

# Business succession

## Outline of approach

### Key points

- A business succession agreement sets binding rules for the exit of a business owner in the event of death or total and permanent disability, and how they (or their estate or family) are paid for their interests on their exit
- Insurance policies can be used to fund part or all of the purchase price for an exiting owner's interests
- Below is a summary of some of the tax and commercial issues to be consider when implementing a business succession agreement

### Overview

1. We have three primary objectives in developing business succession plans and agreements. These are to:
  - (a) keep the arrangements as simple as possible
  - (b) ensure certainty in relation to the outcomes you want to achieve
  - (c) ensure the arrangements are tax effective.
2. Our documentation can be tailored to meet your needs. For example, the agreements can encompass:
  - (a) single or multiple entities
  - (b) utilisation of death, trauma and total and permanent disablement insurance proceeds to payout or reduce debt
  - (c) full or partial insurance
  - (d) utilising insurance held in superannuation funds.

### Ownership structure

3. There are three general ownership models for business succession insurance policies. These are:
  - (a) self-ownership (where the policies are owned by the life insured, their spouse or their superannuation fund)
  - (b) cross ownership (where the policies are owned by the business 'partners' of the person insured)
  - (c) insurance trusts (where the policies are owned by a third party trustee).
4. Our view is that self-ownership is the appropriate model for most clients. This approach has a number of advantages:
  - (a) It is the simplest and least expensive structure.
  - (b) It provides greater certainty, as you can be guaranteed that the insurance proceeds will be received by you or your estate or family.
  - (c) The tax implications are clear.
5. The Tax Office issued a draft 'statement of principles' some years ago in relation to the taxation consequences of different approaches to business succession planning. The Tax Office's position can be summarised as:
  - (a) cross ownership should not be used if any trauma or TPD cover is involved
  - (b) the self-insurance approach will provide the best tax outcome
  - (c) 'appropriately' structured insurance trust arrangements may achieve the same tax outcomes, but private rulings are recommended.

## Capital gains tax implications

6. The capital gains tax implications of a business succession agreement applying the 'self-ownership' model were considered by the Tax Office in their draft statement of principles.
7. Under the self-ownership model, there will be no tax payable on the receipt of the insurance proceeds as a result of your death or TPD (because the proceeds are received either by you or your spouse or superannuation fund).
8. However, if you or your estate transfers your interest in the business, that transfer will constitute a disposal for capital gains tax purposes and tax may be payable depending on the cost base you have for that interest.
9. The draft statement of principles indicates that, if the purchase price is a nominal amount or the difference between market value and the insurance proceeds, the Tax Office will regard the parties as not dealing 'at arm's length' and will deem the outgoing party or estate to have received market value for their business interest. The continuing parties will be deemed to have a cost base equal to market value.
10. The effect of this is that your estate will be in essentially the same position as if you had sold your interest immediately before your death. They are not disadvantaged as a result of the application of these tax principles.
11. The government has introduced special capital gains tax concessions for small business owners in recent years and, if your estate sells your interest in the business within two years of your death, the estate may be eligible to claim some of these concessions, which could substantially reduce the tax impact on your family.

## Can insurance policies be held in a superannuation fund?

12. An insurance policy to fund a business succession arrangement can be held in a superannuation fund provided your business succession agreement is carefully drafted. If not done correct, it can create superannuation compliance issues.
13. This is more easily catered for with a self-managed superannuation fund. However, retail funds that provide the facility to make binding nominations of beneficiaries are also suitable.
14. However, using superannuation as part of the business succession arrangements will not be suitable or practical for all clients and caution is required.
15. The superannuation option may not be suitable if you receive a payout under a TPD policy as you are only permitted to hold any occupation TPD insurance in superannuation and you may have difficulty withdrawing the funds from superannuation in a tax effective way if you are under 60.

## GST issues

16. Generally, there will be no GST payable on the transfer of interests in a partnership, company or trust.
17. The main reason for this is that it is generally the business entity that will be registered for GST purposes and not the individual interest holder.
18. Also, transfers of interest in partnerships, companies and trusts will usually not be subject to GST as they will qualify as financial supplies.

