTS?

A fully funded Buy Sell Business Succession Plan can help ensure the business survives when a co-owner dies or suffers a long term illness or accident.

- The parties must be insurable
- Generally the target is small to medium businesses
- The business has potential for sustainability and profitability.
- There must be an identifiable successor that is prepared to commit to a long term arrangement

In a funded buy sell strategy the client will need to access lawyers accountants and financial planners, whose respective expertise and qualifications will be necessary to implement the strategy

- The authorised adviser implements the insurance and prepares the statement of advice
- The accountant can provide a valuation of the business and advises in relation to tax and accounting matters
- The Lawyer prepares the documentation to implement the arrangement.

Time consuming? Yes partly to come to terms with the issues involved as well as arranging the insurance and satisfying underwriters and then getting the clients to make a decision and commit to the expense.

It takes time

- to identify and explain the problem
- for the owners of the business to see the need
- for the owners to reach an agreement
- to arrange the insurance
- finalise and embed the strategy
- don't forget the ongoing review

### THE PARTIES

The risk analysis involves identifying who owns what

- The Proprietors (owners or persons who run the business)
- Associated Parties (family trusts and associated entities that may own the interest in the business)
- Relatives who stand to inherit the business

Note

*There are usually related parties or entities such as trusts and companies that may have some direct or indirect control over the transfer of the ownership when the time comes and ideally they should also be identified or be made a party to the arrangement to ensure the transfer of the business is affected as intended.*

*For example owners of the shares in the company or units in the trust from which the business is run may be the family trusts of the members. In a self insurance arrangement the agreement needs to bind the trustee to sell the business interest that as a trust asset will not automatically pass into deceased's estate.*

#### Interesting side issue

The adviser may be found advising everyone in the business, acting for the buyer acting for the seller acting for the spouses and beneficiaries. It is handy to recall *McGeoch V Hendricks and Ors (2007) NSWSC 311 (11 April 2007)*. Here the lawyer was found liable for breach of the Trade Practices Act misleading and deception provision and also for acting in a position of conflict of interest. The lawyer failed to adequately protecting the interests of all the parties including those he did not think he was acting for, he failed to inform them to obtain independent professional advice. This action concerned a business succession arrangement where the mother who changed her will after it had been agreed to leave a specific house to her son in the will in exchange for gifting the family farm to the other son. It was held that the lawyer failed to protect the interests of the son and should have put in place a simple agreement to protect the son's interest.

In short, don't forget to identify who you act for when you are simply attempting to protect the future of the business.

*McGeoch V Hendricks and Ors (2007) NSWSC 311 (11 April 2007)*

#### THE FUNDING

For the owners of the business to fund the agreement in the event of the death or disability of one of their number they require access to the funds at precisely the time that the funds are needed. The successful transition of ownership depends on the availability of cash to fund the purchase of the deceased interest in the business. Life insurance provides the best alternative.

#### The alternatives:

Borrowing is not satisfactory.

- *Not all the potential purchasers will be in the same financial position to raise the necessary security for the loan at an unexpected time.*
- *The availability of funds is dependent upon the Bank agreeing to the loan and there is no certainty that the funds will be made available and additional security will be required.*
- *The borrower will have to provide evidence of the ability to service the loan as interest will be payable.*

Saving the funds uncertain

- *funds can be set aside each year, usually allocated from after tax paid profits where tax has been paid at the greater of the company or the individual's rate. Also the time that the funds will be required is uncertain. Therefore a vital factor missing.*

Terms payments no immediate transfer

- *the purchase price can be staggered over a period of time but this may depend on sustainable profitability of the business after the contingency event has occurred*
- *this may solve part of the problem but the estate continues to have an interest in the business until the full price is paid*

#### Insurance

The preferable vehicle is a life insurance policy;

- usually no tax is payable on the proceeds
- the fund is separate from the business and not reliant on business profitability.
- funds are available at the time they are needed
- cost of the premium represents a small fraction of the value of the fund that will be required

Note

*Life insurance is a financial product and must be recommended by a person who is suitably qualified trained and authorized to advise as to the appropriate policy. A referral can be made by the accountant provided there is disclosure of any commission sharing. The lawyer and the accountant can provide general strategic advice but unless an authorized representative they are restricted from providing product advice and dealing in a financial product.*

#### [What is the business worth?](#)

A business is only worth what someone is prepared to pay to acquire it.

