

Brett Davies
LAWYERS
Tax Lawyers Australia



BUSINESS BUY SELL

Tim Pepper BA, LLB

Brett Davies Lawyers

Overview



- Business Succession Planning
- The Insurance Funded
- Buy Sell Agreement

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



- 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.

John, Keith & Nicole



- John ran 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.
- Nicole had never been involved with the business.

- After many fruitless arguments and telephone calls, John decided that enough was enough and 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



- Forward risk planning by John and Keith could have ensured –
 1. there was a planned transition of ownership to relieve the spouse from responsibility in the business
 2. that Nicole received a fair value for the business interest
 3. the prevention of the forced sale of the business
 4. the ongoing stability and profitability for John and the employees

How to identify prospects?



- **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**

To implement the strategy



- 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 explanation a valuation of the business and advises in relation to tax and accounting matters
- The Lawyer prepares the documentation

Time consuming?



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



A 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**

The funding



- 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

What is the business worth?



- A business is only worth what someone is prepared to pay to acquire it
- **WHAT THE OWNERS WOULD ACCEPT**
- **INDEPENDENT VALUATION**
- **FORMULA METHOD**
- Ideally the amount of insurance required will be equal to the amount required for the survivor to acquire the business interest.

What is often overlooked?



- **Guarantees for the business debts**
- **Deceased has lent money to the business**
- **Div 7 Loan account balances**
- **Accumulated loan account balances**
- **In the valuation methodology, the adviser can look at the business and include the loan accounts.**

The agreement



- **It is not a sale and purchase of business agreement**
- **Conditional contracts**
- **Put call options**
 - option to buy (continuing owners) and
 - an option to sell (estate)
- **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 insurance policy



- Agreement is needed to 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

Policy ownership



- The core of the arrangement
- Self Ownership
- Cross Ownership
- Trustee Ownership

Self insurance



- **Policy is owned by the life insured.**
- **Proceeds of the policy accepted on death 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.**
- **Owners have control of their policy.**

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.**

Trust ownership



In trust ownership arrangements

- the trustee can own the policy or hold the policy
- proceed held on trust for the beneficiary presently entitled
- usually a bare trust
- can be a superannuation trust & premiums are tax deductible Sec 279 ITAA 1936 (but word of caution)

What types 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:** Any type of life policy

Otherwise there may be tax on the policy proceeds.

Tax treatment of life insurance policies



- The proceeds from are not assessable income under sections 6-5, 6-10, 15-30 as they are a receipt of capital.
- Section 118-300 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.
- The term “original beneficial owner” Tax Determination TD94/31, is the first person who -
 1. at the time the policy is effected, holds the rights or interest; and
 2. possesses all the normal incidents of beneficial ownership, e.g. is entitled to the benefits of the policy proceeds

The premiums



- **Buy Sell arrangements are for a capital purpose. Therefore, the premiums for the underlying insurance policies are not tax deductible.**
- ***Trauma premiums payable under 'trauma' insurance policies are not allowable deductions but CGT can apply to trauma proceeds if –***
 - 1. the payment is made to a trustee***
 - 2. the payment is not made to the injured person or the spouse***

The options



- The granting of then option (the buy sell or put call options) is a CGT event D2 Sec 104-10(3)

For tax purposes the market value is nil

- The buy-sell agreement is not entered into for the purposes of paragraph 104-10(3) (a) of the ITAA 1997 ID 2004/668
- Watch out for unconditional contracts however

The transfer



- No CGT is payable when the asset devolves on the Legal Personal Representative (LPR) 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

Implementation



- **Owners Meeting**
- **Agree the Value**
- **Decide the Policy owner**
- **Families Informed**
- **Insurance Proposal**
- **Underwriting**

Wills



- **The will can serve as an effective buy sell arrangement**
 - only in the case of death,
 - where the parties are closely related
 - & can be trusted not to change their wills
 - the deceased owns the business interest
- There can be agreement or rather a promise, not to change the will and this is often termed a “mutual will”

Conclusion



- **It may seem complex and it is**
- **This is why specialised business commands a premium for the experienced adviser**
 - Financial Adviser
 - Accountant
 - Tax Lawyer
- **Together, they can achieve tax effective Business Succession Plans for their clients**
- **The challenge is for all 3 professional groups to work together**