## Outline of major provisions in Cooper Grace Ward business succession agreement

### Use of put and call options

19. Our agreements provide that when a triggering event occurs (death or TPD) the continuing parties have an option to buy the interest of the deceased/disabled party (call option) and the estate of the deceased/disabled party has an option to require the continuing parties to buy their interest (put option).
20. The advantage of using put and call options, rather than a conditional agreement, is that it is clear that the date of disposal occurs at the time the option is exercised.

21. With some conditional agreements, the deemed date of disposal may revert back to the date of the original agreement, which will require significant extra work in lodging amended tax returns and may also result in the loss of capital gains tax concessions in some instances.
22. The use of put and call options also ensures that duty will not be payable unless and until a triggering event occurs.

#### Purchase price

23. There are a number of alternative approaches and the appropriate choice will depend upon your requirements.
24. If you are confident that the level of insurance cover is equal to or greater than the value of your interest in the business, the agreement can provide for the interest of an outgoing party to be assigned for a nominal amount provided the insurance proceeds are paid.
25. Alternatively, the outgoing party or their estate may receive an amount equal to the market value of their interest **less** the amount of the insurance proceeds.
26. This ensures you or your family will receive the full value for your interest, but the continuing parties only have to fund the difference between the value of your interest and the insurance proceeds (if any).
27. Some clients nominate a specific value that is effective as at the commencement date of the agreement. This value is reviewed on a regular basis.
28. As a failsafe mechanism, we generally recommend that, if the value has not been reviewed for a set period of time (perhaps three years), then the market value will apply.
29. This protects against the possibility that you overlook the need to carry out regular revaluations.
30. If the purchase price is to be determined by reference to market value, the alternative approaches usually are either to agree on a formula to calculate goodwill or to refer the valuation to an external independent party (usually an accountant).

#### Business debts

31. Our agreement provides that the continuing parties will assume liability for all business debts and will use their best endeavours to ensure that any guarantees given by the outgoing parties or their family are released.
32. In many cases financiers and lessors who hold guarantees may not give a release and you and your family may have to rely on the indemnities given by the continuing parties.
33. Where the level of external debt is significant, you should consider taking additional insurance to allow for repayment or reduction of the debt.
34. The obligation to apply the agreed proportion of the insurance proceeds in repayment or reduction of debt is incorporated in the agreement.

#### Time for payment

35. To the extent the purchase price is funded from insurance proceeds, the agreement provides for payment within seven days of the determination of the price or payment of the proceeds, whichever occurs last.
36. If the actual purchase price is the difference between market value and the insurance proceeds, the agreement can incorporate provisions for payment of this excess amount by instalments over an agreed period of time.

#### Enforcement issues

37. To give certainty to all parties it is essential that everyone involved can be confident the agreement will be implemented if a party dies or becomes disabled and with minimal interruption to the operations of the business.
38. Under the self-ownership approach, the interests of you and your family are protected because the insurance proceeds will be paid directly to you or your estate or family members.

39. The important issue for the continuing parties is to ensure that, if one person dies or is disabled, they or their estate is bound to transfer their interest in the business once the insurance proceeds are paid.
40. Our agreements have several provisions that are designed to achieve this outcome:
  - (a) The agreement provides that it is binding not only on the actual parties but on their estate.
  - (b) This means that your executors will be bound by the business succession agreement, which will override the terms of your Will (if they are in conflict).
  - (c) We also include an irrevocable power of attorney that allows the continuing parties to sign transfers of shares or other necessary documents on behalf of the outgoing party or their estate.
41. There may be circumstances where the agreement should contemplate, and allow for, the outgoing party's interest to pass to their spouse or descendants, rather than being disposed of by the estate immediately. This may be important to take advantage of the small business capital gains tax concessions, for example.
42. This aspect involves complex tax issues and specific advice is necessary. However, it is important to be alert to the possible need to include parties other than the actual business owners in the business succession agreement to take advantage of these generous tax concessions.

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