The key factors that a purchaser will examine are profits, assets, potential return and goodwill.

In a buy sell arrangement the sum insured should ideally not be less than the value of the business at the time the funds are needed therefore before arriving at the sum insured the parties agree the sale price and a valuation may need to be performed.

The valuation of the business can be determined in a number of ways.

#### WHAT THE OWNERS WOULD ACCEPT

- This can be an arbitrary amount taking into account the assets less liabilities and the profit derived. Many businesses do not make profits; therefore a precise valuation is difficult. The insurance level can be reviewed regularly so that the sum insured adequately reflects the current value the owners place on the business.

#### INDEPENDENT VALUATION

- Can be performed when entering the agreement (as this determines the sum insured) by an independent accountant or valuer. The "market value" is a price agreed between a willing but not anxious seller and a willing but not anxious buyer.

#### FORMULA METHOD

- An appropriate formula will depend upon what is commercially acceptable in a particular industry as well as what is agreeable between the parties.

Ultimately in closely held private companies the owners and their advisors will arrive at a value that they are prepared to pay and accept for the transfer of their interest in the business. It is the valuation that the members place on their interest that is the bottom line.

Ideally the amount of insurance required will be equal to the amount required for the survivor to acquire the business interest.

Note

*Many businesses are not profitable on paper and other supporting documentation can be provided to establish and justify the insurable amount for the purpose of underwriting.*

#### [What is often overlooked?](#)

If there are guarantees for the business debts, then the guarantee remains binding on the estate after their death and this may delay the administration of the estate.

If the deceased has lent money to the business then the estate of the deceased will demand repayment of the debts unless there is a loan forgiveness clause in the will and sizeable loans can often result in the business being wound up to recover outstanding loan account balances owed to the estate.

Div 7 Loan account balances represent company loans to directors of companies and represent amount owed to the company by the potential deceased director/shareholder this may also be a debt to the estate that will affect the amount ultimately received on the sale of the interest in the business.

Family trust generally have accumulated loan account balances these can be washed over a period of time or insurance may be effected to cover any repayment.

In the valuation methodology the adviser can look at the business and include the loan accounts which may be taken into account and to review appropriate strategies to deal with these account balances or whether they are to be included in the sum insured in a self insured arrangement where the insurance proceeds will be paid to the estate.

For example

Joan tells his wife that he has arranged a funded buy sell transition for \$500,000 and that the wife will receive that amount in exchange for the shares in the company. The problem arises that she may only receive a net amount of \$250,000 after the loan account has been discharged.

John could then

- self insure for \$750,000 to account for the sale of the business and allocate \$250,000 with an authority for payment of debt clause included in the will.

The amounts owed to or by directors needs to be addressed in the valuation of the business. This may sound odd but the parties are not fully arms length particularly if the spouse expects to receive a specific amount.

Note

*The valuation that the Underwriters will accept is a reasonable value. Throughout the process the underwriters are concerned at identifying the possibility of adverse risk selection – in short the insured profiting by taking more cover than is a reasonable indemnity to cover the loss that will be experienced.*

### **THE AGREEMENT**

Firstly the agreement is not a sale and purchase of business agreement. Whether a conditional contract or a put call option agreement the purported sale and purchase occurs after the contingency event has occurred.

To fund the acquisition of the business each of the parties mutually promises to take out insurance on the understanding that the part or all of the life insurance proceeds will be used to acquire a deceased's interest in the business from the deceased's estate or to pay for the transfer of ownership upon total and permanent disability.

It is important to ensure that there is no actual interest being transferred in the agreement at the time the buy sell agreement is signed by the parties.

The Buy Sell Agreement sets out

- the method agreed to be adopted in transferring the interest
- who receives the insured benefit
- how the interest is to be transferred

### **Conditional contracts**

Conditional contracts can be drafted where the transfer is conditional upon a specific event occurring. Without clear wording the interest may be disposed of for CGT purposes at the date of the signing of the agreement. Improperly worded contracts can trigger a CGT liability at the time of signing the contract.

The ATO considers a contract subject to a condition precedent to its formation will not be entered into for the purposes of CGT event A1 until the death of a party to the contract.

This is to be distinguished from a condition that does not prevent the creation of the contract – i.e non-fulfillment of the condition merely entitles a party to terminate the contract:

There is a difference between a condition precedent and a condition subsequent. In the former case, the transaction creates no enforceable rights unless and until the condition is satisfied. In the latter case, there is a binding contract although certain obligations may not arise until the condition is satisfied. *Perri v. Coolangatta Investments Pty Ltd* (1982) 149 CLR 537, Mason J.

### **Put and Call options**

In preference or in addition to conditional contract clauses for the sale and purchase of the business the transfer is commonly initiated by creating an option to buy (continuing owners) and an option to sell (estate)

Options

- These are binding agreements that come into effect at a particular point in time or upon the happening of some specified event, E.g. on the death of A then B will exercise the option to acquire the interest of A

## Put and Call options

- Option for the seller to be bound to sell, this is generally referred to as a call option and in this scenario the seller can be called upon to sell the interest.
- Option to purchase the interest, this is referred to as a put option, i.e. an offer must be put to the seller.

At the time of death the deceased's estate can offer to sell and/or the survivors can offer to buy the deceased's interest upon service of the notice to the other exercising the option.

Example Nicole & Keith.

Keith gives John the "right" to purchase his interest in the business. This is following the happening of a specified event – such as death.

John has the right to buy out Keith's interest. The option is merely "exercised" by John. The price is set (or there is a formulae) in the option agreement. John gives Keith the same right that now if Keith suffers one of the events he (or rather his wife Nicole) can force John to buy him out. Even if John does not want to exercise his option he is still forced to still buy Keith out because Nicole (Keith's wife) exercised the option.

Together this is called a "Put / Call Option". The ATO will treat the acquisition date as the date that the interest is acquired (ID 2003/128) not the date of the agreement to grant the options.

### The protection for John is as follows:

Assume Keith has died; John may exercise the option to "call" upon Nicole, as the Widow, to sell Keith's interest in the business to John at a predetermined price.

### The protection for Nicole, the Administrator of Keith's estate is as follows:

Alternatively, Nicole may have the option to "put" to John that he must buy Keith's interest in the business.

## THE INSURANCE POLICY

The process will commence upon submitting a statement of advice to outline the recommendation and to recommend financial product and a sum insured and attend to the application form.

For a number of reasons e.g. the different ages, gender, habits and "risks" presented by each of the business owners the premiums may vary considerably and some parties may be uninsurable

Agreement is needed how the premiums are to be shared or allocated.

The premiums

- can be pooled and each pays a proportion
- each pays for their own policy registered in their name
- each pays the premium on the other life insured's policy

*Note*

- If a business owner has not used his or her best endeavours to maintain the required level of insurance to cover the purchase price and there is a shortfall then the agreement can provide that the purchase price to acquire the deceased's interest will be reduced by the amount of the insurance proceeds received by the relevant principal or his estate and the balance paid under a terms contract.*
- Commonly the shortfall can be picked by a terms payment i.e to pay an amount over a period of years but ideally the insurance proceeds should be sufficient and it is appropriate for the insurance adviser to review that the proceeds will remain sufficient given the growth in the value of the business.*
- Another alternative for the uninsurable proprietor is to employ the insurance bond as a separate "savings plan" that could accumulate funds in a tax paid environment but these products are generally not popular these days. These products are now unfashionable due to relatively poor investment returns compared with managed investments.*

Each business owner submits to the process of underwriting – including the medical examination, proposal filling, and business valuation procedures justifying the quantum of cover required.

## Policy Ownership

The ownership of the life insurance policy is a key factor in the implementation of the arrangement. The types of policies are also a key factor largely due to the tax implications.

Firstly decide who will receive the proceeds of a policy. This is the named Policy owner unless there is a nominated beneficiary.

Policy ownership is fundamental to the type of arrangement to be entered into.

#### Self Ownership

- A owns a policy on A
- In self ownership, as the term suggests the owner of the business insures their own life, the policy owner is the person who is selling the business interests, the person or their trust or their company. This is the associated person.

#### Cross Ownership

- A owns a policy on B and B owns a Policy on A
- In cross ownership the policyholder is the person who will tender the payment of the purchase price and buy the share of the business. These are the continuing parties who will tender the proceeds to buy the business interests from the estate or owner of the interests.

#### Trustee Ownership

- A trustee owns the policy as an asset of the trust and at the time the payment falls due the trustee receives the sum insured and pays this amount to the beneficiaries of the trust who will tender the proceeds to buy the business interests from the estate or owner of the interests or will accept the proceeds in exchange for transferring the ownership of the business (self ownership).

The objective of a buy sell arrangement is not only to provide the necessary funds but to agree the mode of the transfer of the interest.

#### Either

The estate or spouse accepts receipt of the insurance proceeds and transfers the interest (self ownership)

Or

The surviving owners pay the sum insured in exchange for the transfer of the interest (reciprocal ownership)

Or

A Trust holds the policy and administers the funding to the beneficiary

#### Self Insurance

- Policy is owned by the life insured who agrees that the proceeds of the policy will be accepted as the consideration for the sale of the interest in the business.
- owner can also nominate someone else to receive the insurance proceeds in exchange for the transfer of the business interest

In a self insurance arrangement the life insured is the policy owner and the proceeds are paid to the estate. The proceeds are agreed to be accepted by the deceased estate as the consideration for the transfer of the interest in the partnership or for the transfer of the shares or units held in the estate to the surviving business owners.

Such self insurance arrangements simpler and to a certain extent easier to install where trauma policies are to be employed and then to vary in the future with additions and retirements of the other business owners as simply a new owner takes out a policy on their life and agrees to be bound by the existing buy sell agreement.

- Owners insure their own life to the extent that they would agree to sell their interest in the business.
- Owners have control of their policy.

#### Note

*The advantage is that if the policy is no longer required for the buy sell arrangement then the policy owner can continue the policy without having the effect a transfer from another owner.*

*In effect the estate of the deceased will have both the funds from the life insurance policy as well as the interest in the business, therefore the validity of the agreement is very important for the interest to pass to the surviving business owners.*

#### Reciprocal ownership

In reciprocal policy ownership arrangements

- one owner can insure the life of another,
- where there are more than two the owners jointly insure the life of an owner.

#### Note

*These arrangements are not suitable where there are a number of partners or proprietors of the business named as policy owners or numerous changes in the owners over time given that it will be necessary to constantly update the policy ownership thereby confusing who may be the original beneficial owner of the policy.*

*These arrangements are often selected by proprietors who suspect that the estate (usually the partner's spouse) may not be trusted to transfer the business interest if they are also in receipt of the proceeds under a self insurance arrangement. It is important in their risk profile that they control the policy proceeds.*

#### Trust Ownership

The trust takes out the policy in the name of the trustee or holds the insurance policy and will divide the proceeds between the beneficiaries upon the insured event occurring and where there is a surplus, to pay the surplus as the beneficiary directs.

In trust ownership arrangements

- trustee can own the policy or hold the policy
- proceed held on trust for the beneficiary presently entitled

Usually a bare trust is employed but some advisers advocate the use of a superannuation trust.

Superannuation must be for the sole purpose of providing

- Retirement Benefits to Members,
- Death Benefits to Members' Dependants
- Certain Ancillary Benefits permitted under the Superannuation Law

APRA *Superannuation Circular* No III.A.4, dealing with the sole purpose test, states that it is not the type of investment which must be considered but the purpose(s) for which the investment is made and maintained that is relevant

Usually the self ownership method is employed. A retirement benefit (such as TPD) or death benefit can be paid from the trustee of the Superannuation fund either to the member (on TPD) or on death to the estate or the member can nominate payment to the deceased's spouse directly. Also the premiums are tax deductible Sec 279 ITAA 1936

With the withdrawal of the lifetime superannuation limits, an unlimited amount of benefit can be paid from the fund and remain concessional taxed when paid to a tax dependent.

With time constraining us suffice it to say that superannuation as a trust along with any other form of trust can be adapted for the buy sell arrangement but it is important that legal advice be firstly obtained.

On the particular point of a superannuation being involved in a business, the ATO's view is as follows.

*Another indication of a possible contravention of the sole purpose test is where a fund is running a business as part of its investment strategy. The view is that **if a superannuation fund is conducting a business, then it is not being administered for the sole purpose of providing benefits for the members and beneficiaries of the fund.** [Emphasis added]. (See ATO Fact Sheet 2061*

Apart from the above, consideration must also be given to the prohibition in SISA on giving loans and financial assistance to members and their relatives. Although sec 65 deals with loans to members, the prohibition may cover a partnership as a relationship between persons carrying on a business.

### What types of policy?

The arrangement does not usually involve adverse tax consequences provided the correct type of policy is employed to match the arrangement that is contemplated.

The proceeds of a policy of insurance on the life of a person are generally received tax free if of a capital nature and paid to the original beneficial owner of the policy or an assignee for no consideration.

Other policies covering investment proceeds, critical illness trauma or sickness benefits are only received tax free if the recipient is the person insured or their spouse.

Rather than run the risk of taxing the proceeds the vanilla solution of Life and TPD is the most favoured product employed.

#### **POLICY OWNERSHIP**

#### **TYPE OF POLICY**

Group Ownership:

- Life and TPD

Cross Ownership

- Life and TPD.

Insurance Trust:

- Depends on the type of trust generally Life and TPD

Self Ownership

- Generally any type of policy

Note

*The fixed trust or bare trust can own and hold the policy and Sec 106-50 treats the acts of the trustee as that of the beneficiary where there is present entitlement. This is where the trustee holds the policy and the policy proceeds for the insured. For the purpose of section 118-300 ITAA a trustee will be regarded as the "beneficial owner" of such rights or any interest in such rights if the trustee possesses all the normal incidents of beneficial ownership. TR 2004/D25.*

*The Group life or multiple life policy can be employed but if there are continuing changes to the partnership or the business then question whether the ultimate recipients will be the original beneficial owners or the recipients will receive the proceeds of a policy of the life of the insured if not the named insured.*

*For many reasons outlined above the self ownership method provides the greatest flexibility for the type of policy selection that is to provide the foundation for the buy sell funding. Also the rather vanilla solution of life and TPD are the more usual insurance options employed.*

*An investment policy which does not make the death of a person an event triggering a payment is not a 'policy of insurance on the life of an individual' for the purposes of section 118-300 (TD 2007/4)*

### TAX IMPLICATIONS

The main capital gains tax issues applicable.

- whether capital gains tax is payable on the sale of the interest in the business and claiming concessions
- what stamp duty is payable on the agreement
- whether capital gains tax is payable on the creation of an option
- whether capital gains tax is payable on the insurance proceeds.

Yes, you have to be very careful to structure your Business Succession Plan so that you avoid unnecessary tax.

### Stamp duty

A properly prepared Business Succession Plan ensures that only nominal **stamp duty** is payable when you sign the Business Succession Plan which is usually prepared as a deed. Western Australia duty legislation contains specific exemption for these buy sell option agreements. The Duties Act 2008 (WA) succeeds the Stamp Duties Act 1921

For stamp duty purposes, duty is payable by the actual insurance company under *Stamp Duty Act 1921 (WA) sec 96(2)* when a life insurance policy is affected.

### Tax Treatment of Life Insurance Policies

Section 118-300 *Tax Act* provides a Capital Gains Tax exemption. The CGT exemption is subject to the qualification that it does not apply if the person is not the original beneficial owner and acquired the rights or interest for an amount of money or other consideration. Other consideration may be construed from the adjustment of the rights of ownership of the business.

A disposal by a person who is not the original beneficial owner still qualifies for exemption under section 118-300 if the person provided **no consideration** in acquiring those rights.

The term "**original beneficial owner**" is not defined and has no accepted legal meaning. In Tax Determination TD94/31, the Commissioner states that the original beneficial owner is the first person who:

- at the time the policy is effected, holds the rights or interest; and
- possesses all the normal incidents of beneficial ownership, e.g. is entitled to the benefits of the policy proceeds and has the power of management and control over the policy, as well as the power to transfer, grant as security, surrender or otherwise dispose of the policy.

### The Premiums

There is clearly no doubt that these arrangements are for a capital purpose and therefore the premiums for the underlying insurance policies are not tax deductible. It then follows that if the premiums are not tax deducted then the policy proceeds received are not assessable income but this is not always the case (see trauma policies).

If premiums are paid by the business on behalf of the proprietors then there is an expense payment fringe benefit and FBT is payable.

If premiums are paid by the private company consideration may need to be given to Div 7A ITAA (the deemed dividend rules) alternatively premiums could be paid from the loan account.

### Tax Treatment of Trauma Policies

The purpose of trauma insurance is to provide a capital amount to the insured in the event of a specified medical condition occurring also termed critical illness.

Tax deductibility of premiums. If the policy does not replace earnings lost by the taxpayer (as is the case for the Business Succession Plan) then the Commissioner considers that the benefits payable under trauma policies do not constitute assessable income. Thus, on the basis of *FC of T v DP Smith*, 81 ATC 4114, a deduction is not allowable (Taxation Determination TD 95/39 and TD 95/41).

#### *Note*

*Trauma premiums payable under 'trauma' insurance policies are not allowable deductions but CGT can apply to trauma proceeds*

The effect of Capital Gains Tax and Section 118-37 contains a number of exemptions from the CGT provisions. Section 118-37 exempts any sum received by way of compensation or damages for any wrong or "injury" suffered by the taxpayer "to his or her person", or "in his or her profession or vocation". "Injury" is not limited to physical injury. The Commissioner accepts that a specified illness in a trauma insurance policy is an "injury" for the purposes of section 118-37: Taxation Determination TD95/43. The exemption under subsection 118-15 applies if the taxpayer who obtained the proceeds under trauma insurance policy is either the person insured under the policy or the spouse of the person insured under the policy: Taxation Determination TD 95/43.

The Commissioner considers that compensation received by a trustee in his or her capacity as trustee is not exempt from CGT liability: Taxation Ruling TR 95/35. but there is TD 14 that the same treatment will apply if the payment is made to a trustee for a taxpayer who has been injured.

### Granting the options

The granting of an option (the buy sell or put call options) is a CGT event D2 Sec 104-10(3) but the market value is nil as it is a personal right between the business owners. The relevant date is the date the option is exercised. Also the contract is subject to the condition precedent that an insured event occurs. Accordingly, no agreement will be entered into for the purposes of CGT event A1 until the death of a party to the contract. Income tax Capital gains tax:

The buy-sell agreement is not entered into for the purposes of paragraph 104-10(3) (a) of the ITAA 1997 until the condition precedent to its formation is met. Buy-sell agreement - time of CGT event A1 ID 2004/668

#### [The policy proceeds](#)

Capital gains tax is not payable on the insurance proceeds provided that the policies are not transferred or assigned for consideration.

The proceeds from a life insurance policy, payable on the death of the insured person, are not assessable income under sections 6-5, 6-10, 15-30 of the *Income Tax Assessment Act 1997* (ITAA 1997) as they are a receipt of capital. The proceeds are not considered to be income according to ordinary concepts under section 6-5 of the ITAA 1997. *Marac Life Assurance Ltd v. Commissioner of Taxation* [1986] 1 NZLR 694

*ATO Interpretative Decision ATO ID 2003/1189*

#### [Capital gains tax issues](#)

Lets turn to the sale and purchase of the business.

Transfer to the LPR At the time of transfer after death, no CGT is payable when the asset devolves on the legal personal representative (LPR) as any gain or loss is disregarded. The LPR acquires at market value unless the deceased acquired the asset before 20 September 1985 at the deceased acquisition price.

Transfer to the business owners. Capital Gains Tax is triggered on the "disposal" of the business (that is when Nicole sells to John). Subsection 104-10(1) of the ITAA 1997 provides that CGT event A1 happens on the disposal of a CGT asset. A CGT asset is disposed of if there is a change in its ownership from one entity to another i.e when you enter into the contract for the disposal or, if there is no contract, when the change of ownership occurs. The time when a contract is entered into is the time when it comes into existence for general law purposes.

- Capital gains tax is payable on the sale of the interest in the business. The small business CGT concessions may operate to reduce this CGT liability.
- CGT is paid by the deceased owner's estate in accordance with the normal capital gains tax rules.
- CGT relief may be obtained as rollover relief or the small business 15 year exemption
- under a self insurance arrangement the surviving business owners will be acquiring an asset for a nil cost base

The cost base for a CGT asset is generally determined under Subdiv 110-A. However, the special rules contained in Subdiv 112-may apply for example sec 112-20 which covers the scenario when no consideration is received for the asset. If there is no consideration. In sec 112-20(1)(a) would apply and the cost base is deemed to be the market value of the at the time of acquisition. Under a similar rule in sec 116-30, the value of the capital proceeds received by the former partner's estate for the share will be deemed to be the market value of the share.

#### [Small business relief](#)

There are the four concessions in Div 152 ITAA 1997.

Generally the vendor of the business (LPR or beneficiary) can claim the small business relief if the

- asset is sold within 2 years of the date of death of the deceased (the Commissioner may extend this period)
- asset would have qualified if the deceased had disposed of the asset immediately before his death provided the LPR carries on the business and it qualifies as an active asset.

This is a separate topic of its own

#### [Permanent Incapacity](#)

*Regarding the small business 15 year exemption where a person is under age 55 a condition to be satisfied to qualify for relief is that the individual is permanently incapacitated at the time of the transfer of the business. The ATO takes this to mean due to ill health (physical or mental) where it is unlikely the person will again engage in gainful employment for which the person is reasonably qualified by education training or experience. If there is an expected chance of recovery then the individual may not qualify.*

*The adviser should pay careful regard to ensure the policy condition complies with the ATO definition to ensure consistency and the position where a sale of shares is called for but the vendor will not qualify for the concession.*

*Division 152 - Small business relief ITAA1997*

For a supply to be subject to GST it has to be a taxable supply. If there is no consideration given by the surviving partner for the acquisition of the share. The supply of the share would thus not be a taxable supply.

The supply of life insurance is treated as a financial supply and is input taxed (see GST Regulations reg 40-5.09). No GST will thus be included in the premiums paid by the business

### IMPLEMENTATION

#### Owners Meeting

- The parties reach agreement on the terms of the agreement and the price or method of valuation to be paid at the time of transfer. A minute of the meeting is recorded.

#### The Value-

- The valuation of the interests (Market Value) is determined which determines the sum insured. Sum insured = transfer value unless part (in which case an additional clause is added to the agreement)

#### The Policy owner

- The Policyholder is determined which determines who receives the sum insured on death or disability.

#### The Families Informed

- Often forgotten but as the arrangement is to be binding on the deceased estate, and lessen any problems arising in the future, the family members should be informed of the arrangement.

#### Insurance Proposal

- The insurance proposal is completed plus usually an insurable interest declaration stating the nature of the interest between the parties and the necessary medical investigations are arranged.

#### Underwriting

- Financial underwriting details as required are supplied. Get set for some delay and self learning about the health and smoking habits of the Parties.

#### The Agreement

- Finalise the contract and have the parties execute the contract and attend to stamping if necessary

### WILLS

- Generally it is advised that an instruction to a deceased's executor or trustee who will administer the deceased's estate should accompany the Will or a clause making reference to the arrangement be inserted in the will. In addition ensure there are powers to run the business to ensure the active asset test is met and just a note of caution that if insurance funds are used to pay a debt that reference is made to this in the will.
- The will can serve as an effective buy sell arrangement where the parties are closely related and can be trusted not to change their wills without notifying each other. The restriction is that ownership changes only in the case of death, and assumes that the deceased owns the business interest and not a trust or company as is often the case.
- There can be agreement or rather a promise not to change the will and this is often termed a "mutual will" where the parties enter into an agreement no to change the will.

### CONCLUSION

It may seem complex and it is. This is why specialized business commands a premium for the experienced adviser.

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This is where the Financial Adviser, the Accountant and Tax Lawyer when acting in **concert together** can achieve proper tax effective Business Succession Plans for their clients. The challenge is for all 3 professional groups to work together.

All legislative references are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless specified otherwise